JAM JOLLEY ASSET MANAGEMENT, LLC

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James Grant

Volatility returned to the global financial markets in the second quarter. The "Greek Crisis" which seemed contained in the first quarter spread to the other debt-laden European countries in the second quarter. "Macro" issues came front and center and essentially destroyed investor optimism about improving corporate earnings which led to the stock market rally that began in March of 2009. In addition, worries that China was slowing, coupled with the "flash crash" of May 6th, had investors fleeing from equities and back into the safe haven treasury market. In case you missed it, the "flash crash" was a mind-boggling nearly 1000 point decline that still has not been fully explained by any authorities. After four consecutive quarters of gains, the S&P 500 and Dow Jones Industrial Average declined by 11.4% and 9.4%, respectively. Most of the damage to the indexes came in May with the Dow Jones Industrial average declining by 7.9%, its worst percentage drop since 1940. There was essentially nowhere to hide in the equity markets during the quarter: growth, value, large, small—they all declined precipitously, with no real standout performer.

Index	2nd Quarter 2010	YTD 6 mos.
DJIA	-9.41%	-5.04%
S&P 500	-11.45%	-6.66%
S&P Mid Cap	-9.59%	-1.36%
Russell 1000/Growth	-11.74%	-7.65%
Russell 1000/Value	-11.15%	-5.12%
Russell 2000	-9.92%	-1.95%
NASDAQ Comp.	-12.04%	-7.05%

Too Many Technicians?

These days everyone is studying the market chart patterns or "technicals" of the markets. "Head and shoulders" chart formations and the "Death Cross" are all the financial media is babbling about these days. Investors are confused after the dizzying ride the markets have given them these past three years. The market experienced a 57% decline in eighteen months, followed by an 80% rally in thirteen months…and now a 16% decline from the April highs. Little wonder investors have begun to search for new answers with regards to the stock market. Technical analysis is frequently contrasted with fundamental analysis, the study of economic factors that influence prices in financial markets. Technical analysis holds that prices already reflect all such influences before investors are aware of them, hence the study of price action alone. Most would agree that those who base decisions on "chart patterns" or technical factors are predominantly "traders" rather than long term "investors". That being said, are there really any long term investors anymore? "Fast Money", "Mad Money", leveraged ETFs, inverse ETFs, hey we even got babies trading on the E*Trade commercials!

We aren't against trading or "technical analysis", however, it seems that the masses have concluded that fundamental analysis and "buy and hold" don't work anymore. Kind of the mirror image of 1999 when "buy and hold", tax efficiency and indexing (ultimate buy and hold strategy) were all the rage. Those who bought the S&P 500 index on 12/31/99 have lost 1.57% annualized. An investment of $100,000 made in the index would have turned into $84,680 (and that is before any fees)! In our "*Spring 1999—Investment Outlook*" we stated:

"The S&P 500 is no longer a broadly diversified index, but rather one that is concentrated very heavily in a few large companies….the top five stocks in the index (lets call them the "Nifty Five" composed of Microsoft, General Electric, Wal-Mart, Merck and Intel) together have more impact than the bottom 300 stocks in the index combined." The valuations on those five stocks was absurd and in that same letter we stated, "The nifty-five, which is comprised of Microsoft, General Electric, Wal-Mart, Merck and Intel currently have an average price/earnings ratio (trailing 12 months) of over 47 times earnings."

As you can see, doing what the masses were doing proved to be costly to investors in 1999. Will the same be true this time? We have reprinted a copy of our "*Spring 1999—Investment Outlook*" and enclosed it for your review.

Equity Valuations

Let's take a look at the "nifty-five" which we considered to be grossly overvalued in the spring of 1999. All of the companies have survived the "internet bubble", the housing collapse and corresponding meltdown of the financial sector. In fact, with the exception of General Electric, I think it is

fair to say the "nifty-five" might be as strong as ever from a balance sheet perspective. For example, Microsoft is currently sitting on approximately $47 billion in cash and Intel $17 billion. The average stock price decline from the all time highs for the five stocks is approximately 60%. The average price/earnings multiple has declined from 47 times in the spring of 1999 to just under 13 times trailing earnings today. Based on forward earnings estimates the five stocks trade at an average price/earnings ratio of just over 10 times earnings. Currently, the five stocks average dividend yield is approximately 3.1% despite a General Electric dividend cut which took place during the financial crisis. Not too bad when compared with the yield on the 10-year treasury note of just under 3%. So if one were to assume that these stocks go nowhere for ten years and there are no dividend increases (or declines), the holder of these five common stocks would come out ahead of the holder of the 10-year treasury at that bond's maturity. In the current environment, where yield is scarce—one would think that the dividend yields would attract more income oriented investors. Not to mention that dividends historically rise over time. In fact, anyone who bought Johnson & Johnson stock in 1980 and held on, is now earning more than the purchase price in dividends annually. Through mid-June, 135 companies in the S&P 500 index raised their dividends. Corporate balance sheets are flush with cash. Currently, S&P 500 nonfinancial companies had a record $837 billion in cash at the end of March 2010, up from $665 billion a year earlier. This would imply plenty of room for more companies to increase dividends over the coming year. Furthermore, the average taxable money market fund is currently yielding .04%, providing no competition for investor funds. While investors are currently fleeing from equities in favor of bonds, might that prove to be the wrong decision? While there is tremendous uncertainty in today's economy, is it possible that the "risky asset" proves to outperform the so called "safe" asset. As James Grant of Grant's Interest Rate Observer recently stated, "Mr. Market delights in switching labels. When he thinks nobody's looking, he sticks the "risky" label on the "safe" asset, and the "safe" label on the "risky" asset. Yet, not infrequently, it's the supposedly risky asset that winds up preserving capital or even delivering capital gains. It all depends on price."

Headwinds

Currently, there are a number of "headwinds" which could slow the current economic recovery or even result in a "double-dip" recession—the sovereign debt issues, higher taxes, BP oil spill, fiscal imbalances in federal, state and local governments, austerity measures, slowdown in China, deflation, etc. The list goes on and on. The uncertainty surrounding those events has investors in a near state of panic. I can tell from conversations with clients that nobody, and I mean nobody, wants to relive what they encountered in 2008. Much focus has recently been on Europe, which most expect to slow markedly over the coming year. According to Morningstar, Europe represents approximately 15% of the world economy. The U. S. economy is less dependent on exports than most other developed nations, with exports making up approximately 12% of our GDP. Exports to Europe make up approximately 25% of all U. S. exports, implying that if U. S. shipments to Europe disappeared entirely, the U. S. GDP would fall by roughly 3%. Bad yes, but not the type of event that would spell doom for our economy.

Where the economy goes from here remains the variable spooking most investors. Are the stock and bond markets both signaling a double-dip or is it just a slowdown, the so called pause that refreshes. Housing appears to be slowing once again as the incentives disappear, however, the impact on the economy and financial institutions should be more muted than before. The economy and markets should also benefit from the fact that companies have already cut their staffs to the bone, inventories are lean and the banking system has already been recapitalized. Corporate balance sheets are the strongest they have ever been. Cash holdings by S&P 500 companies, whether measured as a percentage of corporate assets or as a proportion of total stock market value, are at or near record levels. The ratio of free cash flow to stock market value is close to an historic high. This sets the stage for mergers and acquisitions, capital spending, share buybacks and dividend increases.

Summary

Obviously, there is much uncertainty with regards to the global economy. The headwinds are real and many will take years to overcome. The excesses and leverage that have been built up over the years will not disappear rapidly. However, the large capitalization, multinational companies have seen their valuations compress dramatically over the past ten years. At roughly 12 times earnings and a dividend yield of over 3%, could much of the uncertainty regarding the future be priced in? The recent 16% pullback in the equity market would seem to be discounting little if any earnings growth for 2011 versus the 15% plus many had been expecting just three months ago. Most of the large capitalization, multinationals have proven time and time again that they can survive in most monetary and fiscal settings. How is it that corporate America (ex the financial sector) rode through the difficult economy with relative ease? Corporate balance sheets have never been stronger. Expenses were cut to maintain profitability. Contrast that with the state, local and federal governments who have mismanaged finances to the extent that many are on the brink of insolvency. Companies have proven they can adapt and survive, many have prospered. While our future appears uncertain at the present time, I would not rule out the possibility that stocks could once again prove to be the best performing asset class. While no one can predict with any certainty whether the next 10-15% move will be up or down, the odds seem to favor equities over the longer term. With many high quality equities down 60% over the past decade is now the time to be bearish?

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