JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook

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"I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over."

Warren Buffett
NY Times OP/ED 10/16/08

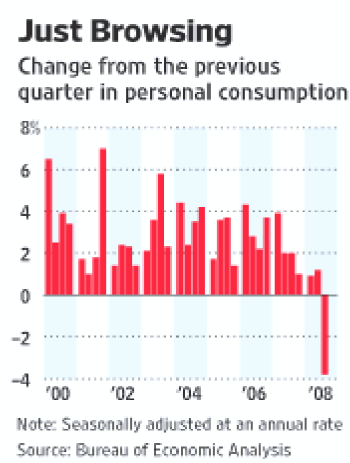
The only good thing about 2008 is that it is finally over. The Dow Jones Industrial Average plummeted 33.8%, the biggest annual decline in 77 years. Only 1931 (-52.7%) and 1907 (-37.7%) were worse. The S&P 500 declined by 38.5%, the worst since 1937. By the time the indexes bottomed in November, they had essentially wiped out virtually all the gains since the end of the 2000-2002 bear market. In fact, at its lowest point the S&P 500 sank to its lowest level since April 1997. Over the past 10 years, stocks as a broad group are down and their performance trails that of almost every asset class including government bonds, gold and even real estate. (The chart below shows total return including price change and dividends—numbers above are price change only.)

Index	4th Quarter 2008	2008 12 mos.
DJIA	-18.40%	-31.83%
S&P 500	-21.96%	-37.03%
S&P Mid Cap	-25.55%	-36.23%
Russell 1000/Growth	-22.79%	-38.44%
Russell 1000/Value	-22.18%	-36.85%
Russell 2000	-26.12%	-33.79%
NASDAQ Comp.	-24.27%	-40.54%

Most mutual funds fared even more poorly than the market indices. In fact, the Investor's Business Daily mutual fund index declined by 43% for the year ended 12/31/08. Many well regarded mutual funds stumbled badly. The Fidelity Magellan Fund fell by 49.4%, Longleaf Partners by 50.6%, CGM Focus Fund 48.2% and Legg Mason Opportunities Trust managed by Bill Miller fell by a whopping 65%. Fidelity Magellan's ten year compound return now stands at a negative 3.5%, meaning that $100,000 invested ten years ago would be worth roughly $70,000 today. Despite lower interest rates, most bond funds fared poorly in 2008, as investors shunned anything but U. S. treasuries. High-yield bond funds declined by approximately 26% for the year just ended. Government bonds were the only safe haven in 2008, the Lipper U. S. Government bond fund category returned a positive 5.22%. Yes, the sooner we can put 2008 out of our minds the better.

End of Negative Savings Rate

In the past, we have discussed the "wealth effect" which refers to the tendency of people to adjust their spending as their wealth (which is concentrated in housing and stocks) changes. Essentially when their wealth rises, the consumer spends more, when their wealth declines, spending weakens. For the past quarter-century, higher stock prices coupled with higher home values propelled the consumer to spend more of their incomes and to borrow more. In 1982, the personal savings rates (income minus spending) was 11% of disposable income. In 2006, the personal savings rate stood at essentially zero. According to Robert Samuelson of the Washington Post, the lowered savings rate added about $1 trillion annually to personal consumption. In recent months the consumer has begun to wake up to the fact that they must begin to save again. Americans have seen their 401-K balances shrink, their home values decline and they are now worried about potential job loss. Since September 2007 American's personal wealth has declined by approximately $9 trillion. Furthermore, they have lost confidence in the government, who cannot keep their own house in order. According to the Federal Reserve Bank as of September 30th, the nation's households paid down their debts (for the third quarter of 2008) for the first time since 1952. This has negative implications for personal spending as can be seen from the chart below.



The consumer is adjusting in a manner that makes sense—begin to save more and consume less. It makes perfect sense for the consumer to rebuild their balance sheet and become more liquid. Goldman Sachs has predicted that the personal savings rate could hit 6-10%--could it be a new era for saving? Ironically, this phenomenon has economists worried…they believe that this decreased spending can exacerbate the economy's problems. The so-called "paradox of thrift" argues that if everyone saves, then there is a decrease in consumption which leads to a fall in aggregate demand and thus leads to a fall in economic growth. The government will likely respond with a sizable economic stimulus package to take the U. S. consumer's place as the engine of growth. The fact that the consumer represents approximately two-thirds of the domestic economy makes this a challenging and expensive (likely $1 trillion or more) proposition. In addition, eventually a new source of demand must be found to sustain growth. The most obvious answer for that lies in the Asian economies (which are net savers) who should consume and spend more as their imports increase.

Finally, They Get It!

On December 1, 2008, the National Bureau of Economic Research (NBER) officially announced the U. S. economy is in recession. The committee determined the economy peaked in December 2007 ending an expansion covering 77 months. A year ago (1/15/08) in our *Investment Outlook—Winter 2008* we stated, "Whether we need it or not, it now appears likely that we are heading in that direction (recession) if not already there." On April, 15, 2008 in our *Investment Outlook—Spring 2008*, we stated, "Let's also conclude that, for all practical purposes, the U. S. economy is now in recession (likely started late last year)." So the declaration of "recession" by the NBER came as no surprise to us or the stock market for that matter. So while they just declared that we are in recession, the duration of the current recession is currently twelve months. This is already longer in duration than the ten month average registered by all recessions since 1945. It should be noted that stocks tend to discount the future, with stocks topping out approximately seven months before recessions begin and bottoming approximately four months before they end. The average decline in the equity markets (peak to trough) associated with recessions has been approximately 27% versus a whopping 52% for the current recession. On the brighter side, stocks have been up on average 23.4% (excluding 2001) off the bottom by the time the recession actually ends. Like Warren Buffett stated, "So if you wait for the robins, spring will be over."

Earnings/Valuations

We expect that corporate earnings over the coming year will be very weak. We believe that S&P 500 earnings of $50 are likely in 2009, down approximately 20% from 2008 and down 42% from the peak in mid-2007. This will represent only the third time in 80 years that S&P 500 earnings will decline three years in a row. We would expect that earnings will trough in 2009 and begin to head higher in 2010. It is our belief that even if a fiscal stimulus bill passes in early 2009, the full benefit will not be felt in the economy until 2010. Based on our expectations that earnings will begin to show quarter over quarter improvement in 2010, we will likely look to reduce our cash weightings as we find compelling investment opportunities over the next few months. We must not ignore the fact that the markets are forward looking and would like to be fully invested well before the earnings picture brightens.

In looking at equities, it is our conclusion that while near term earnings will remain under pressure, valuation levels are at the most attractive that they have been in the last ten years. Longleaf Partners in a recent client letter stated, "Using trailing average five year earnings through 2008 to calculate the S&P 500 earnings coupon, U. S. equities are the cheapest they have been since the depression when compared to the 10-year treasury yield." For the last ten years the S&P 500 has essentially gone nowhere (annualized return for the S&P 500 for the past ten years is -1.4%). Ten year returns on equities have only been negative on two other occasions, 1938 and 1939, since tracking began in 1926. Amazingly, the NASDAQ is approximately 70% below its March 2000 peak. In the most recent *Barron's Magazine,* Fred Hickey makes the case for owning Microsoft (one of our holdings as well). Hickey points out that Microsoft currently trades at $20, lower than ten years ago, when they did $12 billion in revenues. Now revenues are approaching $60 billion. Microsoft currently trades at around 10 times earnings, yields 2.7% and generates $19 billion a year in operating cash flow. As value investors, we also sleep well at night knowing that Microsoft has approximately $20 billion in cash on the balance sheet. Essentially, they are positioned to weather practically any economic downturn. While the heady growth days are clearly behind Microsoft, they are survivors and should participate in any economic recovery.

Presently investors see no "catalyst" or sense of urgency to invest in equities. Investors focusing on capital preservation would rather buy treasury issues with little or no real return than allocate money to equities. In fact, the demands for treasury bonds have reached the "bubble" phase according to David Rosenberg of Merrill Lynch. The Leuthold Group recently stated that "The $8.85 trillion held in cash, bank deposits and money-market funds is equal to 74% of the market value of U. S. companies. The last time cash accounted for a larger percentage of market value was in 1990." The ratio peaked at 75% in October that year, coinciding with the Drexel Burnham Lambert collapse and thrift industry collapse. Immediately following that, the S&P 500 rallied 23% in six months and 30% in a year. Robert Doll of Blackrock stated, "It's a mountain of cash. Somebody's just got to find a match and light it."

In summary, we are becoming more constructive with regards to equities. While we believe the news will be dismal over the coming months, valuations have become more compelling. Buying in front of bad news is not easy, but we believe that those who do will be handsomely rewarded.

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