JOLLEY ASSET MANAGEMENT, LLC

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> *"Not only is the strategic case for small cap investing highly dubious, the tactical case is truly appalling. Currently in both Europe and the US, small caps trade at a substantial premium to large caps—the liquidity premium is negative. Investors are paying for the pleasure of holding illiquid stocks! This makes no sense to us. To believe in a negative liquidity premium you must believe small caps are less risky, less cyclical, and less idiosyncratically exposed than large caps!"*
>
> *James Montier*
> *Dresdner Kleinwort*

After a lackluster first quarter, stocks around the world surged in the second quarter. Domestically, bigger was better, with larger companies delivering the highest returns, followed by mid-caps and then small-caps. Growth styles outperformed value styles for the quarter as evidenced by the 6.86% return for the Russell 1000 Growth index versus 4.93% for the Russell 1000 value index. For the past year or so, we have repeatedly stressed that large capitalization stocks were attractively priced after years of stagnation. Finally, the markets seemed to agree with us on that point. For the twelve months ended June 30, 2007, the Dow Jones Industrial Average (up 23.01%) and the S&P 500 index (up 20.56%) outpaced the S&P Mid Cap index (up 18.51%) and the Russell 2000 index (up 16.43%).

Index	2nd Quarter 2007	2007 YTD
DJIA	**9.03%**	**8.82%**
S&P 500	**6.24%**	**6.99%**
S&P Mid Cap	**5.84%**	**11.98%**
Russell 1000/Growth	**6.86%**	**8.13%**
Russell 1000/Value	**4.93%**	**6.23%**
Russell 2000	**4.42%**	**6.45%**
NASDAQ Comp.	**7.50%**	**7.78%**

As shown in Table 2, for the seven years ended December 31, 2006, large-cap stocks (S&P500) had a 1.10% annualized return versus 7.91% for small-cap stocks (Russell 2000) and 10.08% return for mid-cap stocks (S&P 400). The sizeable performance discrepancy leaves large capitalization stocks bargain priced when compared to small and mid-cap issues. In addition, stocks of larger companies tend to do better when the dollar is weak (their foreign earnings are worth more converted back to dollars and US exports become more competitive), which is partly why the mega-caps are now experiencing stronger earnings growth than smaller companies. In an investment world that does not feature any major asset classes selling at bargain prices, high quality, large cap equities appear to be the only game in town. When Charles Royce, manager of the Royce Value Trust, (Royce Value Trust is the oldest and largest small-cap closed end fund) speaks about small-caps it pays to listen. In his April 30, 2007 letter to shareholders Mr. Royce stated:

> *"The fact that so many otherwise sensible people now appear to think that a small-cap downdraft is unlikely only serves to underscore our confidence that it will occur. Whenever premises are invented, with seemingly irrefutable logic, to determine why a style or asset class is playing by different rules, it's a sign of danger. We were on the other side of this in the late 90's, when first large-cap and then Internet stocks were thought by some to be capable of perpetually positive results. We remain old fashioned in that we still believe in reversion to the mean and the mortality of any market cycle. We do not know what will trigger it, and we do not know when, but we are confident it will happen."*

Table 2—Equity Returns 12/31/99-12/31/06

Index	Cumulative	Annualized
S&P 500	7.98%	1.10%
S&P 400 (Mid Cap)	95.86%	10.08%
Russell 2000 (Small Cap)	70.42%	7.91%

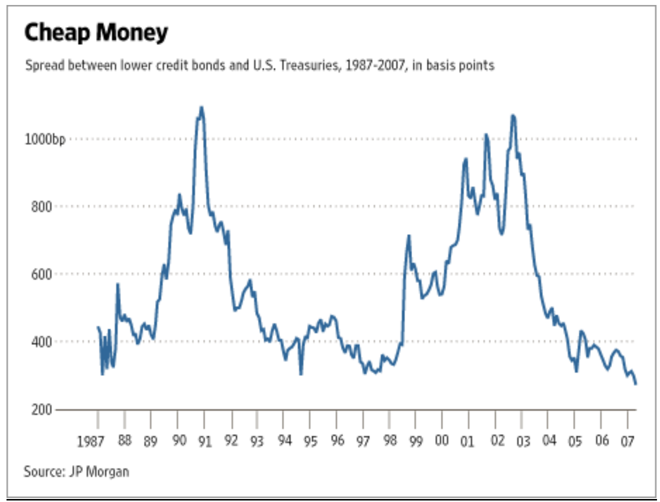
Are Stocks Cheap?

Every time I turn on CNBC, I hear the same thing over and over—"stocks are cheap". On the surface the reasoning appears valid. They point out that the S&P 500 has gone nowhere for seven years and earnings have doubled, so stocks must be cheap. Interest rates are low versus the earnings yield, so stocks must be cheap. Private equity firms are buying companies like crazy, so stocks must be cheap. Well, as you know we don't usually accept what is said on CNBC as the gospel, so we did some research to try to answer the question, are stocks cheap?

First, lets look at price/earnings multiples. The S&P 500 is currently trading at 18 times trailing earnings and 16.2 times forward earnings. However, one should remember that the S&P 500 does not always tell the whole story. The index includes a disproportionate amount of energy and financial stocks which typically trade around 10 or 12 times earnings. Removing them results in an industrial component around 20 times trailing earnings and 18 times forward earnings. Furthermore, if one were to take out the largest 25 companies in the S&P 500 index, the remaining 475 stocks trade at approximately 20 times the 2007 estimates. We also like to look at the Value Line index, which is an equal weighted index, comprised of 1700 large, mid and small-cap companies. In 2000, the median stock in the Value Line Index traded at around 13 times earnings. Today the median stock in the Value Line index is between 19 and 20 times earnings. In summary, despite all the hoopla on CNBC, the average stock was much cheaper in 2000 than it is today. The most concerning aspect to the valuation picture is the fact that profit margins are currently at forty year highs. So while the S&P 500 might appear to be reasonably valued currently, if profit margins returned to more normal levels, the price/earnings ratio would be considerably higher.

Second, let's look at what is going on with interest rates. At the end of the first quarter of 2007, estimated profit at the S&P 500 companies represented a yield of approximately 6.5% versus a 10-year US treasury yield of 4.65%. Obviously, an investor would prefer a 6.5% stream of earnings (which should theoretically grow over time) versus a bond return of 4.65% (fixed). However, stocks have rallied by over 6% over the past three months and rates on the 10-year treasury bond have backed up from 4.65% to just under 5.2%. In early June, Bill Gross of PIMCO abandoned his 25 year bullish stance on US treasury bonds. Gross raised the forecasted range on the 10-year note to a 4%-to-6.5% range from a 4%-to-5.5% range for the time frame 2007-2011. He confirmed that this is a "major shift" from his previous longstanding bullish stance on bonds. After Mr. Gross' change of heart, the stock market dropped 400 points in two days, rivaling the big one day rout that occurred in February. One question for the bond market is whether the Fed will begin to focus on "headline" inflation rather than "core" inflation. As you know the "core" number ignores energy and food price inflation. In the past, bond investors have been living in a world where nobody eats or drives. While the equity markets are likely to be able to handle current interest rate levels, any significant rise from here would likely trigger a correction in equities.

Third, let's look at what is going on with "private equity". As we discussed in our "*Winter 2007—Investment Outlook*", private equity has become one of the major forces driving stocks over the past few years. According to Bridgewater Associates, there is $300 billion of capital committed to these funds that has yet to be deployed. With typical levels of leverage employed by buyout funds, this could equate to almost 3 trillion in buying power. Over the last few years buyouts as well as corporate share repurchases have removed a sizable amount of stock from the market—about $1 trillion (net of new and secondary issues) since mid-2004. Though some of that stock will eventually come back into the market as private equity firms exit their investments by taking their privatized holdings public, this shrinking supply of stock seems likely to continue for a while and has bullish implications. The abundance of cheap money and record low credit spreads (see "Cheap Money" chart) would seem to indicate that economic cycle has been repealed. As Steven Rattner of the Wall Street Journal recently stated, "But to think that corporate recessions—and the attendant collateral damage of bankruptcies among overextended companies—have been outlawed would be as foolhardy as believing that mortgages should be issued to home buyers with no down payments and no verification of financial status." Mason Hawkins, Chairman and CEO of Southeastern Asset Management recently stated, "Right now the world is leveraged to the hilt." Hawkins noted that private equity players could have a tough time if businesses they have bought (and loaded with debt) struggle. The race to go public by many private equity firms would seem to indicate that the boom is in the latter innings.



The conclusion from the above exercise is that the average stock today is not cheap on an absolute basis. The high quality, large capitalization stocks offer relative value and appear attractive on a risk versus reward basis. Low interest rates and availability of credit have been very important factors in the equity market and any significant reversal of these trends would likely have negative ramifications for the equity markets. Corporate balance sheets remain exceptionally strong and stock repurchases coupled with continued private equity activity should provide a floor for stocks should a correction occur in the coming months. We are not market timers however; recently, portfolio cash levels have risen somewhat as we have been unable to find attractive buy candidates as quickly as we would like. As you know, we utilize a bottom up stock picking approach, using fundamental analysis to search for portfolio companies. At this point in the cycle (five years into the current bull market), we believe our discipline to focus on risk before reward will serve our clients well. We would urge our clients to focus on "absolute" rather than "relative" returns and not get caught up in the "media" hype. Buying what is popular has never worked on Wall Street. That is precisely why Jolley Asset Management was formed, to provide a vehicle whereby our focus and discipline could be preserved. We believe our clients will be handsomely rewarded.

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