JAM JOLLEY ASSET MANAGEMENT, LLC

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"There are two times in a man's life when he should not speculate: when he can't afford it and when he can."

"OCTOBER: This is one of the peculiarly dangerous months to speculate in stocks in. The others are July, January, September, April, November, May, March, June, December, August, and February."

Mark Twain
Pudd'nhead Wilson's New Calendar

On September 18, 2013 the Federal Reserve officials pledged to stay the course with zero interest rates and QE3. The Fed had been toying with the idea of tapering from the $85 billion a month bond buying program, but just at the last moment Ben Bernanke "saw his shadow" and went scurrying back into his hole. Perhaps that insures six more months of QE3! The equity markets love affair with Bernanke and the Fed continued during the past quarter. Once again stocks forged ahead with the S&P 500 climbing 5.24% for the quarter and the Dow Jones Industrial Average rising by 2.17%. As can be seen in the chart below, growth strategies trumped value in the most recent quarter and year-to-date. The strongest quarterly returns could be found in the NASDAQ composite and small caps (Russell 2000) with returns of 10.82% and 10.21%, respectively. Lower quality stocks continue to outpace the rest of the market. According to Bank of America/Merrill Lynch stocks with a quality rank of A+ returned 17.02% year-to-date, versus a return of 32.72% for stocks with a quality rank of C&D. Stocks continued to be the "only game in town". For the year-to-date, long-term treasury bonds lost 10.49%, gold declined 20.28%, emerging markets fell 4.05% and investment grade bonds fell by 2.45%.

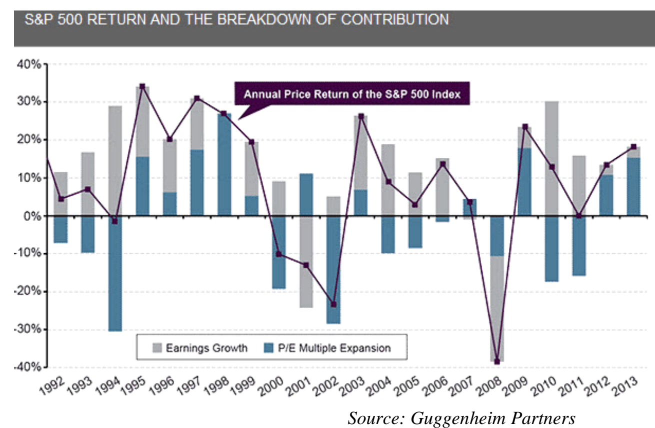
Index	3rd Quarter 2013	9 mos. ending 9/30/13
DJIA	**2.17%**	**17.67%**
S&P 500	**5.24%**	**19.79%**
S&P Mid Cap	**7.54%**	**23.23%**
Russell 1000/Growth	**8.11%**	**20.87%**
Russell 1000/Value	**3.94%**	**20.47%**
Russell 2000	**10.21%**	**27.69%**
NASDAQ Comp.	**10.82%**	**24.90%**

The market has now advanced for approximately 720 days without a 10% correction, providing a sense of confidence to market participants. As we discussed in our *Investment Outlook—Summer 2013*, speculative forces have become more prevalent as investors have concluded that the Greenspan/Bernanke/(Yellen?) put will not expire anytime soon. As is typically the case, speculative trading activities become more pronounced as bull markets mature. These speculative strategies can be best seen in the hot market for initial public offerings and the "short squeezes" that have been so prevalent in 2013. The Renaissance Capital US IPO Index climbed a whopping 30.6% for the third quarter and over 50% for the year-to-date. The Goldman Sachs Most Short Rolling Index returned 14.15% for the most recent quarter and 38.04% for the nine months ended September 30, 2013. Keep in mind the "most shorted" stocks have been selected by professional investors as being "over-valued" or fundamentally flawed. In some ways the markets remind us of 2007 when ex-Citigroup CEO Chuck Prince eloquently stated:

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

Multiple Expansion

The total return of a stock or stock index can be broken down into three main components. Total Return = Dividends +/- Earnings Growth +/- Change in P/E ratio. When dissecting the 19.8% rise in the S&P 500 index thus far in 2013, it is estimated that approximately 16% has come from price/earnings multiple expansion. The price/earnings multiple expansion has been the primary driver of U. S. equity returns for 2012 and 2013 as earnings growth for the last two years has been a little over 2% a year while the market has returned over 38% over the last 21 months.



Source: Guggenheim Partners

According to Morningstar, the average price/earnings multiple since 1871 has been 15.5, while the median has been 14.5. Currently, the S&P 500 trades at approximately 15.1 times trailing earnings which is essentially in line with the long-term average. Trough earnings coupled with below average price/earnings multiples are the best combination for a bull market move. The current scenario of all time high profit margins coupled with an average price/earnings ratio would imply below average returns for equities going forward. If we assume that interest rates have bottomed, it will be extremely difficult to see profit margin expansion or price earnings multiple expansion going forward. In early 2013 Adam Parker of Morgan Stanley stated, "The reason we got multiple expansion last year was the Fed is creating trillions of dollars on a computer". Parker points out that the Fed driven multiple expansion essentially "robs from the

future". Any further move upward in stock prices without acceleration in corporate earnings would likely create an environment in which we would look to reduce equity exposure for client portfolios.

Investment Versus Speculation

The financial media today does little to explain to market participants the difference between investing and speculation. Investors and speculators have always co-existed in every market place since the beginning of time. Benjamin Graham wrote in *Security Analysis* in 1934 that "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative." Graham expressed concern that the term "investor" was universally applied to anyone and everyone who participated in the stock market. John Bogle, the founder of The Vanguard Group, argued in his recent book that in the minds of most individuals, investment and speculation are now indistinguishable. In the *Intelligent Investor*, Benjamin Graham stated, "Outright speculation is neither immoral, nor (for most people) fattening to the pocketbook. More than that, some speculation is necessary and unavoidable."

Investors typically believe that a stock actually represents a fractional ownership of an underlying business. They typically will buy a security when the current price is lower than the perceived value based on fundamental analysis. The belief is that over the long term stock prices will appreciate or depreciate based on the company's long term execution and business prospects. Speculators tend to buy and sell securities based on whether they believe the price will rise or fall in value. They view securities as pieces of paper to be traded with little or no regard for investment fundamentals or value. Speculative trading is usually technically oriented and based on "price action" and chart patterns. Technical analysis utilizes past share price data to essentially predict future market movements. One big difference between investors and speculators tends to be the time frame associated with an investment. Investors tend to be long-term oriented and speculators tend to be short-term oriented. As we have mentioned over the past couple of quarters, the markets have recently become more speculative in nature. Speculators typically do not use valuation measures in their decision making process, thus leaving room for huge pricing disparities between the fundamental value of a company and the stock price of that company. Warren Buffett in explaining speculation versus investment stated, "It's a tricky definition, you know, it's like pornography." By that Buffett was referring to the famous quote, "I know it when I see it."

The markets have become bifurcated in recent months. You have the momentum stocks and then everything else. The environment is reminiscent of 1999, when momentum and day trading investing strategies were all the rage. Low trading volumes have made it quite easy for hedge funds and high frequency traders to engineer a group of stocks into parabolic moves upward. Due to the low interest rates, many companies have continued to buy back shares despite skyrocketing prices. Buybacks lower share counts, effectively accelerating EPS growth while net income growth may be more modest. Ironically, many of the corporate insiders who approve share repurchases at the corporate level are selling shares they hold personally. The chart below contrasts a few "anointed" momentum names compared with some well-regarded "blue chips". I think Buffett was right in regard to speculation, "I know it when I see it".

Company	*Revenues*	*Mkt Cap*	*Price/Sales Ratio*	*P/E Ratio*	*12 Month Price chg**
Exxon	$399.7B	$383B	1.04	10.8	(6.7%)
Target	$73.3B	$40B	.55	15.3	(1.1%)
GE	$147.4B	$248B	1.68	17.8	4.0%
Coca-Cola	$48.0B	$165B	3.4	19.7	(3.6%)
Facebook	$6.1B	$124B	20.3	221	144.1%
Chipotle	$2.9B	$13.5B	4.7	45.7	54.5%
Yelp	$178M	$4.7B	26.4	n/a	157.2%
Tesla	$1.3B	$22B	16.9	n/a	155.0%

*period ending 10/4/13 (does not include dividends) Source:TelemetOrion

Summary

The S&P 500 has advanced by approximately 152% from its February 2009 lows while the Russell 2000 and the S&P Mid Cap index have both advanced by more than 200%. Warren Buffett recently made the following statement regarding the current market, "They're probably more or less fairly priced now. We're having a hard time finding things to buy." Investment alternatives such as bonds and cash appear relatively unattractive. We believe bonds have entered a secular bear market that could last twenty years or more. Returns on cash are essentially zero, with Bernanke pledging to keep rates low into the foreseeable future. While we are not bearish on high quality, blue-chip stocks, we do believe the speculative "momentum game" will end badly. We would also caution against chasing the small and mid-cap names and indexes, as the recent run-up in those areas has resulted in stretched valuations.

It has been almost two years since the equity markets have seen a 10% correction. We would likely become more aggressive buyers in the event of a meaningful pullback. While not market timers, we cannot rule out the possibility of reducing equity exposure somewhat if stock price gains continue to far outpace earnings growth. We will continue to focus on investing with a "margin of safety" and continue to sidestep the areas of the markets that we consider ripe with speculation. Our "value investing" strategy has served us well through other difficult periods before; including the closet-indexing craze, the "internet bubble" and the "financial crisis".

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