JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook Volume 1, Issue 51• Spring 2011

"Investment success also requires remembering that securities prices are not blips on a Bloomberg terminal but are fractional interests in - or claims on - companies. Business fundamentals, not price quotations, convey useful information. With so many market participants fixated on short-term investment performance, successful investing requires a focus not on how one is doing, but on corporate balance sheets and income and cash flow statements."

Seth Klarman—2010 Baupost Letter

The markets overcame a pair of major shocks in the first quarter as investors instead focused their attention on the strengthening U. S. economy. The S&P 500 returned 5.9% in the first quarter, its best first quarter since 1998. The market's strength is particularly impressive when one considers the March 11th earthquake and tsunami in Japan, bringing the world's third largest economy to a virtual standstill. In addition, Portugal now appears to be in need of a "bailout" and tensions continue to grow in the Mideast, resulting in oil spiking by some 16.8% in the first quarter.

Index	1st Quarter 2011	Trailing 12 months
DJIA	7.11%	16.52%
S&P 500	5.92%	15.65%
S&P Mid Cap	9.36%	26.95%
Russell 1000/Growth	6.03%	18.26%
Russell 1000/Value	6.46%	15.15%
Russell 2000	7.94%	25.79%
NASDAQ Comp.	4.83%	15.98%

The small and mid cap stocks were the standouts for the quarter and the past twelve months, as investors (or should I say traders) continued to chase performance as they have done since the market bottomed in 2008. Recently, the problems in Japan have been seen by some as a positive for the small caps, which have more domestic exposure relative to the multinationals that dominate the large cap sector. There was little difference between "growth" and "value" styles for the quarter, but "growth" has clearly been the standout over the past twelve months. Despite reasonable valuations and cash rich balance sheets, the tech heavy NASDAQ has been a market laggard over the past quarter and year.

Are There Any Long Term Investors Left?

Ever since the Bernanke speech in Jackson Hole at the end of last August where the Fed laid out plans for QE2, the risk trade has been on in full force. After all, Bernanke, unlike previous Fed Chairmen, actually encouraged speculation by making comments about targeting higher asset prices. While I'm sure equity prices were targeted by other Fed officials, it was generally understood that it would not be appropriate to mention such in public speeches. After all, the Federal Reserve's mandate has been to maximize employment and maintain price stability, not to target asset prices. In January of this year, Chairman Bernanke, when asked about the success of QE2 stated, "Our policies have contributed to a stronger stock market, just as they did in March of 2009, when we did the last iteration. The S&P 500 is up 20% plus and the Russell 2000 is up 30% plus."

Index	Return since 8/27/10*
S&P 500 Index	25.1%
Dow Jones Industrials	21.9%
Russell Top 50 (XLG)	21.1%
S&P Mid Cap	35.7%
Russell 2000	37.3%

price only thru 4/1/11 (does not include dividends)

As the chart above shows, since Bernanke outlined his plan for continued asset purchases (QE2), small cap stocks have surged by some 37.3% versus 25.1% for the S&P 500 and 21.1% for the fifty largest companies (XLG). Investors (traders) chased stocks with high volatility, beta and leverage, while high quality companies with strong fundamentals and good valuations were left behind. As Jeremy Grantham of GMO stated in his January letter:

"Bernanke's party plans could not have been more transparent. Lower rates. Make cash unpalatable. Drive investors to speculative, risky assets, no matter what the valuation. Reflate assets to make investors feel wealthier. All done in order to get the real economy going again."

Small caps appear rich to us at over 21 times forward earnings versus around 14 times forward earnings for the S&P 500 index. Other than chasing beta (Russell 2000 beta approximately 1.2 times), we don't see the attraction. The larger capitalization companies have better balance sheets, better global growth prospects and better dividend yields. However, we must understand that much of what is going on today is about speculation and trading rather than investing which is based on fundamental analysis. Speculative trading is also being fueled by surging levels of margin debt, which currently is approximately $350 billion or 2.2% of total stock market capitalization. This is one of the highest percentages on record.

The "*Buttonwood Column*" which appears in "*The Economist*" magazine recently wrote that in periods of excess liquidity investors tend to overpay for certain assets. They compare investors to those who like to bet on a horse race like the Kentucky Derby, they tend to favor 100 to 1 outsiders. The article states that "their motivation may be the desire for a big win to justify the act of gambling at all".

Apparently, investors are hoping for "more bang for the buck" just as people buy more lottery tickets when the payout is known to be large. "A related tendency is for investors to overpay for shares in fast-growing companies, wrongly assuming that such growth rates can be maintained over the long term. Everyone wants to find the next Apple." As Seth Klarman of Baupost Group recently stated in his 2010 year end letter to his investors:

> ***"Every security or asset is a buy at one price, a hold at a higher price and a sell at some higher price. Yet most investors in all asset classes love simplicity, rosy outlooks, and the prospect for smooth sailing. They prefer what is performing well to what has recently lagged, often regardless of price."***

On a recent *Mad Money* show, Jim Cramer explained in rationalizing the purchases of momentum names such as Netflix and Chipotle Mexican Grill, "You see, you aren't really buying stocks of companies when you buy these momentum names, you are simply anticipating what the hedge funds and mutual funds with their big guns crave. That's what matters." Call it musical chairs, the greater fool theory, whatever. Speculation is back, momentum is all the rage and somebody will be left holding the bag.

Bifurcated Markets

Eleven years ago in our *Investment Outlook—Spring 2000*, we talked about a bifurcated market. Technology stocks were priced at sky high multiples and the S&P 500 traded at 28 times earnings, while the mid and smaller cap indexes were valued at very attractive levels. Today, we are essentially looking at the opposite scenario, where large capitalization companies are attractively valued at around 14 times earnings while many growth companies have sky high valuations. The common characteristic in the two instances is that in both cases the Fed had provided excess liquidity for long periods of time. In 2000, the reason for the easy money policy was the fear of Y2K disruptions. The "quantitative easing" the Fed is now employing is an attempt to jump start the economy despite many structural imbalances. Both instances created excess liquidity which is, once again, finding itself in the financial markets and inflating a subset of the market.

Just like the 1999-2000 period, the bifurcated markets we are seeing is not one that should be feared, but one that a disciplined value investor can take advantage of. Many of the finest companies in the world are selling with valuations that offer investors a "margin of safety". The fact that market participants are ignoring this and chasing momentum names at any price is giving long term investors an excellent opportunity to snap up global franchises at reasonable prices. Johnson & Johnson, Microsoft, Cisco Systems, J P Morgan, Wal-Mart Stores and General Electric are some of the best companies in the world, yet presently nobody cares. People would rather watch *Fast Money* and *Mad Money* and get the trade of the day. James Montier of GMO recently wrote a research report entitled, "The Seven Immutable Laws of Investing". In that report, he addressed the risks of investing without a "margin of safety". He referenced an article in Fortune Magazine put together in August 2000 called, "*Ten Stocks to Last the Decade*". If one had invested $100 in an equally weighted portfolio of these overpriced growth stocks ten years later you would only have $30 left. That is what value investors consider to be a permanent loss of capital.

Montier's set of principles are worth repeating and are largely based on Benjamin Graham's writings who was generally considered to be "the father of value investing". They are as follows:

- Always invest with a margin of safety
- This time is never different
- Be patient and wait for a fat pitch
- Be contrarian
- Risk is the permanent loss of capital, never a number
- Be leery of leverage
- Never invest in something you don't understand

As a disciplined value investor, we will continue to focus on risk versus reward. Our analysis will consider balance sheet strength as well as a company's earnings and cash flow history. It is our belief that high quality large capitalization stocks represent the last truly cheap asset class. In many cases, the yield on these companies exceeds the yields on bonds or certificates of deposit by a wide margin. The zero interest rate policy by the Federal Reserve has resulted in what we believe to be mispriced values for many different asset classes. Speculative investment activities have moved front and center as traders find comfort in the "Bernanke put" and bailout mentality. Momentum strategies always work until they don't work. Most momentum investors believe they will be able to beat others to the exit doors when market conditions become less favorable. The current "quantitative easing" will end on June 30th. Will the Fed move to QE3? Will interest rates begin to rise if the Fed no longer is supporting the bond market? Will inflation begin to rise to a level above which the financial markets find acceptable? How will the consumer react to even higher oil prices? How will the economy be impacted by the massive global debt crisis? Investing with a "margin of safety" will be imperative to prevent a permanent loss of capital as investors face a number of macro-economic headwinds going forward. This is a time to remain invested, but as always remain disciplined and focused. In our opinion, this is not the time to be playing "musical chairs".

Frank G. Jolley, CFA

JAM JOLLEY ASSET MANAGEMENT, LLC

210 Bryant Street, Suite A
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