JOLLEY ASSET MANAGEMENT, LLC

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"Value investors must be strong and resilient, as well as independent-minded and sometimes contrary. You don't become a value investor for the group hugs. Indeed, one can go long stretches of time with no positive reinforcement whatsoever. Unlike some other fields of endeavor, in investing you can do the same thing as yesterday but achieve completely different reported results. In the long run, the research and analysis you perform should overcome market forces; the fundamentals ultimately matter. But in the short run, markets can trump effort and insight."

Seth Klarman

After selling off on Brexit fears near quarter end, stocks rallied back strongly the last three days of the quarter to finish just below where they were before the UK referendum. Despite a myriad of political and economic uncertainty surrounding Brexit, the U. S. equity and bond markets have been viewed by the world as a safe haven by many investors. In comparison, stock markets in Europe and Asia have not fared as well as the U.S. markets in the first half of 2016. The Stoxx Europe 600 is down 9.8% in 2016 and Japan's Nikkei Stock Average has fallen a whopping 18%. One reason for the sharp snapback in U. S. stocks is the notion that Brexit has given Janet Yellen an excuse to hold off on raising rates once again. Peter Schiff, a long-time critic of the Fed, stated, "Since the process is bound to be long, messy and fraught with uncertainties this will be a handy excuse that the Fed will be able to rely on for years." Schiff concludes that Brexit is a gift for Yellen who has been painted in a corner by seven years of zero interest rate policy (ZIRP). "She (Yellen) could even use this as an excuse to cut rates back to zero and launch QE4." According to Jeffery Gundlach of DoubleLine, the U. S. treasury market now accounts for 60% of all positive yielding G10 debt securities. Currently there is over $13 trillion of bonds worldwide trading with a negative yield, making our bonds look relatively attractive as the 10-year U.S. treasury bond currently yields 1.33%. The combination of this with our "safe haven" currency has resulted in global money flows into U. S. stocks and bonds. Our markets represent the "cleanest dirty shirt" as they say. As the chart below shows, stocks turned in a mixed

Index	2nd Quarter 2016	2016 YTD 6 Mos.
DJIA	2.07%	4.31%
S&P 500	2.46%	3.84%
S&P Mid Cap	3.99%	7.93%
Russell 1000/Growth	.61%	1.36%
Russell 1000/Value	4.58%	6.30%
Russell 2000	3.79%	2.22%
NASDAQ Comp.	-0.56%	-3.29%

performance for the quarter and first half of 2016. For the six months ended June 30th, the markets were led by the S&P Mid-Cap index and the S&P 500 Index with gains of 7.9% and 3.8% respectively. The smaller cap Russell 2000 Index trailed with a 2.2% return, while the NASDAQ Composite index actually lost 3.3%. Value outperformed growth by almost 5% for the first half of the year, despite a surge in growth (relative to value) post-Brexit at quarter end. During the first six months of 2016, the markets were led by the telecommunication services and utility sectors which gained 21.8% and 21.2%, respectively. Led by an 84% rise in oil prices since mid-February, energy stocks snapped back with a 14.2% gain for the first half of 2016. Market laggards were financials (-4.1%), information technology (-1.2%) and healthcare (-.04%). As the chart below shows, defensive bond proxies have led the way in the first half of 2016 as interest rates fell to the lowest levels since 2012.

S&P 500 Sectors	Qtr	YTD (6 mos)
Energy	10.8%	14.2%
Materials	3.1%	6.2%
Industrials	0.8%	5.2%
Consumer Discretionary	-1.3%	-0.1%
Consumer Staples	3.9%	9.0%
Health Care	5.8%	-0.4%
Financials	1.5%	-4.1%
Information Technology	-3.3%	-1.2%
Telecom Services	5.8%	21.8%
Utilities	5.9%	21.2%

Brexit

Britain's surprising vote to leave the European Union (EU) after more than four decades caused a knee-jerk decline in global financial markets followed by a sharp relief rally. What happens next is largely unknown and some experts point out that the referendum is not even legally binding. The UK government must now exercise Article 50 of the Treaty of Lisbon and request an exit from the EU. Most projections are that the entire process will take years, not months. Immediately after the referendum, speculation was that Brexit would cause a recession in the UK but most felt it would not cause a recession in the U. S. or globally. Currently U. S. GDP is expected to grow by approximately 2.5% and it is doubtful that the impact from Brexit will be that significant even if the European economy slows somewhat. Estimates are that S&P 500 companies only have direct UK sales exposure of around 3%. As mentioned earlier, Brexit could be another reason for the Federal Reserve Board to hold off on raising rates. Some have gone so far as to speculate that the Fed could renew its bond-buying program (QE4) in an effort to provide liquidity and fight the prospects of slower growth. It seems pretty much in the cards that rates will be "lower for longer." Leading up to the Brexit vote and in the aftermath, volatility in the markets has increased. We would expect this to continue in the coming months as investors attempt to grasp the full impact of Brexit. One thing appears certain, populism in developed countries is real and voters are angered about being left behind by globalization. Jeffery Gundlach recently said this about the landmark "Brexit" vote, "(Brexit) is evidence we're living in an increasingly uncooperative world." It will be important to see if other countries follow Great Britain's lead in the coming months.

This is Not Your Father's Market

Brexit, negative interest rates, robo-advising, gamma hedgers, risk-parity, high frequency traders, smart beta and exchange traded funds; *Mad Money*, *Fast Money*—ponytailed day-traders on CNBC telling you how to invest your money on a daily/hourly basis. None of this existed or impacted the markets just twenty-five years ago. These participants don't care about the balance sheet, the income statement or any fundamentals for that matter. In fact if one were to study closely he would find that some of the best performers in the market (since the Fed pushed rates to zero seven years ago) essentially have no equity or net worth on the balance sheet—in some cases it's actually negative due to ongoing stock buybacks. We have discussed our displeasure in corporate buybacks that take place at prices above a company's intrinsic value and jeopardize the balance sheet in the process. We believe this to be self-serving for the corporate insiders and not in the interest of most shareholders. Most of today's market participants "rent" stocks rather than own them—they plan to be long gone before fundamentals matter. Our regulators have watched and allowed machines to take over—it is estimated that over 70% of the volume is now machine controlled.

As a fundamentalist who is focused on finding value in the market, there are two ways to view these forces. First of all it is quite frustrating, waiting patiently for the market to recognize value inherent in the businesses you own. Secondly, we realize that businesses can come in and out of favor—they move in unpredictable cycles and what is hated one day may be loved the next day on the basis of new facts or investor perceptions. The fact that today's markets are driven by computers and algorithms rather than "bottom up" fundamental analysis gives tremendous opportunities to patient, long-term value investors. It is imperative that a value investor be resilient and independent minded so that he or she might be able to embrace these short term market mis-pricings and turn those into their clients favor. A value investor must possess the contrarian mindset to take advantage of the bipolar market and welcome it. To quote Benjamin Graham, **"**I'll sell you some of my interest for way less than you think its worth." And other days, "Mr. Market" comes by and says, "I'll buy your interest at a price that's way higher than you think its worth." Today "Mr. Market" is paying quite dearly for slow growth sectors such as utilities and consumer staples as investors (or algorithms anticipating investors next move) attempt to capture above average dividend yields. The utility sector is up 21.3% year to date and is currently yielding approximately 3%. If we were to see that sector correct to price levels of six months ago one would lose seven years' worth of dividends! Hardly worth chasing the yield in our opinion. We can thank the Federal Reserve and central bankers (ZIRP and negative interest rates) across the globe for this behavior. As Warren Buffett once stated, "Price is what you pay, value is what you get". Remember our strategy is simple, to buy bargains and sell what we deem to be fully valued.

We believe and operate on the notion that value investing continues to be the best investment strategy for the patient investor who is long term oriented and somewhat risk averse. We understand that an investor's confidence rises as prices rise and is undermined when prices fall—and believe that a conservative value strategy lessens the chance of liquidating a portfolio at an inopportune time. As Benjamin Graham pointed out, a value strategy may experience what he called a "temporary loss of capital" but in speculative investment strategies one risks a "permanent loss of capital". One must only go back to the internet bubble of 1999-2000 where speculators saw their money evaporate with essentially no reasonable chance of recovery. We invest in common stocks not to buy a piece of paper to sell in a couple of minutes—but as a vehicle to have fractional ownership in what we believe to be a business that is undervalued in the marketplace. As Warren Buffett said, "If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes." While value investing is most logical (buy low, sell high), it is not easy to implement. Asset prices can move in unexpected ways for disappointingly long periods of time. In the long run, the fundamental value approach seems foolproof—as the business grows, ultimately the share price will reflect that. However, in the short run stocks are being moved by investor perceptions and money. The financial news media creates further problems as most viewers don't understand that they are being led by traders who are talking their "own book" and may sell tomorrow what they promote today. Nobody it seems is interested in strategies that may require a holding period of more than a week to work out.

At the end of 2015 growth had outperformed value for the past three, five and ten year periods. For the 10 years ending 12/31/15 growth had outperformed value by 2.4% a year. This trend finally appears to be coming to an end and in fact appears to have finally reversed. For the first six months of 2016 value seems to have regained its footing and has outperformed growth by 4.9% despite a surge in growth indexes just after the Brexit vote. Ed Clissold of Ned Davis Research stated recently, "The catalyst is going to be better economic growth and the visibility on financials. Once those things are in place, then you could talk about probably a once-a-decade type of rotation (from growth to value)." Only time will tell if this trend will continue but the case for value seems particularly compelling given the excessive valuations found in many high quality dividend payers. The Fed has pushed income seeking investors into these issues and valuation levels appear to have been ignored in the process. We are quite confident that a disciplined value approach will serve our clients well over the coming years.

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