JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 76• Summer 2017**

Buffett and Graham on Quants. Wise beyond their time?

"Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics the more uncertain and speculative are the conclusions we draw therefrom. In forty-four years of Wall Street experience and study I have never seen dependable calculations made about common-stock values, or related investment policies that went beyond simple arithmetic or the most elementary algebra. Whenever calculus is brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience, and usually also give to speculation the deceptive guise of investment."

Benjamin Graham/The Intelligent Investor (1949)

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"In my opinion, investment success will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets." Warren Buffett (1987)

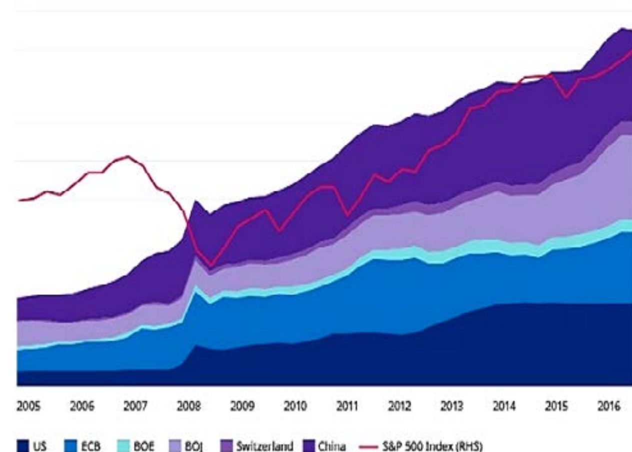
Stocks continued their climb during the second quarter of 2017. A Fed rate hike, valuation concerns and political bickering in the U.S. didn't faze the market as investors focused on the potential for tax reform and growth. U. S. stocks set records for the first half amid the best quarterly earnings growth among S&P 500 companies in nearly six years. According to FactSet, S&P 500 companies are expected to show earnings growth of 9.8% in 2017. Among stocks, large caps (S&P 500) outperformed both small caps (Russell 2000) and Mid-Caps (S&P Mid Cap) by a wide margin for the quarter and first half of 2017. The Russell 1000 Growth Index trounced the Russell 1000 Value index by 9% for the first half—the exact opposite of 2016, when value outpaced growth by a wide margin. Market leaders in the first half were technology (+17.2%), health care (+16.1%) and consumer discretionary (+11.0%). Amazon, which represents a 15% weighting of the consumer discretionary sector, was the primary driver of that sector's strength. Multiline retailers such as Macy's, Target and Kohl's were actually big decliners in the first half. Energy (-12.6%) and telecom (-10.7%) were the worst performing sectors for the six months of 2017. Ironically, the energy sector was expected to provide the biggest boost to S&P 500 earnings growth in 2017, as earnings were expected to rebound dramatically from a difficult 2016. Continued weakness in energy would likely result in S&P earnings growth of closer to 7% versus the expected 9.8%.

Index	2nd Quarter 2017	2017 YTD 6 Mos.
DJIA	**3.95%**	**9.35%**
S&P 500	**3.09%**	**9.34%**
S&P Mid Cap	**1.99%**	**5.99%**
Russell 1000/Growth	**4.67%**	**13.99%**
Russell 1000/Value	**1.34%**	**4.66%**
Russell 2000	**2.47%**	**4.99%**
NASDAQ Comp.	**3.89%**	**14.07%**

The S&P 500 has now gone approximately 250 days without a 5% drawdown. Typically the market, (as measured by the Dow Jones Industrial Average) experiences a drawdown of 5% every 47 days or approximately 3 times a year. The lack of volatility is perhaps a result of central banks and governments flooding the markets with liquidity all over the globe. This liquidity surge is going on despite the Fed's move to taper—the other central banks have now taken over for the Fed. The Swiss National Bank now owns an estimated $80 billion in U. S. stocks and has bought roughly $17 billion worth of U. S. stocks this year. That is more than $10,000 in U. S. stocks for every man, woman and child in Switzerland. This is all part of an attempt to hold down the value of the Swiss franc. Ray Dalio of Bridgewater Associates recently stated that we are approaching the end of the central bank era, "the directions of policy are reversing". He further stated, "Our responsibility now is to keep dancing, but closer to the exit and with a sharp eye on the tea leaves." Like everyone else, Dalio plans to exit before the crowd.

Schroders

Value of assets on central bank balance sheets vs. the S&P500 index



While we are not calling for a "bear market", we do think one should realize that the "low volatility" period we have seen is unlikely to continue. The chart below shows a history of declines in the market for the Dow Jones Industrial Average dating back to 1990. We should all take note and be prepared for increased levels of volatility. As a common practice, it always makes sense to review and rebalance one's portfolio on a periodic basis.

History of Declines (1990-2016)

Type of Decline	Average Frequency (approx.)	Average Length
5% or more	3 times a year	47 days
10% or more	Once a year	115 days
15% or more	Once every 2 years	215 days
20% or more	Once every 3.5 years	341 days

Source: Capital Research & Mgmt

Why Value?

Jolley Asset Management, LLC (JAM) was founded some nineteen years ago to provide a vehicle through which we could implement a value investing style that was developed in the early 1930s by Benjamin Graham at Columbia University. It perhaps would have been easier to take other approaches—such as passive strategies, growth strategies or use quantitative research in putting together portfolios. We agree with Warren Buffett who once said, "What is "investing" if it is not the act of seeking value at least sufficient to justify the amount paid?" Consciously paying more for a stock than its calculated value— in the hope that it can soon be sold for a still-higher price—should be labelled speculation." Seth Klarman of Baupost Group stated, "I must remind you that value investing is not designed to outperform in a bull market. In a bull market, anyone, with any investment strategy or none at all, can do well, often better than value investors. It is only in a bear market that the value investing discipline becomes especially important because value investing, virtually alone among strategies, gives you exposure to the upside with limited downside risk." Limiting downside risk is what attracts us to "value" because avoiding large drawdowns are the key to long term compounding of returns. The observations below may also give you a better understanding of our investment philosophy and our views on the current state of the markets.

1) We do not like to overpay for a company, as we feel that the price one pays for a security is a big determinant in that security's long term returns. We believe that many times "great companies" are not "great investments" and for that reason when you look at your account statement there is no Amazon, no Priceline, no Netflix, etc. Buying market darlings typically works in the bull years but not over a full market cycle. Back in 1999 and early 2000, I was often asked by clients and prospects why our portfolios looked different than their other portfolios. Many times what we don't own turns out to be more important in determining returns than what we do own.
2) We do not obsess with benchmarks. We educate our clients that in strong bull markets we anticipate lagging the benchmark. Our outperformance typically occurs in the down and flat years. Our goal is to outperform over a full market cycle, which includes bull and bear market phases. We also believe that the only way to beat a benchmark is to be different than the benchmark and live with the tracking error risk that may take place over the short and intermediate term.
3) We do not like momentum strategies or technically based strategies where profits depend upon the greater fool theory. The "Fast Money" and "Mad Money" crowd where they focus on the "cool kid" stocks inevitably crash and burn. The entire day-trading industry disappeared after the 1999-2000 top while our clients prospered. For every Amazon, there are ten or more "hot stocks" that drop dramatically and never recover. This is a permanent loss of capital. (i.e. 1999-2000 hangover).
4) We do not dislike index strategies, provided the participant goes directly to Vanguard or a low cost provider and avoids market timing. We don't see tremendous benefits to utilizing passive products within an active strategy. Studies show that few buy the S&P 500 index fund and leave it alone—negating the tax efficiency inherent in indexing.
5) We do not like the fact that indexes such as the S&P 500 are market cap weighted which results in more and more investor dollars flowing into what many times may be the most expensive part of the market (such as FANG—Facebook, Amazon, Netflix and Google). At times, the S&P 500 index acts somewhat like a momentum fund driven by the top holdings. We believe equal-weight indexes make more sense.
6) We do not like the fact that the Federal Reserve has become integrally involved in our financial markets. Much of the work of the Fed today is to correct the mistakes they made years ago. We would much prefer a market where prices were determined by market participants rather than a central bank.
7) We do not like the fact that there are nearly 6,000 indexes today, up from fewer than 1,000 a decade ago. Meanwhile, the number of stocks in the Wilshire 5000 Total Market Index has shriveled to 3,599, from 7,562 in 1998.
8) We do not like the fact that just 10% of today's trading is from fundamental discretionary investors. JP Morgan's Marko Kolanovic estimates "fundamental discretionary traders" have been overtaken by passive and quantitative strategies which now make up approximately 60 percent, more than double the share a decade ago. We believe when "quants" move in tandem, liquidity will become a big issue for the markets.
9) While we like exchange traded funds (ETF's), we are concerned that when the markets break, they could be destabilizing like they were in the "flash crash" of May 6, 2010. We also believe that ETF fads can drive massive valuation distortions in the underlying basket of securities. I should point out that this does create enormous opportunity to the "value" oriented investor who gets the opportunity to sell or buy at advantageous prices based on ETF money flows.
10) However, we like the fact that we don't have to own over-priced securities or sectors and can concentrate client funds where we see the best risk-reward over the long term.
11) We like the fact that we deal with individuals who focus on goals and objectives rather than monthly performance and market timing. We don't window dress our portfolios.
12) We like the fact that we are an independent advisor and we can place our client's interest first rather than be forced to utilize certain products and hit certain quotas in order to be adequately compensated.
13) We like the fact that we have great clients who understand what we are trying to accomplish with regards to their accounts. As Seth Klarman stated, "Having great clients is the key to investment success".

Summary

The investment world has changed dramatically since JAM was formed in 1998. The one constant throughout has been our "value" approach, which has never wavered. This has enabled us to navigate successfully through the treacherous markets of 2000-2002 and the financial crisis of 2008. We remain committed to value, a businesslike strategy focusing on risk and reward.

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