JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 45• Fall 2009**

> ***"Interest rates are at zero, there's $2 trillion plus on the Federal Reserve's balance sheet, and yet the economy is still losing jobs. What exactly is the stock market romancing?"***
>
> ***Bill Gross, PIMCO***

Different quarter, same results! The stock market continued to confound the skeptics and for the second consecutive quarter equities of all types rallied strongly. For the third quarter, small and mid-caps led the way, with the Russell 2000 up 19.28% and the S&P Mid-Cap index up 19.98%. Value outperformed growth for the quarter, led by the beaten down financial sector, which gained roughly 25%. For the nine months ended 9/30/09, the S&P 500 index has returned 19.25% while the Dow Jones Industrials have returned 13.42%. It is hard to believe that just six months ago, the S&P 500 was down approximately 26% (3/6/09) as investors pondered the worst downturn since the great depression. In hindsight, at the lows of 666.79 on the S&P 500, investors were pricing in Armageddon. After a 58% rally in the S&P 500 in just seven months, one might now conclude that we have entered the financial equivalent of nirvana. Were things really as bad as we thought on March 6th? Probably not. Are things really as good as we think they are today? Only time will tell.

Index	3rd Quarter 2009	YTD (9mos) 9/30/09
DJIA	15.73%	13.42%
S&P 500	15.62%	19.25%
S&P Mid Cap	19.98%	30.14%
Russell 1000/Growth	13.97%	27.11%
Russell 1000/Value	18.24%	14.85%
Russell 2000	19.28%	22.43%
NASDAQ Comp.	15.66%	34.58%

Finance 101 Quiz

Please select the correct answer

From October 2007 through March of 2009 the S&P 500 index fell by roughly 57%. From March of 2009 through September of 2009 the S&P 500 rose by roughly 57%. If one had invested $100,000 in the S&P 500 at the beginning of October 2007 and held until September 2009 how much would his portfolio be worth today?

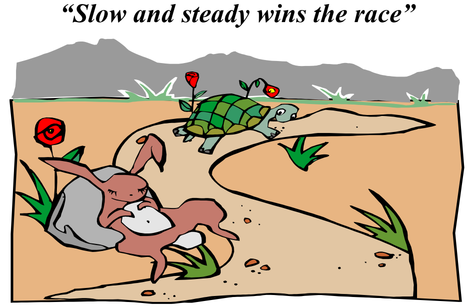
a) $100,000
b) $ 91,622
c) $ 67,510
d) $ 82,421

The reason we asked this question was to emphasize the importance of compounding in investing. This is often misunderstood by investors and the talking heads on CNBC. Today everyone is focusing on returns, the high beta "risk trade" is back. You hear the commentator/cheerleader on CNBC saying, XYZ Fund is up 35% this year, versus 19% for the S&P 500 this year. What they fail to tell you is XYZ Fund was down 55% last year. How has the fund done over five years, over ten years, over the market cycle? Those are the relevant questions, not how the fund has done this year. Now back to the question at hand. The correct answer is C or $67,510. For an investor to make back all of the losses from a 57% decline, the portfolio would have to increase by another 48% (on top of the 57%)! That is precisely why it is so important to avoid the big down years and to focus on risk-adjusted returns. Our focus at Jolley Asset Management is to evaluate the "downside" risk in a security before looking at it's "upside" potential. We don't have to make as much in the bull market phase provided we lose less in the bear markets.

Chasing Beta

Since the stock market rally began in March, the market leaders were stocks that investors had left for dead earlier in the year. Companies with questionable balance sheets, heavy debt loads and high fixed costs were the place to be! The push by the Fed to cut interest rates to zero triggered a stampede by speculators into the beaten down riskier stocks. Wall Street sometimes refers to this as the "beta trade". As you know, the beta (β) of a stock or portfolio is a number describing the relation of its returns with that of the financial market as a whole. Essentially, a stock with a beta of one posts returns in line with the market. If it has a beta of two, it historically moves twice as fast as the market. Merrill Lynch recently pointed out that stocks with a quality rating of C&D have returned 120% year-to-date, nearly six times the performance of A+ rated stocks. Certainly a large portion of this speculative move was fueled by heavy "short-covering", as short-sellers were blindsided by the massive rally off the bottom. As you might expect, we are not the "high beta" type of investor. In our *Fall 2000—Investment Outlook*, we compared our value approach to Aesop's fable, The *Tortoise and the Hare*. From that letter of nine years ago we stated,

"Slow and steady wins the race"



"Investing is very much like a long race or marathon; the winner may not be the one who sprints out to the early lead. To be successful in investing one must be able to ride through the bear market so that they can participate in the next bull market over the horizon. It is our belief that investing with a "margin of safety" under the value principles of Benjamin Graham, gives the investor the best chance to succeed at investing over the long term. We are the first to acknowledge that there are times when it becomes difficult to adhere to a value discipline. Value investing is not a simple philosophy to practice. Many who attempt or claim to be value-oriented fail to maintain the discipline or patience required to succeed. However, it is that very discipline and patience that enables the value investor to avoid getting caught up in speculative bubbles, even during periods of short term under performance."

Valuations

As we discussed last quarter, this is a difficult time for valuation analysis because depressed earnings result in higher than normal price/earnings ratios. Perhaps we will have a clearer view of the earnings backdrop after this month. The trend has been that earnings have exceeded lower expectations due to cost-cutting, but revenue growth has been non-existent. According to Ned Davis Research, the median price/earnings ratio for the S&P 500 is 19.8x, which their work shows as approximately 17% above fair value. When looking at the broader markets (1375 institutional grade U. S. common stocks in the Ned Davis Research database), the median price/earnings ratio is 23.4 times earnings. We should point out that price/earnings ratios are generally higher when inflation is low; however, today's markets are beginning to look and feel as they are "priced for perfection". When looking at dividends, stocks also look to be getting pricey. The price/dividend ratio is 53 times, which is where it was at the 2007 highs. To put that number into perspective, before the 1987 crash, the price/dividend ratio was 12 times. When examining price/book value as a "valuation metric", we get the same answer. Currently, the Dow Jones Industrial Average is trading at approximately 3.6 times book value versus a fifty year average of just over 2.2 times. In summary, valuations in the equity markets have moved from undervalued to somewhat overvalued in a span of just six months. While we can find individual equities that meet our valuation criteria, the market as a whole appears to have gotten ahead of itself in light of the 58% rise from the bottom.

For the third quarter, corporate earnings are expected to decline for the ninth consecutive quarter (operating earnings). For all of 2009, earnings are expected to fall by approximately 17% from 2008's level. Investors are now looking forward to the fourth quarter and next year, where year over year comparisons should be favorable. For 2010, Wall Street is projecting profit growth of 26%, in what would represent the first gain since 2006. Many corporations have started to restock depleted inventories. The weak U. S. dollar should boost revenues and earnings for many large multi-nationals which dominate the S&P 500 index. Additionally, the cost cuts which have been implemented over the past year should also help drive earnings when companies begin to see revenue growth.

Recession Over?

In mid-September, Federal Reserve Chairman Ben Bernanke stated that the recession was "very likely over". The Fed Chairman further stated, "Even though from a technical perspective the recession is very likely over at this point, it is still going to feel like a very weak economy for some time as many people still find their job security and their employment status is not what they wish it was." Bernanke and investors seem to agree that the economy and the stock market are in some type of economic "sweet spot" (remember Goldilocks?) as they see inflation "subdued for some time" despite a pick up in the economy. Bernanke also seems unwilling to take away the "punch bowl" as the Fed stated, "Economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period." Conspicuously absent was any mention of the Fed's exit strategy with regards to the zero interest rate policy and "quantitative easing" program. Excessive leverage and easy monetary policy are what got us into the economic mess we are currently in. Ironically, the cure for our current economic woes: excessive leverage (in the government sector) and easy monetary policy. I guess it makes sense, treat the hangover with a "little hair of the dog that bit you". My only question is what will we do for an encore?

Investment Strategy

While we believe Armageddon is "off the table", we expect any recovery to be muted, in light of the "weak consumer" and high levels of government debt. "Cash for clunkers", the credit for first time home buyers and a "zero" interest rate policy can't last forever. We continue to look at the markets opportunistically, buying one company at a time when we believe it's valuation makes sense. Recently, we have taken a somewhat more active approach with regards to the equity portfolios as we have sold names that have reached our price objectives and replaced those with companies whose stock prices (and we believe risk) have declined. Our focus continues to be on high quality, large capitalization issues. Many of these companies will be able to grow based on their exposure to more rapidly growing foreign economies. Their balance sheets are exceptionally strong. We believe the risk/reward is extremely favorable for a number of these companies. With regards to the fixed income arena, we are essentially refusing to chase yield and keeping maturities short. In addition, we continue to focus on high "credit quality" in bond portfolios. It is our belief that the Fed will ultimately have to raise rates, which should provide fixed income investors with better opportunities in the next year or two.

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