JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 39• Spring 2008**

> *"Clearly, the recession that hasn't begun yet is over. At least, that's what all the folks who never saw the recession coming, then decided we were going to have one, and who now say it's over, believe. I know because I heard them say so on TV, time and again."*
>
> *Helene Meisler*

Despite some strength at quarter end, stocks were down sharply in the first quarter of 2008. The S&P 500 declined by 9.47% for the quarter and the Dow Jones Industrial Average by 6.81%. The quarterly decline for the Dow Industrials was the worst in five and a half years. The S&P 500 has now declined for five consecutive months which represents the longest losing streak since October 1990. The average equity mutual fund fared worse than the large capitalization averages, losing 10.6% for the quarter. Value outperformed growth for the quarter as evidenced by the 8.72% decline for the Russell 1000 Value index, compared with a loss of 10.18% for the Russell Growth Index. The NASDAQ composite index was the weakest of the major indexes, declining by 14.07%. International stocks, which some had thought were de-coupled with the domestic markets, no longer provided a "safe-haven" for investors. The average global equity fund declined by 9.7% for the quarter just ended.

Index	1st Quarter 2008	Trailing 12 months
DJIA	-6.81%	1.62%
S&P 500	-9.47%	-5.18%
S&P Mid Cap	-8.85%	-6.97%
Russell 1000/Growth	-10.18%	-.75%
Russell 1000/Value	-8.72%	-9.99%
Russell 2000	-9.90%	-13.00%
NASDAQ Comp.	-14.07%	-5.89%

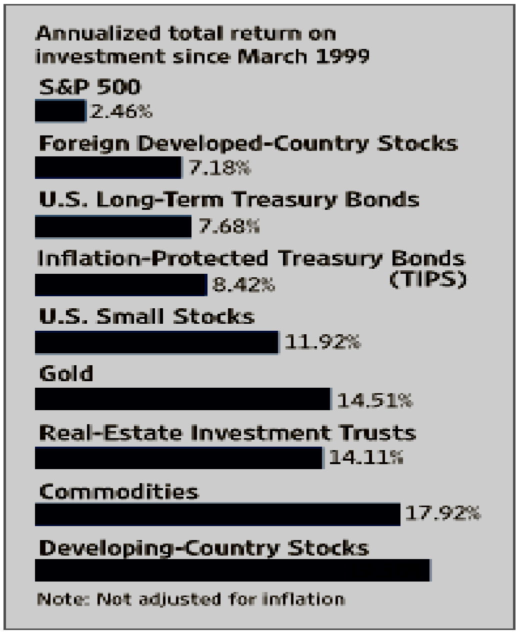
For the past couple of years, we have favored large capitalization issues over small and mid-cap issues. As the chart above shows, small cap's domination over large caps ended last year. In fact, the Dow Jones Industrial Average managed to generate a positive total return for the past twelve months, while small capitalization issues (Russell 2000) declined by 13%. Our rationale was largely based on valuations and the fact that many of the large cap companies have global businesses which should benefit from exposure to faster growing overseas economies. According to the Leuthold Group, large cap companies derived 42% of pre-tax income from foreign sources in 2006 versus about 20% for small caps. According to data from the Leuthold Group, median year-over-year operating earnings grew by 14.8%, 11.0% and 5.2% for large-caps, mid-caps and small-caps, respectively. While the valuation gap is not as compelling as a year ago, we believe that large capitalization issues will continue to do better over the coming year. The most recent cycle of small cap leadership lasted eighty-five months and ended in April 2006. We believe it is highly unlikely that small caps will regain their leadership position any time soon.

Bear Market Bargains?

Recently, the talking heads on CNBC have debated whether we have entered into a "bear market" or just a "corrective" phase. They contend that a decline of greater than 10% is a "correction" and a decline of 20% or more is a "bear market". March 10th was the low point for the S&P 500, when it was 19% below the October 2007 high. The Russell 2000 index also hit its low point on March 10th, 25% below its 2007 peak. Whether this is a "bear market" or "correction" is irrelevant at this juncture, but for simplicity purposes, let's go ahead and conclude that we are in a "bear market" phase. Let's also conclude that, for all practical purposes, the U. S. economy is now in recession (likely started late last year). As we discussed in our *Investment Outlook—Winter 2008*, we typically don't know if we have been in recession until after the fact. By the time the National Bureau of Economic Research officially pronounce we had a recession, it will likely be over. Furthermore, when most investors become convinced that we are in a "bear market" and the economy is in recession, it will typically be reflected in stock prices. The time to prepare for the "bear market" and "recession" has likely passed, and in our opinion, it is too late to sell "high quality" equities. Some of the reasons supporting this view are as follows:

- Stocks (S&P 500) are down approximately 15% from their peak. In six of the past eight 20% or more market declines since 1950, stocks delivered double-digit annualized returns over the following three years. The only two times this did not occur was in 1973-1974 and earlier this decade.
- The Fed has clearly indicated that it will do everything within its power to cushion the debt-deleveraging cycle. Congress may also enact policies to provide support to the housing market.
- Markets are forward looking—one must refrain from looking in the "rear-view" mirror. Stocks typically rebound months before the end of a recession. If we are currently in recession, stocks will likely begin to rebound later this year. For that matter, it is possible that many stocks could have already seen their lows.
- The stock market as measured by the S&P 500 has struggled for the past 10 years. According to a recent article in the Wall Street Journal, the S&P 500 index annualized total return since March of 1999 has been only 2.46%. Could it be possible, that high quality, large capitalization companies

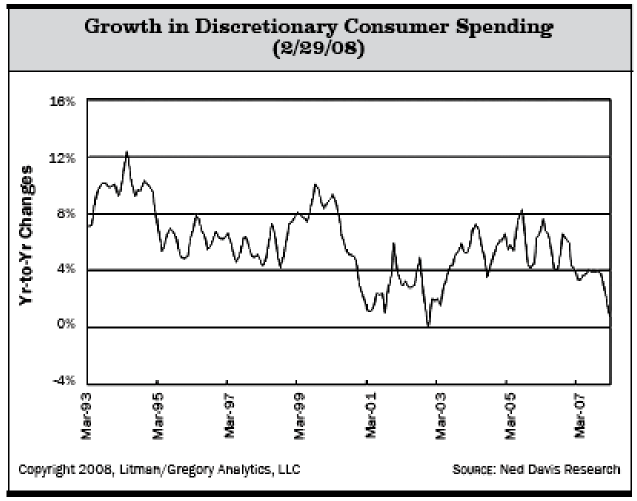
represent one of the best asset classes available? (see chart below)



Source: Wall Street Journal

While we don't want to be appear naively optimistic about the market, we do believe that there are and will continue to be opportunities among the recent market rubble. We must make a distinction between the daily prices reflected in the stock market (Benjamin Graham referred to this as Mr. Market) and the underlying intrinsic value in the businesses we own. There can be a silver lining in all of this gloom if we can eliminate much of the noise and hysteria and focus on buying into a business at a bargain price.

The decline in interest rates to negative levels in real terms will likely force institutional investors to reallocate more funds to equities from the fixed income area. Michael Metz of Oppenheimer recently stated, "The householder now faces the quandary of where to allocate capital. In a world of negative real returns from debt instruments and deflating real estate, and assuming systemic risk is minimal, the asset of choice increasingly is equities." We continue to favor large capitalization, multinationals that should benefit from faster growing economies outside of the United States. We continue to think the consumer will remain sluggish due to a decline in real income, slow job growth and high debt levels. While many strategists are looking to the consumer discretionary sector as an "early cycle" investment theme, we believe this will prove to be unprofitable in the coming months.



Fixed Income

Treasury bonds benefited from a "flight to quality" in the first quarter. Worries about credit quality, inflation and the economy all impacted the fixed income markets in the quarter ended March 31, 2008. Mortgage backed debt, auction rate preferreds and municipal issues were under pressure as leveraged participants all headed for the exits at the same time. The Fed responded to the turmoil by cutting rates by another 200 basis points, bringing the federal-funds target rate to 2.25%. The Fed also offered investment banking firms access to its lending window for the first time and orchestrated a government assisted buyout (bailout) of the struggling Bear Stearns. Essentially, the only fixed income vehicle that investors wanted were Treasury issues. During the quarter, the yield on the three-month bill touched a low of .50% and the 30-year bond reached a low of 4.1%. For the first time in decades, yields on tax-free municipal bonds surpassed the yields on similar maturity Treasury bonds during the quarter. According to Merrill Lynch the average long-term municipal bond yields 5%, compared with a 4.3% yield on the 30-year treasury bond. We have continued to emphasize short dated U S Treasury notes, high quality corporate bonds and high quality municipal issues. During the past quarter, we eliminated our position in Treasury Inflation Protected securities, as the real yield turned negative for the first time since the Treasury Department started issuing the securities in 1997.

Summary

While we continue to expect a difficult economic backdrop, we believe it is likely that much of the earnings slowdown has already been discounted into equity prices. History has shown that recessions and the accompanying "bear market" phase typically create the most compelling investment opportunities. In addition, we have never believed that "market timing" would result in out-sized returns for most individual investors. It is our goal to make market volatility our friend rather than foe by using such periods as an opportunity to buy high quality companies at a more attractive level.

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