

Jolley Asset Management

Investment Outlook

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"The propensity to gamble is always increased by a large prize versus small entry fee, no matter how poor the true odds may be. That's why Las Vegas casinos advertise big jackpots and why state lotteries headline big prizes."

Warren Buffett, Letter to John Dingell (March 82)

spec.u.la.tion-- noun--an act of speculating; as (a): assumption of unusual business risk in hopes of obtaining commensurate gain (b): a transaction involving such speculation.

ca.pit.u.la.tion--noun--the act of surrendering or yielding.

While capitulation (market bottoms) and speculation (market tops) often occur at inflection points in the market; it is quite unusual that we see both occur in the same market simultaneously. However, that is precisely what has happened in our domestic equity market over the past month. In a sense, that should not seem so unusual, since we have really been in an environment with two distinct markets, the "old economy" (NYSE) and the "new economy" (NASDAQ). As we discussed in our last *Investment Outlook*, it has really been a bull market for technology stocks, with the rest of the equity market being left behind in what was essentially a "bear market".

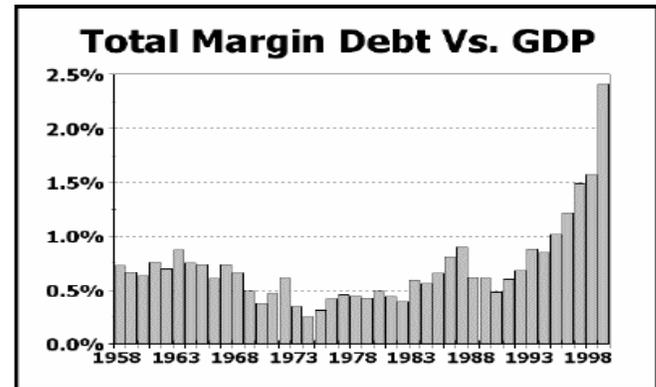
The speculative frenzy in the tech-laden NASDAQ continued in January and February, with fuel being provided by rising margin debt. Since 1994, margin debt has grown roughly in line with market values; however, since October 1999, it has soared by 45%. The rise in borrowings occurred despite continued warnings by Fed Chairman Alan Greenspan and SEC Chairman Arthur Levitt. We have felt for some time that Mr. Greenspan should have raised margin requirements to rein in the speculation, rather than continuing to push interest rates higher. As usual, all manias eventually end, and as of writing this letter we are seeing what could possibly be the

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end to one of the greatest "speculative bubbles" of our lifetimes. On April 4th, the NASDAQ experienced a massive



inter-day decline of some 13.6% (which brought the index down approximately 28% from its March 10, 2000 high); largely driven by panic related margin liquidation. While the damage to the NASDAQ indices appears moderate, many individual securities have plunged.

What triggered the decline is difficult to pinpoint; however it was most likely a combination of events: 1) Clinton comments related to biotechnology patents, 2) Abby Cohen recommending that Goldman Sachs clients reduce their technology sector exposure to a market weighting, 3) Mark Mobius, the legendary emerging markets fund manager for Franklin/Templeton Funds, commenting on the vulnerability of the internet sector, and 4) Peapod, Inc., CDNow, and dr.koop.com, all received qualified opinions from their auditors questioning whether the companies could continue as a going concern due to negative cash flows. (Didn't these companies just go public?). All of these factors, coupled with the sky-high valuation of the NASDAQ, resulted in a panic liquidation by the "new economy" participants. Needless to say, margin calls and waves of forced liquidations contributed to the massive decline.

This past quarter also experienced what I believe was a "capitulation" by several renowned "value investors". George Vanderheiden of Fidelity Investments, Robert Sanborn of the Oakmark Fund, Bill Sams of FPA Paramount, and Julian Robertson of Tiger Management all stepped down as they encountered massive fund outflows from impatient investors. As Julian Robertson of Tiger Management put it, the pundits

have proclaimed "Avoid the Old Economy and invest in the New and forget about price, and in truth, that has been the way to invest over the last eighteen months". Robertson went on to point out that he had great faith that "This too, will pass" and that value investing remains the best course for investors. Perhaps, people should pay a little more attention to someone who generated a compound rate of return of over 25% since 1980. As Russ Kinnel of Morningstar stated, "Investors can now make a pretty compelling argument as contrarians that all of this is a sign to go back to value funds." For the month of March, value equity funds not only decisively beat growth funds, but also trounced technology funds, which were brought down by the correction in the NASDAQ Composite in the last three weeks of March. Morningstar reported that for the month of March, large-cap value funds returned 9.18% versus 3.11% for large-cap growth funds; mid-cap value funds returned 8.99% compared with a loss of 5.54% for mid-cap growth funds; and small-cap value funds returned 2.98%, while the small-cap growth funds tumbled 7.92%. Technology funds for the month of March fell by 6.12%.

Index	1 st Quarter 2000	YTD
DJIA	(-4.66%)	(-4.66%)
S&P 500	2.29%	2.29%
S&P 500 (Eq. Wt/Geometric)	(-3.45%)	(-3.45%)
S&P Mid Cap	12.68%	12.68%
Russell 2000	6.80%	6.80%
Value Line	(-.55%)	(-.55%)

As we have discussed on numerous occasions, the bifurcated market has created some of the best opportunities for value oriented investors in recent years. While the S&P 500 appears relatively expensive on the surface at 24 times forward earnings, the median price/earnings ratio is a more reasonable 13.5 times. According to Elizabeth Mackay at Bear Stearns, this places the median price earnings ratio on the S&P 500 at the bottom of a ten-year range for the first time since 1994. Currently we are finding tremendous value in financials, utilities, consumer staples and energy. While we most definitely are aware that this contrarian approach may not produce quarter to quarter performance, we are actually much more concerned about the intrinsic value inherent in the underlying business of portfolio companies. Our other primary concern is the amount of absolute risk inherent in our client portfolios. That is why we pay attention to price/sales ratios, price/earnings ratios, book value and competitive forces in our analysis. Our investment process includes evaluating not only

the upside potential but the downside risk as well. The biggest issue today is not whether CISCO Systems, Qualcomm, or Yahoo are dominant, well positioned companies with strong management teams. The issue, as we see it, is merely based upon the price one is willing to pay for what could prove to be unsustainable growth. The chart below highlights companies with price/earnings ratios over 100 times trailing earnings and their corresponding growth rates. To determine the future price of these stocks, the

Unsustainable Values?

Large-cap companies with price/earnings ratios over 100

Company	Market Cap *	1999 P/E	Est. Growth	P/E in 5 years	P/E in 10 years
Cisco Systems	\$452	148.4	29.5%	73.9	40.9
AOL/Time Warner	232	217.4	31.5	100.0	51.1
Oracle	211	152.9	24.9	91.3	60.5
Nortel Networks	167	105.6	20.7	74.5	58.4
Sun Microsystems	149	119.0	21.1	82.8	64.0
EMC	130	115.4	31.1	54.0	28.1
JDS Uniphase	99	668.3	44.0	195.5	63.5
Qualcomm	91	166.8	37.3	61.8	25.5
Yahoo!	90	623.2	55.9	122.6	26.8
15 non-tech	2,361	30.4	13.7	23.8	20.3
S&P 500	11,281	28.6	12.5	23.8	21.3

*3/7/00, in billions Source: Bloomberg

assumption is made that investors expect to receive an average return of 15%. If one were to give Oracle (to pick one) the benefit of the doubt and accept that they can grow at 24.9%, for the next ten years, the price/earnings multiple would still be at a hefty 60.5x ten years out. According to Sanford Bernstein, only one company, IBM, has ever grown by more than 20% for fifteen consecutive years. Only time will tell how the list above will fare. One must also question the competitive advantage of many of these companies, as technology is a rapidly changing and evolving industry. What may look today to be an insurmountable technological lead may turn out to be only an illusion.

Adhering to an investment discipline is not always the easiest, or the sexiest course of action. However, in today's environment of media hype and irresponsible financial journalism; discipline is not only difficult, but often made out to be old-fashioned. The fact that individuals have been selling stocks from the S&P 500 at 28x trailing earnings to buy stocks in the NASDAQ with a price/earnings ratio of over 200 times, indicates a willingness to assume greater risk to reap possible huge gains. We are simply unwilling to risk our clients' capital just because some CNBC anchor, turned celebrity, is making what could turn out to be ill timed or misinformed comments. Value has already seen its own "bear market" and capitulation phase; the speculative bubble in the NASDAQ has now been pricked. While we are unwilling to rule out one last gasp of speculative fever, we do believe the odds have now shifted dramatically to the value camp. Nothing would suit us better than a "rational" investment climate where earnings and dividends matter again.

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