JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook Volume 1, Issue 49• Fall 2010

"Having great clients is the real key to investment success. It is probably more important than any other factor in enabling a manager to take a long-term time frame when the world is putting so much pressure on short term results."

Seth A. Klarman
Presdent—Baupost Group

As we entered the third quarter, market participants had plenty to worry about. A lackluster economic backdrop and political uncertainty were just a couple of the problems facing investors this summer. Stocks surprised everyone by staging a strong rally for the quarter with the S&P 500 advancing by 11.30%. Most of the rally came in the month of September as the S&P returned 8.8%, its best September since 1939. For the quarter, growth strategies trumped value strategies as evidenced by the 13.0% return for the Russell 1000 Growth index versus a return of 10.1% for the Russell 1000 Value index. Stocks with high dividend yield (top 100 ranked by yield in the S&P 500) were market leaders and returned approximately 4% more than the S&P 500 for the quarter. This new leadership by high quality dividend paying stocks is a healthy trend that we expect to continue as yield starved investors seek alternatives to certificates of deposit and "safe haven" treasury issues.

Index	3rd Quarter 2010	YTD 9 mos.
DJIA	11.18%	5.58%
S&P 500	11.30%	3.89%
S&P Mid Cap	13.12%	11.57%
Russell 1000/Growth	13.00%	4.36%
Russell 1000/Value	10.13%	4.49%
Russell 2000	11.29%	9.12%
NASDAQ Comp.	12.30%	4.38%

Many strategists believe the catalyst for the rally was the fact that corporations are flush with cash. The most recent data available showed the industrial companies in the S&P 500 with a record $843 billion in cash up from $773 billion a year earlier. The recent level of cash was equal to 11.6% of stock market value, nearly double the average levels for 1980 through 2007. This is good news because eventually companies will have to do something with all that cash. Dividend payouts have begun to recover slowly as have stock buybacks. Currently, more U. S. stocks are paying dividends that exceed bond yields than at any time in the past fifteen years. The strong balance sheets have also led to increased merger and acquisition activity. In the first nine months of 2010, deals valued at approximately $759 billion were announced, up from $556 billion in 2009.

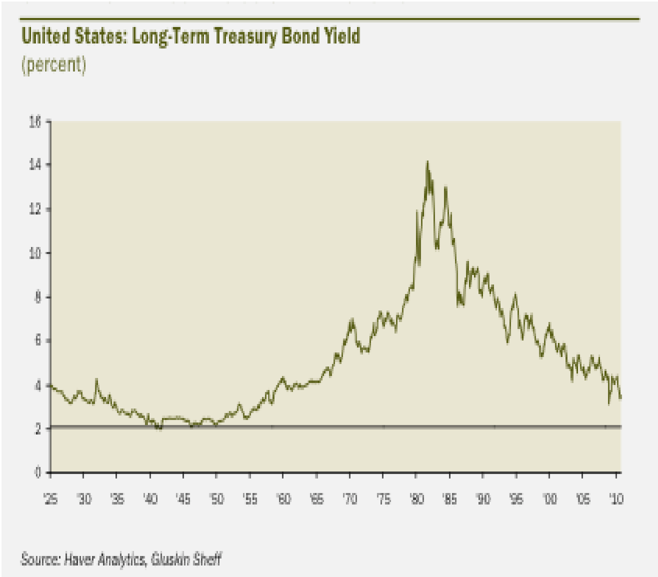
Crowd Mentality?

The recently ended quarter seems to back up our often stated claim that "market-timing is a futile exercise". Investors that followed the crowd and sold as the market approached the lower end of its trading range have missed a massive rally. It is probably an understatement that investors have become disenchanted with the market over the past decade. A recent report from TrimTabs Investment Research suggests that around half of all investors in equity funds have lost at least 25% over the past ten years. Many of these investors continue to leave the market as evidenced by the fact that they have pulled approximately $43 billion from equity funds during the past quarter. Ironically, bond mutual funds took in a record $87 billion in the quarter according to the Investment Company Institute. This brings the total net new investments in bond funds since the beginning of 2009 to $620 billion. Vincent Deluard recently stated, "It was a lot easier (for retail investors) to buy stocks in the late '90's, when stocks were going up and houses were going up, than it is for them to buy stocks now, when they're much cheaper." Those who are now rushing into bonds and bond funds are courting with disaster. According to the Wall Street Journal, the last time interest rates on Treasury bonds were as low as they are today was in 1955. The subsequent 10 year annual return to bonds was 1.9% or just above the inflation rate. The possibility of substantial capital losses on bonds looms large. Jeremy Siegel, professor of finance at the Wharton School recently pointed out the following:

Interest rates do not have to rise much for Treasury bond investors to realize substantial losses. If, over the next year, interest rates on the 10-year Treasury rise to a level reached last April of 3.99%, the return on the bond is negative 9% (including interest paid). If rates rise to 5.30%, the level reached before the financial crisis, the loss will double to 18%. If the 10-year interest rate rises to the record postwar level of 15.84%, the loss will be 73%, far worse than any bear market in stocks (including the last one) since the Great Depression. All these are computed from the 2.47% rate reached by the 10-year Treasury on August 31.

If the 30-year treasury yield, which ended August at 3.52%, returns to its April high, bondholders will suffer a loss of 17%. If yields reach the average *level it has been over the past 30 years of 7.3%, the bondholder will experience a price a decline of 50%, equal in magnitude to the worst bear markets in stocks in the past 50 years.*

While bonds will likely rally further based on the Federal Reserve's "quantitative easing moves", the bond bull market is clearly getting "long in the tooth". On October 5th, Warren Buffett stated, "It's quite clear that stocks are cheaper than bonds, I can't imagine anyone having bonds in their portfolio when they can own equities." The retail investor is selling stocks and buying bond funds. After a 28 year old bull market in bonds, perhaps investors might be a little late to the party.



Quantitative Easing (QE2)

Quantitative easing or (QE2) is all the talk these days. The purpose of quantitative easing is for the Federal Reserve to buy government debt in order to bring down yields and in turn bring borrowing costs down. While the effectiveness of the first round of quantitative easing is somewhat in question, QE2 is essentially "Bernanke's put". Any economic weakness or negative financial developments will be met with QE2, which will according to Brian Sack, a senior official at the New York Fed, "…can still lower longer-term borrowing costs for many households and businesses, and it adds to household wealth by keeping asset prices higher than they otherwise would be". David Rosenberg of Gluskin Sheff recently responded:

"Imagine running a policy aimed at getting people to spend money based on an artificial level of asset values—what an admission. Then again that is what the Fed has been all about since the LTCM bailout of 1998. We're still not convinced after reading this sermon that this next pull another rabbit out of the hat experiment is going to end with very much success." Rosenberg goes on to say that there is something to be said for "paying for our mistakes" and calls the Fed "irresponsible at best, dangerous at worst."

Marc Faber, publisher of the Gloom, Boom and Doom Report, recently said, "the *Bernanke put* is cut from the same cloth as the fabled *Greenspan put*—only the strike price is different."

While we also have philosophical problems with the "quantitative easing" where the Fed is essentially targeting higher asset values (including equities), we have no doubt that their policies can be at least somewhat effective over the short term. Essentially, the Fed is forcing people's hands—moving them from low yielding money funds and certificates of deposit into equities and lower rated fixed income instruments. For years, the "Greenspan put" worked like a charm in stabilizing (manipulating) the financial markets, in fact, so well that market participants referred to him as the "Maestro". Easy money policies from the Federal Reserve essentially got us into the predicament we are currently in; attempting to solve the problems by doing more of the same will likely prove to be unsuccessful. Europe's austerity measures, while painful in the short term, might prove to be more effective in the long run.

Our investment strategy should not be based on whether we agree politically and/or philosophically with what the administration/federal reserve/government is doing. As a portfolio manager, our job is to look at the various asset classes (and securities) in an attempt to determine which are most attractive from a risk versus reward scenario. Despite the broad based rally in the most recent quarter, stocks still appear to be the most logical choice over the near term. Either the economy improves, which would be positive for corporate earnings and stock prices, or the Fed implements QE2, which would result in lower interest rates and buoy asset values. We do know that in this scenario, the likely result that will ultimately play out will be higher inflation which will be devastating for longer term bonds. While bonds still make sense when trying to minimize the risk of a portfolio, we are staying in short duration bonds and trying not to reach for yield. Equities on the other hand, seem historically cheap when compared with bonds. Currently, more U. S. stocks are paying dividends that exceed bond yields than any time in the last fifteen years. One way to compare stocks and bonds is to compare the bond yield with the "earnings yield" of a company and/or index. The earnings yield is nothing more than the reciprocal of the price/earnings ratio. So the S&P 500 with a price earnings ratio of approximately 13 times has an earnings yield of 7.6%. When compared with the current yield on the 10-year treasury of 2.39%, stocks appear cheap. According to Jason Trennert, chief investment strategist at Strategas Research, the gap between the "earnings yield" and the 10-year treasury yield is the widest it has been in about 30 years. The cash buildup which has occurred within corporate America over the past few years will likely result in increased dividends, accelerating stock repurchases and potential for merger and acquisition activity. Large multinational companies have prospered despite a "slow growth" environment over the past few years. In addition, most of the large multinationals have exceptional growth potential in the developing economies which are experiencing higher growth rates than the U. S. Currently, most individual investors are either pessimistic or indifferent with regards to the stock market. Large cap stocks have just completed their worst 10 year stretch ever, while bonds have been in a 28 year bull market. In our opinion, the odds favor stocks going forward. Like Wayne Gretzky stated, "I skate to where the puck is going to be, not where it has been."

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