JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 50• Winter 2011**

Ben Bernanke on what the Fed did and why:

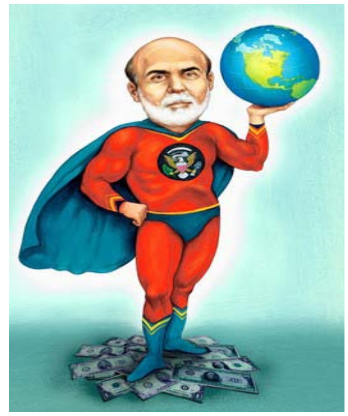
"This approach eased financial conditions in the past and, so far, looks to be effective again. ***Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action****. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment.* ***And higher stock prices will boost consumer wealth and help increase confidence****, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."*

Ben Bernanke (11/4/10)
Washington Post OP/ED

Stocks continued their winning ways in the fourth quarter as investors continued to react positively to the unprecedented efforts by governments and central banks around the globe to stimulate their economies and the financial markets. Federal Reserve Chairman Ben Bernanke's quote above made clear that the Fed was targeting equity prices in an effort to jump start an economic expansion. Stocks got another positive jolt in December when Congress extended the Bush tax-cuts for two more years. The old adage, "don't fight the Fed", seems to have been right, at least thus far. Cyclical sectors led the market in 2010 while defensive sectors generally lagged the market. In the fourth quarter and for the full year, small stocks outperformed large stocks by a large margin and growth styles outperformed value styles. For the year, the S&P 500 index and Dow Jones Industrial Average returned 15.06% and 14.04%, respectively. Since the market bottom (3/29/09) when the Dow Jones Industrial Average bottomed at 6,547.05, the market has rallied 76.8%. Despite the surge, the Dow Jones Industrial Average remains some 18% below its all time high of 14,164.53 reached on October 9, 2007.

Index	4th Quarter 2010	Yr. Ended 12/31/10
DJIA	8.02%	14.04%
S&P 500	10.76%	15.06%
S&P Mid Cap	13.50%	26.64%
Russell 1000/Growth	11.83%	16.71%
Russell 1000/Value	10.54%	15.51%
Russell 2000	16.25%	26.85%
NASDAQ Comp.	12.00%	16.91%

While Bernanke's efforts to push equity prices higher seems to be working quite well, the bond market's twenty-eight year bull run appears to be coming to an end. The ten-year Treasury note yield jumped .78% in the fourth quarter to



3.3%. At one point during the quarter, the ten-year bond topped 3.5%. This has negative implications for mortgage rates, which could possibly delay a much needed rebound in housing. In our last *"Investment Outlook—Fall 2010"*, we warned investors about the risks of following the crowd into the bond market. In the fourth quarter of 2010, long term treasury bonds lost 8.87% bringing full year returns to 9.57%. The weak bond market seemed to get investors attention and they responded by pulling $5 billion out of taxable bond funds in the first three weeks of December. This represents the first outflows from bond funds in about two years.

Outlook 2011

Operating earnings for the S&P 500 are expected to rise by approximately 32% for the quarter just ended. This will mark the last of the easy comparisons. Profit growth is expected to slow in 2011, with the consensus calling for a 13% increase. Consensus estimates for the S&P 500 index is $92 for 2011, indicating a forward price/earnings ratio of approximately 13.7 times earnings. This compares favorably with the median price/earnings ratio of 16.4 times since 1956. The S&P 500's earnings yield (reciprocal of the price/earnings ratio) stood at 6.45 times at year end, which was approximately 3.1 percentage points higher than the yield on ten-year treasury bonds. This spread is close to the highest level in the last twenty years. This would suggest that stocks are cheap relative to bonds. Could an asset allocation shift from bonds to equities be a positive catalyst for stocks in 2011?

When looking at revenues, expectations have been more modest, with analysts projecting 7.5% revenue growth for the quarter just ended and 7% for 2011. Financials have been the biggest drag on S&P 500 revenue growth, with revenues in that sector still below the levels of 2007. *Barron's Magazine* recently pointed out that two out of three S&P 500 companies have already reported higher revenues than levels of three years earlier, even though the index remains some 20% below its 2007 peak. Currently, the S&P

500 is trading at 1.3 times sales, which compares favorably with a multiple of 1.6 times sales in 2007.

Corporate balance sheets have never been stronger. Rather than spending on capital expenditures or hiring workers corporate America has been hoarding cash. Non-financial companies were sitting on $1.9 trillion in cash at the end of September. Cash currently represents 7.4% of companies' total assets, the highest level since 1959. We would expect companies to begin to deploy that cash as they become more comfortable that the economic recovery is on solid ground. The massive cash balances could result in more capital spending and hiring over the next few quarters. This could have positive implications for the unemployment problem we are currently facing. It also would likely result in higher dividends, share repurchases and merger and acquisition activity. Buybacks are expected to total $375 billion this year, the fourth highest annual level since 1985.

Dividends increased 8% in 2010 and Howard Silverblatt of Standard & Poor's projects another 9% increase for 2011. Despite those increases, Sliverblatt points out those dividends will still remain approximately 18% below the 2008 levels. He projects dividends will return to the 2007-2008 levels by 2013 and then only "if the economy cooperates". Increased dividend payments came from 1,729 companies in 2010 versus only 145 with lower dividend payments. Currently, approximately 75% of large capitalization companies pay dividends versus less than 40% for the rest of the market.

Large Cap Leadership?

Could 2011 be the year that high quality, large capitalization stocks finally outperform? After the strong market rally over the last two years, mid cap stocks are less than 2% from their all time highs, while small caps (Russell 2000) are less than 8% from their all time highs. Believe it or not, the S&P 500 index is still approximately 20% below its all time peak reached in October of 2007. Large caps have underperformed the mid and small caps dramatically since the market bottom in 2008 and for the past decade. Fundamentals seem to suggest that large capitalization issues are cheaper despite higher dividend yields, better balance sheets and more exposure to higher growth markets overseas. As the chart below shows, large cap stocks have been in the doghouse for the last one, three, five and ten-year periods. I think one could logically conclude that one of the major reasons for the underperformance is the indisputable fact that the large capitalization companies were grossly overvalued in the 1999-2000 period. As Benjamin Graham once stated, "The future value of every investment is a function of its present price. The higher the price you pay, the lower your return will be."

*Returns **	*1 year*	*3 years*	*5 years*	*10 years*
S&P 500	12.78%	-14.35%	.75%	-4.74%
S&P Mid-Cap	24.85%	5.72%	22.93%	75.57%
S&P Small Cap	24.98%	5.21%	18.55%	89.32%

**cumulative returns* *Source: Standard & Poors—excludes dividends*

In our opinion, the valuation pendulum has now swung in favor of the large capitalization companies. Currently, the S&P 500 is trading at just under 14 times projected 2011 profits while mid caps and small stock indexes trade at price/earnings ratios of 16 and 17 times, respectively. With the S&P 500 companies, you get a dividend yield of 1.8% versus 1.3% for the mid-cap index and 1.2% for the small cap index. In November of 2010, Jeremy Grantham of GMO predicted that the highest quality stocks will return 5.1% above inflation over the next seven years, compared with an annual loss of .8% for small stocks. It appears evident to us that on a risk versus reward basis, high quality, large capitalization issues are the place to be.

Fixed Income

After a twenty-eight year run, we believe the bull market in bonds has finally run its course. Central banks across the globe are working together to reflate the economy and commodity prices have been soaring. It now appears that the Fed has likely succeeded in its battle against deflation. Although bond yields aren't likely to soar over the coming year, we think there could be a gradual rise in interest rates. We are continuing to manage fixed income portfolios using a laddered approach with a maximum maturity typically within five years. We continue to use high quality corporate issues in fixed income and balanced portfolios, while we have shunned treasury issues in recent months. In addition, we have continued to use TIPS (treasury inflation protected bonds) and have purchased some floating rate preferred issues in an attempt to protect portfolios from higher inflation and interest rates down the road. In municipal securities, we are continuing to emphasize short-dated, high quality, general obligation issues. We would emphasize that while we believe bond investors may face headwinds in the coming years, bonds remain an integral part of client portfolios and continue to be used as a tool to manage overall portfolio risk and volatility.

Summary

In summary, we believe that the economy is improving slowly and equities (high quality, large cap) are attractively priced. It is our belief that at current valuation levels, stocks are more attractive than bonds. Clearly, there are many macro issues facing the economy which could provide a "shock" to the system and, if not dealt with properly, will be a "headwind" for years to come. At some point, the Fed will need to implement an "exit strategy" from its quantitative easing which will likely be a source of investor anxiety going forward. We believe our "value" approach, where we focus on risk before reward, will serve our clients well.

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