JOLLEY ASSET MANAGEMENT, LLC

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Experience teaches us that one of the most common errors in selecting stocks for purchase, or for sale, is the tendency to emphasize only the most obvious factor; namely the temporary outlook for sales and profits of the company.

John Templeton

The second quarter of 2015 was marked by increasing volatility in the financial markets. This was largely the result of the Greek debt crisis, the massive stimulus by the European Central Bank, slowing profit growth and the anticipation of interest rate increases by the Federal Reserve. According to FactSet, S&P 500 companies reported profit growth of just .8% in the first quarter of 2015, and they are projecting a decline in earnings of approximately 4.5% in the second quarter. In the first-half of 2015, the markets have been led by the healthcare and consumer discretionary sectors which returned 8.7% and 6.0%, respectively. The weakest sectors for the first-half were utilities which fell by 12.3% and energy which declined by 6.1%. For the quarter and first six months, the markets were led by the NASDAQ Composite index, which was boosted by technology and biotechnology company holdings. The Russell 2000 index (small caps) also performed well in the first six months of 2015. Bank of America/Merrill Lynch estimated that biotech companies contributed more than one-third of the Russell 2000's first-half returns. Small caps also benefited as investors sought out companies that generate a majority of their sales domestically and are not as sensitive to movements in exchange rates as the large multinationals.

Index	2nd Quarter 2015	2015 YTD 6 Mos.
DJIA	**-.32%**	**.04%**
S&P 500	**.28%**	**1.23%**
S&P Mid Cap	**-1.06%**	**4.20%**
Russell 1000/Growth	**.12%**	**3.96%**
Russell 1000/Value	**.11%**	**-.61%**
Russell 2000	**.42%**	**4.75%**
NASDAQ Comp.	**1.75%**	**5.30%**

As the bull market enters year seven, it has become increasingly difficult for value investors to match the S&P 500 index returns. The S&P 500 index is a market capitalization weighted index which means the largest companies can drive the index higher, while many stocks in the index are not participating. This is precisely what is happening now. Over the past twelve months, four of the S&P 500 sectors have shown price declines led by the energy sector decline of 24.3% and the utility sector decline of 6.4%. Five sectors advanced over the past year led by healthcare (primarily biotech) which was up by 22.2% and consumer discretionary which advanced by 14.7%. The industrial sector was essentially flat over the past twelve months. The discrepancy between the S&P 500 index and the average stock can also be seen by examining the Value Line index. The Value Line index equal weights approximately 1700 companies with varying market capitalization ranges. For the past twelve months, on a price change basis, the Value Line index was down by .8% while the S&P 500 index advanced by 5.25%. Momentum strategies have become all the rage in this market, and we must admit that the current period reminds us of the market in the 1999-2000 time period. In an effort to jog your memory of that period, we have attached our *Investment Outlook—Spring 2000* to help you see the similarities. The chart below is somewhat self- explanatory and is included to show the discrepancies between returns and valuations for a group of high flying growth favorites (The Haves) and a group of high quality blue-chip companies (The Have Nots). In essence, we believe we are now in a market where investors/traders are overpaying for hyper-growth and momentum issues and tossing out blue-chip companies with reasonable valuations and excellent long-term prospects.

"I was dreamin' when I wrote this, so sue me if I go too fast, But life is just a party and parties weren't meant to last."

Prince—1999

Party Like It's 1999?

Company	12 Mo. Return	6 Mo. Return	P/S	P/E (trail)
The Haves				
Netflix	49%	90%	6.9	172
Apple	32%	15%	3.4	16
Facebook	35%	15%	18	86
Valeant Pharma	88%	56%	9.1	77
Shake Shack	n/a	181%	5.3	369
Under Armour	45%	27%	5.6	90
The Have Nots				
Exxon Mobil	-20%	-11%	1	12
Schlumberger	-28%	2%	2.2	22
General Motors	-13%	-6%	0.4	15
Wal-Mart	-5%	-16%	0.5	15
IBM	-12%	6%	1.8	14
Johnson & Johnson	-7%	-7%	3.7	18

As of 7/6/15 based on trailing 12 mos

Value investing principles helped us miss the party (market top) in 1999 and we believe will help protect client capital going forward. After the 2000 bubble burst, value investors who stuck to their discipline, not only protected capital but were able to make outsized returns while the S&P 500 and momentum crowd suffered from massive losses. Will history repeat itself?

Value Investor's Dilemma, Which Stock Do I Buy?

$ in (billions)	Stock A	Stock B
Market Cap $	232.8	249.1
P/E Ratio	14.5	86.1
Price/Sales	.48	17.6
Earnings/Share	4.97	1.03
Revenue $	485.6	12.5
Net Income $	16.4	2.9
Total Assets $	203.7	40.2
Total Equity $	81.4	36.1

Source: Bloomberg

Back in 1999, a good client of mine walked into my office and asked me why his portfolios (that we were managing) didn't look like everyone else's? We didn't own Lucent, JDS Uniphase, Yahoo, Cisco Systems, Coca-Cola or General Electric. We explained that while those were great companies, we felt that investors were overpaying for growth and it would be difficult for the company to ever grow into the stock price. It is very easy to confuse a great company with a great stock. The exercise below helps to explain how we think and why we avoid what we perceive to be overpriced stocks. This is the type of exercise that we are forced to do on a daily basis in managing client portfolios. Just looking at the data above, which stock would you prefer to see in your portfolio? Some additional information that may help in the decision is that Stock A is down approximately 4% over the past year, while Stock B has risen by 35%. Obviously, I have not given you all of the information that you need to make an informed decision. Is the business growing? What industries are the two businesses in? What are the revenue and earnings growth rates? Are they dominant in their industry? How long have they been in business? What are the barriers to entry? Keep in mind that the average stock in the S&P 500 index trades at approximately 18 times earnings. So Stock A trades at a substantial discount to the market, while Stock B trades at a significant premium to the market. Which stock would you want in your portfolio going forward? Obviously, Stock B has price momentum and Stock A has underperformed the market over the past twelve months. If you tune into CNBC and listen to Mad Money host Jim Cramer or watch the short-term traders on Fast Money, you would take the data above and select Stock B. For traders this would be an easy answer, but keep in mind traders, for the most part, don't care about the underlying fundamentals. They only care about the price action. However, we are long term value investors and would definitely want to know more about Stock A as a potential investment, while we would discard Stock B as being too expensive to own. No need to even consider including in our portfolios, it just would not meet our investment criteria. We would also point out that both of these securities are S&P 500 components. The index would own more of Stock B than Stock A, despite that fact that Stock A had approximately 40x the revenue and 5x the earnings of Stock B. The market has voted and Stock B is considered more valuable, despite what the revenues and earnings might otherwise imply. As Benjamin Graham stated, *"In the short run, the market is a voting machine but in the long run, it is a weighing machine."* Sticking with a value discipline is not easy and often times makes the value manager appear "old fashioned" and uninformed. Keep in mind, the value manager is well aware that not owning Stock B is hurting portfolio performance on a short-term basis versus the S&P 500 benchmark index. Clients would love to see Stock B in the portfolio, after all they hear about it all the time on CNBC. Their friends talk about it at cocktail parties…they wonder why they don't own it. In the mind of the value investor, it seems highly unlikely that Stock B will ever grow enough to justify its valuation. No matter how sexy the company is and no matter what industry they are in, it is simply too expensive to own. The value investor views owning a stock as owning a piece of a business, rather than owning a piece of paper. Once again, Stock A trades at less than 15 times earnings and Stock B trades at almost 18 times revenues. For those seeking income, Stock A also pays a dividend of 2.7% versus no dividend yield for Stock B. Company A has increased its dividend for forty-one consecutive years. I'm sure a few of you have already guessed what Stock A and Stock B might be, but for those who have not here you go. Stock A is Wal-Mart and Stock B is Facebook. Facebook is a glamorous growth company while Wal-Mart is nothing more than the most dominant retailer in the U. S. Facebook was founded just eleven years ago, while Wal-Mart was founded fifty-three years ago. Both are fine companies and both are extremely well managed. Perhaps we should revisit this exercise in a couple of years and see which company's stock wins the race. We must remember, a good company doesn't always make for a good stock.

Summary

The markets have become more volatile in recent months as profit growth has slowed and investors have begun to weigh the impact of problems in Greece and China. The bull market is getting long in the tooth as we enter year seven of the advance. The market has now gone some forty-five months without as much as a ten-percent correction in stock prices. The S&P 500 is now trading at 18 times trailing earnings, while the historical average over the past ten years has been 15.7 times. As we discussed earlier, a number of market sectors have experienced large price corrections over the past twelve months, providing a number of opportunities for the value oriented investor. Companies in the energy, materials and industrial sectors have declined precipitously as the dollar has strengthened and global growth has slowed. It is our belief that most of the bad news is already priced into those stocks and they offer great opportunities for the long-term value investor. On the other hand, we have a hard time fathoming how investors and/or traders will make money chasing momentum issues which are priced based on projected growth which may never be realized. We have seen this movie before and we believe that the ending will be the same. Please feel free to call if you would like to review your asset allocation and/or to discuss the markets. Thanks again for the confidence you have placed in Jolley Asset Management, LLC.

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