JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 32• Spring 2006**

> *"When we buy a large cap, we hear: How can you buy that dog? It has done nothing for five years."*
>
> *Ron Muhlenkamp*
> *Muhlenkamp Fund*

Stocks started off 2006 with their best start of the new millennium, with every major index posting solid gains. In fact, the S&P 500 (price change only) rose more in the first quarter of 2006 than it did all of last year. As has been the case for the past several years, the leaders continued to be the small and mid-cap indexes, which rose by 13.9% (Russell 2000) and 7.6% (S&P Mid-Cap), respectively. The strong performance in the equity markets has the major indexes at five year highs and the small and mid-cap indexes at all-time highs. The chart below summarizes first quarter returns for the major indexes.

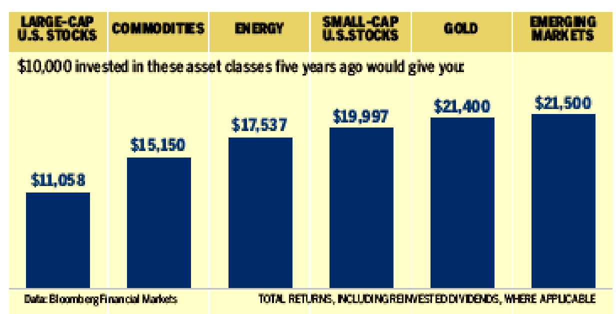
Index	1st Quarter 2006
DJIA	**4.37%**
S&P 500	**4.28%**
S&P Mid Cap	**7.63%**
Russell 1000/Growth	**3.09%**
Russell 1000/Value	**5.93%**
Russell 2000	**13.94%**
NASDAQ Comp.	**6.10%**

Despite the rally, valuations appear reasonable. Currently, the S&P 500 trades at 18.5 times trailing earnings and 16.6 times 2006 estimates. Over the last fifty years, the average P/E ratio was 17.4 times and over the last twenty-five years the average P/E ratio was 20 times. Based on these numbers, stocks continue to look reasonably attractive. Turning to the length of the current economic expansion, our economy has been growing for a little over four and a half years, which equates to an average post-World War II expansion. Corporate profit margins are near record high levels, but have little room for improvement. Currently the economy is facing some headwinds from a slowing housing market and higher short-term interest rates. Going forward a lot will depend upon the new Federal Reserve chairman, Ben Bernanke. After the last Fed meeting, Bernanke stated that more rate increases might be needed to prevent inflation, which investors translated to mean that the Fed would push rates to 5% in May and maybe 5.25% in June. The fear of higher interest rates may put a lid on the markets over the near term.

Given the recent move in equity prices and the lower volatility, investors have become somewhat complacent over the past few months. Investor confidence has returned as evidenced by a surge in trading volume at the online brokers. We are somewhat troubled by the apparent return of the day-trader mentality and the popularity of shows like *"Mad Money"* with Jim Cramer. Recently, CNBC has even launched a Squawk Box Fantasy Portfolio Challenge, where you can win a 2006 Maserati Gransport by trading a hypothetical portfolio for eight weeks. This is not the type of journalism one typically sees at market bottoms. We should point out that it has been nearly three years since the Dow Jones Industrial Average has corrected 10% from a high. The last pullback of that magnitude occurred in 2003 when the United States invaded Iraq. Bob Doll of Merrill Lynch Investment Management recently stated, "The bull market does seem to be losing some steam. The market has enjoyed one of its longest stretches in history without experiencing a 10% decline….we believe such a correction will occur at some point in 2006."

Rodney Dangerfield (S&P) 500?

Like Rodney Dangerfield, large capitalization companies just can't get any respect. Bull markets in commodities, precious metals, small and mid cap stocks, energy, real estate and foreign stocks have left the S&P 500 in the dust over the past five years.



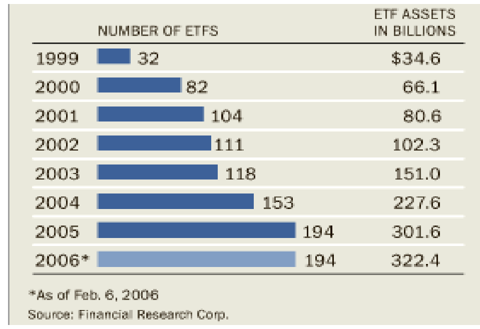
Could high quality, large capitalization stocks be the only bargain left? Jason Trennert of ISI Group thinks so and recently stated that blue-chips could be "the cheapest asset class in the developed world." We have been stating for some time that we feel the risk/reward tradeoff is most attractive for the large cap sector. Ironically, we felt just the opposite six years ago. Investors were flocking to the S&P 500 index, buying the large cap basket (S&P 500 index funds), without paying attention to what was in the basket. At that time we felt there were extraordinary opportunities in the small and mid cap universe. Since then much has changed. The relative valuation of the twenty-five largest S&P 500 companies is currently near a twenty year low. This has largely been the result of higher earnings coupled with lower stock prices. Non-financial domestic companies now are sitting on approximately $1.5 trillion in cash, and as you would expect, most of it is in the larger blue chip names. This provides these companies with the flexibility to increase dividends, accelerate share repurchases and make acquisitions. Not to pick on the small caps, but we currently feel that some of the excesses that were showing up in the large cap universe, are now showing up in the smaller stocks. According to ISI Research Group, the price earnings multiple on the Russell 2000 is now 25 times, compared with 15 times for the S&P 500.

One explanation of what has transpired and pulled money away from the S&P 500 index and the large caps, is the explosion in exchange-traded funds or ETF's. Fifteen or twenty years ago, for an investor to get exposure to small caps or emerging markets, an individual or institution had to hire a portfolio manager or buy a mutual fund that specialized in that particular market niche. It was much more cumbersome and costly than is the case today. Now all one has to do is purchase one of the 190 plus ETF's (which are listed and trade just like stocks by the way) and bingo, they have the exposure. According to *Smart Money Magazine*, ETF's are pulling in assets six times faster than traditional mutual funds. In 2005, investors poured in a whopping $54 billion into exchange-traded funds. While we like ETF's and the potential benefits that they offer investors and portfolio managers, in some cases we wonder if "the tail is wagging the dog". In the case of the Russell 2000 for instance, investors want exposure to small stocks, because of the strong recent performance. So the investor buys shares in the iShares Russell 2000 (symbol—IWM) ETF, who then has to go buy shares in the basket of underlying companies in the index, which pushes the share prices higher (many of which are highly illiquid) and the underlying index higher. This creates more interest from those who don't want to miss out on one of the strongest sub-sets of the equity market.

Chasing Performance?

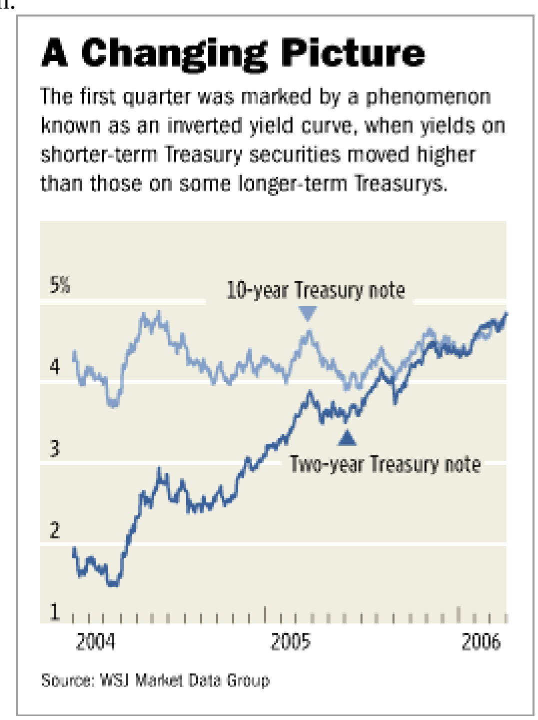
	2002	2003	2004	2005	Current
IWM Assets in (billions)	**$2.1**	**$4.5**	**$7.0**	**$7.4**	**$8.7**

In many cases, no one is paying attention to the prices that are being paid for the underlying companies that comprise the index. Ironically, this is shockingly similar to what happened five or six years ago when investors were clamoring for S&P 500 index funds, even though many of the underlying securities were grossly over-valued. The chart below shows just how big the explosion in ETF's has been.



Fixed Income

Bonds underperformed stocks in the first quarter as the Federal Reserve hiked rates for the fifteenth time, moving the rate on Federal Funds to 4.75%. For the quarter, the Lehman Brothers Aggregate Bond index was down .65% and the return on the long term treasury bond was a negative 4.07%. The yield curve was inverted for thirty eight days starting in late December, meaning that short term yields were higher than long term yields. This is a rare phenomenon in the bond market that preceded the last four recessions. At the very least many experts thought it was foreshadowing a weaker economy. The treasury curve inversion now seems to be a thing of the past. Economists are now predicting the GDP to advance by 3.3% in 2006, not the slowdown that many felt the inverted curve was signaling. At quarter end, the yield on the benchmark 10 year treasury stood at 4.86%, the highest level since June 2004. The yield curve is essentially flat as the yield on the 30 year Treasury closed the quarter at 4.90% not far from the rate on the 10 year note. In summary, it appears the economy will slow to a more normal rate of growth, but not enough to encourage the Fed to start cutting rates anytime soon.



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