JOLLEY ASSET MANAGEMENT, LLC

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> *"What the hell do I care if somebody else makes money faster? There is always going to be somebody who's making money faster, running the mile faster or what have you. So in a human sense, once you get something that works fine for you in your life, the idea of caring terribly that somebody else is making money faster strikes me as insane."*
>
> *Charles Munger—May 7, 2003*

In the first quarter of 2004, the markets continued their winning ways in January and February, before a correction took hold in March. While the month of March ended with a rally that brought the smaller cap indexes into the black, the larger capitalization benchmarks remained in negative territory for the month. As can be seen in the chart below, the quarter was somewhat of a mixed bag, with small and mid-cap indexes posting nice advances, while the Dow Jones Industrial Average (-.43%) and the NASDAQ Composite (-.46%) actually finished negative for the quarter. The S&P 500 trailed the small and mid-cap indexes, but managed to generate a respectable return of 1.69%

Index	1st Qtr 2004	3 Yrs Ended 3/31/04*
DJIA	**-.43%**	**3.77%**
S&P 500	**1.69%**	**.63%**
S&P Mid Cap	**5.06%**	**10.72%**
Russell 1000/Growth	**.79%**	**-1.74%**
Russell 1000/Value	**3.03%**	**4.31%**
Russell 2000	**6.00%**	**10.90%**
NASDAQ Comp.	**-.46%**	**2.71%**

***Note: 3 yr numbers represent annualized returns**

The three year numbers in the chart above show a very distinct difference between the returns achieved in small (Russell 2000) and mid-cap (S&P Mid-Cap) stocks versus the large capitalization indexes (DJIA and S&P 500). On an annualized basis, the small and mid-cap indexes have returned well over 10%, while the S&P 500 has barely managed a gain. What has caused this aberration? It is our belief that this has occurred due to the massive over-valuation that occurred in the late 90's in the large mega-cap names. On countless occasions we reminded our clients of the increasing risk in the S&P 500 index due to the infatuation with indexing and "closet indexing". In fact in our "*Investment Outlook--Spring 1999*" (five years ago) we made the following statements and observations:

> Excerpts from our Investment Outlook—Spring 1999
> (Five Years Ago)
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> "The S&P 500 is no longer a broadly diversified index, but rather one that is concentrated very heavily in a few large companies." We pointed out that "the valuations of many of these companies have escalated to a level that I feel uncomfortable with." We further stated, "That since 1990, the S&P 500 index has seen market prices rise by some 17.9% annually, while earnings per share and book value have compounded at rates of 7.3% and 2.6% respectively." In addition we noted that "The nifty-five, which is comprised of Microsoft, General-Electric, Wal-Mart, Merck and Intel, currently have an average price/earnings ratio (trailing 12 months) of over 47 times earnings." We summarized that, "many of these companies' stock prices have outpaced increases in their underlying corporate values." So while five years ago we thought many of the popular large cap names were over-priced, we pointed out that the Value Line index (equally weighted index comprised of 1700 companies) "was trading with a median price/earnings ratio of 16.5 times versus 32.5 times for the S&P 500 index." Our conclusion was that, "What is most ironic is that despite these warnings about the mega-cap stocks and the quality of corporate earnings, there are countless opportunities in common stocks today. Many small and mid-capitalization stocks are trading at very attractive valuation levels."
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> *Please note: All of our prior "Investment Outlooks" are available for viewing at our website: www.jolleyasset.com*

As we all know, things are always easier to look at in a rear-view mirror, but we must always remind ourselves that financial markets are forward looking. Our multi-cap style allows us to invest across the market capitalization spectrum. We simply want to invest in the areas that offer the best risk/reward tradeoff for our clients. Five years ago, when we found the large cap sector to be relatively over-valued, we migrated down in size to find value. Ironically, today the pendulum has swung in the opposite direction, with the most attractive ideas appearing in the large cap arena. Table 2 below provides some basis, that in fact, large cap equities are now (as a whole) cheaper than the small and mid-cap indexes.

Table 2

Index	Price/Earnings Ratio (trailing)	Dividend Yield
S&P 500	**23.5x**	**1.65%**
S&P Mid Cap	**24.1x**	**1.07%**
Russell 2000	**58.7x**	**1.00%**

It is ironic that currently two of our largest holdings are Microsoft and Merck (see box above), which five years ago we believed to be extremely unattractive from an investment point of view. We have frequently said, a great company does not always make a great investment. Microsoft and Merck have always been admired as well run companies, but what makes them attractive from an investment perspective today? What has changed from five years ago? Currently Microsoft trades at 21 times (quite a bit lower if you strip out the $52 billion in cash they currently have on hand) forward earnings and Merck at 14 times forward earnings. In 1999, Microsoft and Merck traded at peak price/earnings ratios of 84x and 36x respectively. Well just what has caused this multiple contraction to take place? Table 3 below summarizes what has happened with both company's earnings and dividends since 1999.

Table 3

	1999	2000	2001	2002	2003	2004E
Merck EPS	$2.45	$2.90	$3.14	$3.14	$2.92	$3.13
Merck Div/Share	$1.10	$1.26	$1.38	$1.42	$1.46	$1.49
Microsoft EPS	$.71	$.85	$.69	$.71	$.92	$1.18
Microsoft Div/Share	0	0	0	0	$.08	$.16

While we would be the first to point out that the above numbers have slowed from previous time periods, they do show respectable progress nonetheless. (It should be pointed out that Merck distributed shares in Medco Health Solutions in 2003 as a tax-free spin-off). While both companies have grown in terms of higher earnings and dividends over the last five years, the stock prices have declined dramatically. Merck peaked in December of 2000 at a price of $86.35 versus the March 31, 2004 close of $44.19. So while Merck's earnings and dividends have increased, it share price has tumbled by roughly 49%. In the case of Microsoft, it shares peaked in December of 1999 at $59.19; as of March 31, 2004 they closed at $24.93, down close to 58% from their all-time high. Just like Merck, Microsoft's price has declined despite higher earnings and implementation of a cash dividend. Essentially, five years ago, we thought the market was paying too dear a price for these two companies, and now we think the market is not paying enough. Furthermore, both have outstanding balance sheets and spend large sums of money on research and development.

Going back to table 2 on the front page, it could be easy to conclude that domestic stocks (of all market capitalization ranges) are not cheap statistically. This has made our job more difficult, especially in light of the fact that our default position is typically a money market fund or short-term fixed-income instrument with little or no yield. We have been searching for ideas that meet our investment criteria, with little luck as of late. As you are likely aware, we always pay attention to Warren Buffett, the Chairman of Berkshire Hathaway. It is worth pointing out that as of 12/31/03, Mr. Buffett was sitting on roughly $31 billion in cash and equivalents. Buffett thought equities were too expensive in early 2003, when the indexes were far lower than they are today. While we are not market timers, we do find ourselves moving more cautiously than usual due to the valuation levels. However, opportunities do exist. The economic cycle is relatively early, which suggests that economic growth is likely to continue several years before another recession. Though the early-cycle gains for stocks have already been strong, normally at this stage of the cycle equities would still have several more years of out-performance compared to defensive investments. Fiscal stimulus remains strong, further supporting this expectation. The message we would like for you to take away is this: while stocks are not over-priced (especially in light of improving earnings and current levels of interest rates), there is not much margin of safety and the nominal returns we expect don't motivate us to take on above average risk. The environment we describe is essentially the same one we described last quarter, the economy continues to improve, but the market has largely discounted that fact.

Inflation possibly looms as one of the greatest risks down the road. The substantial monetary stimulus provided by the Fed for some time now raises the risk of inflation in the coming years. China's booming economy is another factor that adds to that risk. Outside of commodity price inflation, inflation appears to be muted at the present. However, if the economy continues to improve, it is possible that inflation could move significantly higher in the coming years. This would have negative implications for both the equity (multiple contraction) and fixed income markets (higher rates = lower bond prices). While inflationary pressures do appear to be mounting, no major inflationary up-tick seems imminent.

Fixed Income

Domestic bonds defied the experts in the first quarter by advancing in the wake of strong economic growth. For the quarter ended March 31, 2004, bonds as measured by the Lehman Intermediate Government Corporate Index returned 1.74% for the quarter, essentially matching the return on the S&P 500 index. The strength in bonds was largely the result of the economy's inability to create jobs thus far in the recovery. However, the surprise 308,000 surge in U. S. non-farm payrolls in the March employment report (released on April 2, 2004) once again threw hot water on the bond bulls. The payroll report caused many to believe that the Federal Reserve board could raise rates by a quarter of a percentage point by August. Fed officials have insisted they are in no hurry to tighten monetary policy. Our posture with regards to fixed income markets has been to maintain a defensive posture with exposure to short duration treasury, corporate and municipal issues. Additionally, we have initiated positions in Treasury Inflation Protected Securities (TIPS) in portfolios where deemed appropriate.

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