JAM JOLLEY ASSET MANAGEMENT, LLC

**Investment Outlook** **Volume 1, Issue 46• Winter 2010**

> ***"The best investors do not target returns: they focus on risk."***
>
> ***Seth Klarman***

The financial markets staged a remarkable recovery in 2009, as governments around the globe implemented coordinated rescue efforts. The markets, which stared at the abyss in the first quarter of the year, rebounded strongly as pessimism turned into optimism in light of the unprecedented monetary and fiscal stimulus. At its low point on March 9, 2009, the Dow closed at 6,547, some 54% below its all-time high reached in October 2007. From that low point in March, the Dow Jones Industrial Average soared just over 59%, which represented its fastest climb since 1933. The Nasdaq Composite rallied even more, rocketing 79% from its March low. For the year, the S&P 500 returned 26.4% and the Dow Jones Industrial Average returned 22.6%. "Growth" out-performed "value" throughout the year as evidenced by the 37.2% return for the Russell 1000 Growth Index versus 19.7% for the Russell 1000 Value Index. The "growth" indexes were led by technology issues which advanced a whopping 59% in 2009. According to Merrill Lynch, lower quality issues led the way in 2009. Stocks ranked C&D in the Merrill Lynch Quality Index soared 122.9% for the year, while stocks rated A and A+ moved up 22.9% and 27.9%, respectively. The "dash to trash" was somewhat surprising in light of the events that took place earlier in the year. It appears the "zero interest rate" policy by the Federal Reserve was just what was needed to get the "animal spirits" going again. The "Greenspan put" or should I say "Bernanke put" is alive and well.

| Index | 4th Quarter 2009 | Yr. Ended 12/31/09 |
|---|---|---|
| **DJIA** | **8.09%** | **22.60%** |
| **S&P 500** | **6.01%** | **26.41%** |
| **S&P Mid Cap** | **5.56%** | **37.38%** |
| **Russell 1000/Growth** | **7.94%** | **37.21%** |
| **Russell 1000/Value** | **4.22%** | **19.69%** |
| **Russell 2000** | **3.87%** | **27.17%** |
| **NASDAQ Comp.** | **6.91%** | **43.89%** |

## The Lost Decade

Despite the huge rally in 2009, the S&P 500 remains approximately 29% below the all time high reached in October of 2007. For that matter, the U. S. stock market just wrapped up one of its worst decades ever. Michele Gambera, chief economist for Ibbotson Associates, recently stated, "The last 10 years have been a nightmare, really poor" for U. S. stocks. Investors would have been better off owning pretty much anything but stocks, in fact, putting money under a mattress would have done better than the S&P 500, which lost about 1% a year for the decade. An investor who placed $100,000 in the S&P 500 index at the beginning of the decade finished with $90,720 ten years later. This long period of negative returns has long-lasting implications for investors who were counting on the stock market for their retirement planning. Many were counting on 10% returns as they entered the decade. The poor returns of the last ten years are largely due to the outsized returns the market generated in the 1990's when stocks rose by 17.6% a year. As Jeremy Grantham stated, "We came into the decade horribly overpriced." In our *Investment Outlook—Fall 1999* we stated, "As the millennium draws to a close, it also appears that the bull market of the 90's has finally run its course." In that same letter (10 years ago), we pointed out that the S&P 500 was trading at over 31 times earnings, 6 times book value and had a dividend yield of 1%. If nothing else, this difficult stretch proved one thing, "valuation does matter". Our multi-cap strategy and value discipline have enabled our clients to navigate successfully through this difficult decade. It seems that our approach of investing with a "margin of safety" and focusing on risk before return were particularly well suited for the past ten years.

## *Déjà vu?*

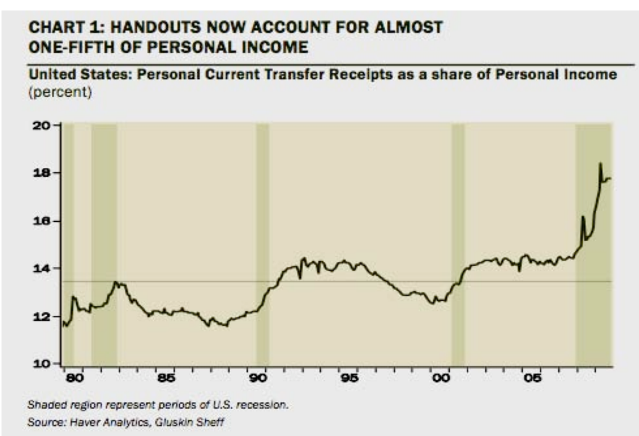
***December 28, 2009*** ***February 15, 1999***


Being on the cover of *"Time Magazine"* has always been known as a curse of sorts. Over the years many cover stories have been run at inflection points, where sentiment has typically gone to extremes. On February 15, 1999, Alan Greenspan, Robert Rubin and Lawrence Summers appeared on the cover as the "Committee to Save the World". We all know how that turned out. We don't really have the space to fully cover all the wonderful things (just kidding) this trio has done for the U. S. economy. Now we get Bernanke, who Wall Street claims saved the financial system as we know it. While it is obvious that Bernanke's crew saved his Wall

Street cronies, it is uncertain as to the long term implications for “main street” who will ultimately get to pay back this enormous “debt” that was taken out on our behalf. We may be in the “minority” but we are quite frankly tired of being “saved” by our government. Privatizing profits and socializing losses is not the way a “capitalist economy” should operate.

## Outlook 2010

The economic recession likely ended around late summer or early fall of 2009. As typically is the case, the equity markets had already moved up in anticipation of an economic recovery. That is what makes market timing so difficult; one must buy stocks when the news appears to offer little reason for optimism. As Warren Buffett stated in his NY Times OP/ED in October 2008, “So if you wait for the robins, spring will be over.” While we believe this recovery will show an initial burst of strength, we think it is likely to produce sub-par growth as the expansion matures. We must remember this was not a normal cyclical downturn. It was a recession brought on by massive deleveraging, a liquidity freeze and credit tightening by financial institutions. While it appears we have now weathered the storm of a financial collapse, we will likely face headwinds from the unwinding of excess government involvement, a less accommodative banking and investment community, higher inflation and rising interest rates. Additionally, a higher than normal level of unemployment seems to be the “new norm”. Another concern is the rapidly growing federal deficit. As Chart 1 below shows, handouts now total approximately 20% of personal income. We would expect the rhetoric to finance the rapidly ballooning deficit through higher taxes will become louder as the year progresses.

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## Equities

The consensus forecast is for S&P 500 earnings to grow by approximately 27% in 2010 over 2009 levels. Earnings comparisons over the next three to four quarters should be relatively easy ones for most companies, as earnings will be compared with the recessionary periods of the last twelve months when revenues were extremely depressed. While this will make for good headlines, we must remember that a portion of this news has already been discounted into the current level of stock prices. For that reason, we would prefer to become more aggressive buyers of equities on pullbacks in the market or corrections in individual stocks or sectors. At some point, we would expect a market correction on the magnitude of ten to fifteen percent, as the Fed will be forced to exit from its ultra-stimulative monetary stance. This will likely result in somewhat higher bond yields, which will provide more competition for equities. We believe any correction in the near term will be contained unless long term inflationary expectations begin to rise markedly.

We expect high quality large capitalization stocks will likely lead the market in 2010. Historically, small company shares have performed best at the start of bull markets (as was the case last year) but as rallies mature, blue chip leaders tend to out-perform. Furthermore, if the economic recovery is muted, these businesses offer more stable earnings and better downside protection. A decade ago (which was the last time large-caps were in favor), the largest ten stocks in the S&P 500 had an average price earnings ratio of fifty-nine times earnings. Today, the price/earnings ratio of the top ten is closer to fifteen times. Most larger companies also have greater exposure to faster growing economies such as Asia. This should translate into higher growth rates for many multi-nationals despite a relatively tepid economic recovery in the U. S.

## Fixed Income

If one had put all their money in Treasury bonds over the last two decades they could have enjoyed an annualized return of 8.5%. That is better than the stock market and three hundred basis points above the bond markets historical average. Unfortunately, it appears as though the easy days for the bond market might be over. As rates rose during 2009, treasury bonds fell, resulting in a loss of 17.6% for the long dated treasury bond in 2009. We have maintained a defensive posture in our fixed income portfolios as we have felt that the Fed would ultimately have to reverse their easy monetary policy and “quantitative easing” over the next few quarters. The likelihood of higher interest rates and higher inflation over the next few years will likely result in a “bear market” for bonds and could spell trouble for many fixed income investors. For that reason, we are focusing on short dated treasury issues and high quality, corporate and/or municipal obligations. We continue to hold a large amount of FDIC insured bonds which were purchased in lieu of treasury issues. We have also allocated a portion of our fixed income portfolios to treasury inflation protected securities (TIPS), to keep pace with inflation. Our bond portfolios are typically “laddered” which will give us the opportunity to reinvest a portion of the money each year at higher yields if interest rates rise. It is our belief that this will help us weather any potential “bear market” for bonds.

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