JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 26• Fall 2004**

> *"We shouldn't elect a President; we should elect a magician."*
> *Will Rogers*

The rally that started in mid-August failed in the third quarter of 2004 as stocks simply faced too many headwinds. Investors were mesmerized by concerns about skyrocketing oil prices, geopolitics, earnings and the upcoming election. As the chart below shows, equities were led lower by the tech heavy NASDAQ composite which declined by 7.37% for the quarter and is down by 5.32% for the year to date. The S&P 500 index has fared somewhat better, with a quarterly decline of 1.87% and a positive 1.51% return for the nine months just ended. The average equity mutual fund fell by 2.76% for the quarter according to Lipper Analytical. Value outperformed growth for the quarter largely due to strong performance of the energy and utility sectors. Growth was hit hard by the weakness in the technology and consumer staples sector.

Index	3rd Qtr 2004	9 mos. ended 9/30/04
DJIA	-2.90%	-2.06%
S&P 500	-1.87%	1.55%
S&P Mid Cap	-2.11%	3.84%
Russell 1000/Growth	-5.23%	-2.63%
Russell 1000/Value	1.54%	5.54%
Russell 2000	-3.14%	2.88%
NASDAQ Comp.	-7.37%	-5.32%

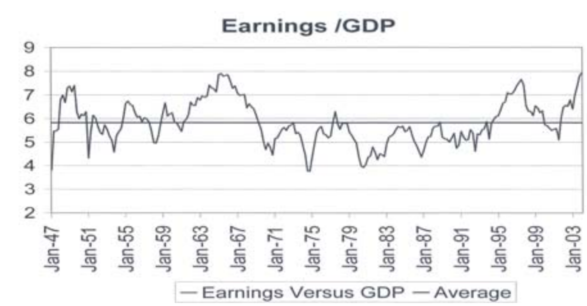
As we head into the final quarter of 2004, perhaps we should examine some of the issues, both positive and negative that are likely to impact equity prices.

Positives

- Generally speaking the economy is healthy. Global economic growth is expected to come in at a thirty year high in 2004. Productivity growth remains encouraging.
- Corporate earnings have surged and as a result, cash on corporate balance sheets is extremely high. In fact, for the S&P 500 companies, it is roughly double the level of some five years ago. This should bode well for both employment and capital spending. The strong balance sheets also allow corporations flexibility with regard to acquisitions, stock buybacks and increased dividend payouts.
- Valuations are much improved as earnings have accelerated while stocks are essentially unchanged for the year. The 12 month forward price/earnings ratio for the S&P 500 currently stands at 16 times, the lowest level in over seven years.

Negatives

- The economy has improved but continues to have structural problems. The Federal Reserve is walking a tight rope between inflation and deflation. Continued easy monetary policy could ignite inflation, resulting in higher interest rates, possibly leading to a sharp slowdown in consumption. Household debt levels are high and any significant rise in interest rates could result in severe problems for household finances.
- The current account/trade deficit remains huge at around 5% of GDP and nearing $600 billion. Asian central banks cannot support the dollar forever. The growing budget deficit is also a longer term challenge.
- Price/Earnings multiples appear low when compared with the latter half of the 1990's, but they are relatively high from a historical point of view. Furthermore, earnings growth is above its long term trendline and corporate profit margins are at record highs. (see chart below). This would imply a likely deceleration in earnings growth going forward.
- The sharp rise in oil prices is equivalent to a tax on consumers. Higher global demand (China) and the geopolitical risk premium are largely responsible for the recent spike in prices. While difficult to predict, it is unlikely that energy prices will return to the levels of the last decade.
- Terrorism is an ongoing risk that won't go away soon. The costs of our involvement in Iraq and Afghanistan are adding significantly to the federal budget deficit.



Source: Prudential Financial

When weighing the evidence above, we believe the most likely result will be a range bound market through year end. Stocks certainly face increasing head-winds; however, the alternatives available to investors offer little in the way of competitive returns. Investors will continue to focus on the upcoming elections and the consequences of a Bush or Kerry administration. On a positive note, at least we will have clarity on the issue in the next month.

Bush vs. Kerry / Investment Implications

As you know investor focus is presently on the elections, which is viewed as having significant economic consequences for America and quite possibly the world. Michael Metz, Chief Investment Strategist at Oppenheimer & Company recently stated in a strategy report that "…critical investment implications will stem from the response of the next administration to the domestic challenges from the rising burden of entitlements, under funded retirement programs, the skyrocketing costs of healthcare, rising deficits and an expanding imbalance of trade, as well as from a possible economic slowdown". He further points out that we are likely to be facing a deceleration of growth in 2005. Metz points out that most of the major stimuli that benefited the economy over the past couple of years will be absent—tax cuts, a surge in deficit spending and defense outlays, and mortgage refinancing. What measures will be taken if the economy does falter? The report points out that the Bush administration is committed to making the tax cuts permanent. Targeted tax increases are likely and could take the form of a value added or flat tax. This could have negative implications for spending, especially among lower income groups. On the other hand, Metz believes that a Kerry administration, would likely propose measures to stimulate employment or subsidize low wage earners and bolster unemployment benefits, with positive implications for the marginal consumer. Corporations would be the likely place to look for increased revenues, which now are experiencing sharply reduced effective tax rates. A Republican administration could implement changes that would eliminate many widely used tax shelters and encourage a repatriation of accumulated foreign profits. To counter any negative economic impact, the favorable tax laws for treatment of capital outlays, could be extended. A Democratic administration is likely to be less accommodating and impose a larger burden directly on corporations.

Value Investing

As you know we consider ourselves to be value investors and operate under the belief that he who makes the least big mistakes will likely come out the investment winner over time. Believe me; not making any mistakes in investing is impossible. That being said, it is our goal to minimize large mistakes in our client portfolios. That is why we prefer companies with lower risk profiles, even if it may result in not hitting the next "home run" on the upside. While this is easy to talk about and preach, in reality it is very difficult to implement. Just this year, investors have seen blow-ups in stocks that were typically considered to be "defensive, safe-havens" such as Colgate, Coca-Cola, Merck, Unilever and Fannie Mae. These are all wonderful non-cyclical companies with tremendous barriers to entry. However, the investment landscape is full of examples of once popular stocks considered "safe enough for widows and orphans" that have declined precipitously over longer periods of time. AT&T and Eastman Kodak are two examples of companies whose fortunes have been dramatically impacted by rapid technological change. It should be pointed out that not all "fallen angels" will continue their downward spiral. Companies many times can adapt and breathe new life into their declining businesses, such as Eastman Kodak is attempting to do with its transformation to a digital world. From a "value investor's view what we are largely attempting to do is to identify which companies represent "value" and which are "value-traps".

Value or Value Traps

Values can occur in the equity markets in all shapes and sizes. Some examples include:

1) Broken growth companies—growth companies that have undergone a period of slow or no growth that are believed to be transitory in nature.
2) Maturing growth companies—growth has permanently slowed and management must adjust the business model to remain a successful investment going forward.
3) Companies whose prospects are in decline, but management adopts an appropriate business model.
4) Companies that are in decline, but management is in denial and adopts value destroying strategies.

Quite satisfactory returns can come from the first three examples above, provided that a proper price is paid for the underlying equity. However, avoiding stocks in the fourth category is one of the biggest challenges facing value investors. These are often referred to as "value traps". On the last day of the quarter, Merck, surprised the world by announcing that they were pulling Vioxx from the market in light of studies showing cardiovascular side effects. Merck was one of our holdings—undoubtedly the growth at Merck had slowed in recent years, but they remained a triple A rated company, with a below market price/earnings multiple and above average dividend yield. Prior to the Vioxx announcement, we would have categorized Merck as a maturing growth company—growth had slowed, but we felt over time, the highly regarded research labs at Merck would ultimately rebuild the drug pipeline. Now Merck faces not only the loss of product revenue, but they also face litigation risk, which at this time is not quantifiable. Is Merck a value, or a value trap? We are currently reviewing the prospects of Merck and the potential risk due to increased litigation. Our decision to hold or sell will be based upon our conclusion. Perhaps the best lesson to learn from the Merck experience is that in equity investing we must be prepared to expect the unexpected. Diversification by sector, industry and company are imperative for risk control. For the diversified portfolio, Merck was just a hiccup, not a heart attack. That is precisely why we always stress the importance of a diversified portfolio for clients.

Frank G. Jolley, CFA

JAM JOLLEY ASSET MANAGEMENT, LLC

111 Candlewood Road, Suite B
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