JOLLEY ASSET MANAGEMENT, LLC

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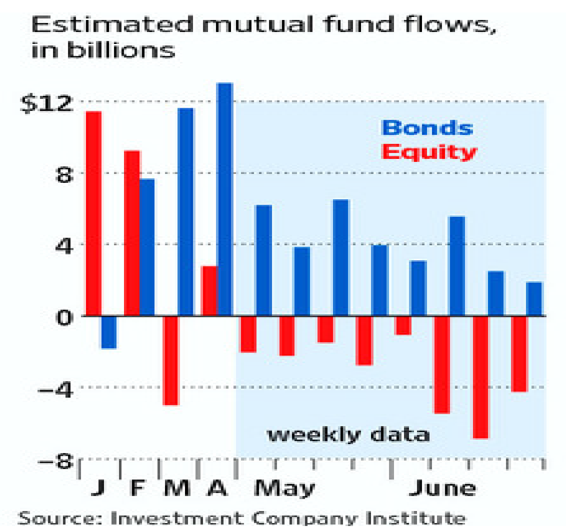
"Slower growth in coming years means investors should own more stocks, Dividend-paying stocks will return about 7 percent to 8 percent per year, far higher than what investors can earn in bonds. "I'm not bearish on bonds, I'm not saying bonds are a bad investment. I'm saying that with the liabilities that people have, they need to earn more."

Laurence Fink, BlackRock
June 10, 2011

Risk on—Risk off—Risk on again. During the first four months of 2011, $18 billion was shifted into domestic equity funds according to the Investment Company Institute. During the eight weeks ended June 22nd, $26 billion was pulled out of domestic equity funds. Investor sentiment swung from optimism about a global expansion at the beginning of the quarter to concerns about an economic "soft-patch" attributed to soaring oil prices and the Japanese earthquake. The swings have been exaggerated by the lower trading volumes which were down by approximately 30% from the same quarter last year. The sharp quarter end rally was driven by an apparent resolution of the debt crisis in Greece coupled with sharply lower oil prices.



The concerns about Greece, coupled with rising interest rates in China, have caused many global investors to view the U.S. markets as a "safe haven". In 2011, the S&P 500 has outpaced the MSCI World (ex U.S.) index by 5.6%. The U.S. markets also beat the emerging markets by wide margins in both the second quarter (2.7%) and year-to-date (7.9%).

As can be seen from the table below, the S&P 500 and Dow Jones Industrial Average managed to post gains for the quarter of .10% and 1.36%, respectively, while the other major indexes ended the quarter in the red, despite the frantic quarter end rally. Growth strategies trumped value based strategies as evidenced by the .76% gain in the Russell 1000 Value Index, while the Russell 1000 Value index declined by .50%. Quality and defensive issues led the market in the first half of 2011. Stocks rated B+ or better by Bank of America/Merrill Lynch outperformed stocks rated B or worse by 3.3 percent. We believe this leadership will likely continue over the immediate future.

Index	2nd Quarter 2011	YTD 6 mos.
DJIA	1.36%	8.56%
S&P 500	.10%	6.02%
S&P Mid Cap	-.73%	8.56%
Russell 1000/Growth	.76%	6.83%
Russell 1000/Value	-.50%	5.92%
Russell 2000	-1.61%	6.21%
NASDAQ Comp.	-.27%	4.55%

Equity Valuations

Analysts expect S&P 500 companies to earn approximately 18% more this year than in 2010. The S&P 500 index is currently trading at approximately 13 times 2011 estimates compared with an average of over 20 times since 1991. The S&P 500 is currently trading at around 9 times cash flow and at 2.2 times book value. Valuations from an historical perspective certainly appear reasonable, if not cheap. Disappointing numbers from the housing, employment and manufacturing sectors would imply that earnings growth will likely slow in the second half of 2011 and into 2012. Concern over the second half slowdown will likely prevent a "melt-up" in the market like we got last summer when Bernanke implemented QE2. Price earnings ratios will likely remain below their historical levels because of all the uncertainties related to future growth. Thus far Fed Chairman Bernanke has given no indication if the Federal Reserve will start a third round of "quantitative easing". Barring a double-dip recession, we would anticipate stocks remaining in a relatively tight trading range with an upward bias. A trading range between 1250 and 1400 on the S&P 500 certainly would appear likely between now and year end.

Large Cap versus Small Cap

The lone sector of the market that looks particularly inexpensive remains the mega-cap companies. It truly is one of the few "cheap" asset classes left. Since early 2009, low quality (high beta) stocks have been significantly outperforming the high quality companies. Some of this could be attributed to the "zero interest rate policy" of the Fed through the implementation of QE1 and QE2. QE2 officially came to an end on June 30th. With the absence of this easy money policy, we would expect the higher quality mega-cap companies to outperform the small and mid cap indexes for the next several quarters. Jason Parker, an equity analyst at Morgan Stanley recently stated, “Our view that the mega-caps (top 30 by market capitalization) are undervalued and the rest of the market (stocks 31 through 500 by market capitalization) are modestly overvalued.” Furthermore, blue chip stocks typically fare better during periods of moderating growth.

Steve Romick, the portfolio manager of the five star FPA Crescent Fund, recently explained why he is heavily concentrated in large cap stocks. “One of the myths about small cap stocks is that they grow faster than large cap. And they certainly can, because the companies are more nimble, but that is not necessarily the case.” Romick further stated that the Russell 1000 has outperformed (he is referring to earnings growth not stock price performance), the Russell 2000 for the last 15 years consecutively. He attributes this to the fact that the large cap companies have more overseas exposure and that the overseas markets have grown faster than the U. S. Mr. Romick currently believes that as a group, small cap stocks are about as expensive relative to large cap stocks as they have been since the early 1980’s.

Many of the mega-cap stocks have tremendous cash hoards. In total, the companies in the S&P 500 are sitting on approximately $960 billion in cash (highest level ever). In the first quarter of 2011, the five companies with the greatest cash balances—Microsoft, Cisco Systems, Google, Apple and Johnson & Johnson added $15 billion to their cash positions. Meanwhile, the dividend payout ratio (the % of earnings paid out in dividends) fell to just under 29% for the past four quarters. According to Howard Silverblatt of Standard & Poor’s, that is the lowest level since 1936. Essentially companies are earning more than they ever have before, but payouts are nowhere near their highs. This should lead the way to increased dividends, stock buybacks and merger and acquisition activity. It should be pointed out that a large portion of this cash is piling up outside the U. S. and cannot be brought home without paying taxes of up to 35%. Corporate America has been lobbying for a tax holiday which would encourage companies to bring the cash back home. Many are pointing out that it could boost the economy by leading to more capital investment and job creation in the U. S. Additionally, any such tax break would likely be viewed as a positive catalyst for the stock prices of many large capitalization companies.

Stocks versus Bonds

PIMCO’s Bill Gross, who last year was named by Morningstar as the fixed income manager of the decade, favors some high quality dividend paying stocks over U. S. treasury securities. In fact, Gross recently stated that he views treasuries as overvalued based on his analysis of historical yields and the fact that the Fed has been purchasing approximately 80% of all treasury supply under the QE2 program. Compared to Treasuries, Gross thinks certain blue chip stocks are much more attractive investment alternatives. At a Morningstar investment conference in June, he specifically mentioned two consumer stocks he liked: Procter & Gamble and Johnson & Johnson. The stocks yield 3.2% and 3.4%, respectively, versus 3.0% for the ten-year treasury bond. From a risk perspective, there are obviously major differences between U.S. government bonds and blue-chip equities. Short-term U.S. Treasury securities (if held to maturity) are by definition risk-free, while stocks are volatile and expose the holder to specific company risk and market risk factors. However, with a high quality equity investment, there is typically a rising dividend (income stream), versus a fixed coupon (income stream) generated by the treasury issue. This provides the investor with protection against higher inflation, which is likely to accelerate in the coming years.

Headwinds

Economic data has recently deteriorated and talks of a “double dip” recession have returned. Essentially, we have a jobless recovery despite massive amounts of government spending and stimulus. Housing activity shows no signs of rebounding. Approximately 25% of homeowners have a house worth less than their mortgage according to Core Logic. Consumers continue to spend, however, it appears to be funded by borrowing as consumer credit has increased for eight straight months. According to Fidelity Investments, a record number of Americans are making hardship withdrawals from their retirement funds as a source of immediate cash. The government deficit is ballooning and the Fed is running out of options. QE3 appears to be out of the question, unless we see a stock market decline of some 15% to 20%. We are approaching the 100% debt to GDP threshold where foreign investors typically avoid a country’s debt. State governments are attempting to balance their budgets, which will put a drag on GDP growth going forward. Many public pension plans are significantly underfunded which ultimately will result in higher taxes to many. Greece has been in the headlines but the problems could spread to other European countries which have high debt to GDP levels. This could create a problem for European banks which could result in slower growth in the Euro-zone economies. Growth in China is slowing as the central bank is fighting surging price inflation with higher interest rates. The list of headwinds we face domestically and globally could go on and on, but I think you get the picture.

Summary

We expect the markets to remain in a trading range with an upward bias over the next couple of quarters. Earnings growth remains strong and high quality, large capitalization stocks appear to be attractively priced. Strong balance sheets, growing dividends and buyback activity should enable this sector to lead the market over the coming year. Any sustained weakness in the equity market will likely be met by further moves by the Fed (Bernanke Put) in the form of QE3.

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