JOLLEY ASSET MANAGEMENT, LLC

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"Ben Bernanke is the Wizard of Oz of the financial world, pulling on monetary levers behind the scenes to drive a 14% increase in equity prices during the past year despite corporate earnings that are up only 4%. It's not the improvement in earnings that's driving equities. The 87% correlation between the Fed's balance sheet and the S&P 500's five hundred point rally indicates the U. S. central bank had much to do with it." David Rosenberg Gluskin/Sheff

For the last four years, investors have been rewarded by following the old Wall Street adage of "Don't fight the Fed". Historically, periods of easy monetary policy have been a good time for investors to favor riskier assets such as equities and reduce exposure to safe investments such as treasury bonds and certificates of deposit. During the quarter just ended, the move into riskier assets accelerated, as central banks around the globe continued their aggressive monetary support. Yield starved investors seemed to have concluded that the Fed's zero interest rate policy is here to stay, and that they will have to embrace "riskier assets" such as equities to generate suitable returns. As we discussed last quarter, savers who are receiving essentially zero return on deposits are currently losing approximately 3% a year in purchasing power when inflation is taken into account.

For the quarter just ended, the S&P 500 rose by 10.61%, while long-term treasury bonds fell by 2.71% and investment grade corporate bonds were essentially flat. The allure of precious metals seemed to fade and gold declined by 3.95% in the first quarter. Stocks were led by defensive sectors such as health care (+15.2%), consumer staples (+13.8%) and utilities (+11.8%). The weakest sectors of the market were technology (+4.2%) and materials (+4.2%). The move into the defensive sectors seems to be a combination of two factors, the search for yield and fears of an economic slowdown. One odd occurrence that took place in the quarter was the fact that in a market led by defensive areas, low quality equities outpaced high quality equities by a wider margin. The Bank of America/Merrill Lynch low quality stocks which were rated C&D (+ 18.1%) outpaced high quality A+ rated stocks (+ 10.35%) by 7.75%. On one hand, there seems to be a search for yield by investors in the high quality bond-surrogate type of defensive names. On the other hand, there is growing speculative trading environment which tends to favor both momentum and lower quality issues. Value strategies have outperformed growth over the past quarter and year. The Russell 1000 Value Index returned 12.31% for the quarter compared to 9.54% for the Russell 1000 Growth index. Small and mid cap indexes have outperformed larger stocks over the past quarter and year.

Index	1st Quarter 2013	Trailing 12 months
DJIA	12.02%	13.33%
S&P 500	10.61%	13.96%
S&P Mid Cap	13.45%	17.83%
Russell 1000/Growth	9.54%	10.09%
Russell 1000/Value	12.31%	18.77%
Russell 2000	12.39%	16.30%
NASDAQ Comp.	8.21%	5.69%

Different this Time?

I have been writing quarterly investment letters for approximately seventeen years now—two years of letters at Centura Bank followed by fifteen years at Jolley Asset Management, LLC. The investment climate we are now in is unlike any I have seen in the last seventeen years so why not try to get my message across in a little different format. After all, what is driving the markets is currently less about the typical topics we discuss such as the economy and corporate earnings and more about the Fed and central bankers across the globe. So bear with me as I try this new quarterly letter format. While I acknowledge that I cannot review the movies as well as Roger Ebert, the renowned film critic who recently died, I'm going to take a stab at showing how some popular movie themes relate to today's financial scene. Please let me know your thoughts!

"The Wizard of Oz"

You may have seen comparisons over the past few months between Ben Bernanke and the "Wizard of Oz"…they have been numerous. I wish I could take full credit but that would be unfair. Charles Calomiris, Columbia University economist and member of the Shadow Open Market Committee, when referring to the drastic changes in Fed monetary policy recently stated, "We aren't in Kansas anymore". In today's economy, the role of the Wizard seems to be played by Ben Bernanke and most of his actions tend to take place behind the curtain. In Dr. Bernanke's defense, he has been dealt a difficult hand of cards. The 2008 financial crisis coupled with an inept Congress has forced the Fed to take on the role of savior. Once Bernanke had pushed rates to essentially zero during the financial crisis, he was forced to try to push a different "set of buttons" to stimulate the economy. QE1, QE2, Operation Twist and QE3 have all artificially lowered interest rates, which in turn have raised financial asset prices and real estate prices. Bernanke in essence is trying to stimulate growth by triggering animal spirits and the wealth effect. The Fed through these unusual techniques seems to have had some success. The economy has stabilized and the stock market has recently made all time highs. Certain sectors such as housing seem to be improving and recovering from depressionary type conditions. The Fed recently said it will continue its $85 billion monthly bond-buying stimulus program until the economy improves. The central bank also pledged to keep interest rates near zero until the national unemployment rate falls to at least 6.5%, and as long as inflation stays in line with its 2% target.

Jim Grant from "Grant's Interest Rate Observer" calls the Fed's move an experiment, "and we are lab rats in the financial markets." Grant further states, "The Fed's balance sheet is exploding. They have added over $3 trillion in new securities since QE began. Bernanke's money printing is counter-productive and is why the economy won't recover. If it were as easy as printing money or creating credit to levitate an economy or to reactivate business activity, the world would have been richer many generations ago." Grant believes "We are all living in a land of speculation and manipulation" and the end result will be much higher inflation. I'm just waiting for the Fed Chairman to click his heels three times and say, "There's no place like stocks".

"Groundhog Day"

In "Groundhog Day", Bill Murray (Phil Connors) is a weatherman who is sent to Punxsutawney, Pennsylvania to cover the annual Groundhog Day event. The plot of the movie has Phil Connors reliving the same day (Groundhog Day) over and over again. Phil realizes that no matter what he does the same day will start over tomorrow. Eventually, he begins to adapt his behavior like any rational person would be expected to do. That is essentially what is happening with investors who have been conditioned by Federal Reserve Chairmen Greenspan and Bernanke. Investors have continuously been rewarded by buying on every dip, because they can rest assured the "Greenspan put" or the "Bernanke put" will be there if anything goes wrong. We have discussed this "put" on numerous occasions, but to summarize, the "Bernanke put" essentially puts a floor on stocks through easy monetary policy. Goldman Sachs recently stated it expects easy monetary policy from the Fed until at least 2016. This "put" or backstop on the market results in investors acting differently and taking on more risk than they otherwise would be comfortable taking. Despite horrific macro-economic issues over the past couple of years, the S&P 500 has now advanced for over 540 days without a 10% correction. Since 1962, the index has rallied for at least 500 days without a correction only five times. Essentially, any market decline is met with buyers who have been conditioned to believe that the risk is limited due to Fed policies. Not only has the market not corrected, speculative strategies are now the norm. Margin debt has exploded to $364 billion in January 2013, its second highest level since $381 billion in July of 2007. Short-sellers who attempt to capitalize on companies with declining fortunes or over-valuation have been taken to the woodshed. Heavily shorted securities have skyrocketed (despite fundamentals) as institutional investors have targeted these companies for purchase in an attempt to squeeze shorts. The Goldman Sachs Most Short Rolling Index (50 most shorted names in Russell 3000 Index) was up 13.6% in the first quarter, outpacing any of the major indexes. Funny, these were the stocks that were supposed to go down. When investment strategies and algorithms are concocted to own the "worst or most over-priced" securities, it makes one take notice. Low quality or junk stocks have outperformed high quality stocks since the market bottomed in early 2009. According to Ford Equity Research, the average junk stock has returned 273% in that period versus 171% for high quality issues. There is absolutely no concern by many "professional investors" owning Netflix at 560 times trailing earnings or LinkedIn at 899 times trailing earnings. Like Phil Connors, traders/speculators have no fear because they know that tomorrow will play out just like today did. Bernanke will be there to save the day. In the movie "Groundhog Day", the time loop eventually ends. The Bernanke put will also expire one day, although the timing is unknown.

"Jerry Maguire"

In "Jerry Maguire", Tom Cruise (Jerry Maguire) was a sports agent who, for philosophical issues, wanted to go out and form his own agency. Things didn't go exactly as planned and Jerry essentially was trying to survive with only one client, Rod Tidwell (Cuba Gooding, Jr). Rod was loyal, yet in contract negotiations he demanded to Jerry, ***"Show me the money"***. Corporate America has been doing just that. While Fed policies may have encouraged risk taking among investors, corporations have been hunkered down and have positioned themselves wonderfully over the past decade. At the end of 2012, cash as a percentage of total assets for S&P 500 companies approximated 13.3%, near an all time high. This gives companies the ability to handle economic shocks going forward but it also gives companies the ability to increase dividends, do stock buybacks and finance mergers and acquisitions. According to Howard Silverblatt of Standard & Poor's, from 2007-2012 dividends on the S&P 500 have grown by more than 14% a year. This trend of higher dividends should continue going forward. The current dividend payout ratio of 30% is well below the average of 58% over the last 87 years. The current dividend yield on the S&P 500 of 2.16% compares favorably with the ten-year U. S. treasury yield of 1.71%. While politicians and elected officials around the globe have been unable to mind the store, corporate managers have done an exceptional job over the past decade "showing us the money".

Summary

The markets soared in the first quarter essentially giving investors an above average year in just three months. Valuations on the large capitalization stocks remain reasonable at approximately 15 times forward earnings. Balance sheets remain exceptionally strong giving companies' tremendous flexibility going forward. While we remain constructive on the blue-chips, we do have concerns over the increased speculative activity that has entered the markets. We also have concerns over how the Federal Reserve will exit the "bond-buying" programs without creating market dislocations. We continue to find companies that we believe offer investors compelling value and we will attempt to reduce exposure to companies and sectors where valuations have become stretched. We remain convinced that our "value" strategy will serve our clients well over the coming year.

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