JOLLEY ASSET MANAGEMENT, LLC

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> *"Investing is a popularity contest, and the most dangerous thing is to buy something at the peak of its popularity."*
>
> *Howard Marks*

Renewed optimism around tax reform coupled with strong profit growth led the markets to another new high in September. The past quarter was the eighth straight quarter of positive returns for the S&P 500 and also eleventh month in a row of positive returns for the S&P 500 benchmark. Stocks have been leading all major asset classes (including bonds, cash and gold) for the quarter and year to date. Ten of the eleven S&P 500 sectors are now positive for the year—with only consumer staples showing a negative return. During the quarter, technology remained the market leader, but energy and telecom were close behind—which was a reversal from negative returns in the first six months. "Growth" strategies continued to trump (no pun intended) "value" during the quarter and year to date. As the chart below shows, the Russell 1000 Growth Index spread over the Russell 1000 Value Index for the three and nine month period were 2.79% and 12.8%, respectively. Value did make a comeback in the month of September, outperforming value by 1.62%. .

Index	3rd Quarter 2017	2017 YTD 9 Mos.
DJIA	5.58%	15.45%
S&P 500	4.48%	14.24%
S&P Mid Cap	3.22%	9.40%
Russell 1000/Growth	5.90%	20.72%
Russell 1000/Value	3.11%	7.92%
Russell 2000	5.67%	10.94%
NASDAQ Comp.	5.79%	20.67%

It's Different This Time?

We recently had some "Jolley Asset Management" t-shirts made with the tag line "because it's never different this time". The tag line was added to be thought provoking. How quickly market participants forget that markets move down as well as up. We've already gotten questions—what does that mean? The late John Templeton, one of the world's greatest investors once stated:

> *"The four most expensive words in the English language are, "This time it's different."*

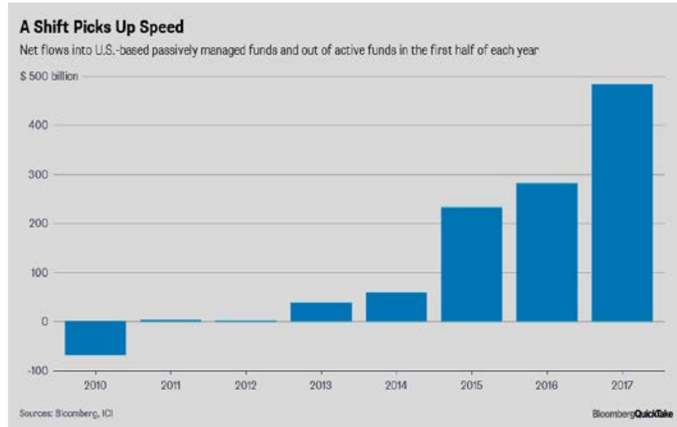
We often hear people arguing that "the old rules no longer apply". "This time it's different". Whether it is regarding valuations, credit cycles, or any of the other common metrics, to ignore the lessons of the past is to invite disaster. History shows us that major crises in the markets usually occur when the old rules are ignored and people believe that current exceptional market conditions are justified by special circumstances. The investment world is filled with many participants with short memories and those that have never experienced a "bear market". After all, in a bull market the "cool kids" rule. As Jim Rogers stated, "When things are going right, we all need a 26-year-old (money manager). There's nothing better than a 26-year-old in a great bull market, especially in a bubble," because they're "fearless," said Rogers. To youthful investors, a bull market will never end, and they will tell you exactly why — and believe what they're saying wholeheartedly. Rogers concludes, "So in the bull market, you've got to have a 26-year old. But when they end, you don't want the 26-year-old around."

While we embrace technology faster than most people, we don't always see "eye to eye" about what it might mean from an investment point of view. Today's market is much different than the one we cut our teeth on—today's market is driven largely by algorithms, money printing by central bankers, chart patterns, passive strategies and money flows into exchange traded funds. Fundamental investing where one pays attention to valuation is currently taking a backseat to today's passive and technical strategies, where valuations are largely ignored Robo-investing, artificial intelligence, electric cars, self-driving cars, food delivery, etc. (the list goes on and on)—how will they impact profitability of businesses? Currently Tesla (the company of brainchild Elon Musk) is making its Model 3 car by hand (production problems) yet, the market places a higher market capitalization on it than Ford and BMW. Does McDonalds delivering food make the business model more enticing? If everyone delivers where is the inherent advantage? Market share gains from grocers possibly, but nobody really knows how this unfolds and the economic impact to the underlying businesses just yet. Right now Amazon is the market darling. The market is rewarding the company for its unrelenting pursuit of growth, despite its lackluster earnings performance. As long as the company can break-even on its new ventures, market participants applaud. One disturbing fact was recently pointed out by Scott Galloway, Marketing Professor at NYU, "Since 2008 Walmart has paid $64B in corporate income tax, while Amazon has paid $1.4B. This is despite the fact that, in the last 24 months, Amazon has added the value of Walmart to its market cap. The most uncomfortable question in business, in my view, is how we pay our soldiers, firefighters, and teachers if a firm can ascend to $460B in value (#5 in the world) without paying any meaningful corporate taxes." Amazon is a "disruptor" that we pay attention to daily in our investment process. We own Dollar Tree Stores where we believe the price points are so low that Amazon does not compete and Wal-Mart where we believe the company has adapted and has such critical mass that they can compete head on. Amazon trades at 3 times sales and 124 times projected earnings for next year versus 1 times sales for Wal-Mart and 17 times earnings estimates for next year. Will the government allow Amazon to run the rest of retail and all the jobs associated with it out of business? These are questions we must ponder in our decision making process when managing portfolios. We do know we don't want to get in Amazon's path of destruction with our holdings, but we also know that from a valuation perspective owning Amazon shares are not for us.

I recall in March of 2000 (height of the internet bubble) when Cisco Systems had the largest market cap in the world at a whopping $565 billion. Three years later the market cap shrank to $151 billion and now some seventeen years later sits at $167 billion (despite having cash of close to $70 billion dollars). I recall being questioned in 1999 and 2000 as to why I didn't own Cisco Systems shares—they were simply too expensive. Since the peak, Cisco has grown revenues from approximately $19 billion to $48 billion today. Earnings have risen from $2.7 billion to $9.6 billion today. Ironically, Cisco is a long-term holding in our client portfolios today. Cisco is a perfect example of how markets become irrational and overpaying for growth can be dangerous. So enough rambling about the t-shirt tag line, but I think you can tell that we are passionate in our belief that "valuations matter" and our reminder that "this time is never different." If you would like a t-shirt please call us!

Passive Investing Bubble?

All financial bubbles share certain characteristics, but a driving force behind each is it appears to be rationalized by "it's different this time". Bubbles form when prices are pushed up to levels without regard to the intrinsic or economic value of the underlying asset. In a recent research piece by Charles Brandes, (Brandes Investment Partners) he points out that a possible bubble in passive investing is a result of money being *directed* to passive investment vehicles rather than being thoughtfully *invested*. Brandes points out that "*invested* means that a rational case for investing has been made, including an assessment of expected earnings, profits, etc." Inflows to companies from passive strategies are based upon size and liquidity and are decoupled from fundamentals. In the first half of 2017, flows out of active and into passive funds reached nearly $500 billion. Investment dollars flow to companies not because of sound fundamental analysis, but because these companies are in a benchmark. With the market-cap weighted indexes, the largest companies in the index proportionately receive larger and larger allocations. Passively directing money simply causes stock prices for select companies to inflate, regardless of valuations or other fundamental factors. Currently the top five holdings in the S&P 500 index are all technology companies, and comprise just under 12% of the index—also causing diversification issues and possible liquidity issues should the crowd ever decide to exit a company or the sector.



While I'm sure there are those who believe that passive strategies will continue to grow in popularity, think for a minute if market participants realize that share prices and values have decoupled. Major index holdings would be re-priced, potentially below their true underlying business values. Keep in mind individuals tend to act with a herd mentality. Who will be bidding for many of the exchange traded funds in a contagion or passive selloff? One of the reasons that passive strategies and exchange traded funds have worked so well is there is no cash drag to reduce returns. When the market declines, there will be no cushion from cash to temper the decline. Jim Rogers recently stated, "When we have the bear market, a lot of people are going to find that, 'Oh my God, I own an ETF, and they collapsed. It went down more than anything else.' And the reason it will go down more than anything else is because that's what everybody owns". One day the passive bid (from investors and central banks) under the market will go away. The passive bidder will likely convert to an urgent seller which will could exacerbate any decline. What would trigger any such decline is currently unclear. The culprits may be hawkish central bankers, geo-political issues, etc—we just can't predict the future. We do believe that active "value" managers would be at least partially insulated from the downturn. Money flows have already fled value strategies and depressed areas of the markets. After the 2000 tech bubble burst, value generated wonderful returns relative to the S&P 500 index.

Summary

Passive strategies have been the investment vehicle of choice since the 2008-2009 financial crisis. The popularity of passive investing is leading to a decoupling of price and value, which is potentially problematic for the markets. Investing platforms utilizing modern technology and algorithms do not necessarily shield investors from the growing risk of passive investing. We remind our clients that owning a security is the same as owning a business—there is a price to buy and a price to sell. Passive strategies pay no attention to valuation. In fact they essentially implement the opposite strategy; the more a security rises, the more you own. Value investing is a long term, time tested strategy. At Jolley Asset Management, LLC we strive to invest with a "margin of safety", which means buying only when we can do so at a discount to the estimated intrinsic value. Our strategy focuses on a security's downside risk before its upside potential. We believe that "It's never different this time" and we invest our portfolios accordingly.

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