JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 85• Fall 2019**

> *"In my opinion, investment success will not be provided by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgement with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl around the marketplace.*
> *Warren Buffett*

The S&P 500 posted its best nine-month performance since 1997, gaining 20.55% on a total return basis. Despite unease about the global economy and trade tensions, investors see few alternatives to U. S. stocks. Just a year ago, the Federal Reserve was on course to "normalize" interest rates, only to reverse course in response to slowing growth and declining stock prices. Much of the rally has been predicated on the belief that the Federal Reserve would start a new easing cycle and in July the Jerome Powell Fed cut rates for the first time in a decade. As James Bianco, head of Bianco Research recently stated, "Two percent is now a big, fat yield. Most investors haven't adjusted to that." In past letters we have mentioned the acronym T.I.N.A.—which stands for there is no alternative (to U. S. stocks). Well T.I.N.A is back after a short hiatus. There is now over $16 trillion in negative interest rate debt in the world. While rates in the U. S. may not go negative, a return to zero does not seem out of the realm of possibility. In the third quarter, the markets were led by interest sensitive sectors such as utilities (+8.4%), real estate (+6.9%) and consumer staples (+5.4%). Laggards included energy (-7.2%), healthcare (-2.7%) and materials (-0.7%). The broad market took somewhat of a backseat to the large caps in the third quarter as evidenced by the Russell 2000 decline of (2.4%), S&P Mid Cap decline of (-0.9%) and the NASDAQ Composite decline of (-0.9%). In the third quarter, the Russell 1000 Growth Index (+1.5%) continued to lead the Russell 1000 Value Index (+1.4%) despite the fact that value outperformed dramatically in September. At one point in August, the Russell 1000 Growth index was 9% ahead of the Russell 1000 Value index—that margin narrowed to 5.5% at quarter end. Below we discuss why we believe the inevitable rotation to value is close at hand.

Index	2019 3rd Qtr	2019 YTD
DJIA	**1.83%**	**17.51%**
S&P 500	**1.70%**	**20.55%**
S&P Mid Cap	**-.09%**	**17.87%**
Russell 1000/Growth	**1.49%**	**23.30%**
Russell 1000/Value	**1.36%**	**17.81%**
Russell 2000	**-2.40%**	**14.18%**
NASDAQ Comp.	**-.09%**	**20.56%**

Momentum Investing Peaking?

In our *Investment Outlook, Summer 2018,* we explained how passive strategies by default are momentum based and the companies with the highest market capitalizations receive increasingly larger money flows. The end result from the disproportionate money flows is the potential for excessive valuations for the largest index components. Remember, financial metrics other than market capitalization are essentially ignored when the S&P 500 Index (and other indexes) is constructed. In the letter we compared Disney and Netflix, and Walmart and Amazon. In our comparison we noted that Netflix had a market cap of $177 versus $156 billion for Disney, despite the fact that Disney had revenues of $55 billion compared with $11.7 billion for Netflix. Not to mention Disney generated $12 billion in cash flow versus a negative cash flow of $1.7 billion for Netflix. Netflix was the market darling while Disney had become stagnant as cord-cutting threatened growth. Since 6/30/18 when that letter was written, Disney has introduced their own streaming service (yes, they do have content) and their shares have risen by over 24% and have paid another 2% in dividends over that fifteen-month period. On the other hand, Netflix has declined 30.4% over the fifteen-month period and appears to be headed even lower as competition has clouded their growth outlook. When looking at the Walmart versus Amazon comparison we noted back in July of 2018 that Walmart's earnings of $9.86 billion dwarfed Amazon earnings of $2.37 billion. We also pointed out that Amazon's weighting in the S&P 500 was five times that of Walmart. While, we conceded that Amazon was growing faster and the Amazon Web Services business was dominant, we still felt that the valuation discrepancy was too wide. Over the fifteen-month period Amazon has returned 2.3% while Walmart has advanced over 37% and paid holders another 2% or so in dividends. While we are aware that an exercise such as this may seem short sighted, we do believe it could signal that investors are becoming less enamored with momentum and growth at any price strategies. *FANG,* which is the acronym for Facebook, Amazon, Netflix and Google, is down just over 10% for the past twelve months.

The initial public offering market (IPO) where investors are seeking the next great growth companies has punished those who purchased shares in recent weeks. Goldman Sachs recently stated that this has been the worst year for IPO's since 1995. In our *Investment Outlook—Spring 2019* and *Investment Outlook—Summer 2019* we warned our clients that most of these "unicorns" coming to market were priced excessively and were more driven by FOMO (fear of missing out) than fundamentals. As Seth Klarman explained, "Investors even remotely tempted to buy new issues must ask themselves how they could possibly fare well when a savvy issuer and greedy underwriter are on the opposite side of every underwriting. Indeed, how attractive could any security underwriting ever be when the issuer and underwriter have superior information as well as control over the timing, pricing, and stock or bond allocation? The deck is almost always stacked against the buyers." The IPO market has gotten so bad in recent weeks that WeWork withdrew its highly anticipated IPO on September 30th which had been assigned a potential $47 billion valuation by SoftBank, its biggest backer. WeWork has since fired its CEO and laid off up to one-third of its workers. WeWork's valuation has now been estimated at $10 billion, some 79% below the price bantered around just weeks ago. Some have even speculated that WeWork could possibly file for bankruptcy. Made me think of the Ernest Hemingway line in *The Sun Also Rises— "How did you go bankrupt Bill? Gradually and then suddenly."* Risk happens fast.

While the S&P 500 index was within a couple of percent of its all-time highs at quarter end, it seems strange that FANG is 10% below its highs. There has been carnage in market darlings, such as Netflix, Tesla, and a multitude of growth stocks in 2019. Is the growth stock/momentum mania on its last legs? If the momentum and growth at any price peak is at hand, would the implication be that "value" stocks will take the leadership baton? We believe either a reacceleration of global growth or a recession could serve as a catalyst for a rotation from growth to value. If the macro environment improves, growth becomes more abundant and investors tend to shun growth and favor value. On the other hand, if we enter a recessionary period, growth issues which are priced for perfection will likely face a reality check much like they did in the 2000 to 2002 time period. Many "value" issues are cyclical and already pricing in an expected recession and downturn in earnings. Investor expectations for "value" are low and investor sponsorship is essentially non-existent. Today reminds us of the market of twenty years ago, when technology was the crowded trade and active managers threw in the towel to adopt "closet indexing" strategies. Over the following three years (2000-2002) the Russell 1000 Value Index outperformed the Russell 1000 Growth Index and S&P 500 Index by 40.8%, and 23.0%, respectively. Ben Inker, the head of asset allocation for GMO recently wrote a piece titled "Shades of 2000" with the executive summary stating the following:

The years leading up to the 2000 stock market bubble were extraordinary and unprecedented. They caused unique pain to the portfolios of valuation-driven investors. The valuation extremes, though, created the greatest opportunity set for valuation-driven investors since the Great Depression. While the events of the last decade have not been as striking as those of the late 1990s, the recent cycle has gone on for significantly longer and the pain caused to our portfolios has begun to approach 1990's levels. As the current cycle has ground on slowly but surely, the valuation extremes have moved wider, creating an opportunity set for valuation-driven investors that looks as extraordinary as what we saw 20 years ago.

Digitization

Over the past ten years the world has become digitized with everything converted into a digital format so that it could be processed by a computer. Music albums were replaced by MP3 files (remember the iPod?) which were stored on a device and now those have now been replaced by streaming services such as Spotify. Linear television has been replaced by streaming services such as Netflix, Hulu and Amazon Video. Millennials love streaming while the baby boomer generation has understandably been slower to adapt. I bring these up because I am convinced that in most cases, technology provides a better product for the end user. The investment process has also gone through radical changes as digitization and artificial intelligence have taken hold. Stocks once traded in eighths and quarters. No more—now stocks are traded by computers and they trade with penny spreads influenced by algorithmic programs and artificial intelligence. The specialist system and market makers which provided much-needed liquidity in times of market imbalances are now gone. Bespoke Investment Group did a study of the S&P 500 from 1993 through February of 2018 which showed that the overnight returns for the fifteen-year period were up 571% in the overnight period and down 4.4% during the regular trading session. In other words, all of the gains for the fifteen-year period came in the overnight session while you slept. Today's markets are much less liquid resulting in huge gaps up and down (for both the markets and individual securities) as electronic buyers and sellers disappear when unexpected news hits. Indexes used to reflect how the basket of underlying stocks were doing. Now indexes are the investment vehicle of choice and the movement of the index drives the underlying stocks. Yes Grandpa, the tail is wagging the dog. Valuations on individual stocks and research has taken a back seat to "technical analysis" which is largely trend following with buy and sell signals based off of price movements and volume. Seldom is a balance sheet analyzed. Today's research is based on chart patterns and has become very short term focused. Algorithmic programs and today's investment process require digital inputs—technical analysis rather than a balance sheet line item (which requires tedious research) seems to be the preferred data set that is utilized today. Technical analysis (much like indexing/passive) is largely momentum based—buying strength and selling weakness. The end result is bifurcated markets—pockets of overvalued sectors and stocks, and pockets of undervalued sectors and stocks which are shunned by the masses. Herein lies the opportunity for the value investor. If one is willing to go against the grain—there seems to be the chance to sell at prices substantially above intrinsic value and buy shares at prices significantly below intrinsic value.

When the masses all adopt the same basic investment strategies and processes, it is our opinion' that in the long-term results will be disappointing or mediocre at best. As Benjamin Graham wrote in the book, *The Intelligent Investor*, in 1949, "Those formulas that gain adherents and importance do so because they worked well over a period, or sometimes merely because they have been plausibly adapted to the statistical record of the past. But as their acceptance increases, their reliability tends to diminish. This happens for two reasons: First, the passage of time brings new conditions which the old formula no longer fits. Second, in stock market affairs the popularity of a trading theory has itself an influence on the market's behavior which detracts in the long run from its profit-making possibilities.". Furthermore, any investment strategy that pays no attention to valuation or the price you pay for a security seems doomed. As Warren Buffett stated, "Price is what you pay; value is what you get". As a portfolio manager, one must have strong conviction to not confuse the current market price of a stock with the intrinsic value associated with that security. We often remind ourselves and our clients to not assume that a great company translates into the stock being a great investment. When a stock soars (to overvalued levels) and the news is positive, investors often become emotionally attached to that security. On the flip side, when a stock plummets (to undervalued levels) investors often become disillusioned, capitulate and sell. The human emotions of fear and greed will always drive the financial markets, and this is the one area of investing that we do not believe will ever be successfully digitized. This is where we come in as an advisor/portfolio manager; to be rational in our decision-making process when the markets may not be so rational.

Summary

Jolley Asset Management was formed twenty-one years ago, to provide a vehicle whereby our focus and value discipline could be preserved. We continue to believe that investors are overpaying for growth and that most investors are crowded into the same areas of the market. As Savita Subramanian of Bank of America/Merrill Lynch stated, "This huge world of investible assets has shrunk down to a small cohort, we're all in this echo chamber where everyone goes to the same dinners and drinks the same Kool-Aid." We are finally starting to see some early cracks in the "growth at any price" story for the first time since this bull market began over ten years ago. The initial public offering market and a number of market darlings have begun to falter in recent weeks, as investors have balked at the valuations. In our opinion, active management and "value" strategies, seem positioned well for the future. The valuation spread between "growth" and "value" are at all-time highs. We believe that fundamental analysis and active management, where a focus is placed on risk and reward might finally be ready to shine versus "passive" strategies. As we have discussed on numerous occasions, the S&P 500 index has taken on the characteristics of a "growth" fund as the index is market capitalization weighted and dominated by growth issues. We would much prefer to invest in the "equal-weight" S&P 500 index than the market cap weighted version. Today's market does remind us of the 1999-2000 time period and like Ben Inker of GMO, we believe the opportunity in "value" is the best it has been in years. Please feel free to contact us with any questions or comments. Thanks again for the confidence you have placed in Jolley Asset Management, LLC.

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