JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 55• Spring 2012**

> *"Profit margins are probably the most mean-reverting series in finance, and if profit margins do not mean-revert, then something has gone badly wrong with capitalism. If high profits do not attract competition, there is something wrong with the system and it is not functioning properly."*
> *Jeremy Grantham--GMO*

Just six months ago, investors were in panic mode as the euro-zone was on the brink of collapse. The equity markets have since rallied dramatically for two consecutive quarters. In fact, this is only the twelfth time in history that the S&P 500 has recorded back-to-back quarterly returns of greater than 10%. We warned investors against attempting to "time the markets" last fall. It has been our experience that "market timing" is a futile exercise. Timing the markets, requires two good decisions, when to get out and when to get back in. Because of the emotional state of investors during market down-turns, most have a hard time getting both right.

The markets were led in the first quarter by the NASDAQ composite which returned 18.67% for the quarter. Apple led the way for the NASDAQ and technology sector. In fact, since Steve Jobs' death on October 5, 2011, Apple shares have skyrocketed more than 58%. Apple's move coincided with the excitement surrounding the Facebook IPO which was announced last fall. Many experts expect the company to be valued at close to $100 billion when it hits the market. Facebook revenues in 2011 were just $3.7 billion, so the shares will be priced at approximately 27 times revenues. Funny, we thought stocks trading at 27 times earnings were expensive! The speculative nature of the market was not just apparent in the technology sector. According to Bespoke Investment Group, S&P 500 companies that pay no dividend rose an average 17.8% in the first quarter versus a rise of 3.2% for the highest yielding decile. Bank of America/Merrill Lynch recently pointed out that non-dividend paying companies in the Russell 2000 index returned 15% for the quarter versus a gain of 9.4% for dividend paying stocks. With the shortage of yield available in the world, the move to lower quality, non-dividend payers makes little sense to us. One would expect rational investors to be gravitating towards dividend paying securities. We obviously under-estimated the power of ZIRP (zero interest rate policy)! As the following chart shows, growth led value in the most recent quarter and over the past two quarters. In summary, it has been quite a six-month period for equity investors. The prolonged period of zero interest rates seems to have resulted in a "speculative frenzy" in certain sectors of the market. We are content to remain invested in the high quality, large cap sector which we continue to believe offers investors reasonable value along with a growing stream of dividend income. We will leave the rest of the market to the "Fast Money" and "Mad Money" followers.

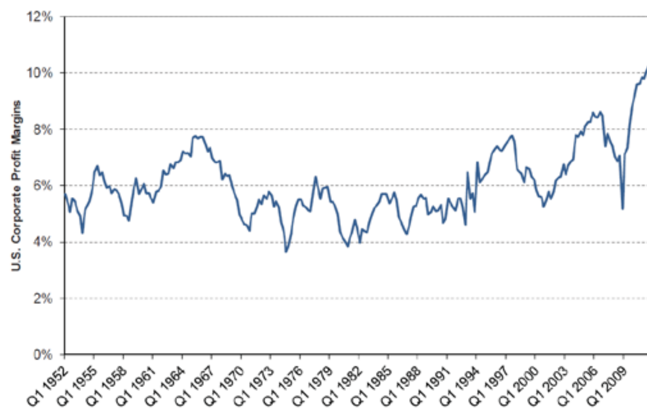
Index	1st Quarter 2012	Last 6 months
DJIA	8.89%	22.72%
S&P 500	12.59%	25.89%
S&P Mid Cap	13.50%	28.23%
Russell 1000/Growth	14.69%	26.85%
Russell 1000/Value	11.12%	25.68%
Russell 2000	12.44%	29.83%
NASDAQ Comp.	18.67%	27.99%

Earnings/Profit Margins

Fourth quarter earnings for S&P 500 companies grew about 6% year-over-year according to FactSet Research. The fourth quarter was the first quarter that earnings have failed to increase by double digits in the last two years. If one were to strip out the 116% profit increase by Apple, the S&P 500 earnings increase for the fourth quarter slips to just 3%. Two years ago, companies were coming off of recessionary levels making comparisons easy. As we move forward, earnings comparisons have become more and more challenging. First quarter earnings are expected to be essentially flat with a year ago (without Apple's 50% increase they actually would fall by 2%) largely due to a challenging economic environment in Europe. Despite the dim outlook for the first quarter, analysts are optimistic that earnings growth will improve as we move through the year. This is based on stabilization in Europe and accelerating growth in emerging markets.

Corporate profit margins are currently at the highest level in history. The improvement in margins has essentially come from two main factors: lower labor expense and lower interest expense. Recently, there has been much debate on whether corporations will be able to maintain their profit margins going forward. James Montier of GMO research recently stated that profit margins which are at record highs, must fall in future years. Essentially Montier is pointing out that corporate profitability has surged due to the fact that the government and the household sector have both spent beyond their means at the same time. Any hope for continued high profit margins will depend upon the government and the household sector to maintain these

unsustainable spending patterns indefinitely. Conversely, any



deleveraging of presently debt-heavy government and household balance sheets will predictably result in a sustained reduction in corporate profit margins. This will be difficult for the household sector as wages and salaries have fallen to new lows relative to GDP. Scott Grannis, former chief economist of Western Asset Management, recently stated, "Tis true that right now U. S. profits are above average, but they're not ridiculously so." From a global perspective, U. S. corporate profits as a percent of global GDP appear reasonable and below the peaks from the late 1960s. The fact that S&P is massively exposed to global growth is another factor supporting the case that the current levels of profit margins are sustainable.

Valuations

The S&P 500 index is currently trading at approximately 13 times forward earnings estimates. Even though profit growth is slowing in 2012, corporate earnings are likely to beat the record they set in 2011. FactSet Data is looking for S&P earnings of $105 per share, up more than 10% from the $95 per share achieved in 2011. The valuations found in the mid and small cap sectors of the market seem less compelling. The S&P Mid Cap 400 currently trades at 17.7 times trailing earnings and 15.3 times forward estimates, while the Russell 2000 index trades at a whopping 25.4 times trailing earnings and 19.8 times forward estimates. In addition, the dividend yield on the S&P 500 is 1.9% currently versus 1.3% for both the S&P Mid Cap Index and the Russell 2000 Index. In addition to lower price earnings ratios and higher dividend yields, the larger, multi-nationals are better positioned to participate in global growth opportunities going forward. We continue to believe the risk/reward favors the larger companies. We will remain focused on that subset of the market for client portfolios.

Dividends

History has shown that dividends have been an important source of total return for equity portfolios. Over the past 100 years, dividends have accounted for over 40% of the S&P's total return. Typically, owning stocks that increase their dividend regularly has proven to be a good hedge against inflation, especially compared to many bonds which offer a fixed income stream over the life of the bond. With bond yields at record lows, dividend paying securities have once again become popular for investors seeking growth and income. Howard Silverblatt of Standard & Poor's recently stated, "Companies have the money, they have the ability, and dividends are back in fashion." According to Mr. Silverblatt, actual cash dividend payments rose by 11% in the most recent quarter, with the forward indicated dividend rate now at an all-time high. The dividend payout ratio (dividends as a percent of earnings) is currently only 30%, versus an average of approximately 50%. The low dividend payout ratio, coupled with strong balance sheets gives corporations the ability to raise dividends faster than earnings growth over the intermediate term. Silverblatt of Standard & Poor's is projecting a 16% increase in dividends in 2012. While dividend paying securities have lagged the market in the first quarter of 2012, we believe it is more a function of "beta chasing" and "momentum investing" (than fundamentals) which will ultimately end badly for participants. It is our belief that high quality, dividend paying securities should remain the focus of long term investors.

Boredom Discount

I recently came across an intriguing research piece by Dylan Grice, Strategist of Société Générale in which Mr. Grice states:

> *"After analyzing returns of low (boring) and high beta (big upside opportunity, big risk) stocks, he finds that higher quality stocks carry the sort of lower risk which is supposed to attract a low return, we've consistently found them to be higher return. Quality stocks, in other words, seem to possess that attribute most desirable to the long-term investor: systemic undervaluation." "We also think the same psychological tendency that overvalues lottery tickets undervalues quality stocks, as their robust business models and solid balance sheets do tend to be quite boring." "If high beta/low quality stocks live in the world of possible triple-digit returns, attracting lottery ticket overvaluations, low beta/high quality stocks live in the world of near certainty, attracting the boredom discount."*

In summary, Grice points out that investors systematically overpay for high-volatility, high-beta stocks because they like the thrill (kind of like gambling or buying a lotto ticket) leaving a large swath of the market undervalued and under-owned. We concur with Mr. Grice, boring is good.

Summary

While no one would have predicted it six months ago, the equity markets have just strung together two consecutive quarters of double-digit returns. While we continue to find the valuations of high quality, dividend paying companies to be reasonably valued; it is our belief that many sectors of the market are being driven by speculative forces rather than by fundamentals. High frequency trading and momentum strategies are currently all the rage as market participants have embraced the "risk on" trade in response to Bernanke's prolonged ZIRP (zero interest rate policy). Earnings comparisons have become more difficult and profit margins seem poised to contract from record high levels. Dividends continue to be a bright spot and should grow more rapidly than earnings over the balance of the year. While we would not be surprised to see a pullback in equity prices in the coming months, we remain firmly committed to high quality, large capitalization equities. We believe our focus on risk before reward will serve our clients well over the balance of the year.

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