JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 44• Summer 2009**

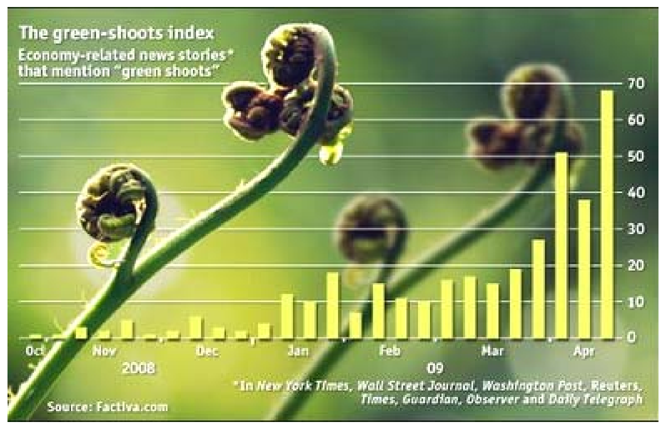
> *"I had cataract operation on my left eye about a month ago and I thought that maybe now I'll be able to see green shoots. We're not seeing them. Whether it's retailing, manufacturing, wherever. We have a big utility operation. Industrial demand is down like we've never seen it for a simple thing like electricity. So it hasn't happened yet. It will happen. I want to emphasize that. But it hasn't happened yet."*
>
> *Warren Buffett (6/24/09)*

Stocks posted their best quarter since 1998 with the S&P 500 index and Dow Jones Industrial Average returning 15.94% and 11.92%, respectively. During the quarter, investors became more comfortable holding riskier assets, prompting a shift away from cash and U.S. government bonds. According to Seth Klarman of Baupost Group, "The pressure not to lose has been replaced by the pressure not to miss out." While it is debatable if economic conditions have improved (the so called "green shoots" theory) or merely "less bad", the stabilization was enough to persuade investors to boldly re-allocate portfolios in the direction of equities. Warren Buffett recently joked on CNBC that he had cataract surgery about a month ago, "but he still can't see green shoots." Whatever the reasons, stocks strong second quarter performance essentially wiped out the first quarter losses and put most major indexes into positive territory for the first half of the year (see chart below). "Growth" indexes dramatically outperformed "value" for the first six months of the year. The tech heavy NASDAQ posted the best first half returns, as investors were attracted to the "cash-rich" balance sheets found in most technology companies.

Index	2nd Quarter 2009	YTD (6 mos) 6/30/09
DJIA	**11.92%**	**-2.00%**
S&P 500	**15.94%**	**3.26%**
S&P Mid Cap	**18.75%**	**8.47%**
Russell 1000/Growth	**16.32%**	**11.53%**
Russell 1000/Value	**16.70%**	**-2.87%**
Russell 2000	**20.69%**	**2.64%**
NASDAQ Comp.	**20.05%**	**16.36%**

Green Shoots?

We have spent a great deal of time thinking about the rally that began in March of this year. Is this a "bear-market" rally? Is this a "cyclical bull market", within a "secular bear market phase"? We must admit the speculative nature of the move, with many issues rising two and three fold, has made us more cautious as of late. Furthermore, the media's infatuation with "green shoots" and the renewed focus on short-term returns is not a particularly healthy development in our opinion. Economically, we still face enormous headwinds, namely rising unemployment, huge government deficits and a tapped out consumer who is finally beginning to save again. Recently, the media has begun to tout some performance numbers that have been generated by certain mutual funds for the first half of 2009. The Wall Street Journal recently ran a story discussing how most mutual funds were now "Beating the Street". This past week on CNBC, one of the "talking heads" was gushing about the Legg Mason Opportunity Trust and the fact that it was up a whopping 31.2% for the first half of 2009. What they fail



to tell you is that the same fund was down a stunning 65.5% in 2008. Most investors would assume that the fund had now made up approximately half its losses, but unfortunately, the math doesn't work that way in investing. If an investor had put in $100,000 on the first day of 2008, the balance would have declined to $34,500 at the end of 2008, before rebounding to $45,264 at June 30, 2009. So despite the mind-boggling returns in 2009, you are still down a staggering 54.7% in eighteen months. We are not trying to criticize Legg Mason or Bill Miller (fund manager); we just want to point out that huge losses are very difficult to overcome in investing. We believe that to be a successful investor one must understand the "power of compounding" and the importance of avoiding the big losses. This is precisely why we have adopted a conservative, value approach, where we focus on "downside" risk before considering the "upside" potential of a security. Quite simply, you do not need to make as much in the up years, if you lose a lot less in the down years. While an investment process such as ours tends to be boring most of the time, it tends to work well for investors over the long term.

Economy & the Markets

From the bottom (666.79) reached on March 6, 2009, the S&P 500 rocketed by 43% to 956.23 on June 11, 2009. Clearly the markets have been discounting that the worst is over for the economy. In fact, if the economy emerges from the recession in the fall, as the consensus are predicting, the March lows would appear to be validated. Remember, stocks typically begin to advance some six months before the economy actually recovers. On average, the S&P 500 historically rallies approximately 20% from the lows to the end of the recession. Why has this recovery off the lows been twice the norm? Could it be attributed to the fact that the markets overshot to the downside in the first part of 2009 when participants were anticipating financial Armageddon? Could it be the massive government stimulus package that has buoyed the large advance? In April, Jim Grant of *Grant's Interest Rate Observer* put together a chart showing the amount of stimulus as a percentage of GDP, both monetarily and fiscally, for this downturn compared to the previous thirteen recessions. For those, the cumulative monetary stimulus was about 6%, while thus far in this single recession, it has been 18%.

According to David Rosenberg of Gluskin, Sheff & Associates, the rally in the equity markets has seen price earnings multiples expand from around fifteen times trailing earnings to around twenty-three times currently. It is logical for price earnings multiples to expand when earnings fall precipitously as they have done in this recession. That being said, we will need a meaningful rebound in corporate profits to keep share prices at current levels.

Attempting to time the end of the recession and estimate earnings for the next twelve months appears to us to be a futile exercise. Furthermore, what if the economy recovers somewhat in the fall and then falls back into recession next year as the effects of the stimulus package wears off (double-dip recession). We would point out that even after the strong rally off the bottom, that stocks have gone nowhere (that is putting it mildly) for the last ten years. From June 30, 1999 to June 30, 2009 the S&P 500 index has lost 20.2% or -2.23% (annualized before any fees) per year. So it seems fair to conclude that this secular bear market has been with us for a while. We constantly hear talk of the "lost decade" in Japan. Well, for all practical purposes our last decade has been "lost" for equity investors. It is our belief that investors will fare better over the next ten years. At least the odds appear to back that belief up. Since 1926, U.S. large-cap stocks have never posted two consecutive decades of losses. We continue to believe that at current price levels, high quality equities will outperform cash and bonds over the coming five and ten year periods. What we are focusing on is to remain invested in the equity markets through companies with strong balance sheets and the ability to withstand a protracted downturn. Nobody is likely going to call the "turn" in the economy (except Jim Cramer who will make the call every three to six months!) or get the estimates right. We have concluded why not just focus on the companies that we believe will survive and prosper over the coming years. As we have stated over and over, market-timing doesn't typically work in investing. The move in stocks of over 40% in the past few months seems to validate that thesis.

Investment Discipline

Warren Buffett once said, "Successful investing requires a quality of temperament, not a high IQ. You need an IQ of 125, tops—anything more than that is wasted". We would agree that the ability to rein in one's emotions, such as fear and greed, are more important than intelligence when investing in the stock market. Successful investing requires discipline and adhering to an investment process through thick and thin, no matter what the short term consequences. With that discipline comes "career risk" for portfolio managers such as myself. When I started Jolley Asset Management, LLC in 1998, a bubble was beginning to form in the technology/internet sector and the mega-cap names were trading at nose-bleed multiples. During the height of the tech bubble, the market price/earnings ratio was around thirty-one times earnings. Our discipline kept us away from those issues, but it was clearly a career threatening decision. Had we been wrong for any extended period of time, many clients would have likely jumped ship and my business would have possibly failed. In 1999, our equity composite finished the year up 3.8% versus 21.0% for the S&P 500 index. Not exactly the type of start we had envisioned. Believe it or not, I was actually quite pleased as many value managers experienced down years in 1999…at least we had positive returns. In our ***Winter 2000—Investment Outlook***, we stated, ***"What today's portfolio manager is most concerned with is benchmark risk, the risk associated with underperforming a specific benchmark and losing his or her job or bonus"***. The payoff came in the period from 2000-2002, when our value approach trounced the averages. Many value managers, who had abandoned their disciplines in an attempt to prevent fund outflows, were justifiably annihilated. We take great satisfaction in knowing that our clientele was able to avoid the losses experienced by many investors. Avoiding technology issues in 1999-2000 was not in any way reflective of intelligence, it was a gut-wrenching experience when even the most disciplined value investors were questioning their own investment process.

In a recent speech given at the Morningstar Conference in May of this year, Robert Rodriquez of the FPA Funds stated the following, "I believe superior long-term performance is a function of a manager's willingness to accept periods of short-term under-performance. This requires the fortitude and the willingness to allow one's business to shrink while deploying an unpopular strategy." It is our belief that while the next ten years will be better than the last ten, they will remain extremely challenging for investors. While we realize that our decisions will not always be correct, rest assured that we will not be held hostage to the fear of under-performing a specific benchmark or index. Jolley Asset Management, LLC was formed eleven years ago, to provide a vehicle whereby our focus and discipline could be preserved. We firmly believe our clients will be rewarded handsomely.

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