JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook Volume 1, Issue 75• Spring 2017

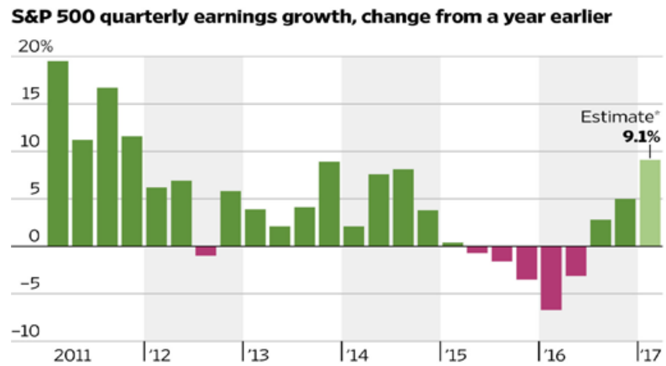
> *"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."*
> *John Maynard Keynes*

The S&P 500 index posted its best first quarter in four years as investors focused on a stronger economic growth outlook. The "Trump" trade (companies expected to benefit from change in government policy based on Trump agenda) seemed to lose momentum as the quarter progressed—investors shifted their focus to the technology sector and other higher growth issues. The failure of the Republican's health care bill to replace the Affordable Care Act has led many investors to question Trump's other campaign promises such as a corporate tax overhaul and infrastructure spending. Growth issues outperformed value as shown by a wide margin in the first quarter of 2017, reversing last year's trend where value trounced growth. For the first quarter the Russell 1000 Growth index returned 8.91%, versus 3.27% for the Russell 1000 Value index, a whopping 5.64% margin. For the trailing twelve month period, the Russell 1000 Value index remains approximately 3.46% ahead of the Russell 1000 Growth index. Growth's outperformance for the quarter was largely due to the fact that technology, consumer discretionary and health care comprise approximately 70% of the growth benchmark. The technology sector rocketed by 12.16% for the quarter led by Apple which rose by a staggering 24%. Small cap stocks (Russell 2000) and mid cap stocks lagged the market but still posted respectable gains of 2.47% and 3.94%, respectively.

Index	1st Quarter 2017
DJIA	**5.19%**
S&P 500	**6.07%**
S&P Mid Cap	**3.94%**
Russell 1000/Growth	**8.91%**
Russell 1000/Value	**3.27%**
Russell 2000	**2.47%**
NASDAQ Comp.	**9.82%**

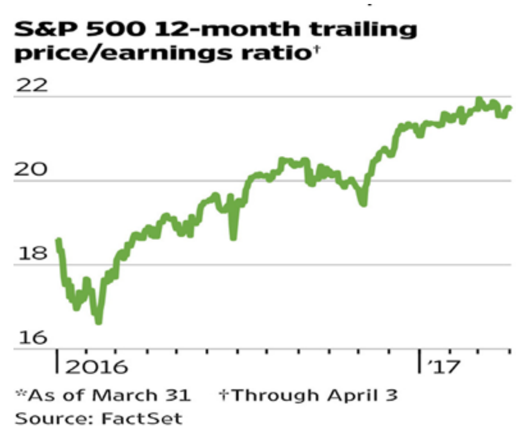
Corporate Profits

Analysts expect U. S. companies to report their strongest quarterly earnings in years. The projections call for S&P 500 companies earnings to grow by approximately 9% from the first quarter a year ago. According to FactSet, this would represent the highest growth since the fourth quarter of 2011. FactSet is also projecting revenue growth for the quarter of approximately 7%, the biggest increase in more than five years. In recent years much of the earnings growth has come from cost-cutting and buybacks so any acceleration in revenue and earnings growth would likely be a positive for U. S. stocks. Disappointments on the earnings



Source: FactSet

front would likely result in a pullback for stocks in light of the 10% run since Election Day. On the valuation front stocks are not cheap, trading at 21.7 times trailing earnings and approximately 17.2 times projected forward earnings. According to FactSet, over the past ten years stocks have traded at approximately 16.5 times trailing earnings. Any progress by the administration on corporate tax rate cuts, repatriation and deregulation could be key factors in supporting current valuation levels.



Index Investing

Today one only has to open the pages of a financial publication or turn on the financial news to find someone discussing the virtues of index investing. More often than not they are referring to the S&P 500 index funds and Vanguard in particular. As you might know Vanguard and John Bogle were the pioneers in indexing and started the first index fund back in 1975. In the first quarter of 2017 the Vanguard Group took in $111 billion in new client funds or nearly $2 billion per day. While Vanguard also has actively managed funds, the bulk of the money flows have been into the passive index fund products. On an annualized basis fund flows are running approximately 46% ahead of the record inflows the firm saw in 2016. As Eric Balchunas of Bloomberg said in a recent interview, "Fish are jumping in the boat now". While we understand the appeal of index funds and believe they make sense for many investors, we do believe the possibility exists that "when fish jump in the boat" you may want to jump out. The appeal of index funds is largely due to the low cost structure and implied tax efficiency due to low turnover. In addition, the general perception that the fund essentially reflects the overall economy makes perfect sense on the surface. Bruce Berkowitz from Fairholme Funds recently stated:

> "This mania for all things indexation will lead to disaster. Indexation in general is a good idea... But there are some assumptions there. I like index fund investing. The wide diversification across many companies and the low level of fees is a recipe for long term success. I don't however believe that putting new money into index funds is always a good idea. Valuation matters."

The last time investors were this enamored with index funds was when the markets were driven by the internet bubble/nifty-fifty market of late 1999-2000. Portfolio managers found it extremely difficult to beat the indexes and most active managers "threw in the towel" and became closet indexers in an attempt to avoid losing assets. "Career risk" was driving portfolio manager decisions. As John Maynard Keynes once said, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." In our *Investment Outlook—Spring 1999* we stated, " In the S&P 500 index the top five stocks in the index (let's call them the "Nifty Five", composed of Microsoft, General Electric, Wal-Mart, Merck and Intel) together have more impact than the bottom 300 stocks in the index combined. Investors who thought they were invested in a diversified basket of shares were actually concentrated in a few mega-cap companies with excessive valuations." Those five companies traded at an average of approximately 47 times trailing earnings at the time! In our *Investment Outlook—Fall 1999* we pointed out that …the top 50 companies in the S&P 500, make up approximately 50% of the index"… and "that technology companies currently comprise 25% of the index." In that 1999-2000 period investors overpaid for what they perceived as a "sure thing". That didn't work out well, as from March 2000 to October 2002 the S&P 500 dropped by approximately 49% and it took until 2013 to dig out from that drawdown in capital. More than likely most investors bailed out of the index at some point, further compounding the problems. Ironically, disciplined "value" investors fared much better in that 2000-2002 period. We will be happy to provide our "Equity Composite" showing how we fared during that brutal period for the S&P 500 index. In declining markets index funds tend to suffer from their emphasis on momentum over value. The S&P 500 components are determined by McGraw-Hill a book/magazine publisher rather than an asset manager. The index is market cap weighted and buys more of what is rising and less of what is declining. As companies such as Amazon, Facebook and Apple rise, they become bigger parts of indexes, resulting in the index fund investor owning a bigger and bigger position. Unloved stocks get cheaper as positions are pared to make room for more of the winners. Ironically, investments that are weighted toward the largest, most overvalued stocks and sectors are exactly the opposite of what a prudent manager might implement as a strategy of managing risk.

History shows that the index fund will typically be extremely difficult to outperform in the early phases of a bull market. Like everything else in investing, there are good and bad times to be indexed. The index fund by its very makeup, has no cash drag which inevitably will increase the odds of outperforming active managers in a bull market. Conversely, the cash helps performance in a declining market or "bear market" phase. James Stack a widely respected newsletter author and manager recently stated, "Index investing proponents generally downplay stock market cycles, but bear market survivability is a very real issue for many investors. Passive indexing may appear to be easier and is perceived to reduce risk, but it actually does the opposite as it guarantees that an investor will experience all of the losses in the market index. " Additionally, many tout the performance of the S&P 500 index fund which essentially has very little tracking error from the benchmark S&P 500 index. Fees on the index fund are negligible and are one of the primary reasons investors are attracted to them. This cost advantage totally disappears if and when an investment advisor levies the typical 1% fee at the account level. We find in today's world few advisors manage portfolios with individual stocks and bonds but instead utilize a smorgasbord of exchange traded funds (ETFs) and index funds. The typical advisor attempts to add value through asset allocation and tactical changes and possibly market timing. Even though many "passive/index" products are used, the portfolios are anything put "passive".

Summary

The S&P 500 index just turned in its best first quarter in four years. While stocks are not cheap, valuations don't appear excessive given the current level of interest rates and the outlook for an acceleration in earnings in the coming year. In addition, any progress on lowering corporate tax rates, repatriation or infrastructure spending could become a tailwind for the markets going forward. While we accept and understand the use of passive strategies and index funds by investors, it only makes sense in our opinion if the underlying index is undervalued and if there are no additional fees levied on the customer. We continue to believe in our bottom up, value approach to investing. We always focus on "downside" risk before "upside" potential on a security by security basis. When we talk to clients we discuss that we see our goal as a portfolio manager to outperform the benchmark over a full market cycle. It is inevitable that "bear markets" will occur during the ebbs and flows of the business cycle. While we don't see a recession or "bear" market in the near future we refuse to abandon our principles to chase outsized returns. Thanks again for the confidence you have placed in Jolley Asset Management.

Frank G. Jolley, CFA

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