JOLLEY ASSET MANAGEMENT, LLC

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> *"There is a systematic manipulation of values carried out by our central banks world over. They sit on money market interest rates, they muscle around the yield curve, and they levitate asset prices on the theory that higher stock and corporate bond prices will make us happier and more inclined to spend."*
>
> *James Grant*

The equity markets exploded into year-end as investors correctly anticipated a successful eleventh-hour closure to the "fiscal cliff" negotiations. The S&P 500 closed up 1.6% on the last day of the year, its best last day of the year since 1974. The S&P 500 index has advanced in eight of the past ten years and now has risen approximately 110% from its "bear market" lows made in early 1999. The strong close to the year helped to turn a weak fourth quarter into a mixed one. For the quarter just ended, the Dow Jones Industrial average and the S&P 500 index closed down 1.84% and .38%, respectively. The late year-end rally pushed both the Russell 2000 Index (small cap) and the S&P Mid Cap Index into positive territory, ending the quarter with gains of 1.85% and 3.61%, respectively. The late surge in the small and mid-cap stocks bucked the trend in leadership for the mega-cap stocks that had been in place most of the year. Savita Subramanian of Bank of America /Merrill Lynch recently stated:

> *"In a year that saw equity sentiment plummet, the S&P 500 index returned a healthy 16% percent total return. By our math, about 3% of this came from yield, and price return was roughly split between trend earnings growth (6%) and significant multiple expansion (7%)."*

The strongest sectors of the markets were financials, consumer discretionary and healthcare. The weakest sectors included energy, utilities and materials. For the year, "value" strategies outperformed "growth" with all of the outperformance coming in the fourth quarter.

Index	4th Quarter 2012	Yr. Ended 12/31/12
DJIA	-1.84%	10.16%
S&P 500	-.38%	16.00%
S&P Mid Cap	3.61%	17.88%
Russell 1000/Growth	-1.32%	15.26%
Russell 1000/Value	1.52%	17.51%
Russell 2000	1.85%	16.35%
NASDAQ Comp.	-3.10%	15.91%

Fiscal Cliff Agreement

According to The Tax Policy Center, a nonpartisan Washington research group, approximately 77 percent of American households will face higher federal taxes in 2013 under the agreement negotiated between President Barack Obama and Senate Republicans. Higher-income families will feel the biggest tax increases, but many middle- and low-income families will pay higher taxes as well. While tax rates were increased only on the top wage earners, most workers will see a smaller paycheck as payroll tax rates return to 6.2% versus 4.2%, where they had been for the past two years.

Income tax rates will remain the same for all individuals earning less than $400,000 and couples earning less than $450,000. Income above those levels will now be taxed at 39.6%. Capital gains (long term) and dividends will continue to be taxed at 15% except for filers above the $400,000/$450,000 threshold above whose rate will go to 20%. There's also a new 3.8% Obamacare surtax on investment income for individuals who make over $200,000 ($250,000 for joint filers) a year. When combined with the hike mentioned above, the highest tax rates on capital gains and dividends will rise to 23.8%. The new tax rates are shown in the summary below:

Tax increases that become law in 2013 under the 2010 Affordable Care Act and the bill that passed the Senate on Jan. 1

	2012	2013
Top personal income tax rate[1]	35%	41%[2]
Estate tax	35	40[3]
Capital gains tax	15	23.8[4]
Dividend tax	15	23.8[4]
Medical device tax	0	2.3
Payroll tax	10.4	12.4
ObamaCare payroll tax surcharge	0	0.9[5]

Notes: 1. Above $400,000 income for singles, $450,000 joint filers; 2. Includes effect of phase out of various deductions; 3. Exemption of $5 million; 4. Includes 3.8% ObamaCare investment income surtax; 5. Income above $200,000 for singles and $250,000 for joint filers

Source: U.S. Senate

While the current agreement provided much needed clarity on taxes for the coming years, it essentially "kicked the can down the road" when it comes to spending cuts. The deal delayed the "sequester" for two months and will have to be dealt with by Congress at the same time the debt-ceiling needs to be raised. This means that investors need to be prepared for another showdown in Congress in just a few weeks that will likely result in additional market uncertainty.

Financial Repression

Financial repression is an academic term coined in the seventies used to describe measures by which governments channel funds to places other than where they would end up

in a deregulated economy. Financial repression allows governments to issue debt at lower interest rates than would otherwise be possible. A low nominal interest rate can help governments reduce debt servicing costs, while a high incidence of negative real interest rates liquidates or erodes the real value of government debt. Thus, financial repression is most successful in liquidating debts when accompanied by a steady rate of inflation. Most economists consider it to be a form of taxation. Financial repression essentially transfers money from savers to borrowers. The U.S. and other developed economies are holding down interest rates by investing heavily in their own government bonds. Bill Gross of PIMCO has recently estimated that the Fed is buying approximately 80% of the treasuries that are currently being issued. The Federal Reserve and foreign governments own more than half of the outstanding U.S. Treasury debt. The Fed wants to keep rates low largely to juice the fragile U.S. economy but also to depress government borrowing costs. One of the big costs is that asset prices are distorted by the manipulated level of interest rates. There is essentially no way to tell where interest rates or asset prices would be otherwise. Financial repression is not new. The United States held down interest rates for over three decades after World War II. From the end of World War II until the late 1970s, interest rates on U.S. Treasury bonds were persistently below the rate of inflation, generating negative "real" interest rates for bond investors. Long term interest rates rose gradually during that period and by the late 1970's investors had seen the value of their bonds erode significantly. On the other hand, it should be pointed out that equity investors fared well during the post-war period.

Investment Strategy

In this period of financial repression, many investors are being forced to fundamentally rethink their investment strategies. Traditional 'low risk' portfolios (those that are heavily invested in cash and bonds) are and will likely continue to produce poor and often negative real returns over the next few years. In order for investors to achieve returns that, at the very least, keep pace with inflation and preserve their purchasing power, they are being forced to embrace riskier assets. With that comes increased volatility which makes many investors uncomfortable. We believe investors must take a balanced approach. We favor high quality, large capitalization equities, where valuations are reasonable and corporate balance sheets have never been stronger. On the fixed income side, we continue to favor short duration issues. We are simply not willing to expose clients to excessive interest rate risk when we believe interest rates are at or near the lows for the cycle. We would remind investors that should we see a 1% rise in interest rates, the ten-year treasury bond will see a price decline of approximately 9%. That same 1% rise in rates would result in a staggering 20% price decline in the thirty-year treasury bond. In an attempt to protect clients from "interest rate risk", we have increased exposure to floating rate securities over the past year. In these securities, investors would actually benefit from a bottoming in interest rates. We also are looking into diversifying into emerging markets (and/or companies that will benefit from growth in emerging economies) which have corrected over the past few years.

Our attraction to high quality, large capitalization equities is essentially due to reasonable valuations and pristine balance sheets. Currently, the S&P 500 is trading at approximately 14.2 times trailing earnings and 13.7 times forward earnings. These multinational companies are extremely well positioned to benefit from global growth and are not entirely dependent upon growth in the U. S. S&P 500 (non-financial) corporate cash and equivalents currently exceed $1 trillion, according to S&P Capital IQ. This strong position gives companies the ability to increase dividends, continue share repurchase and finance merger and acquisition activity. S&P 500 companies paid out a record $281.5 billion in dividends last year. That is a 17% increase from a year ago and 14% above the previous all-time high set in 2008. The current dividend yield on the S&P 500 of 2.2% compares favorably with the ten-year treasury yield which is 1.9%. Although tax rates on dividend income will rise as high as 20% in 2013 (23.8% when factoring in Obamacare tax) for the wealthiest Americans, it remains considerably lower than ordinary income tax rates for most taxpayers. Many had feared that dividends would be taxed as high as 40% prior to the agreement that was reached on January 1, 2013. While we are positive towards large-cap stocks, we are less constructive on the small and mid-cap sectors of the market. The Russell 2000 (small cap) index is currently trading at approximately 24.4 times trailing earnings and the S&P Mid Cap index is trading at 16.9 times trailing earnings. While the small and mid-cap sectors have been the clear winners since the turn of the century, we believe the valuations have become stretched. Small and mid-cap indexes have been in a "stealth bull market" for most of the past decade while large caps have essentially gone nowhere.

Summary

This period of financial repression is an extremely challenging period for both advisors and investors alike. Our "value investing" strategy has served us well through other difficult periods before; including the indexing craze, the "internet bubble" and the "financial crisis". Value investing is about having the discipline to always be "price sensitive" and investing with a "margin of safety". As value investors, the price we pay is one of the most important variables in determining the ultimate return of a particular investment. Investing with a "margin of safety" can help prevent a permanent loss of capital for our clients, as contrasted with temporary loss of capital caused by stock market price fluctuations. Market conditions and economic conditions will always change; our value discipline always remains constant. We believe this discipline and focus on risk over return will serve our clients well in the coming year.

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