JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 54• Winter 2012**

> *"Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value."*
>
> *Warren Buffett*

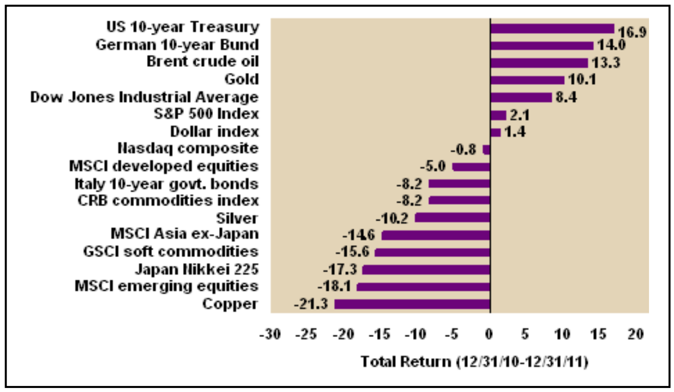
The equity markets took investors on a wild ride in 2011 to finish essentially where they began the year. The S&P index closed 2011 at 1257.60 versus a close of 1257.64 in 2010. That is a price decline of a mere .003%. That represents the smallest price change for the S&P 500 since 1970 when the index gained 0.1%. The S&P 500 traveled an astounding 3240 total points (close to close) while amassing the .003% loss it achieved on the year. Makes a person wonder what the statistical probability of the market closing unchanged was given the extreme volatility?

While the S&P 500 index was essentially unchanged on the year, the total return (including dividends) was a positive 2.11%. The Dow Jones Industrial Average which is dominated by mega-cap, multinational companies produced a total return of 8.35%. The Dow Jones Industrial Average outperformed the Russell 2000 Index by its largest margin in thirteen years. In 2011, the best Dow Jones Industrial performers were defensive names such as: McDonalds, IBM, and Pfizer. The strength in the defensive sectors of the market was essentially offset by weakness in finance, materials and industrial issues. Large capitalization growth outperformed large-cap value largely due to the weakness in the financial sector. The small-cap and mid-cap indexes produced negative returns in 2011. The Russell 2000 Index (small-cap) declined by 4.18% in 2011 and the S&P Mid-Cap index fell by 1.73%. We predicted (one year ago) in our *Investment Outlook—Winter 2011*, that high quality large capitalization stocks would be the place to be in 2011. It is our belief that we could currently be in the early innings of a multi-year market rotation into the mega cap, blue chip companies. For the last ten years, the S&P 500 index (market cap weighted) has advanced by 33.3% (cumulative) while the S&P equal weighted index has gained 87.2% (cumulative). The largest companies in the index have a lot of catching up to do in 2012 and beyond.

Index	4th Quarter 2011	Yr. Ended 12/31/11
DJIA	12.71%	8.35%
S&P 500	11.82%	2.11%
S&P Mid Cap	12.98%	-1.73%
Russell 1000/Growth	10.61%	2.64%
Russell 1000/Value	13.11%	.39%
Russell 2000	15.47%	-4.18%
NASDAQ Comp.	7.86%	-1.80%

The S&P 500 Index and the Dow Jones Industrial Index were both among the 10 best performers among the 91 national indexes tracked by Bloomberg. According to Bank of American/Merrill Lynch, the S&P 500 outperformed the MSCI World ex-US index by 13.7% in 2011 and Emerging Markets by 14.6%. Equity markets in Europe and Asia were routed in 2011. Europe's big decliners were: Greece (51.8%), Austria (34.7%), Portugal (27.6%) and Italy (25.2%). Asia's big losers in 2011 were: Vietnam (27.4%), India (24.6%), China (21.7%) and Taiwan (21.2%). As Dorothy said in the classic movie, ***Wizard of Oz***, "*There's no place like home. There's no place like home*". At least not in 2011!

2011 Asset Class Performance



Source: Bloomberg, Thomson Reuters

Focus on Dividends

The importance of dividends was never more apparent than in 2011. The markets were flat in 2011 with all the returns coming from dividends. The current yield on the S&P 500 of approximately 2.2% compares favorably with treasury bills which earned just .10% in 2011. The same could be said when comparing equities with short term bank CD's or money market funds where the yields have been hovering just above zero. Cash dividends, which have typically contributed approximately 40% of long term equity returns, have always been an important component of total return. The current low interest rate environment has resulted in yield starved investors embracing dividend paying equities to boost their incomes. In the year just ended, high yielding utilities, consumer staples and health care issues were the biggest market winners. The Dow Jones Industrial Average, which yields a healthy 2.6%, was the best performing of the major indexes for the past year.

In 2011, strong corporate profits and strong cash flow enabled 1,953 companies to increase (or resume) their dividends. Only 101 out of the 7,000 public companies eliminated their dividends. The dividend payout ratio still remains at under 30% versus a historical average of approximately 52%. This should allow for healthy dividend increases in 2012. According to Howard Silverblatt of Standard & Poors, "dividend increases will continue across the board for all sectors, with another double-digit gain in actual cash payments". Dividend payments increased by approximately 16% in 2011 and a similar increase is expected in 2012.

Outlook 2012

In the past year, the extreme market volatility has been driven by global macro-economic factors. It appears that 2012 may be much the same type of year. Uncertainty as to how the European crisis will unfold and how much China and the emerging markets slow will be the key issues the markets will be focusing on going forward. In addition, uncertainty with regards to the upcoming election and potential tax policy changes will loom large with investors over the coming months. Corporate profit growth will likely decelerate over the coming year. S&P 500 earnings are expected to grow by 15% in 2011 and 6% in 2012. It should be noted that S&P 500 earnings growth from 1960-2010 averaged approximately 6.5%. Much of the slowdown in earnings will come from a likely European recession (Europe currently represents approximately 18% of S&P profits).

Equity valuations appear attractive. Currently, the S&P 500 is trading at approximately 12.8 times trailing earnings and approximately 12 times 2012 estimates. According to Bank of America/Merrill Lynch, 70% of the S&P 500 companies are trading below their five year average price/earnings multiple. The utility sector is the lone sector to be above its long term average price/earnings multiple. When growth is accelerating investors tend to rotate towards more cyclical companies which typically have more earnings variability. When profits are slowing, as we anticipate in 2012, investors tend to gravitate to larger companies with stable earnings and strong dividend histories. Savita Subramanian of Bank America/Merrill Lynch in a recent research report noted there are many reasons to favor higher quality investments today. He stated that, "With the deleveraging cycle upon us, there could be a return to that type of market environment (which favors large cap). In fact, the next 10 years could be a mirror image of the most recent decade—where larger, cash rich and stable growth stocks trade at a consistent premium as deleveraging compresses valuations for smaller, riskier stocks that need capital in order to survive."

The macro headlines have resulted in extremely negative investor sentiment towards equities. During this period of heightened volatility and negative headlines, investors have been unwilling to take risk. The volatility of the markets in 2011 reminded investors of 2008 and early 2009 and many investors decided to abandon equities rather than get burned again. In the past year, investors pulled an estimated $132 billion from mutual funds that invest in U. S. stocks. This was the fifth straight year of withdrawals for domestic equity funds. Much of the money that left equity funds was reallocated into taxable bond funds which saw cash inflows of $141 billion. Any resolution or progress in dealing with the European debt problems could convince investors to move back into U. S. equities.

Bond Market

For the year just ended, the 30-year treasury bond returned 31.7% while long term corporate bonds returned 7.5%. For the past 10 years, holders of long term treasury bonds have enjoyed a cumulative return of 139.7% versus a cumulative return of 33.3% for the S&P 500 index. Investment grade corporate bonds have returned 84.1% over the same 10-year period. Trends tend to last longer than people expect and that has clearly been the case with the current "bull market" in bonds. We continue to believe that U. S. treasury bond yields are artificially low due to the "quantitative easing" and "operation twist" implemented by Ben Bernanke's Federal Reserve. Needless to say, we have been wrong in our thinking that a "bear market" in the bond market was imminent. Nevertheless, we still believe investors should avoid duration risk in bonds. "Trees don't grow to the sky" and the "bull market" in bonds will end abruptly, it's just the timing we are unsure about. We continue to believe that treasury bonds are extremely unattractive on a risk/reward basis. If one currently owns a 30-year treasury bond yielding 3% and rates rise by just one percentage point to 4%, the bond value will drop by approximately 17%. That is almost six years of interest. On the other hand, rates on the long term treasury would have to drop to 2.2% for you to make 17%. While treasury bonds are considered to be among the safest of investments, we believe investors will be disappointed in returns going forward.

Summary

The macro headwinds that were with us in 2011 appear likely to continue into 2012. The uncertainty in Europe and the emerging markets will lead to continued market volatility in the coming year. In addition, political uncertainty will become an issue that investors will focus on over the next few months. We believe the rotation to high quality, large capitalization stocks is a trend that is in its early stages. Small and mid-cap stocks have been the leaders for the past decade and conditions appear ripe for high quality, large capitalization companies to take over that leadership position. Currently, there is approximately $2.6 trillion in money market funds losing purchasing power. A portion of those dollars will find their way into dividend paying equities in the coming months. Sentiment is extremely negative towards equities, as evidenced by five straight years of redemptions by domestic equity fund holders. Any positive change in the economic backdrop or sentiment could result in a re-allocation towards equities from fixed income investments. We continue to believe the risk/reward for long duration bonds to be unattractive. For that reason, we will continue to emphasize, investment grade short duration securities in client portfolios. We believe our long-term, value oriented approach which considers risk before reward, will serve our clients well over the year to come.

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