JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 71• Spring 2016**

> *"There is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has available funds – cash plus sensible borrowing capacity – beyond the near-term needs of the business and, second, finds its stock selling in the market below its intrinsic value, conservatively calculated."*
>
> *Warren Buffett 2000*

The equity markets slid by 11% (S&P 500) through mid-February, as recession fears spooked investors, but subsequently rebounded 13% amid improving economic data and a dovish Fed. According to Merrill Lynch/Bank of America, the market reversal was the eighth largest reversal in the past 350+ quarters.

Eighth-biggest Reversal in History
S&P 500 During First Quarter

Source: Bank of America/Merrill Lynch

When the quarter ended, the S&P 500 Index returned 1.35% while the Dow Jones Industrial Average returned 2.20%. Sounds uneventful, but in reality the markets provided quite the rollercoaster ride! The S&P 500 index has now generated positive total returns for the last nine quarters. During the quarter, momentum strategies lagged and value outperformed. The Russell 1000 Value Index led the Russell 1000 Growth Index by .9%, a trend that we believe will continue in coming quarters. Defensive stocks (bond proxies) were the best performers year to date, with telecoms and utilities each up 15% each. The energy sector posted a 9% return in the month of March, helped by oil's 40% rally off the February lows. For the quarter, the energy sector returned just over 3%. The worst performing S&P sectors were healthcare and financials, declining by 5.9% and 5.6%, respectively. Pharmaceuticals and biotech continue to be haunted by fears of price regulation and uncertainty associated with the upcoming election. Financials, which performed well in 2015 in anticipation of rate normalization, have reversed course as investors now expect the Yellen Fed to do very little with regards to hiking rates. Low rates means continued low net interest margins going forward. One has to wonder if the Yellen Fed will ever move to normalize rates. While the Fed claims that they are "data dependent", we all know they are really "market dependent" and the "central bank put" is still in place. We do believe the Fed has lost credibility and becoming less relevant, but nonetheless it still doesn't pay to "fight the Fed".

Index	1st Quarter 2015
DJIA	**2.20%**
S&P 500	**1.35%**
S&P Mid Cap	**3.78%**
Russell 1000/Growth	**.74%**
Russell 1000/Value	**1.64%**
Russell 2000	**-1.52%**
NASDAQ Comp.	**-2.75%**

Dangers of Market Timing

> *Market timing is the act of attempting to predict the future direction of the market, typically through the use of technical indicators or economic data.*
>
> *2. The practice of switching among mutual fund asset classes in an attempt to profit from the changes in their market outlook.*
>
> *Investopedia*

The past quarter served as evidence that timing the market is essentially a fool's game. Attempting to time the market—making buy and sell investment decisions based on predictions of market movements—is not the same as investing. Timing decisions are often a result of human psychology, namely fear and greed. The perils of market timing have been studied by Dalbar, Inc., a Boston based financial services research firm. In a recent study they conducted using data from 1995-2014, the following are the annualized returns by asset class relative to the average investor:

Asset Class	Returns
Stocks	9.9%
Bonds	6.2%
International Stocks	5.0%
Average Investor	2.5%
Inflation	2.3%

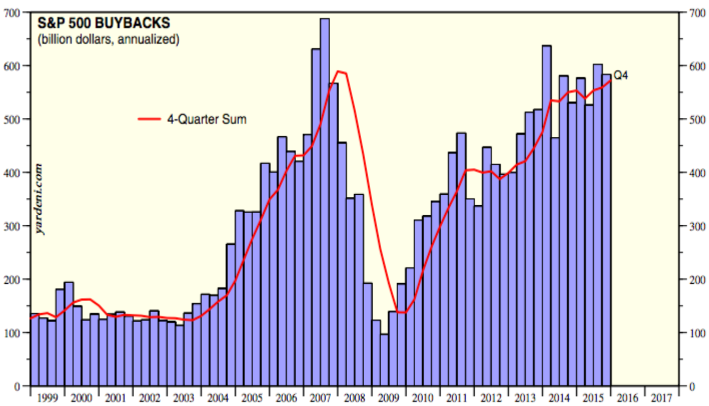
The primary issue the average investor faced? Market timing. Market participants were switching in and out of stocks and/or funds at inopportune times. Even though we know that stocks managed a 9.9% annualized return (including the tech bubble and 2008 financial crisis), investors often still try to enhance returns by timing or become risk averse as markets decline. Loss aversion or "panic selling" often leads to an emotional withdrawal of capital at the worst possible time. While some timers succeed and are the "smartest guys in the room", more often than not, the timing moves backfire and result in investors potentially missing some of the best days in the markets. The chart below shows just how much damage being out of the markets can cost investors if they miss the best 10, 20 or 30 day periods.

Time period out of market	Return
10 best days	6.1%
20 best days	3.6%
30 best days	1.5%
Left alone (no timing)	9.9%

We believe that most investors are better served by controlling risk by strategic asset allocation decisions and staying the course, rather than by attempting to time the markets. The Dalbar study seems to back up that strategy.

Corporate Buybacks

While individual and institutional investors often get their market timing decisions wrong, one would think that corporate managers would do a better job of timing of share issuance and buy-back of shares. After all, who knows more about the company than the management team and corporate board? Ironically, in the past corporations timing for buying in shares has often occurred at the top, with little buying in weak or bear market phases. The chart below shows heavy buyback activity before the bear market of 2008 and very little buyback activity when stocks were dirt cheap in early 2009. Share buybacks have become one of the major



by-products of the Federal Reserve's zero interest rate policy. Borrow money cheaply, buyback shares and boost both earnings per share and the share price at the same time. Since 2013, S&P 500 companies have spent $1.45 trillion buying back their own stock. David Kostin, chief U. S. equity strategist at Goldman Sachs stated that buybacks "will provide an important—and largest—source of demand for U. S. stocks". Howard Silverblatt of Standard & Poor's estimates that for the fourth quarter of 2015, S&P 500 companies issued buybacks to reduce shares by at least 4%, boosting earnings per share by approximately 4%. On the surface buybacks make sense if the common stock is trading at a discount to its intrinsic value and there are no other investment opportunities available which would help the company to grow at a desirable rate for shareholders. However, presently it appears that many share repurchase programs are self-serving moves by management. The buyback temporarily inflates the share price and earnings per share, allowing the managers to receive and exercise options which they later liquidate for large profits. Little thought is given to the fact that the balance sheet is becoming more leveraged and at some point in the economic cycle a pristine balance sheet might come in handy. A look at what has happened in the oil patch recently should serve as fair warning to those who are willing to buy back shares at the expense of balance sheet integrity. Hess, an exploration and production company funded a large buyback with debt to fend off activist group Elliot Management in 2013. From 2013-2014 Hess purchased 63 million shares at an average price of $83 per share, only to turn around and raise capital through the sale of 25 million shares at $39 per share in February 2016. Perhaps Hess's management team only prepared for rising oil prices? Even more troubling are companies where buybacks are taking place while corporate insiders are dumping shares at every opportunity. Worst yet are companies who have no tangible equity on the balance sheet, yet continue to borrow money to fund share repurchases. Autozone, an auto parts retailer has amassed $4.6 billion in debt primarily to repurchase shares and currently has negative equity on the balance sheet of $1.7 billion. Domino's Pizza continues to buy in shares at 39 times trailing earnings, despite having taken on $2.2 billion in debt and having negative equity on the balance sheet of $1.8 billion. Both Autozone and Domino's have been standout market performers—but call us skeptical.

Summary

The first quarter was a roller coaster ride for investors but ended with most of the major indexes closing in positive territory for the quarter. The Fed once again felt the need to jawbone the market higher with dovish overtones as the markets (as measured by most indexes) fell into bear market territory in February. The quarter served as a good lesson to investors as to why "market timing" typically fails both individual and institutional investors. We attempt to control risk by asset allocation decisions rather than "timing" the market. Our "value" style and our focus on "downside risk" tends to steer us to depressed sectors of the market, where expectations are low and where much of the bad news may already be priced in. We believe this lowers the risks to portfolios in difficult market periods. Unfortunately no style of portfolio management is able to capture returns in excess of the "risk-free" rate without the potential for short term setbacks and volatility. Thanks again for the confidence you have placed in Jolley Asset Management.

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