JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 83• Spring 2019**

***Jim Cramer**: "Lyft IPO likely to surge drawing investors back to the whole stock market. Cramer said the IPO which was priced at $72 could open as high as $100 per share".*

***Warren Buffett**:." I don't know why, with all the things you can buy for $25 billion in this world, that you would pick a business (Lyft)that really has to be earning $2.5 or $3 billion pre-tax in five years to even be on the same radar screen as things you can buy right now."*

Fueled by a dovish Federal Reserve and optimism about an eventual trade deal with China, the S&P 500 posted its best quarterly return since the third quarter of 2009. Investors have been on a wild ride over the past six months with the S&P 500 going from record highs (9/20/18) to being down 19.8% on Christmas Eve (20.2% if looked at intraday) to being back within 3% of a record high at quarter end! As we discussed in our "*Investment Outlook—Winter 2019*", "the Jerome Powell "Put" is now safely in place following the lead of Greenspan, Bernanke and Yellen". In the last quarterly letter, we warned of the dangers of market timing and stated, "While we are not expecting, or banking on a sudden recovery in the markets; it is not out of the realm of possibilities given the change in the market structure". We also pointed out that a number of stocks had declined precipitously and were at compelling valuation levels and that there was no need to panic. Probably the best advice in the last quarterly investment letter was to ignore the financial media! The so-called experts on Mad Money, Fast Money, etc. began running for the exits as the markets declined below the 200-day moving average in early December—only to become more bullish in mid-February as the markets once again closed above the 200-day moving average. As the world has become more digitized it seems as if due diligence has shifted from fundamental analysis to technical analysis (study of chart patterns and price action). Good luck to anyone who believes they will improve their investment results by tuning into CNBC. Since 2018, the network's focus has gone from crypto-currencies, to cannabis stocks and has recently embraced the IPO (initial public offering) market. The latest coverage on the IPO of Lyft (ride sharing company) bordered on a clown show—with Cramer and crew pumping a company with a valuation of $24 billion versus revenues of $2.1 billion and an annual loss of $911 million. Ironically, the day before CNBC had Warren Buffett on advising against buying Lyft or initial public offerings in general—stating he hasn't bought an IPO since 1955. Invest with Cramer or Buffett? I think that's what they call a "no-brainer".

Index	2019 1st Qtr	2018 4th Qtr
DJIA	**11.81%**	**-11.31%**
S&P 500	**13.65%**	**-13.52%**
S&P Mid Cap	**14.49%**	**-17.28%**
Russell 1000/Growth	**16.10%**	**-15.89%**
Russell 1000/Value	**11.93%**	**-11.72%**
Russell 2000	**14.58%**	**-20.20%**
NASDAQ Comp.	**16.49%**	**-17.54%**

All eleven S&P sectors were up in the first quarter led by technology (+19.4%), industrials (+16.6%) and real estate (+16.6%). Healthcare (+6.1%) and financials (+7.9%) were laggards in the quarter just ended. According to Bank of America/Merrill Lynch low quality stocks beat out high quality stocks with C&D rated stocks outperforming A+ rated stocks by 10.3% on average. The Russell 1000 Growth Index outperformed the Russell 1000 Value index by 4.17% for the first quarter—a mirror image of the fourth quarter of last year when value beat growth by the same amount.

Quiz Time

One might quickly conclude that if value outpeformed growth by 4.17% in the fourth quarter and growth outperformed value by the same 4.17%, that a growth and value portfolio would have equal amounts at the end of the six month period?

Index	4th qtr	1st qtr	Simple Avg
Growth	*-15.89%*	*16.10%*	*.11%*
Value	*-11.72%*	*11.93%*	*.05%*
Difference	*4.17%*	*4.17%*	*.06%*

Based on a simple average, it appears that from the chart above that growth fared better than value, correct? The simple average is higher; however, that is not how compound returns work—the growth in a portfolio cannot be computed using simple averages. The compound return on the value portfolio is a decline of 1.18% while the compound return on the growth portfolio is a decline of 2.35%. This is precisely why we focus so much on risk. If one loses less they don't have to make as much to get back to even. The Russell 2000 index (small caps) trounced the Russell 1000 Value index in the first quarter of 2019, yet is still down 8.56% for the six month period when looking at compound returns.

The following chart makes the same point, with regard to compound returns. What this chart shows that if one loses 50% they need to make 100% to get back to even or if one loses 30% a return of 43% will be needed to bring the portfolio back to even. This is intuitively why we are value investors. It is our belief that stocks that are purchased at a discount to their intrinsic value and with a "margin of safety" have a better chance to hold their value in a difficult market than "growth" or glamour issues trading at higher valuations and with high expectations. People often forget it took the Nasdaq fifteen years to recover the 80% crash it experienced from the peak in March of 2000.

Importance of Capital Preservation
Return needed to break even after a loss

-75%	***300%***
-60%	***150%***
-50%	***100%***
-40%	***67%***
-30%	***43%***
-25%	***33%***
-20%	***25%***
-15%	***18%***
-10%	***11%***

Nobody in their wildest dreams expected an 80% markdown, but it happened. Moves in stocks, markets and sectors tend to get exagerrated in both directions, both up and down. Obviously portfolio returns need to be examined over a full market cycle—not some time period that has been "cherry picked" during a bull market phase. In summary, the key to long term compound returns is if one loses less in the bad years, they don't have to make as much in the up years.

F.O.M.O

All it took was a little tweaking from the Federal Reserve Chairman Jerome Powell, replacing the word "gradual" with "patient" and Wall Street was off and running. With the "Powell Put" firmly in place, strategists felt comfortable that the Fed could engineer a "soft-landing" for the economy in lieu of a recessionary environment. The "fear of loss" that was so prevalent in the fourth quarter of 2018 has now been replaced with the "fear of missing out". For example the Netflix that was sold in December at $231 and some change is looking good again at $379 just three months later. When share prices head down, that emotion of fear awakens, and the long term investment horizon that one had accepted as reasonable somehow makes little sense. Today the fear of missing out is driving the equity market. Most fund managers were under allocated to equities at the start of the year and "career risk" is now forcing them to play catch up with their respective benchmarks. There is also the assumption that the Federal Reserve has the market's back and there is little fear of anything more than a minor pullback in prices. A March survery by Bank of America/Merrill Lynch showed that fund managers allocation to stocks was the lowest since September of 2016, implying that fund managers are being forced to allocate more money to stocks as prices move higher.

We believe the current enthusiasm for initial public offerings is more of a function of FOMO than fundamentally driven. The Lyft offering was just completed and next up we have Pinterest, Uber and Airbnb. Like Buffett we typically see little value in IPOs and this group of unicorns will likely be no exception. Are the purchases of shares in these offerings a function of fundamental analysis or based on a fear of missing the next Amazon? According to Recode, money-losing companies that went public in 2018 did better than the profitable ones. Cameron Stanfill, an analyst for PitchBook stated, "In general you are not seeing a huge preference either way in public markets for if a company has been profitable or unprofitable at its IPO. This says more about the market than the companies and means investors are prizing future growth over present profitability." As Benjamin Graham stated, "Most new issues are sold under favorable market conditions—which means favorable for the the seller and consequently less favorable for the buyer". Another important observation from Graham, "periods during which new issues/IPOs are are especially frequent are a likely indication that the market is reaching its peak".

John Bogle

John Bogle, who founded the Vanguard Group passed away on January 19, 2019 at the age of 89. Bogle built Vanguard into a giant mutual fund company with $4.9 trillion in assets under management. Probably the most important accomplishment of Mr. Bogle was the creation of the first index fund. As you know index funds have disrupted the financial services industry and according to Morningstar, index funds currently represent more than $6 trillion in assets under management. We have touched on the positives versus negatives for indexing/passive vehicles on many occassions over the last twenty years. Our posture is that if one can stay the course and not become emotional in market swoons, that indexing when implemented direct with a firm like Vanguard makes sense in some situations. However, most individuals don't have the temperament to stay the course during difficult market environments. During the 2000-2002 bear market, the S&P 500 had a 49.2% drawdown and in the financial crisis (2007-2009) the market experienced an even more dramatic 56.8% drawdown. Many investors who were devoted to the passive strategy abandoned ship in those periods as emotions took over. Redemptions for Vanguard's traditional index funds typically are around 8% a year. It is unlikely many of the individual investors who bought the S&P 500 index fund in 2000 have "stayed the course" as Bogle preached. One of the big advantages with indexing/passive strategies is cost, particularly when compared with active strategies. It is doubtful that Bogle would endorse a strategy utilizing low cost index funds in a portfolio where the advisor levies additonal fees of 1-2% at the acccount level. That has become the norm today, you may own an inexpensive index fund or basket of funds, however, the advisor (we call them quarterbacks) who oversees this process collects a fee for his services such as asset allocation, reporting, planning, etc. Essentially the investor has negated the major benefit of indexing—which is cost. Bogle was outspoken in his belief that index mutual funds were superior to index (ETFs). ETFs (exchange traded funds) were supposedly a "better mousetrap" created by Wall Street with the big difference being liquidity—the fund shares can be sold anytime during trading hours, versus once a day for mutual funds. ETFs essentially can be used as a long term or short term investment vehicle. It is estimated that the State Street S&P 500 SPDR ETF has a turnover of approximatly 3,000%, implying that the ETF is in many instances a trading vehicle utilized by all sorts of traders from individuals to algorithmic strategies. One popular trading strategy is to market-time index funds by utilizing moving averages to generate buy and sell signals. Many of those timers were selling into the December bloodbath and buying back in February and March (the old sell low, buy high approach). As one might expect there is a fee levied to implement these strategies as well. According to Bogle, equity ETFs annual turnover is approximately 900%, compared with 120% in the stock market. Does the active trading of passive vehicles such as ETFs and index funds have an advantage over individual equities? In most cases we believe not, particularly when a there is a second fee at the account level. It is our belief that there is a much greater likelihood of wealth creation owning high quality common stocks. Since our firm was formed over tweny years ago (12/31/98-03/31/19), the Russell 1000 Value Index has outperformed the S&P 500 and our Equity Composite (net of fees) has outperformed both. For our full composites and disclosures please contact us via phone or email.

Summary

Investors have been on a roller coaster over these past six months as investors fretted over the Federal Reserve's attempt to normalize interest rates into an uncertain economic backdrop. We had felt it was only a matter of time before the Fed would back off and become more accomodative. The recent policy change at the Fed and the accompanying Powell Put has market participants once again embracing risk. Momentum strategies which were decimated in the fourth quarter are now off to the races. The IPO market is heating up with a number of offerings set to come to market in the next few weeks. While there will be lots of hoopla and hype around these offerings, we prefer to pass on these unproven businesses and focus on companies that we can purchase with a "margin of safety". In a "value" investing strategy we attempt to eliminate the potential for "big mistakes" which can be prevalent with IPOs. Sometimes what you don't own is more important than what you do own. Value investing is not dead, nor is active management. Today's popular investing strategy of tactically trading passive investment vehicles may seem alluring but remains untested over the long term. As we stated in a previous *Investment Outlook*, we have yet to see a billionaire emerge from such a strategy. Thanks again for the confidence you have placed in Jolley Assset Management, LLC.

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