JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 69• Fall 2015**

> *"When any method for selecting stocks becomes popular, then switch to unpopular methods."*
> *Sir John Templeton*

Concerns about the impact from China's economic slowdown sent global equity markets reeling in the third quarter of 2015. This represents the largest decline in stock prices since the third quarter of 2011, when the European debt crisis rocked the markets. During the quarter, the damage was widespread. The S&P 500 index fell by 6.4% for the third quarter and 5.3% year to date. From its high point on July 15th, the S&P 500 declined 12.7%, representing the first correction of more than ten percent in approximately four years. As we have noted on numerous occasions, stocks typically correct ten percent every eleven months. The small cap Russell 2000 led to the downside with a decline of 11.9%. Ironically, many had touted the small caps as safe, as they have less global exposure than their large capitalization counterparts. Growth strategies once again outperformed value for the quarter and year to date. As growth has become scarce, investors have favored companies with high revenue growth and shunned value stocks. For the first nine months of 2015, the Russell 1000 Growth Index has declined by 1.54% while the Russell 1000 Value Index has fallen by 8.96%. For the first nine months only the consumer discretionary sector managed a gain while the remaining nine S&P sectors declined, led by energy and materials, which declined by 23.1% and 17.8%, respectively. Energy stocks have now seen their weighting in the S&P 500 index fall to their lowest level in eleven years. Furthermore, energy sector valuations (price/book) relative to the market are at twenty year lows. The financial media is fixated on a 10% decline being labeled as a "correction" and a 20% decline being characterized as a "bear market". All one needs to do is look at a number of "high quality" blue chips to realize that many sectors are in what we think of as a "stealth bear market". By that, we mean that the average stock has fared much worse than the market capitalization weighted indexes. This is backed up by the fact that the S&P 500 decline (price only) for the first nine months has been 6.9% versus a 12.4% decline for the Value Line index (equal weight) which is not boosted by gains in Netflix, Amazon, Facebook, Google, etc.

Index	3rd Quarter 2015	2015 YTD 9 Mos.
DJIA	-6.91%	-6.88%
S&P 500	-6.44%	-5.29%
S&P Mid Cap	-8.50%	-4.66%
Russell 1000/Growth	-5.29%	-1.54%
Russell 1000/Value	-8.39%	-8.96%
Russell 2000	-11.92%	-7.73%
NASDAQ Comp.	-7.35%	-2.45%

Growth versus Value

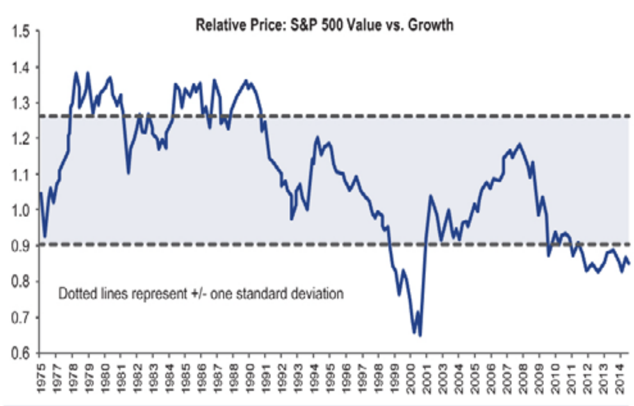
Growth and value are two different fundamental approaches utilized within investment portfolios. Growth stocks represent companies that have demonstrated above average gains in earnings in recent years. Investors are essentially banking on earnings growth continuing regardless of economic conditions. Growth stocks are historically valued at levels higher than the overall market and typically somewhat more volatile than the market. Value stocks are companies that temporarily have fallen out of favor with investors and are cheaper than the market on most valuation metrics. Historically speaking, value stocks have been somewhat less volatile than the overall market. The growth investor is essentially banking on the past and extrapolating those trends into the future. The value investor seeks to buy companies that are priced at a significant discount to their intrinsic value, with the expectation that over a reasonable time period the discount will narrow or disappear. Investments are made with the concept of a "margin of safety", which we believe lessens the chance of loss of capital. Most academic studies have shown that "value" has outperformed growth over the long term and at the same time been less volatile.

Jolley Asset Management is a "value investor". We believe that great long term investment records are made by making tough decisions, which many times may mean going against the herd mentality. Buying what is popular has never worked on Wall Street. That is precisely why Jolley Asset Management was formed seventeen years ago, to provide a vehicle whereby our focus and discipline could be preserved indefinitely. Despite recent market dynamics which have favored "growth" over "value", we believe that we are nearing an inflection point where the pendulum will swing back to value. As the chart below shows, growth has consistently generated superior performance to value over essentially every time period over the last ten years. But as Sir John Templeton stated, "When any method for selecting stocks becomes popular, then switch to unpopular methods."

Russell 1000 Index	YTD	1 YR	3 YR	5 YR	10 YR
Growth	-1.5%	3.2%	13.6%	14.5%	8.1%
Value	-9.0%	-4.4%	11.6%	12.3%	5.7%

According to Brian Belski of BMO Capital Markets "there have been only two other times where the relative price of value versus growth was at such abnormally low levels (1975 and 2000). Following such depressed levels, value embarked on a prolonged period of outperformance following both periods." Belski also makes the case that higher interest rates and an improving economy will ultimately prove to be positive for value stocks. He points out that "The relative performance of value has been highly correlated with the direction of interest rates over the past decade. More specifically, as rates have declined, value has underperformed. This makes sense to us because our work shows that more stable and mature companies – a common characteristic of value stocks – are better able to fundamentally withstand higher interest rates while growth stocks tend to perform better in low or declining rate environments. Thus, we believe value will benefit from the expected long and gradual march higher for rates in the coming years".

Exhibit 2: Growth Outperformance Has Reached Abnormal Levels



Source: BMO Capital Markets Investment Strategy Group, FactSet, Bloomberg.

So while we believe that value strategies will serve up better returns over the coming years, we also believe value stocks currently offer better downside protection than their growth counterparts. Due to the stagnant economy, many investors have piled into a small group of growth companies trading at extremely high valuation levels. Reminiscent of the 1999/2000 top, many of these growth names are burdened with unrealistic growth expectations and any shortfall will likely lead to a large share price decline. On the other hand, value stocks already discount a global recession (in our view) and low valuations and high dividend yields could protect them from much further downside.

Belski's research reminded us that the last time growth outperformed value (prior to the current cycle which began in 2007) by such a wide margin was in 1999. Belski stated, "After peaking in March 2000, the broad market Russell 3000 Index declined 22.0% over the subsequent year. The growth stocks within the Russell 3000 dropped a whopping 42.4% over the same period. Meanwhile, the value stocks managed to eke out a small gain of 1.9%." We believe much of the explanation of growth outperforming value in recent years is the direct result of the Fed's zero interest rate policy (ZIRP). The Fed has kept rates at zero for seven years now and has resulted in what we believe to be a "mispricing" of essentially all asset classes.

Commodity Deflation and the Fed

In the past quarter, most commodities slumped by double digits with oil leading the way. The imbalance between supply and demand is largely attributed to a slowing China, which according to Morningstar, accounts for as much as half of global demand for key industrial commodities. Despite slowing demand for commodities, there have been few production cuts. The latest Grant's Interest Rate Observer notes that "Through the techniques of zero percent interest rates and quantitative easing the Fed set out to boost aggregate demand." When looking at the energy markets 15% decline, Grant's attributes the decline to, "a collapse brought by both human ingenuity and wide open capital markets. The debt-financed fracking boom make possible the production of the marginal unit of energy that toppled the marginal price of energy." So while the ZIRP and "quantitative easing" may have boosted share prices and real estate prices, it seems to have had the opposite impact on the commodities markets. This commodity price weakness has been a major problem for the equity markets in 2015. It has hit the energy, materials and industrial sectors particularly hard, which explains much of the wide discrepancy between growth and value styles in 2015. So while each round of QE (quantitative easing) tended to boost stocks, the real economy has not seen the same exuberance. QE seems to pull demand forward initially, but when stopped, growth slows—requiring more QE. For the first time in nine years, the Fed is discussing the need to raise rates and begin the normalization process. In all honesty, it appears they have painted themselves in a corner and may keep rates at zero for longer.

Summary

Since the financial crisis, corporations have delivered robust profit growth largely due to expanding profit margins. This margin expansion was largely attributable to lower interest expense and labor costs. Corporate profit margins appear to have peaked at a record 9% in 2014, and have since declined to 8.5%, largely due to weakness in the energy and materials sector. Earnings for the third quarter are expected to decline by approximately 4% year over year, but ex-energy show a gain of approximately 3%. On a valuation basis, the markets appear reasonable. At quarter end, the S&P 500 was trading at approximately 16.4 times trailing earnings and 15 times forward earnings which is in line with historical averages. The Federal Reserve remains a "wildcard". The Fed seems convinced that they need to move off zero, but recent market and economic weakness, might result in staying at zero for longer. As we discussed earlier, many sectors of the market are already in their own "stealth bear market" and are likely pricing in a global slowdown. On the other hand, we believe in many instances investors are overpaying for growth. As we discussed earlier, we believe we are nearing an inflection point where value will once again outperform growth. On any further market weakness, we will likely focus on improving quality, which tends to outperform in volatile times.

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