JAM JOLLEY ASSET MANAGEMENT, LLC

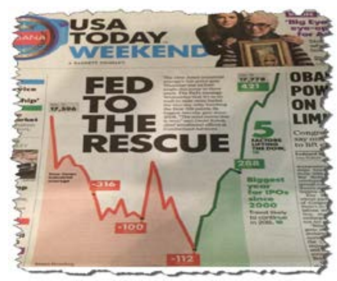
Investment Outlook **Volume 1, Issue 66• Winter 2015**

> *"The margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, nonexistent at some still higher price."*
> *Benjamin Graham*
> *The Intelligent Investor*

Stocks rose for the sixth year in a row in 2014, which represents its third longest winning streak of all time. Not only has the S&P 500 risen for six years in a row, it has also showed positive returns in eleven out of the past twelve years. In the year just ended, the S&P 500 led the major indexes with a gain of 13.69% while the NASDAQ Composite and Dow Jones Industrial Average rose by 13.40% and 9.97%, respectively. The Russell 2000, which is a small capitalization index, trailed the S&P 500 by a wide margin in 2014, logging a 4.89% total return. The Value Line Index, which is an equal-weighted index comprised of 1,700 large, mid and small-capitalization companies, posted a 2.69% return (dividends not included) well below the return of the S&P 500 index. The disparity in returns in the past year can be attributed to the fact that the S&P 500 index is "market cap weighted" where the largest companies in the index can have an outsized impact on the index returns, while the smallest companies in the index impact the returns only minimally. There was also great disparity in returns across the various S&P 500 sectors. The utility sector rose by 24.3% in past year followed by health care which advanced by 23.3%. The energy sector declined by 10% as crude oil plummeted by 46%. Telecom also posted a price decline last year by some 1.2%. The talking heads on CNBC like to refer to the U. S. markets as the "cleanest dirty shirt". By this, they are comparing the U. S. to the equity markets in the rest of the world. According to Bank of America/Merrill Lynch (world markets ex. U.S.) returned 6.6% in local currencies but a negative 3.4% in U. S. Dollar terms. While most global markets are cheaper on a valuation basis versus the U. S. markets, investors who diversified globally, likely realized lower returns in the past year.

Index	4th Quarter 2014	2014 12 Mos.
DJIA	5.17%	9.97%
S&P 500	4.93%	13.69%
S&P Mid Cap	6.35%	9.77%
Russell 1000/Growth	4.78%	13.05%
Russell 1000/Value	4.98%	13.45%
Russell 2000	9.73%	4.89%
NASDAQ Comp.	5.40%	13.40%

On October 15, 2014, it didn't appear that the markets would show any gains at all in 2014. As we have written about ad nauseam, the Fed decided that the 9.9% correction (from high to low) in the S&P 500 was enough, and St. Louis Fed President James Bullard decided it was time to come to the markets rescue. He jawboned the markets higher with the statement that "a logical policy response at this juncture is to delay the end of QE". From that point forward, the markets screamed higher, rising 13.1% in the final six weeks of the year. The S&P 500 index has now gone thirty-nine months without a 10% correction. Typically, the markets experience a correction of 10% or greater every eleven months. Rather than go into another tirade about the Federal Reserve, its policies and impact on the markets, we would refer you to our previous quarterly letters, where we have discussed our thoughts in great detail. In summary, this bull market has been all about the Fed and central bankers across the globe.



Aging Bull Market

One would think that the most difficult periods for managing money would be during the "bear market" periods. In my career, I have been through the 1987 crash, the 1999-2000 internet bubble/nifty-fifty period and the financial crisis of 2008. Ironically, this period strikes me as just as difficult as those time periods. During "bear markets", the rational investor knows that things will eventually improve and stocks bought during those periods will most likely prove to be bargains. In past letters, we have discussed our concerns about the following:

- The longevity of this bull market (fourth longest in history). The S&P 500 has returned approximately 245% since this bull market began over 69 months ago.
- Market dependence on the Fed, how will they exit? Previous attempts to exit have resulted in market declines.
- Valuations. When looking at cyclically adjusted price earnings ratios (CAPE) or the median price/earnings ratio, stock valuations are at or near record highs.
- Speculative investment strategies are prevalent including record high margin debt. Margin debt is currently 2.9% of GDP, the highest in the last 85 years.
- Buybacks and financial engineering have boosted share prices and earnings per share. A surge in corporate buybacks has served as a contrary

indicator in the past. In fact, the last time that buyback levels were this high was 2007. In the last bear market (2009), buyback activity all but dried up.

- T.I.N.A (There Is No Alternative). The Fed's zero interest rate policy has forced investors into risky assets regardless of their risk tolerance. Recent data has shown that U. S. households were the most heavily invested they have been in stocks since 2000.

Value Investing

In a market where the Fed continues to provide a "put" under the market and where interest rates remain at zero, is there any need for "value" styles of investing. Let's be perfectly honest, over the past six years, higher risk has equaled higher returns. Is Benjamin Graham and his strategies relevant anymore? Perhaps we should review the principles of Graham and "value investing".

- ***Stock Ownership is Part Ownership in a Business***. Stocks are not merely pieces of paper or electronic quotations on a computer screen, but they represent partial ownership in a real business. Your research before purchasing a stock should focus on the underlying business and its prospects going forward. It should not focus on charts or technical analysis, as that has little effect on the safety or value of the underlying business. Graham stated, "Investing is most intelligent when it is most businesslike".
- ***Always invest with a Margin of Safety***.
  Margin of safety is the concept of buying a security at a discount to its estimated intrinsic value. According to Graham, "We have here, by definition, a favorable difference between price on the one hand and indicated or appraised value on the other. The difference is the safety margin. It is available for absorbing the effect of miscalculations or worse than average luck. The buyer of bargain issues places particular emphasis on the ability of the investment to withstand adverse developments."
- ***Mr. Market***
  Graham states that "Mr. Market does not always price stocks the way an appraiser or private buyer would value a business. Instead when stocks are going up, he happily pays more than the objective value; and when they are going down, he is desperate to dump them for less than their true worth." Graham explains further, "The intelligent investor shouldn't ignore Mr. Market entirely. Instead you should do business with him—but only to the extent that it serves your interests."

Graham also recommended diversifying one's portfolio between stocks and bonds as a way to preserve capital in market downturns while still achieving growth of capital through bond income. The philosophy was first and foremost to preserve capital, and then to make it grow. Today with the markets up six consecutive years and valuation levels at historically high levels, we believe that investing with a "margin of safety" makes perfect sense. Value investing strategies will continue to serve as our blueprint for investing going forward.

Economic Outlook

Most economists expect the U. S. economy to continue to be the engine of growth for the world again in 2015. U. S. GDP grew a torrid 5% in the third quarter of 2014 and most economist forecast the fourth quarter (2014) to come in around 4%. Goldman Sachs predicts that lower gas prices will amount to a $125 billion "tax cut" for Americans and states that every penny gasoline prices decline is equal to $1 billion dollars in savings for the American consumer annually. Analysts expect S&P 500 earnings growth to accelerate from 5.6% in 2014 to over 7% in 2015. Obviously, lower oil prices will drag earnings down for the energy sector, but should serve as a tailwind for many industries. The strength in the U. S. dollar could serve as a headwind for the S&P 500 in 2015 as the S&P 500 generates approximately 40% of its profits overseas. The S&P 500 is currently trading at a reasonable 17.5 times trailing earnings and 16.6 times forward estimates. However, it should be pointed out that a number of other valuation metrics are flashing warning signs. Currently, the Shiller CAPE (cyclically adjusted price earnings) ratio, the Total Stock Market/GDP indicator and price/cash flow are at levels associated with market tops.

Summary

In summary, the domestic economy seems to be improving and S&P 500 earnings growth is expected to accelerate from 2014 levels. However, as we begin year seven of this bull market, we believe the risk/reward has turned less favorable for investors. Markets around the globe have become far too dependent upon central bankers and unprecedented levels of monetary stimulus. The fact remains that with interest rates at zero, investors have little choice but to embrace risky assets such as stocks. We have now gone over three years without a 10% correction in the S&P 500 index (this fall it corrected 9.9%). In 2014, the S&P 500 index never fell for more than three consecutive days. Most investors have become comfortable that the Fed will continue to be able to micro-manage the economy and stock market—the old adage "don't fight the Fed"—seems to be infallible. But this bull market has been all about "quantitative easing" and the expanding Fed balance sheet. Is the Fed serious about "normalizing" monetary policy? If so, how will investors react? If and when the markets correct by 10% or more, will the Fed jawbone or abandon any "normalization" policy? In our opinion, investing with a "margin of safety" has never made more sense. We remain committed to owning what we believe to be high, quality undervalued equities. As Ben Graham stated in the *Intelligent Investor*, "Investing isn't about beating others at their game. It's about controlling yourself at your own game."

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