JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 56• Summer 2012**

> *"Interestingly, we have beaten the market quite handsomely over this time frame, although beating the market has never been our objective. Rather, we have consistently tried not to lose money and, in doing so, have not only protected on the downside but also outperformed on the upside."*
>
> *Seth Klarman*

Despite the late June rally, stocks closed broadly lower in the second quarter. In fact, the damage would have been much worse had the markets not rallied by an amazing 3.7% (S&P 500) in the last eight hours of trading (2:30 pm 6/28— 4:00 pm 6/29). The late rally was based on news coming from the European summit that euro-zone officials would bolster support for its troubled banks. Essentially, every stock sector finished the second quarter lower. Energy and basic materials were the weakest sectors for the quarter, while the defensive sectors were the best performers. As the chart below shows, the Dow Jones Industrial Average and the S&P 500 were the best performing of the major indexes, as investors gravitated towards the safer, larger capitalization companies. The tech heavy NASDAQ and the S&P Mid Cap index were the worst performers for the quarter just ended.

Index	2nd Quarter 2012	YTD 6 mos.
DJIA	**-1.88%**	**6.84%**
S&P 500	**-2.75%**	**9.49%**
S&P Mid Cap	**-4.93%**	**7.90%**
Russell 1000/Growth	**-4.02%**	**10.08%**
Russell 1000/Value	**-2.20%**	**8.68%**
Russell 2000	**-3.47%**	**8.53%**
NASDAQ Comp.	**-5.06%**	**12.66%**

Our Perspective on Risk

> *Definition of 'Risk' The chance that an investment's actual return will be different than expected. Risk includes the possibility of losing some or all of the original investment. Different versions of risk are usually measured by calculating the standard deviation of the historical returns or average returns of a specific investment. A high standard deviation indicates a high degree of risk. (from Investopedia)*

As a registered investment advisory firm managing investment portfolios, we are constantly confronted with the riskiness of a particular security, asset class or portfolio. Let's be honest, we all want the highest possible return with the least amount of risk. Some clients seem to tolerate risk better than others, something we refer to as "risk tolerance". However, it is human nature to desire more risk when times are good (bull market) and less risk when times are less certain (bear market). It would seem we could constantly adjust portfolios to take advantage of market dislocations (tactical asset allocation). However, tactical asset allocation decisions require "market-timing" which is very difficult to successfully employ. Remember, "market-timing" requires two correct decisions, when to sell and when to buy. Failure to time each correctly can be problematic for investors. Our experience in investments has taught us that we cannot successfully time the financial markets on a consistent basis. We will leave that to the CNBC types like Jim Cramer and the Fast Money panelists (by the way they cannot market-time either, although their cockiness would imply otherwise). We believe risk can be best handled with a strategic asset allocation decision based on a particular client's risk tolerance, time horizon, income needs, liquidity needs in the future, tax constraints, etc. Once the proper asset allocation parameters are set, we monitor the portfolio and rebalance when a particular asset class becomes over or under-weighted. In addition, we believe that as certain conditions change (age, earnings power, risk tolerance, liquidity needs, etc.), we should re-examine the asset allocation parameters that have been put in place.

While we do not try to time the markets, we do attempt to reduce the riskiness of our client portfolios in a number of ways. As a value investor, we believe investing is all about risk versus reward. While a particular security or asset class may appear risky, excluding that asset also introduces risk to the portfolio as well. For instance, if we are concerned about an economic slowdown, we might tilt portfolios towards more defensive sectors such as large capitalization utilities, healthcare and consumer staples. These companies typically hold up relatively well in difficult economic times. So while we are making a bet, we are not willing to be totally out of the market (remember our timing decision could be wrong). Diversification by company, sector and industry groups are obviously important tools which we cannot ignore. However, we are willing (in certain situations) to avoid certain sectors of the market if we deem that sector to be significantly over-valued. Our contrarian instincts lead us to avoid "fad" stocks and momentum issues. While this (avoidance of a particular stock or sector) may result in "benchmark risk", it does not typically result in a loss of capital for our clients. In addition, as a value investor, we follow in the footsteps of Benjamin Graham and Warren Buffett by investing with a "margin of safety" and trying to avoid a "permanent loss of capital" (the internet bubble resulted in "permanent loss of capital" for many participants). While the investment industry measures investment performance versus certain benchmarks and focuses on various statistical measures, we are more concerned with whether or not we are helping our clients meet their stated investment objectives. That being said, our focus on risk versus return has allowed our equity composite (examined) by Ashland Partners) to outperform the S&P 500 index by a wide margin since inception in 1998. From 12/31/98 through 6/30/12, the Jolley Asset Management

Equity Composite (net of fees—available upon request) cumulative return has been 118.5% compared with 41.5% for the S&P 500 index. Essentially, the outperformance is a byproduct of our focus on risk rather than a result of chasing returns.

Presently, we believe that certain areas of the bond market make no sense for investors on a risk versus reward basis. Treasury bonds in particular seem particularly unattractive as the Federal Reserve Board has essentially implemented policies (Quantitative Easing and Operation Twist) which we believe have artificially inflated bond prices. In addition, bonds have essentially been in a 31 year bull market as rates on the 10-year treasury bond have fallen from over 15% in 1981 to around 1.65% currently. Investors need to keep in mind that bonds have an "inverse relationship" with interest rates. If interest rates rise from current levels, bond investors will see the principal value of their bond portfolios fall in tandem. This "interest rate risk" is more pronounced with longer duration bonds and many bond funds. A 1% rise in the yield on the 30-year treasury bond would result in an approximate loss of 18.7% to the 30-year bondholder. That is essentially six years of interest wiped out. On the 10-year treasury bond, a 1% rise would result in an 8.9% loss in principal or approximately five years of interest being wiped out. It is easy to see why we don't like the risk versus reward present in treasury bonds. So while treasury bonds are considered to be "risk-free", we would argue that after taxes and inflation, they are very risky for investors at current price levels. Our dislike for bonds doesn't mean we can abandon bonds in their entirety; our clients can simply not tolerate the risk inherent in all equity portfolios. For that reason, we are staying very short in maturities (less interest rate risk). As always, we must also continue to focus on "credit risk" (risk of default) in bond portfolios. Ironically, constructing bond portfolios today is much more difficult than constructing equity portfolios. Perhaps Mr. Market is telling us something?

Earnings and Dividends

At the mid-way point in 2012, we find about half the world in crisis. Europe remains problematic, there is instability in the Middle East and economic growth in China is slowing. In addition, many multinationals are facing currency headwinds which could make earnings comparisons more difficult. According to FactSet Research, analysts have lowered expectations for 2012 and are currently looking for the S&P 500 to have earnings growth of around 7%-8% on a 2% revenue rise. As we discussed last quarter, earnings comparisons get more and more difficult as we are now in the eleventh consecutive quarter of earnings growth. Consensus earnings estimates of around $106 for the S&P 500 seem a little high to us, as fourth quarter estimates appear too optimistic. A number of companies including Proctor & Gamble, Nike, Ford, and FedEx have all recently warned of results below expectations. Lower energy prices should help certain sectors, but it will result in a projected earnings decline of close to 20% for the energy sector. We believe that the more modest earnings expectations are currently priced into the market. The S&P 500 is currently trading at approximately 13.4 times trailing earnings. This compares favorably with the S&P Mid Cap Index and the Russell 2000 Index (small cap) which trade at 16.1 times and 23.4 times, respectively. We would urge investors to stick primarily with the cheaper, high quality, large capitalization names. These companies tend to lead the markets in times of slowing economic growth. Profit margins for the S&P 500 companies remain at record levels due to record low borrowing costs and low labor costs.

The zero interest rate policy by the Federal Reserve has many investors scrambling for yield. Rates on certificates of deposit, treasury bills and money market funds have yields that are just above zero. After taxes and inflation, investors in those instruments are losing purchasing power. The S&P 500 index yield of 2.12% currently yields more than the 10-year treasury which is at 1.65%. However, it is not difficult to find high quality equities with dividend yields at 3% and above. Current holders of Johnson & Johnson common shares receive 3.7% in the form of dividends which we would expect to increase over time (Johnson & Johnson has increased its dividend for 45 consecutive years) while holders of Johnson & Johnson bonds maturing in 2021 receive 1.67% (yield is fixed) in interest payments. Investors should keep in mind that dividends currently receive preferential tax treatment although that could change in the future. The current dividend payout ratio for S&P 500 companies is approximately 30% versus an average of 58% over the past 86 years. This would indicate significant room for dividend increases over the next few years. Howard Silverblatt of Standard & Poor's recently stated, "Dividends had another great quarter, with actual cash payments increasing over 14% and the forward indicated dividend rate reaching a new all-time high." Even technology companies, which have typically not been big dividend payers, are beginning to pay out more of their earnings in the form of dividends. Moody's Investor Services is projecting a 14.3% rise in dividends for the tech sector in 2012, led by Apple, Intel, Microsoft and IBM.

Summary

In summary, corporate earnings growth is likely to slow in the next few quarters. In addition, the macro headwinds from Europe and slowing growth in China are likely to lead to continued market volatility and rough patches going forward. After a 31 year old bull market, bonds offer little opportunity (besides the coupon) for investors. Jeremy Grantham recently stated, "Stocks are boring; bonds are disgusting. It's a difficult world to operate in." Any investment plan entails risk, even one that invests in what is perceived to be "risk free" assets. It is how one manages risk that will be critical over these next few years. Having the proper asset allocation will be essential for investors given the difficult economic backdrop. Please contact us if you would like to discuss your financial situation and/or your current asset allocation. We believe our conservative value focus, where we focus on risk versus reward, will serve our clients well in the quarters to come.

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