JOLLEY ASSET MANAGEMENT, LLC

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"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

Chuck Prince—CEO of Citigroup
July9,2007—Financal Times Interview

The bull market that began in the U. S. in the fall of 2002 began to falter in the second half of 2007. Housing woes and troubles with the mortgage-backed securities markets spilled over into the broader credit markets and the economy in general, causing investors to take a more cautious approach towards equities. Despite this uncertainty and a difficult fourth quarter, most major equity indexes posted gains for 2007. For the year ended 12/31/07, the S&P 500 index rose by 5.48% and the Dow Jones Industrial Average returned 8.83%. Value strategies underperformed growth by a wide margin over the quarter and the past year. Much of the drag on the value indexes can be attributed to the heavy weightings in the financial sector which were atrocious performers for most of the year. As shown in the chart below, the Russell 1000 Value index actually generated slightly negative returns for 2007 (-.17%). Small capitalization issues (Russell 2000) also turned in negative returns (-1.57%) for the year just ended.

Index	4thd Quarter 2007	2007
DJIA	**-4.01%**	**8.83%**
S&P 500	**-3.36%**	**5.48%**
S&P Mid Cap	**-2.73%**	**7.98%**
Russell 1000/Growth	**-.77%**	**11.81%**
Russell 1000/Value	**-5.80%**	**-.17%**
Russell 2000	**-4.58%**	**-1.57%**
NASDAQ Comp.	**-1.82%**	**9.81%**

Looking Back at 2007

In the past, we have expressed our concern about the risk in the housing market (see *Investment Outlook—Summer 2005 and Investment Outlook—Fall 2005).* We also discussed our concerns about the "credit cycle" and the risk of higher credit losses for the financial sector in our *Investment Outlook—Spring 2007.* Due to those concerns, we have been underweight the financial sector for quite some time, even though financials were typically characterized by low price-earnings ratios and relatively high dividend yields. It was our belief that the easy money policies of the Greenspan Fed had essentially allowed debt to grow at an unhealthy pace and promoted excessive risk taking.

Without a doubt, investors will remember 2007 as the year that the housing market collapsed and triggered a credit crunch. The earnings of just about any company that was involved in homebuilding or lending were crushed. The stock of the average homebuilder dropped over 50% (and over 70% going back to the pre-2007 peak) and financial companies such as Fannie Mae, Freddie Mac, Washington Mutual, Countrywide Financial, Citigroup, Merrill Lynch, and Bear Stearns were among the firms caught in the mortgage market meltdown. On January 7, 2008, Treasury Secretary Henry Paulson stated, "After years of unsustainable price appreciation and lax lending practices, a housing correction is inevitable and necessary." Trying to "bottom fish" in the financial sector was a futile exercise in 2007. Just look at the results of the so called "smart money".

August 2007—Bank of America acquired $2 billion minority stake in Countrywide Financial at $18 per share. On 1/11/08 it closed at $6.33.

November 2007—Abu Dhabi Investment Authority acquired $7.5 billion of Citigroup stock convertible at $37. On 1/11/08 it closed at $28.56.

May 2007—ESL's Edward Lampert acquired an initial $800 million stake in Citigroup at approximately $53 per share. On 1/11/08 it closed at $28.56.

July 2007—Pershing Square's William Ackman acquired 10% of Target when the shares traded around $65. On 1/11/08, Target shares closed at $49.95.

December 2007—Warburg Pincus acquired $1 billion of MBIA at $31 per share. On 1/11/08, MBIA closed at $16.59.

As credit tightened and the housing market suffered, investors became more and more worried about the overall economy, triggering stock declines for many consumer cyclical issues. U.S. exports were a bright spot, reaching an all-time high of 12.1% of GDP (as of 9/30/07). Not surprisingly, companies with significant foreign-based earnings did well including (generally) energy, technology, and basic materials companies. Related to the overseas story was the continuation of demand for energy and raw materials commodities from China and other high-growth developing countries. This trend was also reflected in the strong performance of the energy and materials-related sectors.

Recession?

In our "*Investment Outlook—Fall 2007*" we quoted an article from "The Economist Magazine" that questioned, "Does America need a recession?" Whether we need it or not, it now appears likely that the U. S. economy is headed in that direction (if not already there). On January 9, 2008, Goldman Sachs said that it expects the U. S. economy to drop into recession this year, with the Gross Domestic Product contracting by 1% in both the second and third quarters. David Rosenberg, Chief Economist at Merrill Lynch stated on January 8, 2008, "According to our analysis, this [recession] isn't even a forecast any more but is a present day reality." An official declaration of recession could be a long time coming, however. The U. S. National Bureau of Economic Research (NBER) waits for conclusive evidence, including revisions, so it may be two years before it is officially pronounced. From an investment perspective, we don't have the luxury to wait two years, we must attempt to be ahead of the curve. Warren Buffett once quoted Wayne Gretzky who said, "Skate to where the puck is going to be, not to where it has been." Below, we will summarize some of the investment implications of a recessionary economy as described in an Economic Commentary written by David Rosenberg of Merrill Lynch.

1) Recessions are a normal part of the business cycle—it is not the end of the world. There have been as many recessions as expansions, but they happen to be shorter in duration. Recessions on average, last ten months and see the level of GDP decline by 2%. Recessions are necessary because they end up wringing the excesses out of the economy.

2) Treasury bonds have historically outperformed stocks by 2700 basis points during a cyclical bear market.

3) Historically the 10-year Treasury note declines by more than 300 basis points from peak to trough.

4) The Fed, in recessions, cuts the fed funds rate by an average of 400 basis points.

5) Baa credit spreads widen, on average, by more than 180 basis points.

6) Commodities as measured by the CRB index are down an average of 12% when the U. S. has entered a recession in the past. Of course, China's appetite for raw materials makes this a more difficult call this time.

7) U.S. recessions are typically negative for the dollar and on average the dollar declines by approximately 7%.

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8) In recession, the peak-to-trough decline in the S&P 500 has been around 23%. As of 1/10/08 the S&P 500 has declined by approximately 11% and the smaller stocks (Russell 2000) have declined by 17.7%.

9) In a recession, the worst performing S&P sectors have been consumer discretionary and financials. The best performing sectors historically have been telecom, health-care and utilities.

10) Keep in mind that all 10 S&P sectors are down in a recession—there is essentially no where to hide.

11) Small cap stocks on average under-perform large caps by roughly 300 basis points during recessionary times.

Investment Strategy

In mapping out our investment strategy, we must always remind ourselves that the markets are a discounting mechanism and we must be forward looking. Markets always peak out in advance of recession and typically hit bottom before the recession actually ends. According to David Rosenberg of Merrill Lynch, "Generally, the S&P 500 peaks 5-6 months before the recession begins and also troughs 5-6 months before it ends (at the halfway point—it is here that the Fed has typically cut the funds rate by 300 basis points, which seems to be the trigger for a market bottom during recessions.)" Assuming that we are in an "average" cycle and that a recession began around December or January, this would imply a market bottom around April or May. We must also keep in mind that unwinding a real estate "bubble" as big as the current one might prolong the down cycle. In surveying the damage in the markets, it makes sense to look not only at the S&P 500, which is down around 12% (as of 11/11/08) from its peak, but to also look at the broader markets. The S&P 500 equal weighted index and the Value Line Index (also equal weighted) have declined by 17.2% and 17.5%, respectively, from their peaks (as of 1/11/08).

In summary, while we are not "market timers", we are playing defense with regards to our client portfolios. We believe it is prudent to carry somewhat higher than normal cash levels in the current environment, with the expectation that this will be committed as opportunities present themselves. While we expect there will be an earnings slowdown in 2008, we believe this will be fully discounted by the market in another quarter or so. In addition, we would expect multiple rate cuts by the Federal Reserve and an economic stimulus package from the Administration over the coming months. This will be a challenging year, but we believe our disciplined "value" approach and focus on risk before reward will serve our clients well. Recessions and the accompanying "bear market" phase typically create the most compelling investment opportunities; it is our goal to help our clients capitalize on those opportunities. As Warren Buffett said, "Great investment opportunities come around when excellent companies are surrounded by unusual circumstances that cause the stock to be misappraised."

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