JOLLEY ASSET MANAGEMENT, LLC

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"So you do get an occasional opportunity to get into a wonderful business that's being run by a wonderful manager. And, of course that's hog heaven day. If you don't load up when you get those opportunities, it's a big mistake." Charles Munger
May 5, 1995

The past year was a grueling one for the equity markets, with most of the returns coming in the form of an early Santa Claus Rally (November). For most of the year the markets were flat or falling but there were periods when market strength came in extremely short time periods. As you know, we feel that market timing is a futile exercise and it surely would have been difficult to successfully time the short bursts of performance during the last twelve months. Discipline and patience paid off in what was a decent year for equity investors. As can be seen in the chart below, the total return on the S&P 500 was 4.88% for the year, ahead of the Dow Jones Industrial Average, the Russell 2000 Index and the NASDAQ Composite which returned 1.94%, 4.55% and 1.91% respectively. The standout performer for the year was the S&P Mid-Cap index which advanced by 12.56%. In the end, even though 2005 didn't feel like a good year for investors, in reality it wasn't too bad and marked the third consecutive year of advances for the major indices. The "out-performance" of "value" over "growth" was largely due to energy stocks, which were far and away the year's strongest sector.

Index	4th Qtr 2005	2005
DJIA	1.99%	1.94%
S&P 500	2.03%	4.88%
S&P Mid Cap	3.34%	12.56%
Russell 1000/Growth	2.98%	5.26%
Russell 1000/Value	1.27%	7.05%
Russell 2000	1.13%	4.55%
NASDAQ Comp.	2.64%	1.91%

Over the past two years, we have experienced a strong rebound in the economy and corporate earnings, however, stocks have only advanced modestly. We have essentially been in a period where stocks have worked off the excesses created in the 1990's bull market, when stock price increases outpaced economic reality. This reversion to the mean has actually been quite healthy as it has resulted in more realistic valuation levels for most stocks. As of year end, the S&P 500 was trading at approximately eighteen times earnings versus approximately forty times at the height of the 1990's excesses. While many analysts are calling current levels of the market as "cheap", we would point out that valuations have merely become more normal as the long term average price earnings multiple is about fifteen to sixteen times earnings. This is largely why for the past several years we have been cautioning our clients to temper their total return expectations. While the past three years have been relatively good ones for equities, this mean reversion can be better explained when examining returns over the past five years.

Index	Cumulative Returns 5 years	Annualized Returns 5 years
DJIA	10.58%	2.03%
S&P 500	2.61%	.52%
S&P Mid Cap	51.09%	8.60%
Russell 2000	48.46%	8.22%
NASDAQ Comp.	-10.73%	-2.24%

So in essence, those who were invested in the S&P 500 index or the Dow Jones Industrials over the past five years barely managed a gain. The NASDAQ has been even drearier with a negative annualized return of over 2% over the last five years. But take a look at the Mid Cap and Small Cap indexes, as they have generated returns of over 8% annualized over the same time period. While the divergence in returns is huge for the five year period, it is really very logical. Think back to late 1999. The perception by the masses was:

- S&P 500 Index funds and closet indexing were all the rage. Large companies had a competitive advantage compared to small companies in the global economy. Small companies were at the mercy of their larger more powerful peers who set prices and terms.

- The NASDAQ and the "New economy" companies were the future and would continue to grow at very high rates. "Old economy" stocks would not deliver strong returns. Investors were discouraged from factoring in valuation or even profitability into their company/stock analysis. Revenue growth and price momentum were the keys to identify winning stocks, valuation was irrelevant.

As we stated five years ago, in our *Investment Outlook—Winter 2000*:

"The technology sector and the NASDAQ (largely technology) were in what appears to be a speculative mania, while the rest of the market (old economy) was essentially in a bear market." We concluded, "We believe we are at a critical inflection point, where an investor must be willing to swim against the tide, even if it means foregoing short-term performance."

When an investment or asset class is universally loved, investors should beware. On the other hand, when an asset

or asset class is hated, investors are often presented with great opportunity. Five years ago it was easy to see what was loved and hated.

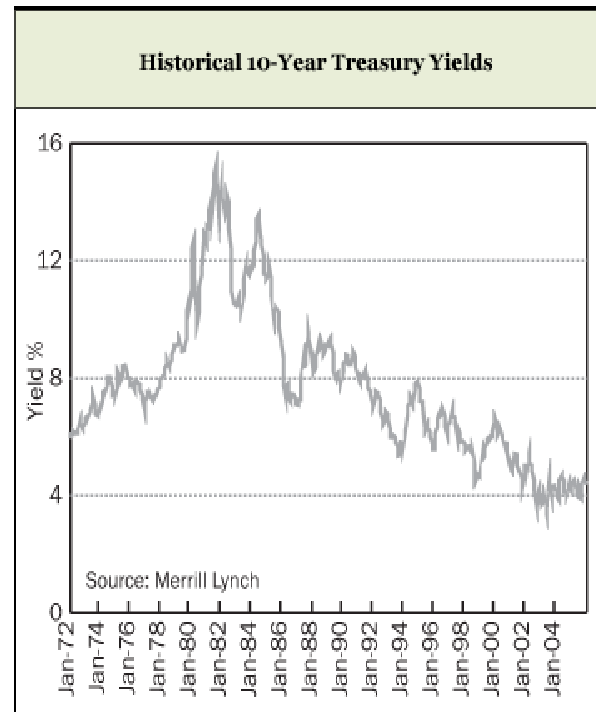
While not as clear cut today as it was five years ago, we believe the odds favor the large capitalization issues in the coming year. Small and mid-capitalization issues look considerably less attractive than they did five years ago, largely due to the significant out-performance since the late 1990's. Small-cap valuations appear stretched with the Russell 2000 index trading at 28 times forward earnings versus 17 times for the Russell 1000 index (large cap). After six years of essentially going nowhere, many large companies appear to be attractively priced. The "quality" premium that one usually has to pay for these companies has essentially disappeared. Additionally, the distinctions between typical "growth" and "value" stocks have become more blurred in recent quarters. While we remain extremely valuation conscious, we are now attracted to companies that might also be attractive to a more traditional growth manager. We are comforted by the fact that some others are seeing the same opportunities. In fact, Mason Hawkins of the highly regarded Longleaf Partners recently stated:

> *"Most recently our research has led us to the type of companies we love to own but rarely have the opportunity to buy—high quality businesses with dominant market shares and entrenched brand names. The stocks are often large cap and very liquid. Their ability to generate free cash is tremendous and their value growth potential is clearly within our double-digit objective. The fact that many small and mid-sized companies have had a strong price run partially fueled by the excess capacity of private equity and buyout funds has probably diverted some of the powerhouse names that are not perceived as takeover candidates. Whatever, the cause, we are thrilled by the opportunity."*

S&P 500 earnings are forecasted to grow by approximately 10% in 2006 after 17% growth this past year. While analysts' estimates of growth may have been underestimated over the past couple of years, the risk for 2006 seems to be that earnings will disappoint rather than surprise to the upside. Higher interest rates, the slowdown in housing and margin pressures could result in lackluster growth in corporate earnings. On the positive side, corporate balance sheets are flush with cash. Corporate cash is now equivalent to approximately 7% of the S&P 500 market capitalization, the highest ratio since 1988. Merger and acquisition activity is soaring and the primary currency being used in those transactions is cash rather than stock, resulting in a major shrinkage in equity supply. In addition, buybacks are also contracting the supply of equity. S&P 500 constituents are expected to buy back some $320 billion in shares this year, compared to a previous high of $197 billion in 2004. Private equity funds are currently estimated to have over $200 billion in capital which can be leveraged into a multiple of that figure, which should provide a boost for equity prices.

Fixed Income

In 2005, bonds held their own, despite the fact that the Federal Reserve raised interest rates by 2%, from 2.25% to 4.25%. The yield on the 10-year Treasury note ended the year at 4.39% compared with 4.22% at the end of 2004. Over the past year, bonds were buoyed by strong foreign buying due to excess global liquidity. The Fed's rate increases already have helped push short-term interest rates above long-term rates, a phenomenon known as a yield-curve inversion, which has preceded every economic downturn in the past 40 years, with only two false alarms. An argument could be made that the overall level of interest rates is too low to constrain economic activity to recessionary levels. Even if a yield-curve inversion doesn't result in an economic slowdown this time, it could spell trouble for certain hedge funds, banks and other investors who engage in a strategy called the carry trade, borrowing money at short rates and investing it in higher-yielding longer-term assets, from corporate loans to junk bonds. The Federal Reserve will likely reach a crossroads sometime in the first half of 2006, and decide when to stop raising short term rates. This change in Fed policy will likely come under the leadership of Ben Bernanke, who is expected to be confirmed by the Senate some time in January, to take over Feb. 1st.



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