JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 82• Winter 2019**

> *"In a market downturn, momentum investors cannot find momentum, growth investors worry about a slowdown, and technical analysts don't like their charts. But the value investing discipline tells you exactly what to analyze, price versus value, and then what to do, buy at a considerable discount and sell near full value. And, because you cannot tell what the market is going to do, a value investment discipline is important because it is the only approach that produces consistently good investment results over a complete market cycle".*
> *Seth Klarman*

Investor concerns about rising interest rates, trade wars and slowing global growth took its toll on the markets in the fourth quarter. From the peak in late September, the S&P 500 index fell by some 20.2%. For the quarter, the S&P 500 index fell by 13.52%, with most of that coming in the month of December, which returned a negative 9.18%. When put into context, December was the 11th worst month over the past fifty years. Mid-caps (S&P 400) and small-caps (Russell 2000) suffered even more, with quarterly declines of 17.28% and 20.20%, respectively. For the year, the total return on the S&P 500 was down (4.38% on a total return basis) breaking a nine-year winning streak dating back to the financial crisis. This winning streak tied the longest on record since 1936. It should be pointed out that the average stock fared much worse than the market cap weighted indexes. The S&P 500 index is market cap weighted and is dominated by a few large cap technology companies which essentially buoyed the index until the fourth quarter of 2018. If one were to take the entire S&P 500 index and equal weight the stocks, the decline for 2018 was 7.99%, versus 4.38% for the market cap weighted index. The Value Line geometric index, which is an equally weighted index comprised of 1675 companies (large, mid and small) declined 15.99% in 2018. Global markets fared poorly as well—global equities declined by 8.9% (in USD terms) and emerging markets fell by 14.2%. Cash was the only major asset class to post positive returns (+1.9%) as long- term government bonds fell (-1.7%), corporate bonds fell (-2.2%) and gold fell (-0.9%).

Index	4th Quarter 2018	2018 12 mos
DJIA	**-11.31%**	**-3.48%**
S&P 500	**-13.52%**	**-4.38%**
S&P Mid Cap	**-17.28%**	**-11.08%**
S&P 500 (Equal Weight)	**-14.23%**	**-7.99%**
Russell 1000/Growth	**-15.89%**	**-1.51%**
Russell 1000/Value	**-11.72%**	**-8.27%**
Russell 2000	**-20.20%**	**-11.01%**
NASDAQ Comp.	**-17.54%**	**-3.88%**

There was essentially no place for investors to hide in 2018. Deutsche Bank did a recent study showing that in the past year (thru 12/20/18), 93% of all asset classes (in US dollar terms) generated a negative total return—the worst on record. The markets have voted, and the voice is clear, the Fed will have a difficult time normalizing interest rates and shrinking the Fed's balance sheet (quantitative tightening) at the same time.

Bear Market or Correction?

Since 1949 there have been nine periods of 20% or greater declines for the S&P 500 index. The average decline in these periods has been 33% and on average has lasted approximately fourteen months. At year end, 57% of stocks in the S&P 500 were down more than 20% from their 52-week highs. From their peak prices in 2018 to December lows, the Russell 200 (small-cap) declined by 27.2%, the S&P 400 (mid-cap) index by 23.7%, the S&P 500 index by 20.2% and the Dow Jones Industrial Average by 19.4%. As of January 4th (date of this writing) the market has recovered somewhat as the Fed assured investors that they will be "patient" in deciding whether to raise rates further and reassured the markets that they could reverse course on "quantitative tightening" if needed. I think one can safely assume that the Jerome Powell "put" is now safely in place, following the lead of Greenspan, Bernanke and Yellen. From the lows in December through January 4, 2019, the S&P 500 index has rallied by 7.8%, bringing the index's decline from the highs to 13.9%. The average maximum drawdown since 1928 has been approximately 16% and the median annual drawdown has been 13%. From this data one can easily conclude that what has transpired in the markets is not that much of an outlier. This decline has certainly been more violent and sudden than most—largely due to the fact that 85% of all trading in the market today is controlled by machines, algorithmic models or passive investing. We have discussed this change in the market structure in several of our quarterly letters—and explained in our *Investment Outlook—Summer 2016, "This Is Not Your Father's Market*". 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 market structure. We do believe that this change in market structure could result in a shorter than normal (fourteen months) bear market phase. Bear market or not, we do expect more volatility in the coming months. One never knows if they are in a "bear market" until after the fact and once the media defines the market as such it is typically too late to run for the exits. One could make a case that while the S&P 500 made a high in late September, the average stock most likely peaked in January/February of 2018—making it difficult to define when the bear market began. The talking heads on CNBC will most likely label the current market as having left a bear market and entered a correction given the recent relief rally, however, we will ignore their gibberish and prepare for the worst and hope for the best. This doesn't mean we see the need to panic as a number of stocks have declined precipitously and are at compelling valuation levels. In many instances we believe that a slowdown in the economy and earnings are largely

priced in. It is our expectation that the average stock may fare better over the next year than the indexes which is the exact opposite of what transpired last year. Valuations in today's market certainly appear reasonable (see chart below). S&P 500 earnings are expected to increase approximately 20% (partially driven by tax reform) for the year just ended, the highest growth rate since 2010. Analysts are expecting S&P earnings to advance by another 7.9% in 2019, although any economic slowdown would likely result in downward revisions. The steep decline in equity prices would imply that most market participants believe that an economic slowdown and lower earnings are in order for next year. Only time will tell who is correct.

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	14.4x	16.1x	-0.5
CAPE	Shiller's P/E	29.0	26.8	0.3
Div. Yield	Dividend yield	2.3%	2.0%	-0.8
P/B	Price to book	2.7	2.9	-0.3
P/CF	Price to cash flow	10.6	10.7	0.0
EY Spread	EY minus Baa yield	1.8%	-0.1%	-1.0

Source: J P Morgan

Course of Action

As you know, we believe that market timing is a futile exercise that seldom pays off for investors. One must be correct twice to effectively time the markets—you must sell at the right time and re-enter the markets at the correct time. Despite what one may think, it is never easy to enter the market in the throes of a bear market. It is our plan to stay the course utilizing our "value" strategy that has helped us successfully navigate difficult market environments of the past. One of the key principles of "value" investing is to invest with a "margin of safety" where securities are purchased at prices sufficiently below their intrinsic value in an effort to minimize the risk of a permanent loss of capital.

In addition to maintaining our strict value approach we also plan to focus on the following in 2019:

Ignore the Financial Media. We will also encourage our clients to do the same. CNBC has been relentless in promoting crypto currencies on their telecast including step by step instructions as to how to buy. Many crypto currencies were down more than 90% in the past year—which represents what we believe to be a permanent loss of capital. As the crypto currencies plummeted, the CNBC crew took to the airwaves to promote one cannabis stock after another, despite valuations that make absolutely zero sense. On 9/18/18 Jim Cramer brought the Tilray (a Canadian marijuana company) CEO on the air—the stock had closed that day at $154 per share (market cap approximately $14 billion) with essentially no revenues or earnings. The following day the stock gapped up to $300 per share ($28 billion market cap) before plumetting to $70.54 per share at year end. This is a perfect example of a permanent loss of capital that people have difficulty recovering from. The Fast Money crew and Mad Money crew are doing viewers a disservice by attempting to recommend securities two to three times a day based largely on technical chart patterns. Seldom do you hear any mention of price/earnings ratios, price/sales ratios or debt levels. There is absolutely no accountability and little public disclosure as to what they are doing with their own money. In my opinion, they should report the news rather than attempt to generate investing/trading ideas for the public.

Fundamental Analysis. In difficult markets and economic backdrops one must focus intensely on the fundamentals. Passive strategies and ETFs essentially ignore the fundamentals of the underlying companies which make up the funds and money flows can result in security prices significantly above or below their intrinsic value. The only way to capitalize is to know the intrinsic value and act on it accordingly. As a "value" investor we must know when to act on market mispricings and dislocations created by passive and algorithmic strategies. We also must pay increased attention to debt levels and balance sheet strength. Buybacks have impaired corporate balance sheets as equity has been replaced with debt to boost short term results. The increased debt levels will begin to be questioned if the economy weakens further. Take the case of General Electric, between 2015 and 2017 the company repurchased $40 billion in shares between $20 and $32 per share—the shares now sit at $8 and the company has a tangible net worth of negative $48 billion. Seriously what was the management team and Board of Directors thinking? As we have stated on numerous occasions, we believe the stock buyback craze will end poorly for many companies and that the big winners of the buybacks have been corporate insiders who have dumped their own personal shares.

Upgrade Portfolio Quality. In the event Jolley Asset Management, LLC decides to exit a position for whatever reason, it is our goal to replace that company with a better business going forward. As markets correct, many times the great companies will be priced as cheaply as the weaker ones, despite having a more sustainable business model. We recently exited a long term portfolio position that has been an excellent perfomer but we had become concerned with the balance sheet, where buybacks have resulted in the company having a negative net worth and increasing debt levels. My goal is to find a suitable replacement with better financial characteristics. It is not difficult to find cheap stocks today and it is our goal to replace that holding with a balance sheet that can withstand a potential financial shock.

Summary

Whether this is a bear market or a case of algos gone wild, we do believe we are in for increased volatility. It is too early to determine whether the economy will falter and whether stocks are accurately predicting an economic recession. We believe this will be a challenging environment and trust that our disciplined "value" approach will serve our clients well. Many stocks are pricing in an economic slowdown, creating what we believe to be compelling values. Please feel free to contact us should there be any questions or if your financial situation has changed.

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