JAM JOLLEY ASSET MANAGEMENT, LLC

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"The cost of performing well in bad times can be relative underperformance in good times."
Seth Klarman

After a somewhat sluggish start to the year, the U. S. stock market surged in the third quarter. Domestic stocks outperformed essentially all the major asset classes including government and corporate bonds, cash and gold for the quarter and year to date. The U. S. is basically leading the world in growth while the eurozone and emerging markets have cooled. Presently, there are few signs that the economic expansion is stalling. U.S. consumer confidence is presently at almost two-decade highs, and corporate earnings are expected to rise approximately 19% in the third quarter. On a price/earnings basis, U.S. stocks are currently trading at a 12% premium to an MSCI index of 22 developed markets and 24 emerging markets. This represents the biggest valuation gap since 2009. The healthcare sector led the market during the quarter up 14%, followed by industrials and technology which rose by 9.5% and 8.5%, respectively. Large caps (S&P 500) led during the third quarter with a healthy 7.71% gain, versus 3.86% return for the mid-caps (S&P Mid Cap) and 3.58% for the small caps (Russell 2000). Growth continued its leadership over value, with a 13.17% difference for the nine months ended 9/30/18. One must go back to the "tech bubble" of 2000 to find a period where the degree of "value" versus "growth" underperformance has been worse. As a "value" investor we remind clients that when the value cycle does turn, both absolute and relative returns are typically very strong. This was particularly true in the 2000-2002 time period.

Index	3rd Quarter 2018	2018 9 months
DJIA	**9.63%**	**8.83%**
S&P 500	**7.71%**	**10.56%**
S&P Mid Cap	**3.86%**	**7.49%**
Russell 1000/Growth	**9.17%**	**17.09%**
Russell 1000/Value	**5.70%**	**3.92%**
Russell 2000	**3.58%**	**11.51%**
NASDAQ Comp.	**7.14%**	**16.56%**

Challenges of the Last 20 Years

Jolley Asset Management has recently celebrated our twentieth anniversary with little or no fanfare. Hopefully we can host a client event and celebrate together next year! Over the last twenty years we have witnessed the tech bubble of 2000 and the financial crisis of 2008 and all of the rollercoaster rides in between. We thought this might be a good time to revisit and reflect on those market events and what our thoughts were at the time….and what the implications are for the future? The late Mark Twain once said, ***"History doesn't repeat itself but it often rhymes".*** As investors we believe we can certainly learn from the past and use our experiences to become better investors in the future. In our opinion, one of the most important roles of the investment advisor is to help the client avoid the big mistakes and large drawdowns in the markets. It's essential to avoid situations where the client could potentially experience a "permanent loss of capital" versus a "temporary loss of capital." With over thirty-seven years' experience in the securities business (28 years managing discretionary accounts and prior to that 9 years as a securities broker) your mind continuously collects data and I try to use that experience so that I can make the best decisions for my clients factoring in both risk and reward. As Benjamin Graham stated, ***"In a roaring bull market, knowledge is superfluous, and experience is a handicap."*** Many times, the novice investor doesn't have the battle scars nor the true understanding of risk. The marketplace has been and will always be driven by the human emotions of "fear and greed"; controlling those emotions are probably just as important as the analytical tools used by wall street analysts. Phillip A. Lowe stated, ***"There are two times when people forget their principles: at the top of the market and at the bottom."*** When stocks are cheap the masses want to sell, when they are rich the masses want to buy. We believe it is our job to temper expectations when markets are expensive and provide sanity and keep our clients on course when markets are rocky (which typically coincides with cheap valuations). We certainly don't hold ourselves out as one who has all the answers, (only the crowd at CNBC led by Jim Cramer has all the answers) but our experience has taught us that stocks that trade at 10 to 20 times revenues often will prove to produce subpar returns for shareholders…. we much prefer companies trading at 10 to 20 times earnings. This belief is why many times we may avoid a market darling that others view as a can't miss holding. The discipline that may hold the portfolio back in the short term, may save the portfolio in the long term.

Tech Bubble (Market top of 2000)

In our *Investment Outlook—Fall 1999* we led off with a quote from Microsoft President, Steve Ballmer who stated, ***"There's such an overvaluation of tech stocks it's absurd, and I'd put our company's stock in that category."*** That was a powerful statement from one of the group of market leaders at that time which was known as the "four horsemen" of tech. In that letter we dicussed Lucent, Dell, Cisco Systems, Microsoft all trading between 36 and 177 times earnings. In our *Investment Outlook—Winter 2000* we led off with a quote from L. Keith Mullins from Salomon Smith Barney which stated, "***First while it sounds like a tale from Lewis Carroll, the best investment strategy for 1999 has been to invest in companies that lose money. No kidding."*** In that letter we also discussed how technology and communication issues represented over 33% of the S&P 500, up from 22% just two years earlier. The S&P 500 index was becoming distorted as 32 stocks (dominated by technology) made up 50% of the S&P 500 index. Indexing and "closet indexing" were in vogue as portfolio managers were facing career risk and chose to hug the benchmark to protect their jobs. In the Spring of 2000 in our *Investment Outlook*, we stated, "*While capitulation (market bottoms) and speculation (market tops) often occur at inflection points in the market; it is quite unusual to see both occur in the same market silmultaneously. At that time, there were two distinct markets, the "old economy" and the "new economy"*. The new economy had been in a bull market led by technology, while the old economy had been left for dead and was essentially in a bear market. Margin debt was at record highs…all the signs of a top were evident. We pointed out how several renowned "value investors" capitulated and stepped down or were fired. George Vanderheiden of Fidelity, Robert Sanborn of the Oakmark Fund, Bill Sams of FPA Paramount and Julian Robertson of Tiger Management all experienced massive outflows from impatient investors. As Julian Roberston proclaimed, ***"Avoid the old economy and invest in the new and forget about price, and in truth that has been the way to invest over the last eighteen months"***. Robertson went on to say, ***"This too will pass"*** and

that value investing remains the best course for investors. In the 31 month period from March 24, 2000 until October 9, 2002 the S&P 500 declined by a whopping 49.1%. On a total return basis, the Russell 1000 Value index outperformed the S&P 500 index by 19.7% over that thirty-one month period, which included the recession triggered by the events of 911. The most staggering statistic is the decline in the NASDAQ, which fell approximately 80% from it's peak on March 10, 2000 until the bottom was made in October 2002. Additionally, one should also remember that after a partial recovery, it fell another 50% during the financial crisis. It took fifteen years until 2015, to regain the 5000 level on the NASDAQ Composite index where it topped out in March of 2000 (many investors seem to have short memories).

We believe there are many similiarities between today's markets and the market of 2000. The "four horsemen" of tech have been replaced by FANG (Facebook, Amazon, Netflix and Google) The flows into passive vehicles, coupled with the liquidation of active strategies has boosted the prices of the index's largest components (largely technology) without regard for valuation, while depressing much of the broad market. In our opinion, this bifurcation in the market favors the disciplined value investor going forward. As John Neff said, ***"Every trend goes on forever until it ends."*** In our opinon, when the "passive" party ends the "tech party" ends or vice-versa. At that point, we believe the rotation to value will take place as it did in 2000.

Finacncial Crisis of 2008

We believe that the financial crisis can largely be attributed by the Federal Reserve policy dating back to to the late 1990's. Essentially Greenspan refused to take away the punch bowl (bailout of LTCM) leading up to the dot.com bubble. Once the bubble burst, the Greenspan Fed pushed rates to forty-five year lows in an attempt to limit the damage. Essentially Greenspan had a "put" or safety net under the market dating back as far as 1998. Dr . Ben Bernanke replaced Greenspan in 2005 and Bernanke continued the policy, essentially micro-managing the economy with market participants realizing that easy money policies would always be there to help the markets stabilize if needed. As we stated in our *Investment Outlook—Spring 2007*, "*He essentially prevented an economic downturn which is healthy and essential in cleansing excesses in a capitalist economy. While on the surface this may seem good, the flood of liquidity has led to an unprecedented period of excessive risk taking."* Credit growth was far outpacing GDP growth over a number of years with 70% of the growth in residential mortgages. Consumer spending in the period leading up to 2007 was fueled largely by home equity extraction. *In our Investment Outlook—Fall 2007, we concluded with the following statement, "Bernanke's recent rate cuts have encouraged many investors to put on the "risk trade" again. We aren't biting."* By 2008 we were in a full blown "bear market" with the S&P 500 losing over 37% for the year. Many investors had devastating results. For the year ending 12/31/08 the flagship Fidelity Magellan Fund lost 49.4%, CGM Focus lost 48.2% and Legg Mason Opportunity Trust lost 65%. Most value investors lagged the S&P 500 as a result of the heavy weightings in financials. While not unscathed, Jolley Asset Management outperformed the popular benchmarks, due to our underweight in the finanial sector and heavy cash position (*performance composites available upon request—please contact our office*). While not market-timers, we let cash build as we exited a number of positions in the second half of 2008. As one might conclude the Federal Reserve came to the rescue. The Federal Reserve went to emergency levels on interest rates and put together TARP, bailing out the entire financial system. To keep the system stable the Fed also implemented QE 1 (quantitative easing) followed by QE 2, Operation Twist and QE 3. These programs under both the Bernanke and Yellen Fed, were essetially large scale asset purchase programs that were deemed necessary due to the fact that rates were already at essentially zero, leaving the Fed little room to support the fragile recovery. These moves were later followed by other Central banks around the world in an attempt to buoy asset prices and economic growth.

Zero interest rate policy coupled with central bank asset purchases have driven share prices higher since the finacial crisis. The economic recovery which had been somewhat sluggish has accelerated with the recent cut in corporate tax rates. The Federal Reserve started a rate normalization process in 2015 under Janet Yellen and that has continued with new Fed Chair Jerome Powell. While the Fed balance sheet has begun to shrink in recent years, it is unclear as to when other central banks will follow suit.

One of the consequences of the Fed policies has been an increasing appetite for debt by U. S. companies. In 2018 there were just 2 companies whose debt was rated AAA, versus 55 companies rated AAA in 2007. Corporate debt is now $2.5 trillion or 40% higher today than it was in 2008. Much of the debt has been used to repurchase shares to boost earnings per share in a period where growth was difficult to come by. In 2018, buybacks are expected to reach a record $1 trillion, a 46% rise from last year – thanks largely to tax cuts and repatriation. While we believe buybacks make sense if the shares can be bought at a discount to intrinsic value, today's buybacks seem to be related to incenting corporate insiders. Corporate executives are using share repurchases to boost earnings per share which drive stock option grants and then selling those shares at inflated prices. There is little regard to valuation in today's repurchase activity (note how buyback activity bottomed at the lows and increased as prices rose). We find it troubling that many buybacks are financed by debt rather than cash flow, weakening corporate balance sheets. We also believe the SEC needs to quickly put an end to situations where buybacks are used to buoy prices for insiders to sell into. In our opinion this has become the norm.

Source: Birinyi Associates, Goldman Sachs Global Investment Research

Summary

The current bull market is approaching its tenth year. Valuations in many stocks are stretched and debt levels have increased dramatically. Corporate earnings growth remains strong but should slow next year as lower tax rates will not provide a boost. Higher interest rates and a less accomadative Fed at some point become a headwind for stocks. Growth issues currently appear priced to pefection and we believe a rotation to value is inevitable over the next year. Investing utilizing a "value" approach with a "margin of safety" has served our clients well through the treacherous markets of 2000-2002 and the 2008 financial crisis. As Seth Klarman said, "***You don't become a value investor for the group hugs***." We realize value looks boring and at times seems out of touch. But history and academic studies have shown that value investing works over the long term. Looking back at the difficult markets of the past reinforces our belief that value remains the best course of action going forward. *Frank. G. Jolley, CFA*

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