JOLLEY ASSET MANAGEMENT, LLC

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> *"To a value investor, investments come in three varieties: undervalued at one price, fairly valued at another price, and overvalued at still some higher price. The goal is to buy the first, avoid the second, and sell the third."*
>
> *Seth Klarman*

Stocks closed out the decade on a high note, with all the major indexes posting gains of greater than 25%. The S&P 500 led the way with a 31.49% return, which was the second-best year of the decade and the thirteenth best year since 1936. The large cap stocks (S&P 500) were market leaders and outperformed the small caps (Russell 2000) by almost 6% for the year. Growth outperformed value by 9.85% for the year, continuing a trend that has been in place for the entire decade. The market advance was broad, as all eleven S&P sectors posted positive returns for the year (first time since 2010). The strongest sectors were information technology, communication services, and financials while the weakest sectors were energy and healthcare. According to BofA Securities, tech drove nearly one-third of the S&P 500 total return for the year. According to Goldman Sachs, multiple expansion accounted for 92% of the S&P 500 return last year. Three 25 basis point rate cuts lifted the price earnings multiple on the S&P 500 from 18x to 23x. Other asset classes posted gains for the year as well, with gold (+18%), long term treasury bonds (+14%), long term corporate bonds (+14%) and cash (+2%). U.S. stocks outperformed other major global markets, outperforming Japan (+15%), Europe (+23%) and emerging markets (+15%).

Index	4th Quarter 2019	2019 12 mos
DJIA	**6.67%**	**25.34%**
S&P 500	**9.07%**	**31.49%**
S&P Mid Cap	**7.06%**	**26.20%**
S&P 500 (Equal Weight)	**7.69%**	**29.89%**
Russell 1000/Growth	**10.62%**	**36.39%**
Russell 1000/Value	**7.41%**	**26.54%**
Russell 2000	**9.94%**	**25.53%**
NASDAQ Comp.	**12.17%**	**35.23%**

The Past Decade

According to Howard Silverblatt of Standard & Poor's, the S&P 500 index, has registered a cumulative total return of about 256 percent, or 13.5 percent annually, since the beginning of 2010. That compares favorably with an average annual total return (including dividends) of 10.3 percent since the 1920's. According to S&P data starting in 1930s, the best decade on record was the 1950s, when the market had a 19.2 percent average annual total return. The worst decade was 2000 through 2009, when the S&P fell (-0.9%) percent (annually). The period just ended (2010-2019) was the fourth-best decade since the 1930s (please see chart below). The gains in the past decade were magnified by the fact that the previous decade returns (2000-2010) were dismal, generating a negative return of 1% annually. That decade included the "dot.com crash" and the "financial crisis", and returns were comparable to the 1930-1939 period which included the Great Depression. In conclusion, while over the past decade returns have been above normal, when considering the past two decades together, returns on an annualized basis have been a below average 6.0%.

Over the past decade, large caps as measured by the S&P 500 (+13.5%) have outperformed the S&P 400 Midcap index (+12.7%) and the small cap Russell 2000 index (+11.8%). This large-cap performance was largely driven by mega-cap technology issues, which currently dominate the S&P 500 index. Growth (Russell 1000 Growth) has outperformed value (Russell 1000 Value) for the decade by 3.4% per year, reversing the trend of the previous decade where value outperformed growth by a whopping 6.5% a year. Over the past two decades combined, the Russell 1000 Value index has outpaced the Russell 1000 Growth index by 1.8% per year. In our opinion, this validates Jolley Asset Management's "value investing" philosophy to which we have adhered to since the firm's inception in 1998. Never once have we wavered in our belief, that in the long run, investing with a "margin of safety" gives our clients the best shot at long term financial success. We are proud that our firm's (GIPS Compliant) equity composite returns after all fees, has exceeded the Russell 1000 Value Index, the Russell 1000 Growth Index and the S&P 500 over the last two decades. *(Please feel free to contact our office to receive full composite disclosures.)* It is amazing that Jolley Asset Management was founded over twenty-one years ago and has spanned across three different decades (soon to be four); time flies when you are having fun!

Returns by Decade

Decade	Annualized
1930-1939	**(-0.1%)**
1940-1949	**9.1%**
1950-1959	**19.2%**
1960-1969	**7.8%**
1970-1979	**5.8%**
1980-1989	**17.3%**
1990-1999	**18.1%**
2000-2009	**(-0.9%)**
2010-2019	**13.5%**

As the last decade began, we were still feeling the effects of the "financial crisis" and the deepest recession since the

"great depression". What followed was unprecedented levels of action by both policy makers and central bankers globally. "The dominant force over the past decade has been monetary policy," according to Kristina Hooper, chief global strategist for Invesco. For almost the entire decade, investors have worried that the stock market rally has become overly reliant on easy money. The bull market has largely been driven by low interest rates and multiple expansion rather than a "booming economy". As mentioned earlier, tech stocks have been the story of the past decade. According to BofA Securities they have contributed nearly 50% of the S&P 500 returns (for the decade). As of December 31, 2019, the top five names in the S&P 500 were all tech and accounted for just under 17% of the index. Apple, Microsoft and Amazon, were all big winners of the decade and exceeded the $1 trillion market cap threshold at year end.

Valuations

As discussed earlier, the 2019 equity market was essentially driven by multiple expansion rather than earnings growth, resulting in valuations for the S&P 500 that appear somewhat stretched. As the chart below shows, most valuation metrics show stocks at levels above the twenty-five-year average. The lone metric (in chart below) that is favorable for equities is the earnings yield minus the Baa corporate bond yield, which remains constructive. This indicator is largely driven by the low interest rate environment.

Valuation	Latest	25 Yr. Avg.
Forward PE	**18.2x**	**16.3x**
Dividend Yield	**1.93%**	**2.09%**
Price to Book	**3.32**	**2.96**
Price to Cash Flow	**12.97**	**10.61**
EY minus Baa Yield	**1.65%**	**(-.03%)**

While market valuations appear stretched, we believe it is helpful to drill down and examine the subsets of growth and value (see table below). As was the case in 2000, the markets are currently bifurcated, with what we believe to be pockets of over-valuation and pockets of under-valuation. We believe this is being exaggerated by passive money flows, which funnels a disproportionate amount of money into the largest companies. As we have discussed, growth has outperformed over the past decade with the result being a price/earnings valuation gap at 10.85 points. This valuation gap represents one of the largest divergences since the global financial crisis. The Russell 1000 Value dividend yield is essentially double that of the Russell 1000 Growth. Dividends are extremely important, and over the long term, dividends have comprised approximately 40% of total returns. On a price/book value basis, the Russell 1000 Value Index trades at 2.22 times, which is essentially in line with it's average over the past twenty-five years. The Russell 1000 Growth index is currently trading at 8.58 times, versus an average of 5.08 times over the same twenty-five-year period. The last time the price/book ratio of the Russell 1000 Growth index exceeded 8 times was June of 1999 and the subsequent 10-year return for the index was -4.2% annualized.

Metric	Russell 1000	Russell 1000 Value	Russell 1000 Growth
Dividend Yld	1.80%	2.22%	1.15%
Price/Earnings	22.25	17.86	28.71
Price/Book	3.59	2.22	8.58

Growth and value have cycled over time. This past decade was dominated by growth and the previous decade was dominated by value. Studies have shown that value has generated superior returns over the long term and delivered lower drawdowns during "bear market" phases. In summary, while the valuations for the S&P 500 index and growth stocks appear richly valued, value issues remain attractively priced. While uncertain as to the timing, we believe the baton will be passed from growth to value early in this decade. As Seth Klarman stated, *"The strategy of buying what's in favor is a fool's errand, ensuring long-term underperformance. Only by standing against the prevailing winds—selectively, but resolutely—can and investor prosper over time."*

Discipline/Process

Over these past two decades this quarterly letter has been used to communicate our thoughts on the financial markets backed up by analysis and logic. The common theme of the letters can be best described by the Benjamin Graham quote, "Investment is most intelligent when it is most businesslike". Value investing just makes more sense for the long-term investor. After all, buying a stock is nothing more than buying fractional ownership in a business, implying you should strive to buy low and sell high. Many popular "passive" strategies are currently doing the exact opposite. Over these past two decades, not once have we questioned our belief that "value" was the best course of action for our clients. Our strategy is to help our clients reach their financial goals and objectives with the highest likelihood of success. We recognize that fear and greed will always be the enemy of the investor. The value investing framework, if properly implemented, gives the portfolio manager a roadmap to help eliminate emotions from the decision-making process. Exercising discipline in the markets (particularly at inflection points) is where we believe we can provide an edge. Warren Buffett stated, "Investing is not a game where the guy with the 160 IQ beats the guy with a 130 IQ. Rationality is essential". It is our belief that thinking rationally and investing with a "margin of safety" will help to guide us successfully through a myriad of economic scenarios.

We believe the coming year in the markets will most likely provide lower returns than 2019. The current bull market is the longest in history and valuations are above historical ranges. Earnings growth will likely be needed to drive share prices higher, as price/earnings multiples are currently stretched. Other factors which will likely drive the markets in 2020 include geo-political risk and the election. While we are not market timers, we will attempt to use any market strength or weakness to our advantage. Thanks for the confidence you have placed in Jolley Asset Management. *Frank G. Jolley, CFA*

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