JAM JOLLEY ASSET MANAGEMENT, LLC

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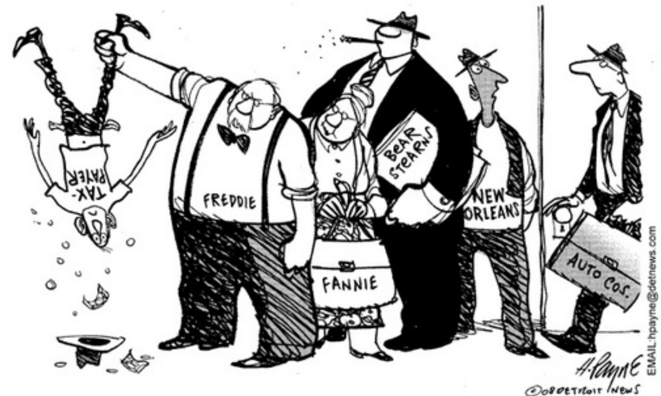
> *"Finally, be aware that the market does not turn when market participants begin to see the light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before."*
>
> *Jeremy Grantham*
> *Chairman—GMO, LLC*

Even though stocks closed with a three week rally of nearly 20% at quarter end, stocks posted their sixth consecutive losing quarter. The string of quarterly declines was the longest losing streak since the six quarters ended June 30, 1970. Furthermore, the quarter just ended was the worst first quarter in percentage terms (DJIA) since 1970. Despite the late rally at quarter end, it will take a rise of approximately 96% in the S&P 500 for the index to get back to its October 2007 high. For the quarter ended March 31, 2009 the S&P 500 and Dow Jones Industrial Average fell by 10.93% and 12.43%, respectively. Growth outperformed value by a significant margin as can be seen from the chart below. The value indices continue to be weighted down by the weakness in the financial sector. The NASDAQ Composite turned in the best quarterly performance as investors flocked to technology companies which generally possess rock-solid balance sheets.

| Index | 1st Quarter 2009 | Trailing 12 months |
|---|---|---|
| DJIA | -12.43% | -35.95% |
| S&P 500 | -10.93% | -38.05% |
| S&P Mid Cap | -8.66% | -36.09% |
| Russell 1000/Growth | -4.12% | -34.28% |
| Russell 1000/Value | -16.77% | -42.42% |
| Russell 2000 | -14.95% | -37.50% |
| NASDAQ Comp. | -3.07% | -32.93% |

## Government to the Rescue?

TARP (Troubled Asset Relief Program), TALF (Term Asset-Backed Securities Loan Facility), PPIP (Public Private Investment Program) and "quantitative easing" are the latest acronyms/buzzwords for programs tossed out by the Federal Reserve and Treasury Department. In summary, the first three programs are aimed at re-capitalizing the banking industry in an attempt to get banks lending once again. "Quantitative easing" is perceived as a way for the Federal Reserve to get money flowing when the normal process of simply lowering rates isn't working. Essentially, the Fed will buy assets in exchange for money by expanding the Fed's balance sheet. As Warren Buffett put it in his recent letter to shareholders, "In poker terms, the Treasury and the Fed have gone, all in." Buffett went on to say, "Economic medicine that was previously meted out by the cupful has been dispensed by the barrel". As to the after effects, Buffett concluded that "one likely consequence is an onset of inflation". The only thing we know for certain is who is footing the bill, the U. S taxpayer.




*"Take a number."*

Not to be out done, the Financial Accounting Standards Board (FASB) recently announced their intent to relax the "mark to market" accounting rules. This will allow for more leeway for how financial institutions account for assets on their balance sheets. This will likely reduce the amount of write-downs in the future at financial institutions, but at the expense of full transparency to the public. For its part the SEC is bowing to pressure from Wall Street and is weighing two proposals with regards to "short-selling" similar to the old "up-tick" rule. Essentially, the government has thrown in the proverbial "kitchen sink" to revive the economy.

## Cash is King or Cash is Trash?

Jeremy Grantham, chairman of Grantham, Mayo, Vann, and Waterloo in his March 2009 letter entitled "Reinvesting When Terrified" recently wrote:

> *"Similarly today, it is both painful and career risky to part with your increasingly beloved cash, particularly since cash has been so hard to raise in this market of unprecedented illiquidity. Every decline will enhance the beauty of cash until, as some of us experienced in 1974, terminal paralysis sets in. Those who were overinvested will be catatonic and just sit and pray. Those few who were brilliant, oozing cash, will not want to easily give up their brilliance. So almost everyone is watching and waiting for the inertia beginning to set like concrete. Typically, those with a lot of cash will miss a large chunk of the market recovery."*

As fear has continued to dominate the markets, a mountain of cash has been accumulated on the sidelines. According to the Bank Credit Analyst, cash has risen to "a whopping 105% of market capitalization, which compares to a historical mean of 44%." The sharp rise is the result of a surge in cash balances coupled with a collapse in market capitalization. With interest rates hovering near zero, the minimal income on this cash will ultimately lure investors back into riskier, higher yielding assets. Corporate cash is also building as businesses (non-financial) have been working to strengthen balance sheets in lieu of buybacks or M&A activity. Warren Buffet, in his recent letter to shareholders wrote:

> *"Clinging to cash equivalents or long-term government bonds at present yields is almost certainly a terrible policy if continued for long. Holders of these instruments, of course, have felt increasingly comfortable—in fact, almost smug—in following this policy as financial turmoil has mounted. They regard their judgment confirmed when they hear commentators proclaim "cash is king," even though that wonderful cash is earning close to nothing and will surely find its purchasing power eroded over time."*

Could the combination of investor cash and corporate cash fuel a sustainable market rally? Quite frankly, it looks as if it already has. Is it sustainable? Only time will tell.

## Analyzing Risk

A recent research report by James Montier of Societe Generale looked back at some of the work of Benjamin Graham with regards to how one should evaluate risk. We thought it was an excellent report, particularly in light of the current economic backdrop. A summary of the report follows:

Benjamin Graham was critical of measuring risk by looking at statistics such as "standard deviation". He thought investors should focus on the dangers of a "permanent loss of capital". In his writings Graham talked about three main risks that could result in losses for investors.

1) Valuation risk. Valuation risk is essentially paying too much when initially purchasing an equity security. A perfect example would be purchasing Cisco Systems in 2000, near the height of the "tech bubble". Cisco had a great balance sheet, good prospects, excellent management but the stock was priced to perfection at over sixty times earnings. Essentially there was no "margin of safety" in Cisco at that valuation level. Value investors spend a tremendous amount of time focusing on "valuations", while "momentum" oriented investors focus less on valuation parameters and more on near term earnings prospects and stock price momentum. Valuation issues are much less of a problem today, with most equities marked down to their lowest levels in decades. To quote Warren Buffett, a Graham disciple, "Price is what you pay. Value is what you get."
2) Business (risk) or earnings risk is considerably more troubling today than "valuation risk". Graham said, "The real risk is…the danger of a loss of quality and earnings power through economic changes or deterioration in management". Measuring business risk is challenging as the value investor must attempt to determine if the earnings decline (and many times dividend cuts) are temporary or permanent in nature. A "temporary" decline in earnings could represent a great buying opportunity for investors, while a "permanent" decline in the "earnings power" would likely result in a "value trap".
3) Balance sheet risk is another risk that Graham focused on in his writings. Graham noted that "The purpose of balance sheet analysis is to detect…the presence of financial weakness that may detract from the investment merit of an issue". During bull market and economic expansions, this risk is most often neglected by investors. However, during economic downturns and credit contractions, this often becomes an obsession. We must remember leverage can enhance profits during good times and penalize earnings during a downswing.

In analyzing companies for inclusion in client portfolios we try to focus on all three "risks" discussed above. Currently, we are generally less concerned with valuation risk (due to lower prices) and more concerned with "business risk" and "balance sheet risk". While I am sure we will make mistakes with portfolio companies, our intent will always be to invest with a "margin of safety".

## Summary

Despite the late quarter rally, stocks were under significant pressure during the first quarter. Global economic conditions have continued to deteriorate and despite the massive government stimulus, there seems to be little hope for a quick rebound in economic activity. In recent weeks, investors "risk appetite" appears to have increased somewhat. Investors sitting on high levels of cash seem to be concerned about missing a meaningful move up in stock prices. Our focus continues to be on risk versus reward with portfolio companies. In coming months, we anticipate putting some of our cash reserves back into what we perceive to be high quality equities. As you would expect, we would prefer to buy on market weakness rather than chase the markets higher. As we have said on numerous occasions, we believe that market timing is a futile exercise. In fixed income portfolios we have been slowly moving away from treasury issues in favor of high quality corporate bonds (many with FDIC insurance), treasury inflation protected bonds and high quality municipal (predominantly general obligation) issues. We know these are challenging times for investors, however, we believe our focus on risk will serve our client well in the coming months.

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