JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 53• Fall 2011**

> *"While it is always tempting to try to time the market and wait for the bottom to be reached (as if it would be obvious when it arrived), such a strategy has proven over the years to be deeply flawed. Historically, little volume transacts at the bottom or on the way back up, and competition from other buyers will be much greater when the markets settle down and the economy begins to recover. Moreover, the price recovery from a bottom can be very swift. Therefore, an investor should put money to work amidst the throes of a bear market, appreciating that things will likely get worse before they get better."*
>
> *Seth Klarman*
> *Baupost Group 2009*

In just three months, investors have shifted their focus from global recovery to worries that the world's developed economies are headed into a double-dip recession. Further complicating matters is the weakness in emerging market economies, such as China. During the third quarter, global equity markets were on edge with developments in Europe resulting in volatility that has not been seen since the spring of 2009. For the quarter, the Dow Jones Industrial Average fell by 11.45% while the S&P 500 index lost 13.87%. It was the worst decline for the averages since the first quarter of 2009 when the markets bottomed during the financial crisis. The small and mid-cap indexes suffered even greater declines as evidenced by the Russell 2000 index decline of 21.87% and the S&P Mid Cap index by 19.88%. Defensive issues were essentially the only bright spot in a brutal market environment. Believe it or not, the U. S. markets outperformed the MSCI World ex-U. S. index by 1.5% in the third quarter and 6.3% for the year to date. Emerging markets also were hit hard and underperformed the U. S. by 1.1% in the third quarter and 7.8% for the nine months ended September 30, 2011.

Index	3rd Quarter 2011	YTD 9 mos.
DJIA	-11.45%	-3.87%
S&P 500	-13.87%	-8.68%
S&P Mid Cap	-19.88%	-13.02%
Russell 1000/Growth	-13.14%	-7.20%
Russell 1000/Value	-16.20%	-11.24%
Russell 2000	-21.87%	-17.02%
NASDAQ Comp.	-12.91%	-8.95%

Macro Headwinds

Throughout the quarter investors were whipsawed by the debt ceiling issues, the downgrade of the U. S. government's credit rating, a weakening global economy and sovereign debt/banking issues in Europe. The horrific daily headlines created tremendous market volatility, prompting many investors to flee equities in favor of treasury bonds despite the relative paltry yields. As of quarter end, the yield on the ten-year treasury fell to 1.71%, its lowest yield since the 1940's. With inflation in the U. S. running around 3.6%, investors are essentially accepting a loss (after taxes and inflation). During August and September, the Dow Jones Industrial Average rose or fell by more than 1% on 29 days and by more than 2% on 15 days. The damage was worse in Europe, in fact, the French and German markets both lost more than 25%, their biggest quarterly decline since 2002. Gold appeared to be a "safe haven" for investors until it swooned by some 12% in a one week stretch in September.

These macro pressures that sent the global equity markets into a tailspin have resulted in some of the best opportunities since early 2009. The recent decline has not discriminated among businesses as global stock market correlations in both the U. S. and Europe have surpassed the level when Lehman Brothers collapsed in 2008. Essentially, the higher the correlation rises, the less differentiation there is in how individual stocks trade. While this is extremely frustrating for investors, it also provides the discriminating buyer with tremendous opportunities.

Bill Gross of PIMCO recently stated, "There is only a *New Normal* economy at best and a global recession at worst to look forward to in future years." Gross also stated, "There are no double-digit investment returns anywhere in sight for owners of financial assets. Bonds, stocks and real estate are in fact overvalued because of near zero percent interest rates and a developed world growth rate closer to 0% than the 3-4% historical norms." While we agree, we would remind investors that the markets are a discounting mechanism and that the recent decline of approximately 20% would imply that we have already entered "bear market" territory. We have always told our clients that we are not market-timers. We do not believe we are capable of predicting what stocks will do in the short term. Furthermore, in order to time the markets correctly require that one sell correctly and then also buy back in correctly. Being accurate with either call is difficult, but when one considers you have to be correct with both calls, the chances of success are remote. Is it possible that high quality, blue chip stocks represent the "best house" in a bad neighborhood?

Stocks versus Bonds

There's been a lot of talk in the financial media recently regarding the fact that many individual stocks are yielding more than the ten-year treasury bond. Following the significant third quarter decline in equities, the yield on the entire S&P 500 actually surpassed the yield on the 10-Year U. S. Treasury. This has been an extremely rare event over the last fifty years (twice in the last 5 years, see chart below).

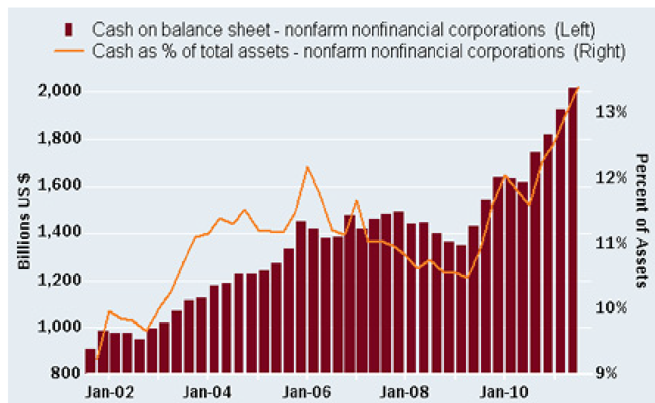
Looking at individual stocks, the number of companies that have a higher dividend yield than the 10-year treasury bond is almost mind-boggling. As of mid-September, 233 (46%) of the stocks in the index have a higher yield than the 10-year, and more than sixty pay a dividend which yields more than twice the 10-year treasury bond.

In this period of relatively high dividend yields, the important consideration for investors is whether or not the dividends are safe. Many times dividend yields are high for a reason and indicate increased risk. Often times if a stock has a high yield, the market is probably not extremely confident in the company's prospects of being able to pay out that dividend. In fact, back in 2008 most financial companies were high yielders, but eventually those dividends were either greatly reduced or eliminated entirely.

Payout rates, which historically average 52%, remain near their lows at under 30%, with strong cash-flow generation giving companies considerable room to increase payments in the future. Part of the reason for the low payouts appears to be the uncertainty over the economy, which prevents companies from making long-term dividend commitments. Standard & Poor's recently announced that dividend increases rose 17.1% during the third quarter of 2011, with 350 issues increasing their dividends versus the 299 that did so during the third quarter of 2010. This is not the type of behavior you would expect to see if companies were concerned about their ability to pay dividends in the future.

Bonds on the other hand have been in 30 year bull market. Rates on the 30-year treasury have declined from 15.4% in 1981 to around 3% currently. Thirty years ago Paul Volcker was trying to kill inflation and succeeded. Today, Bernanke is trying to reflate the system. Volcker succeeded 30 years ago, maybe, just maybe, Bernanke will succeed with his efforts to reflate. If he is successful, treasury bonds will prove to be an extremely poor investment over the next decade.

At quarter end, the S&P 500 was trading at 12 times consensus 2011 earnings estimates and 11 times consensus 2012 estimates. Although we believe those estimates are too optimistic, we would point out that there have been very few opportunities in the last decade to buy high quality blue chips at these valuation levels. Corporate balance sheets are "cash rich" (see chart below) giving companies the ability to increase dividends, execute share buybacks and increase merger and acquisition activity. Furthermore, we believe there will be increasing pressure on Congress to implement a repatriation bill or "corporate tax holiday" allowing U. S. corporations to bring home cash which is currently stranded overseas. A U. S. Chamber of Commerce study released last month predicted that a repatriation tax holiday could result in 3 million new jobs and could increase the domestic GDP by 1-4%. It should be pointed out that this could be done with little cost to taxpayers, as most companies will leave the cash where it is without a preferential tax rate.



"No Market for Young Men"

Jeremy Grantham of GMO recently stated, "This is no market for young men. At least us old men remember what a real bear market is like." Grantham criticizes politicians for acting like "children at play" and the Fed Chairman for putting savers in a box. He points out that retirees must move into riskier investments or have their money languish in savings accounts or low-yielding bonds. Grantham sees economic growth of around 2% for years to come versus the historical average of around 3.4%. Despite the gloomy forecast from Grantham, he states he is currently finding more and more companies that meet GMO's strict value investing discipline.

Brookings Institute recently did a study looking at different age groups to determine who could best handle financial transactions. The study found that the mean age at which financial missteps occur least often is 53.3 years—I fall right in the sweet spot at age 54. As a professional, I have experienced the crash of 1987, the internet bubble, 911, the financial crisis of 2008, etc. We believe our experience in previous bear market cycles will help us in our decision making for our clients going forward. We expect market volatility to continue and we will attempt to use this to our client's advantage. Our experience tells us that over the long term, investing in high quality, blue chip companies at attractive valuations will generate acceptable returns for investors.

Frank G. Jolley, CFA

JAM JOLLEY ASSET MANAGEMENT, LLC

210 Bryant Street, Suite A
P.O. Box 7967
Rocky Mount, NC 27804
(252) 451-1450 Toll Free (877) 4-JOLLEY
Web Site: www.jolleyasset.com
E-Mail: fjolley@jolleyasset.com