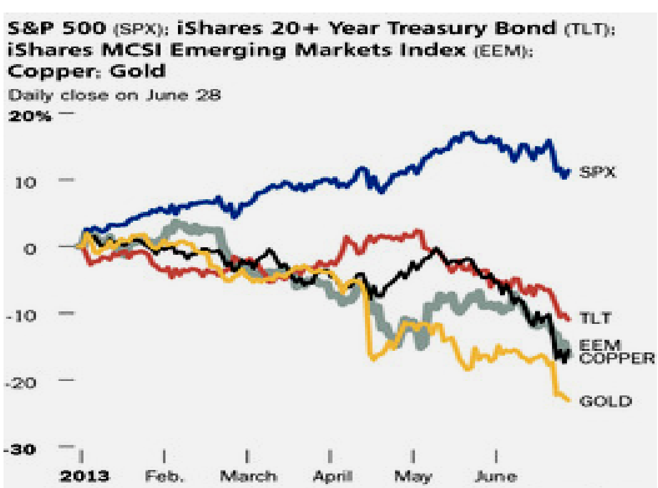
JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 60• Summer 2013**

> *"But this time is never different. History always rhymes. Human nature never changes. You should always be more skeptical of any investment that has soared in price, and you should always be more enthusiastic about any asset that has recently fallen in price."*
>
> *Jason Zweig—Wall Street Journal*

Index	2nd Quarter 2013	6 mos. ending 6/30/13
DJIA	**2.82%**	**15.18%**
S&P 500	**2.91%**	**13.82%**
S&P Mid Cap	**1.00%**	**14.59%**
Russell 1000/Growth	**2.06%**	**11.80%**
Russell 1000/Value	**3.20%**	**15.90%**
Russell 2000	**3.08%**	**15.86%**
NASDAQ Comp.	**4.15%**	**12.71%**

Despite declining in June on concerns around Fed policy, domestic stocks turned in another strong quarter. For the quarter just ended, the S&P 500 and Dow Jones Industrial average returned 2.91% and 2.82%, respectively. For the first half of 2013, the S&P 500 index gained 13.82%, representing its best first half since 1998. At quarter end, the S&P 500 index stood just 3% below its all time closing high which was hit on May 23, 2013. U. S. stocks turned out to be the "cleanest dirty shirt" as most other asset classes were hit extremely hard in the quarter and for the first half (see chart below). For the first half of 2013, long-term treasury bonds declined by 8.19%, investment grade bonds by 3.31% and gold by 28.37%. World equities (excluding U. S.) declined by 3.6% for the second quarter and returned 10.2% for the first half of 2013.



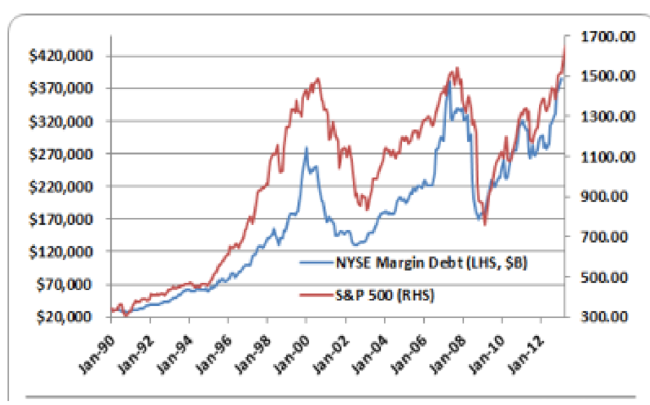
Source: Thomson Reuters

Small cap issues outperformed large and mid-caps for the quarter and year-to-date as can be seen in the table above. Value strategies outperformed growth (year-to-date) as evidenced by the 15.90% return for the Russell 1000 Value Index, versus 11.80% for the Russell 1000 Growth Index. Consumer discretionary, financials and healthcare were the market leaders in the first half of the year while materials, utilities and telecommunications were market laggards. According to Bank of America/Merrill Lynch, lower quality stocks (not rated or ranked C&D) outperformed higher quality issues (those rated A and A+) by a wide margin in the first six months of 2013. Gold tumbled 23% in the second quarter (-28.4% YTD), the biggest quarterly decline since the trading of gold futures began in 1974. Emerging markets were hurt by investor concerns over a slowing China and political unrest in Brazil and Turkey.

Aging Bull Market?

From the lows of 2009, the S&P 500's 51 month rally now ranks 6th among 24 bull markets in the last 113 years of data available. From the lows of March 6, 2009, the S&P 500 has climbed from 666.79 to 1606.28 on June 28, 2013. That represents a 140% rise from the bottom reached in the depths of the financial crisis. As is typically the case, speculative trading activity and strategies become more pronounced as bull markets mature. This bull move appears to be no exception. The easy money policies of Greenspan/Bernanke have created speculative bubbles in different sectors of the economy for the past fifteen years. Bernanke's zero interest rate policy and obsession with the equity markets (wealth effect) has once again led to what appears to be excessive speculation. In April of this year, margin debt hit a new all-time high of $384 billion, surpassing the old high hit in July of 2007. Over the past twelve months, the S&P 500 High

Margin Debt Hits Record Highs



Beta ETF has returned 30.8%, more than doubling the return on the S&P 500 Low Volatility ETF of 12.4%. This coupled with ballooning margin debt implies that the markets have become "frothy" and that investors, or should we say market participants, are clearly chasing returns. The speculative nature of the market recently became obvious with the recent initial public offering (IPO) of a restaurant chain called

Noodles & Company. Noodles & Company (NDLS) was founded in 1995 in Denver and is what analysts refer to as "fast casual". The IPO of Noodles was expected to be priced at a range between \$13 and \$15 per share. The investment bankers priced the shares at \$18/share (6/28/13), above the expected range, only to see the shares open for trading at \$32. Two trading days later, the shares hit \$51.97 intra-day, approximately 400% higher than the low end of the expected pricing range of the underwriters. It appears that "fast-casual" restaurants are the new internet stocks? As Benjamin Graham stated in *Security Analysis, 5th Edition:*

> *"Another alternative is to do whatever everyone else is doing, even though the price of a stock appears high; this is the so-called greater fool theory. This theory is applied on the basis that "I know I am a fool to pay such a high price for a stock but I know that a greater fool will come along and pay me an even higher price."*

Taper Tantrum

On June 18th after a two day Fed meeting, Federal Reserve Chairman Ben Bernanke said the central bank could start winding down its \$85 billion-a-month bond-buying program later this year and end it altogether by mid-2014. This would seem logical, with the economy five years removed from the financial crisis and the stock market at all-time highs. Market participants didn't like the news from Bernanke, sending the yield on the 10-year treasury bond to 2.6% in late June up from 1.6% in May. Investors pulled \$8.6 billion from taxable bond funds in week ending 6/26/13, bringing the total redemptions for the four weeks to \$23.7 billion. The average taxable bond fund lost 2.1% for the quarter, while long dated government bond funds lost 6.3%. Treasury inflation protected (TIPS) funds fared even worse, losing 6.6% for the quarter. Equity investors also were panic-stricken over the possible Fed "tapering", sending the S&P 500 index down approximately 5.7% from the high on 6/18/13 to the low on 6/24/13.

Just as a parent will give in to a child having a "temper tantrum", the Fed gave in to the financial markets. Leaks to the financial press and Fed governors were trotted out one by one to promote a "dovish" message and explain that Bernanke's comments were misunderstood. Fed officials succeeded in calming the markets as bonds stabilized and the S&P 500 regained approximately 3% from the June 24th low until quarter end. Bernanke appears to have "boxed himself into a corner" with his massive bond-buying program (quantitative easing). Apparently, President Obama agrees, as he hinted in an interview with Charlie Rose on PBS that Bernanke will not be back after his term runs out in January 2014. Most expect Obama to appoint Janet Yellen to take Bernanke's spot. Yellen is widely considered to be the most dovish member of the FOMC – meaning she tends to focus on unemployment concerns rather than making inflation a top priority. While it would be nice to have the markets determine the appropriate level of interest rates rather than the Federal Reserve Board, we have our doubts. In our opinion, Yellen will likely continue down the same path as Bernanke and Greenspan.

Investment Strategy

It seems pretty obvious that interest rates have bottomed and that the thirty-two year old secular bull market in bonds has finally ended. As we have discussed for the last year or so, we continue to recommend exposure (for most clients) to the fixed income markets, for asset allocation/risk tolerance reasons. In the fixed income portfolio, we are essentially trying to minimize interest rate risk by utilizing short duration securities and some floating rate securities. Investors who have reached for yield in longer term bond funds will likely have a rude awakening when reviewing their June 30th brokerage statements. Unfortunately, most had no idea how much money could be lost in bonds.

Due to the recent volatility in equities, a number of clients have questioned if now would be a good time to reduce equity exposure to avoid a further market pullback. As we have discussed on numerous occasions, we do not believe investors can successfully time the markets. Timing the markets requires two correct calls, when to sell and when to get back in. Emotions (fear and greed) tend to make both of these decisions very difficult for most investors (both individuals and professionals). As Ron Baron of Baron Capital recently stated on CNBC:

> *"The average investor makes 3% in mutual funds. The average mutual fund has a 7% return over time. Why the difference? Because investors try to 'trade the news' instead of remaining in the fund over a long period of time. As a result they tend to do poorly."*

As value investors, we spend our time focusing on our portfolio companies' prospects, financial statements and valuations (both relative and absolute) and less time on predicting the future direction of the economy and/or markets. We are currently finding value in the more cyclical areas of the market. We have recently added positions in the energy, materials and financial sector and believe they represent good value currently. Over the last two years, the energy sector is only up 3.4% and the materials sector has actually declined by .88%. Many of the historically "defensive" sectors were bid up significantly by investors seeking yield (many had yields significantly higher than bonds) over the last couple of years, making those sectors of the market less attractive in our view. Utilities, real estate investment trusts, and telecommunication issues appear priced for perfection in our opinion.

Although the markets have changed dramatically, our advice has rarely changed over these past fifteen years since Jolley Asset Management, LLC was formed. Invest in high quality businesses when they can be purchased with a "margin of safety". Always try to determine the "downside" risk of a particular investment before considering the "upside" potential. Give the balance sheet equal consideration as the income statement when evaluating a potential equity investment. A successful value strategy requires patience and discipline from both the manager and client alike. We are lucky to have had excellent clients over these past fifteen years. You have been instrumental in our success.

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