JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 79• Spring 2018**

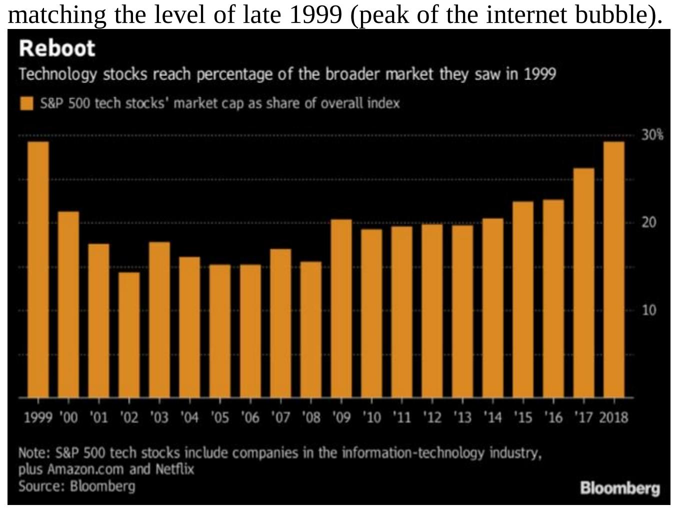
> *"The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values.*
> *Warren Buffett*

After a strong start to the year, the equity markets turned ugly in February and March, snapping a nine-quarter winning streak. A pull back in technology shares, rising trade tensions and fears over higher interest rates and inflation led to a return in market volatility and the downturn in prices. After making a high in January, stocks (as measured by the S&P 500) declined by 10.1%, rallied back 8% by early March, then suffered another 5% decline before bouncing slightly at quarter end. For the quarter, the S&P 500 declined by .76% and the Dow Jones Industrial Average fell by 1.97%. Despite the decline, stocks finished the quarter ahead of long term treasury bonds (-3.2%) and investment grade bonds (-2.2%). During March, the Russell 1000 Growth Index experienced its worst month since January 2016 and trailed the Russell 1000 Value Index by approximately 1%. Despite this quarter-end weakness, the Russell 1000 Growth Index led the market for the quarter, with a total return of 1.42% versus a decline of 2.83% for the Russell 1000 Value Index. Small cap stocks (Russell 2000) beat large cap issues for the quarter, as investors focused on domestic issues, which are less likely to be impacted by any potential trade wars. During the quarter, nine of the eleven S&P 500 sectors had negative returns, with the worst returns coming from telecommunication services (-8.7%), consumer staples (-7.8%) and energy (-6.6%). Only two sectors managed positive returns and they were information technology (+3.2%) and consumer discretionary (+2.8%). Ironically, Amazon.com and Netflix make up approximately 25% of the consumer discretionary sector which potentially overstates/distorts the returns for that sector. Most investors view both of those companies as technology companies. Essentially, technology was all that worked for investors in the first quarter of 2018.

Index	1st Quarter 2017
DJIA	(1.97%)
S&P 500	(.76%)
S&P Mid Cap	(1.15%)
Russell 1000/Growth	1.42%
Russell 1000/Value	(2.83%)
Russell 2000	(.08%)
NASDAQ Comp.	2.59%

March Madness

The NCAA Men's Basketball Tournament is often referred to as March Madness. The tournament is immensely popular largely due to the excitement and that fact that one can always expect the unexpected. The same could be said of the stock market—what is largely expected many times doesn't come to fruition. This year was particularly memorable as many of the favorites failed to advance and for the first time a number 1 seed, University of Virginia lost to UMBC, a 16 seed, in a blowout. Needless to say, I had UVA and my Tar Heels both advancing to the Final Eight in my brackets. The pre-season coaches' poll predicted the following: 1) Duke 2) Michigan State (3) Kansas and (4) Kentucky. Of those four, only Kansas advanced to the Final Four. All the "bracketology" computer models and factors used by the selection committee to create the brackets (and seedings) proved largely worthless in predicting the final tournament outcome. The tournament selection committee selects and seeds based on a number of factors, including computer models that calculate a team's RPI and SOS. The models and process are not perfect, as the team picked to be the best team in the tournament lost to the team picked to be the worst team in the tournament by a wide margin. In today's world where many investment programs and algorithms are "factor based" and utilize "artificial intelligence" we find this to be quite interesting. Could the same scenario hold true for the stock market? Today's number one seeds in the stock market are dominated by technology issues—they have led the bull market for nine years and growth prospects seemingly look great on paper going forward. Today the top weightings in the S&P 500 index are all expected to be winners going forward, not unlike the 1999-2000 internet/tech bubble. The S&P 500 index largest market cap weightings are: 1) Apple 2) Microsoft 3) Amazon 4) Facebook and 5) Alphabet. These five companies are all in the same industry—technology (assuming Amazon is tech— not consumer discretionary) and make up a whopping 14.4% of the market currently. At quarter end, the information technology comprised 24.9% of the S&P 500 index. If Netflix and Amazon were moved to the tech sector (which makes sense) then the tech weighting would make up over 28% of the S&P 500 index, essentially matching the level of late 1999 (peak of the internet bubble).



Picking the popular teams didn't work in the NCAA tourney, only time will tell if buying the popular technology names will work in the stock market this time around.

It's difficult to live up to lofty expectations for both sports teams and companies. The massive market capitalizations being placed on technology issues will make it difficult to generate market beating returns going forward. We must remember technology can change rapidly and can become obsolete quickly. Apple has been able to successfully navigate from the popular iPod and iTunes to a dominant position in smart phones. Other early leaders such as Blackberry and Nokia, were not so lucky. General Electric, which had the largest market cap in the S&P 500 index in late 2000, had a peak market capitalization of over $600 billion. Today GE's market capitalization has shrunk to approximately $115 billion. GE was a loved company who could do no wrong just seventeen years ago, now it is universally hated. When looking at the top five names in the S&P 500 index today, not all will successfully be able to navigate and grow at the same rate in a rapidly changing competitive landscape. As we like to remind clients, there is a difference in a great company and a great stock. As Seth Klarman explained, "risk is not the same as volatility; risk results from overpaying or overestimating a company's prospects". That is precisely what happened in this year's NCAA tourney—the teams with the most talent and the best prospects for the most part disappointed.

Today in college basketball the media has focused all the attention on a few elite, one and done players. The All-American teams are all dominated by college freshmen. As the NCAA tournament shows, the most heavily favored teams with the most talent don't always advance. This past year only one top ten player made up the collective final four rosters and only six top fifty players were on the final four rosters. Villanova, which won the championship, played just two top 20 players and the MVP went to a player who was not ranked in the top 100 players of his high school class. OK, what's this got to do with the market? Just like the sports media focus is on the few elite one and done players, the financial media focuses on just a few select technology issues. These companies currently dominate the market indices and are priced based on lofty expectations that may not be achievable. First of all, it is much more difficult for a company to grow from a larger base than a smaller one. Secondly, competitors always emerge making it potentially more difficult to hit growth targets. In addition, sectors come in and out of favor based upon changing global economic conditions. Analysts typically focus on extrapolating a company's past performance into the future and ignore mean reversion. The hot stock/sector of yesterday, many times becomes the disappointment of tomorrow, especially if the valuations are too high and the assumptions for growth are overly optimistic. What if the regulatory environment becomes hostile due to privacy issues? What if the economy slows or enters recession? Will tech earnings falter in an economic slowdown? Today's financial media only cover what's working currently, there is not equal air-time for high quality companies in out of favor industries. Today the only game in the market has been momentum-based strategies and are in large part driven by FOMO (fear of missing out) and not on fundamental factors. Strong coaching and fundamentals (not media hype) allowed Villanova to win the NCAA championship—they were hands down the best team in the country. Likewise, we believe a fundamental based, value approach to investing (with a contrarian bent) is much more likely to win in the investment game over the next few years.

Correction Mode

The S&P 500 index entered "correction" territory on February 8, closing more than 10% below its all-time high achieved in late January. This recent downside volatility followed an extended period of time with extremely low volatility. In fact, the S&P 500 index had not seen a pullback of more than 5% for more than eighteen months. Market corrections, such as the one we are currently in are extremely common as the chart below shows. Ironically, this exact chart was also included in our "*Investment Outlook—Summer 2017*" in anticipation of such an event. In 19 of the last 38 calendar years, the S&P 500 experienced a double-digit pullback within the year. In every year there was some pullback (only 3% in 2017) and on average the market saw a decline of 12%. While we realize that pullbacks are painful and that selling could accelerate, we would remind investors that corrections are part of the normal investing process.

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.

Summary

Volatility has returned to the markets after an eighteen month hiatus. Trade tensions and the fears around interest rate normalization will likely result in more volatility going forward. We would remind our clients that markets typically correct 10% or more at least annually and are part of the investing process. While we hate corrections as much as you, we do believe the pullback has helped with regard to two issues that were facing the market; investor sentiment and valuations. We continue to expect strong corporate earnings, particularly in light of the corporate tax cuts. Global growth also seems likely to accelerate in the coming months. We continue to believe that our long term value strategy with a focus on risk versus reward will serve our clients well. As is always the case, we would remind investors to look at their long term investing goals and objectives and make sure that their current asset allocation is consistent with those goals. Please feel free to contact us with any concerns or questions.

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