JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 80• Summer 2018**

> *"Risk is the likelihood of permanent capital loss. Opportunity risk is the likelihood of missing out on potential gains. Put together you'll see that risk is the possibility of things not going the way you want."*
>
> *Howard Marks*

Despite rising trade tensions, the S&P 500 Index managed to generate a 3.43% return for the second quarter and 2.65% return for the first half of 2018. The U. S. market has been a safe haven for investors, as the U. S. was the only major region to generate positive returns and outpaced non-U. S. equities by 3.6% in local currency terms and 6.1% in U.S. dollar terms in the first half of 2018. For the last six months, the S&P 500 index also outpaced long-term treasuries (which fell by 2.9%), investment grade corporates (which fell by 3.1%), and gold (which fell by 3.1%). Growth once again trounced value for the quarter and year to date. At mid-year, the Russell 1000 Growth Index is 8.94% ahead of the Russell 1000 Value Index. This comes on top of last years 17% spread, which was the widest since 1999. The S&P gains have been skewed by just a few names in 2018 as the market has narrowed dramatically. Ten stocks have generated 122% of the S&P 500's gain for the year—with eight of those ten being technology stocks. So if you were to take those ten out, the S&P 500 index would have been in negative territory thus far in 2018. When examining the eleven S&P 500 sectors you would find a similar theme. Only four of the eleven S&P 500 sectors posted gains, while seven sectors posted mid-year declines. The consumer discretionary sector was the big winner, up 10.8%, however, if one were to exclude Amazon and Netflix which make up 28.8% of the sector (and ironically most consider to be tech issues), then that sector would have been solidly negative and one of the worst performing sectors. The technology sector now represents 26% of the S&P 500 index, and just under 30%, if you add Amazon and Netflix in—which explains how the tech sector (primarily large cap tech) has been able to drive returns for the S&P 500 index. While tech has been the leader, the rest of the market has clearly struggled. As of early May, twenty of the thirty Dow Jones Industrials had seen their stocks drop by over 10% from their 52 week highs. Eleven of the 30 Dow Industrials, led by GE's 52% decline, had corrected by more than 15%.

Index	2nd Quarter 2018	2018 6 months
DJIA	1.26%	-.73%
S&P 500	3.43%	2.65%
S&P Mid Cap	4.29%	3.49%
Russell 1000/Growth	5.76%	7.25%
Russell 1000/Value	1.18%	-1.69%
Russell 2000	7.75%	7.66%
NASDAQ Comp.	-.50%	8.79%

Déjà vu all over Again

It's "Déjà vu all over Again" is a quote attributed to the late, great Yogi Berra. It seems appropriate today because in many ways the present seems much like a period twenty years ago when Jolley Asset Management was formed. At this time twenty years ago, I was preparing to leave a bank trust department where we had $1.3 billion in assets under management to launch a firm with zero assets and zero clients. It was not easy leaving the security of the bank and many of my close friends and co-workers. The move was made as a new bank trust department head desired to move the investment philosophy from "value" to essentially a "closet index" approach. At that time it had become very difficult to match the index returns as the markets had embraced a "nifty-fifty" phase as well as a "bubble" in technology shares driven by the commercialization of the internet. Ironically, at that time, Fed policy was extremely accomodative as the policymakers had fears related to Y2K and provided excess liquidity. Not too different than when the Fed adopted a "zero interest rate" policy during the 2008 financial crisis and left it there until recently when the Fed began a rate normalization process. In 1998 the markets were led by technology (at extreme valuation levels) and the S&P 500 index was driven by passive money flows (if you can't beat 'em, join 'em philosophy). This drove gains in the "nifty-five"and "nifty-fifty"—eerily similar to today. Jolley Asset Management, LLC was formed to preserve a "value" philosophy at a time when no one cared about "value". Today, once again, the technology sector dominates the market, representing 26% of the S&P 500 (closer to 30% if one were to shift Amazon and Netflix to tech). As of June 30, 2018, the top five names in the S&P 500 are all technology (once again if one would classify Amazon as tech) and comprise a whopping 16% of the S&P 500! That is more than the entire financial or industrial sector of the S&P 500 index. Back in 1999, technology shares comprised 29.2% of the S&P 500 index—only to be more than cut in half by 2002. From the peak in March of 2000 to the bottom in October of 2002, the S&P 500 index declined by 50% (price change only) as market participants fled the glamor sectors of the market. The market thinks "It's different this time", or is it "déjà vu all over again"?

Passive Investing

One of the issues with many passive strategies is that most investors believe they are diversified. As was the case in 1999-2000, this is somewhat of an illusion. The Russell 1000 Growth Index is currently 41.6% technology and the top five names in the index: Apple, Microsoft, Amazon, Facebook and Alphabet make up 26.9% of the index. As we mentioned earlier, the same five names make up 16% of the S&P 500 index. As money flows into passive strategies, flows to technology and the largest companies get a disporportionate amount of those money flows—pushing

prices even higher. In many ways the index fund is similar to a momentum strategy—it is based more on price action than underlying fundamental factors. The more the price (market cap) rises (relative to the market), the more the indexer must own—essentially the opposite of the old "buy low, sell high" approach. As the price (market cap) goes lower the reverse is true, the cheaper it gets, the less you own. Take for example Amazon, which currently comprises 2.97% of the S&P 500 index while Wal-Mart makes up .54% of the index. So Amazon carries a weighting more than five times the value of Wal-Mart in the S&P 500 index. Wal-Mart earned $9.86 billion on revenues of approximately $500 billion last year, while Amazon earned $2.37 billion on $136 billion in revenues. Granted Amazon is growing faster and has a dominant technology business in Amazon Web Services (AWS), but is the market (and the index) properly allocating capital? We must remind ourselves that index buying is being done without any concerns about underlying assets or financial metrics, it is largely based upon market capitalization. Netflix, which is disrupting traditional media and cable companies with its streaming service, currently is valued at $177.5 billion, versus Disney at $156 billion. S&P index funds have a larger weight in Netflix than Disney based on this market capitalization, despite the fact that Disney earned just under $9 billion last year on over $55 billion in revenues, while Netflix earned $558 million on $11.7 billion in revenues. Netflix had negative cash flow of $1.8 billion in 2017 versus Disney's positive cash flow of $12 billion. In the month of May alone, Amazon gained over $30 billion in market cap while Netflix tacked on $17 billion.

Rob Arnott recently did a study of historical global stock market leaders (the top ten companies in the world by market value) to assess how they perform over the subsequent decade. Arnott found that the high market capitalizations (of the top ten) tend to reflect a level of optimism that usually cannot be matched by reality and that the companies have historically underperformed over the next decade. At the end of January 2018, seven of the ten largest companies in the world were technology issues: Apple, Alphabet, Microsoft, Amazon, Facebook, Tencent and Alibaba. Arnott stated that history suggests that at least six of the seven will underperform the market over the next ten years. Arnott said, "I don't want to take those odds." He adds, "People are willing to say, This time is different, but people have been saying that forever." Arnott's advice is to buy value stocks, in the U. S. and globally. To put things into perspective, back in 1998, when Jolley Asset Management was founded the top ten stocks in the world by market cap were: General Electric, Royal Dutch Shell, Microsoft, Exxon Mobil, Coca-Cola Company, Intel, Nippon Telegraph and Telephone, Merck, Toyota Motor, and Novartis. General Electric which was the largest market cap in the S&P 500 index as recently as 2005, was removed from the Dow Jones Industrial Average this past June. Only Microsoft remains on the current list twenty years later.

Value

In the *Intelligent Investor*, Benjamin Graham wrote that "Investing is most intelligent when it is most businesslike." Warren Buffet stated, "Shares are not mere pieces of paper. They represent part-ownership of a business. So, when contemplating an investment, think like a prospective owner." It is unclear to us how someone can invest successfully over the long term without a buy or sell strategy based upon underlying fundamentals and/or valuations. Many of the favorite growth issues of today are currently trading at multiples of 12 to 14 times revenues; as value investors we are seeking companies trading at 12 to 14 earnings. In our opinion, growth has outperformed value in the last bull cycle largely due to the fact that quantitative easing lowered long term interest rates to zero and left them there for close to a decade. Growth stocks, unlike value, have a greater proportion of their cash flows occurring in the distant future making them a long duration asset—which is more sensitive to changes in long term interest rates. As can be expected, growth has benefitted from the zero interest rate policies to a greater extent than value. One other reason for the recent popularity of growth strategies in recent years is that the below trendline economic growth since the financial crisis. Much of the growth in earnings has come from financial engineering—such as buybacks due to the record low borrowing costs. In periods of slow economic growth, investors tend to pay a premium for faster growing companies, especially those with high earnings predictability. Currently the valuation gap between growth and value is at its widest level in many years. Higher interest rates have typically been a positive backdrop for value stocks as has accelerating earnings growth. Both of these factors are occurring today. While it is difficult to predict when the cycle will once again favor value stocks—from a risk/reward perspective we believe there is never a good time to overpay for equities. Those who chased tech in the last cycle and bought a package of Microsoft, Cisco, Intel and Oracle are still below the peak valuations by approximately 20% some eighteen years later. People forget the horror stories; Nortel went from $283 billion market cap to bankrupt, Lucent which was a $285 billion market cap—was merged into Alcatel, which now has an $11 billion market cap and America Online was worth approximately $220 billion before it merged with Time Warner (and was ultimately sold to Verizon for $4.4 billion).

We believe our value investing strategy where we focus on risk versus return will continue to serve our clients well. We are proud of how we have helped our clients navigate through the treacherous markets of 2000-2002 and the financial crisis of 2008. Value investing is not dead, nor is active management. Today's popular investing strategy, which tactically trades passive investment vehicles has promise but remains untested. Furthermore, we have yet to see a billionaire emerge from such a strategy. We prefer a bottom up stock selection process with a focus on both balance sheets and income statements. Thanks again for the confidence you have placed in Jolley Asset Management, LLC.

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