JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook

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> *"It's a great time to be a value investor. The difference between the Russell value and growth index returns is tremendous right now—more than nine percentage points. You have to go back to 1998 and 1999 to see that type of discrepancy. We go through these periods where valuations don't matter, but have seen repeatedly that ultimately stock prices reflect the underlying value of corporations.*
>
> *John Buckingham, Al Frank Management*

The U. S. equity market in 2015 was a tale of two cities. There was a wide divergence in returns which was reminiscent of the late 1990's. As you may recall, in 1999 tech stocks soared by 86%, while the S&P 500 rose by 21%. But even that did not tell the whole story (1999), as the S&P 500 equal weight index rose by only 3.1% and the Value Line Index (a broad equal weight index comprised of 1700 stocks) actually fell by 1.4% In 2015, the wide divergence in returns has returned once again and was driven by the fact the largest ten companies in the S&P 500 rose by 17%, while the remaining 490 stocks were down by an average 5%. On a total return basis, the S&P 500 managed to gain 1.4% while the S&P equal weight index fell by 2.4% and the Value Line Index fell by a whopping 11.2%. The disparity in returns in the past year can be attributed to the fact that the S&P 500 index is "market cap weighted" where the largest companies in the index can have an outsized impact on the index returns, while the smallest companies in the index impact the returns only minimally. There was also great disparity in returns across the various S&P 500 sectors. For 2015, six of the ten sectors posted negative returns versus four posting positive returns. The consumer discretionary and health care sectors led the way with gains of 8.4% and 5.2%, respectively. On the downside, the energy and materials sectors led, falling by 23.6% and 10.4%, respectively.

Index	4th Quarter 2015	2015 12 Mos.
DJIA	7.70%	.21%
S&P 500	7.04%	1.38%
S&P Mid Cap	2.60%	-2.18%
Russell 1000/Growth	7.32%	5.67%
Russell 1000/Value	5.64%	-3.83%
Russell 2000	3.59%	-4.41%
NASDAQ Comp.	8.38%	5.73%

As can be seen in the chart above, the Russell 1000 Growth index outperformed the Russell 1000 Value index by 9.5% in the past year, the biggest spread since 2008. Much of this discrepancy is due to slowing profit growth and the focus on those companies that continue to show strong revenue growth. Richard Bernstein stated, "We shouldn't be surprised, because there's a profits recession, and in profits recessions, markets become very Darwinist." According to Bernstein, that Darwinism means that money flocks to the companies that can show strong revenue growth such as Netflix—whose profits halved in the quarter, but continues to show strong subscriber growth. In periods such as this, when market leadership becomes very narrow, a small handful of stocks seem to be anointed by market participants and the media as "must own" securities. Today, a group of stocks referred to as FANG has been accorded that special elite status. FANG is comprised of Facebook, Amazon, Netflix and Google (now Alphabet). FANG is for all practical purposes, a subset of the top ten names in the S&P 500 index which have buoyed the S&P 500 return in the past year. In a year, when the S&P 500 actually fell, FANG stocks were in a roaring bull market. As the chart below shows, the gains are despite valuations which are at nose-bleed levels and are not investible for value oriented managers (with Alphabet the possible lone exception). As we have said repeatedly over the years, good companies don't always make good investments. As Warren Buffett said, "The future is never clear. You pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values."

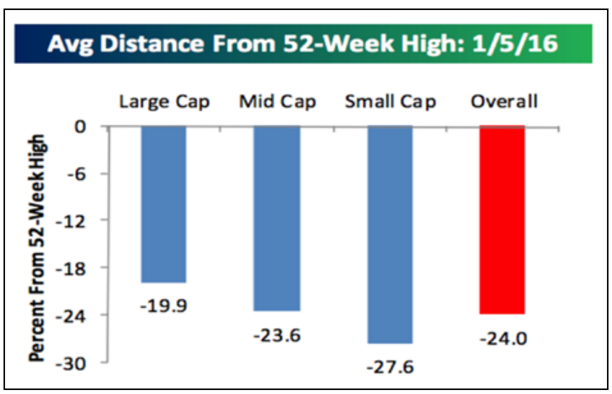
FANG—Too Much of a Good Thing?

Company	Price Change 2015	P/E/Ratio (2015E)
Facebook	34%	48x
Amazon	118%	358x
Netflix	134%	545x
Google (Alphabet)	47%	27x

The strength in the top ten S&P holdings and FANG has been further exaggerated by the influx of money into "passive" investing strategies. This creates incremental share demand for the largest index holdings. In 2015, Vanguard took in $236 billion in new money, while pulling money from actively managed funds. Through November 2015, approximately $139.5 billion was taken out of actively managed mutual funds. Ironically, the last time investors were so eager to pursue "passive" indexing strategies was also in the late 1990's, just before the S&P 500 index peaked. On an optimistic note, the many similarities with the period of the late 1990's does not suggest we are headed for the "worst of times". In fact after 1999, the following years were exceptional for those who followed a disciplined value investing strategy. For the three-year period ending 12/31/02, the Russell 1000 Value Index outperformed the S&P 500 by approximately 23%. I would note, our performance composites did substantially better than the Russell 1000 Value during that three-year period. If you would like to see our Equity Composites, please let us know and we will be happy to provide those to you. (For compliance reasons and in an effort to provide full disclosure and accompanying footnotes, we are hesitant to provide those numbers within this quarterly letter.)

Bear Market?

The market has gotten off to a horrendous start to 2016 losing approximately 6% (S&P 500) in the first five trading days. As was the case in 2015, the story being told in the broader market is much different than that told by the market capitalization weighted indexes. While the S&P 500 (through 1/8/16) is now down approximately 10% from its all-time high reached last year, beneath the surface the damage is far worse. The Russell 2000 index is down 19.3% from its all-time high and the S&P Mid Cap index is down 15.7% from its high reached last year. According to Bespoke Investment Group as of 1/5/16, the average stock in the S&P 500 is now down 19.9% (see chart below). Once again, these losses are not reflected in the market cap weighted indexes, which weight the larger companies more heavily. Damage is even worse in the small and mid-cap space, where the average stock has declined (from its highs) more than 27.6% and 23.6%, respectively. Bespoke also points out that the average stock in the energy sector has been cut in half from their fifty-two week highs while the average stock in the materials sector is down by over 32%.



Source: Bespoke Investment Group

I think it is safe to conclude for all practical purposes that we have entered into a "bear market" at this point. The damage to individual stocks and portfolios has been far greater than would be implied by the market capitalization weighted indexes. While the S&P 500 may not be in "bear" phase as defined by certain "talking heads" in the media, certain sectors of the market most definitely are and "value" strategies definitely are as well. We should keep in mind that value stocks already discount a global recession (in our view) and low valuations and high dividend yields could protect them from much further downside.

Investment Strategy

While I am unsure how long this difficult market phase will last, I believe this is a particularly attractive time for value investing strategies employed at Jolley Asset Management, LLC. Our strategy focuses on the price we pay for a company relative to the market and historical valuation metrics. We seek high quality companies with good balance sheets, which should provide protection even at the bottom of their respective business cycles. We also favor dividend paying securities as we believe dividends are a very important component of a portfolios long term total return. Over long periods of time, value investing has been shown to produce returns that beat the popular indices, but like all investing approaches, it can have periods of underperformance. Our strategy also typically involves sidestepping or avoiding popular areas of the market such as FANG, which is based largely on price momentum rather than fundamental analysis.

While overall market valuations are not cheap, there are opportunities within the S&P 500 due to a widening gap between cheap and expensive stocks (and sectors). According to Bank of America/Merrill Lynch, the dispersion of valuations (based on forward price/earnings ratios) within the S&P 500 has risen from ultra-low levels in mid-2014, to above average, and now sit at a post-crisis high. Consumer discretionary (which was last year's big winner) remains one of the most expensive sectors in the S&P 500 index, while on the other hand, energy valuations continue near rock bottom levels. The weakness in energy and commodity prices is largely a result of fears related to China's economic slowdown. As you know, China represents a large portion of incremental global demand growth. Strength in the U. S. dollar has also had a dramatic impact on many portfolio holdings particularly the industrial sector. Many world class industrial companies are trading at prices which anticipate no global recovery. While not predicting a short term change in those conditions, we would remind investors that any improvement in global growth prospects could buoy share prices well before any earnings recovery.

Summary

The past year and first week of 2016 have been difficult for investors. The average stock has fared much worse than the market capitalization indexes would indicate with most shares now in "bear market" territory. Value strategies have continued to lag behind "growth" strategies, despite compelling valuations in the more cyclical areas of the markets. On the other hand, we believe in many instances investors are overpaying for growth. While the Fed recently bumped its benchmark interest rate by 25 basis points, we feel they will be on hold going forward, due to persistent economic headwinds and global weakness. We believe our disciplined value strategy will once again prove to reward our clients as market volatility increases. 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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