JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 63• Spring 2014**

> *"Value investing works because it is contrary to naïve strategies of other investors, which include extrapolating past earnings growth too far into the future and assuming that a well-run company will always be a good investment, regardless of price."*
>
> *Dr. Josef Lakonishok*
> *LSV Asset Management*

Despite nervousness about a new Fed Chairman and the economic ramifications of a harsh winter, stocks once again posted solid quarterly gains. The S&P 500 index advanced by 1.81%, its fifth consecutive quarterly gain. The Dow Jones Industrial Average lagged the other major indexes and actually closed slightly in the red for the quarter, its first quarterly decline since the fourth quarter of 2012. The Russell 1000 Value Index outperformed the Russell 1000 Growth Index for the quarter, as many of the hot growth sectors began to falter late in the quarter. In the month of March, the Russell 1000 Value Index returned 2.39%, while the Russell 1000 Growth Index fell by 1.01%. This new "risk off" posture by market participants also pressured the Russell 2000 Index and the NASDAQ Composite which fell by .68% and 2.53%, respectively, for the month of March. Despite the weak close to the quarter by the Russell 2000 and the NASDAQ Composite, they continue to be the best performing areas of the market for the past twelve months.

Index	1st Quarter 2014	March 2014
DJIA	-.011%	1.03%
S&P 500	1.81%	.84%
S&P Mid Cap	3.04%	.37%
Russell 1000/Growth	1.12%	-1.01%
Russell 1000/Value	3.02%	2.39%
Russell 2000	1.12%	-.68%
NASDAQ Comp.	.54%	-2.53%

In March and the first few trading days of April, it appears that the pendulum has clearly swung in favor of "value" over "growth" and "large-cap" over "small-cap". We believe that this rotation into large-cap value is in the early innings as investors once again focus on valuations rather than simply chase momentum and performance. "Growth" has outperformed "value" for nearly six years now. This is the longest stretch of outperformance for "growth" versus "value" since 1932.

Bull Market Turns Five

March 9th marked the fifth anniversary of the current bull market. Since 1932, there have been twelve bull markets (bull market is defined as one which gained at least 20% and lasted at least six months or more). Please keep in mind market historians may define bull markets in different terms and many have somewhat different conclusions. We should point out that the S&P 500 index didn't begin until 1957, but S&P retroactively created values dating back to 1926. Bull markets have lasted from 14 months (1932-1933) to 148 months (1987-2000), with the average bull market lasting 60 months. So the current bull market, which has lasted 61 months is not unusual, but is becoming "long in the tooth". In terms of returns, the average bull market has returned 185%, while the median bull market gain has been 132%. In the current bull market, the S&P 500 index has returned approximately 176% from trough levels, which is slightly below the average bull market but considerably ahead of the median bull market gain. As the chart below shows, the Russell 2000 index has gained over 250% since the bear market bottom in March of 2009!

Bull Market Performance Since March 9, 2009

Source: YCHARTS

Stock Buybacks

One of the key drivers of this bull market has been stock buybacks. Standard & Poor's recently reported that for 2013 stock buybacks topped $475 billion, 19% above the $399 billion for 2012. The high point for buybacks was in 2007, when companies spent $589 billion buying in shares. Ironically, during the recessionary year (when stocks were cheap) of 2009, corporate treasurers repurchased only $137.6 billion in shares. Buybacks are typically seen as good for shareholders because it is a tax efficient way to return cash to shareholders and it can also boost earnings per share by reducing the company's share count.

On the surface, buybacks appear to be a "win-win" for shareholders. However, in many instances the buyback is merely used to offset future stock and option grants that are already allocated to corporate insiders. There is also an opportunity cost associated with utilizing corporate cash to buy in shares. In recent years many of the funds that have been allocated to buybacks could have been used to actually improve the business' competitive advantage. For example, a company's global competitiveness may be threatened over the long-term if the company refuses to allocate enough captial to new product development, new plant and equipment and research and development. In the current ultra low interest rate environment, many companies are issuing debt and buying back shares in lieu of investing in their businesses. While this may benefit investors short-term, it is uncertain if it is truly the best use of corporate cash. In a March 21st letter to leaders of companies in the S&P 500 Larry Fink, CEO of BlackRock wrote, "It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies". Fink added, "Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks…We certainly believe that returning cash to shareholders should be part of a balanced capital strategy; however, when done for the wrong reasons and at the expense of capital investment, it can jeopardize a company's ability to generate sustainable long-term returns." For now, the markets love buybacks. The S&P 100 Buyback Index, which monitors 100 stocks with the highest buyback ratios, increased by a whopping 45% in 2013, far outdistancing the S&P 500 rise of 32.4%.

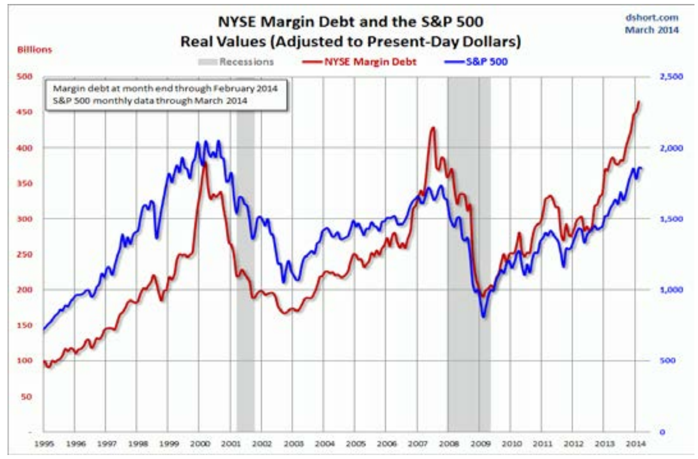
One would think that corporate boards and management teams would excel at the appropriate timing of share repurchases. Who would know better than the corporate insiders whether the shares are attractively valued in the market. However, history has not shown that to be the case. In 2007, corporations bought back $589 billion worth of shares, just before the market collapsed in 2008. Over the following seven quarters, when the markets were at bargain levels, buybacks dropped by 86%. In 1999, Warren Buffett discussed share repurchases in his letter to shareholders:

> *"Now, repurchases are all the rage, but are all too often made for an unstated and, in our view, ignoble reason: to pump or support the stock price. The shareholder who chooses to sell today, of course, is benefited by any buyer, whatever his origin or motives. But the continuing shareholder is penalized by repurchases above intrinsic value. Buying dollar bills for $1.10 is not good business for those who stick around."*

Even more concerning are situations where corporate buybacks are taking place amid heavy insider selling. This should serve as a "red flag" for investors, because such activity raises questions about whether companies are acting in the best interests of shareholders or merely pushing the shares higher for personal gain.

Momentum Game Over?

In recent quarters, we have warned our readers that many areas of the markets had become frothy and that "momentum" investment strategies would likely end badly. The "zero interest rate policy" that the Fed has maintained for the past five years, has led to a speculative trading environment that has looked eerily similar to the 1999-2000 time period. Margin debt recently hit another record high in February eclipsing the highs from 2000 and 2007. In recent weeks, it appears that the speculative bubble in the "momentum" names may have finally been pricked. In just a few weeks' time, many of these "high-



Source: dshort.com

flyers" wings have been clipped. In recent market action, Netflix, Facebook, Yelp and 3D Systems have declined from their 52-week highs by 26%, 22%, 35% and 45%, respectively. While we wouldn't be surprised to see a temporary bounce or short-covering rally in some of the momentum names, we believe it is safe to declare that the game of "musical chairs" is now officially over. In the coming weeks, it will be interesting to find out what hedge fund managers were left standing without a chair.

Summary

The S&P 500 has now advanced for thirty consecutive months without as much as a ten percent correction. While we would not be surprised by a correction in the coming months, we do not believe a "bear market" is likely in the near term, given the fact that returns on cash remain at essentially zero. We believe that the recent trend favoring "value" over "growth" will likely continue, reversing a six-year trend. Valuations on large capitalization stocks remain reasonable at approximately 15 times forward earnings. While the small and mid-cap indexes have corrected slightly in recent days, they still appear richly valued and unattractive on a relative basis. We will continue to focus on investing with a "margin of safety" and attempt to sidestep the areas of the markets that we consider ripe with speculation. Recent market turmoil and geopolitical events have benefited the bond market, which outperformed the equity markets in the first quarter. In our opinion, that trend will be short-lived as the Fed continues to exit "quantitative easing" over the coming months. We continue to believe that bonds remain in a secular "bear market" that could last for more than a decade. Thanks again for the confidence you have placed in Jolley Asset Management, LLC.

Frank G Jolley, CFA

JAM JOLLEY ASSET MANAGEMENT, LLC

210 Bryant Street, Suite A
P.O. Box 7967
Rocky Mount, NC 27804
(252) 451-1450 Toll Free (877) 4-JOLLEY
Web Site: www.jolleyasset.com
E-Mail: fjolley@jolleyasset.com