Boyar asset management

"It is not always easy to do what's not popular, but that's where you make your money. Buy stocks that look bad to less careful investors and hang on until their real value is recognized."

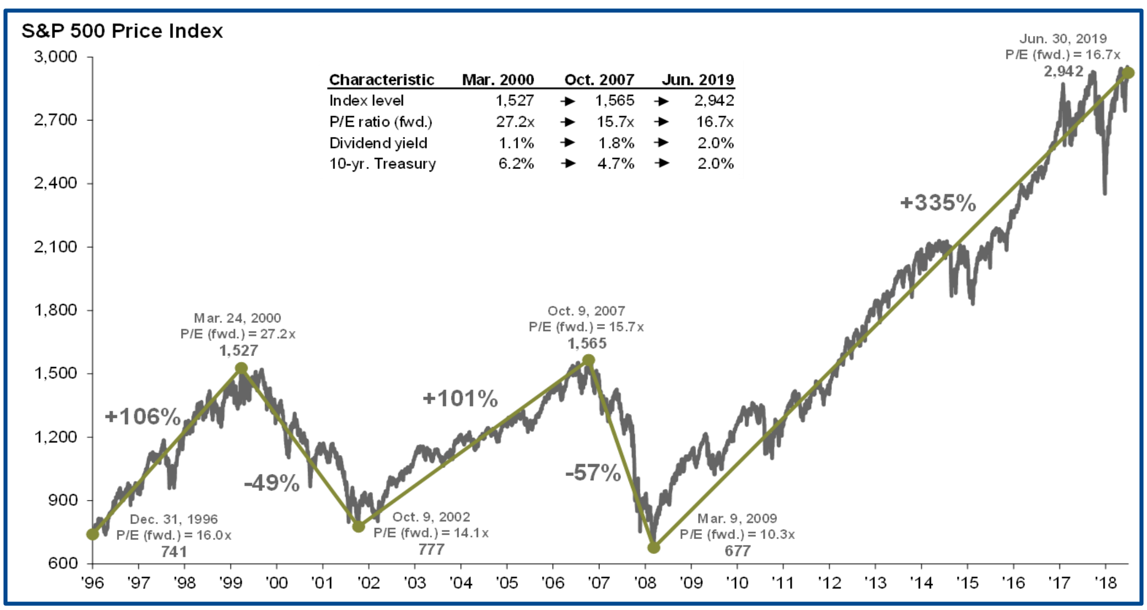
—John Neff

July 24th, 2019

Valuations Do Matter

Howard Marks's most recent investment memo began with a famous observation by legendary investor Sir John Templeton: the four most dangerous words in investing are "this time it's different." But as stock markets hit extremes, Marks argued, investors invariably use precisely this rationale to justify their emotion-driven decisions.

Marks believes (and we agree) that many investors are likely to echo these same four words as they defend higher stock prices. Investors should treat these words with the same caution they would a promise that "the check is in the mail," but today's investors are putting their money into stocks even though equities (as measured by the S&P 500) have increased more than 300% from their lows on March 6, 2009. As they do, all they hear are the reasons why stock market prices will continue to grind higher, why this boom will not be followed by a sharp stock market decline, and why "this time it's different."



Source: JP Morgan Guide to The Markets

Although valuations are not excessively high as measured by the S&P 500—and in fact are not much above its post-World War II average of 15x-16x earnings—certain sectors in the market sell for valuations that we can only describe as "frothy." Take the technology sector, which advanced 27.1% in the 2nd quarter: it has been this year's market leader, and it currently commands one of the highest valuations of any sector (although technology bulls would argue that at 19.4x trailing earnings, it is a bargain compared to its 20-year average of 23.4x earnings).

However, value stocks—which have underperformed growth stocks for some time now—have much more compelling valuations. According to Dubravko Lakos, head of U.S. equity strategy at J.P. Morgan, one basket of 100 value stocks tracked by the bank is trading at cheaper valuations than ever before. In fact, he notes, the last time value was this cheap versus the overall market was at the peak of the dot-com bubble. He argues that in order for value to make a sustained resurgence the following developments must occur:

1) Regulations that foster competition;

2) Saturation of passive products and private equity investments as well as stabilization of active equity AUM;

3) Less policy uncertainty;

4) Sustained reacceleration in global growth;

5) or a full-blown recession

After 2018's selloff, a significant amount of the money that has come back into the market has gone into companies that offer steady dividends (driving up their valuations), which are often perceived as bond substitutes. Rightly or wrongly, investors believe that these businesses' profits are less vulnerable to an economic contraction. According to data compiled by Bank of America, equity fund flows into utilities, consumer staples, and real estate shares have accelerated. Utility firms look particularly pricey by historical standards: they currently fetch an average of 19.2x trailing earnings versus their 20-year historical average of just 14.8x earnings.

The poster child for this "utility mania" is American Water, which currently commands a price/earnings ratio of 35x—the kind of valuation more often associated with a fast-growing technology company. But investors' unwavering faith in the safety of utility stocks isn't really justified by the historical record. The sector's recorded volatility is roughly in line with that of the S&P 500, and its peak-to-trough performance during recent big selloffs has also been similar to that of the broader index. In the aftermath of the 2000 stock market bubble, utilities actually fell by more than the leading stock market indices did.

In our opinion, a better bond surrogate—a sector of the market that is significantly cheaper than utilities and that offers comparable yields—would be the big money center banks. JPMorgan Chase, the world's second most profitable company behind Apple, with a fortress like balance sheet sells at roughly 12x earnings and yields over 2.7%. Its dividend payout is about 30%, so it has the capability to materially increase this distribution over time. Seeing a flattening yield curve, however, investors have shunned this sector—but we believe that investors who take a longer view can expect to be rewarded.

JPMorgan Chase & Co.

As you are well aware, our mission is to invest exclusively in businesses that are selling well below their intrinsic value and that offer a significant margin of safety. At times this investment style has fallen out of favor as investors clamor for the flavor of the day, but during our combined 60+ years of investing, we have never deviated from this approach. Experience has taught us that valuations do indeed matter—and that those who do not heed this lesson will come to wish they had.

The Issue With New Issues

The new issue market of today is reminiscent of the dot-com boom, and most of us remember just how badly that ended. Today's new issues have much more revenue and have been in business far longer, but their lofty valuations remain troubling.

The vast majority of the companies going public today are "unicorns"—privately held startups valued at over $1 billion, most of which are unprofitable. These companies financed their growth via the private equity market, but now their investors want to liquefy their investments via the public markets. Interestingly, a great many are doing so simultaneously, perhaps foreseeing a more difficult market environment on the horizon, perhaps worried that the door to the new issue market will soon close. And perhaps, too, these sophisticated investors fear that the elevated valuations currently being accorded these companies will become less attractive.

So far, 2019 is on track to be one of the biggest years on record for public offerings, as measured by the amount of money raised. By the end of June, 108 companies had gone public in the U.S., raising $38.8 billion—the largest sum by this point in the year since 2000, at the height of the dot-com boom. Notwithstanding the rocky starts of highly anticipated ride hailers Lyft Inc. and Uber Technologies Inc., technology companies that debuted on the U.S. exchanges gained an average of 23% this year, according to Dealogic.

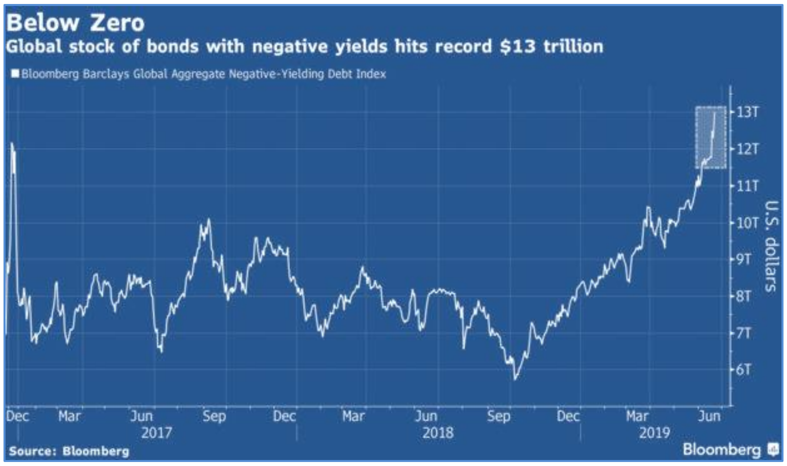
A prime example of the frenzy over new issues in 2019 is RealReal Inc. (founded by Julie Wainwright, best known as the former CEO of Pets.com, which became a symbol of the insanity of the dot-com bubble), which soared 45% in its first day of trading. RealReal's revenue increased 55% from the prior year, to $200 million, but the company incurred a loss of $75.8 million during that same time frame. The San Francisco-based company sold 15 million shares, raising $300 million, for a market valuation of $1.65 billion.

Or consider Beyond Meat, which expects to reach $210 million in revenue in 2019. At the end of May, the company went public at $25 per share, and by July 22 it was selling for $194 per share, for a market valuation of $11 billion—roughly 3x the market value of Wendy's.

—Sources*: The Wall Street Journal, article penned by Jon Sindreu, dated June 29; Boyar Research; a recent investment memo penned by Howard Marks*.

More Consequences of Low Interest Rates

The various central banks' prolonged low-interest-rate policy has stimulated the weakest post-war economic recovery on record. One of the purposes behind setting rates so low is to encourage investors to seek out "riskier" assets with the hope of improving economic conditions. However, this historically long period of accommodative monetary policy (e.g., low rates) has led some investors to make investments that leave us scratching our heads. We view investment in technology stocks or unicorns at extremely high valuations or the purchase of investment-grade corporate or government bonds at low yields as foolish moves that will produce bad results.



Not surprisingly, then, a *Wall Street Journal* article published on July 14 left us in utter disbelief: according to author Paul Davies, more than a dozen junk bonds in Europe trade with a negative yield. Although sovereign debt and highly rated corporate debt can at times trade at negative yields (so that "investing" in them means accepting that you will receive less money than you put in), we had never heard of below-investment-grade bonds' having a negative yield. There are various technical reasons for this phenomenon, but the main reason is that European investors need to park their money someplace—and because sovereign debt has a larger negative yield, they are choosing to "invest" in junk bonds *because they will lose less money that way*. So in the simplest of terms, there are investors who are "investing" in highly indebted companies, knowing in advance that they will receive less money than they originally put in, in order to lose less money than by "investing" in government bonds.

Performance

Stocks notched solid gains in the 2nd quarter, thanks in part to a perceived shift in the Federal Reserve's appetite for further increases to interest rates, extending a rally that propelled the S&P 500 to record highs. The 2nd quarter is a fabulous example of the volatility wrought by headlines and emotions. The market ebbed and flowed with developments in the U.S.-China trade fight, with the S&P 500 rising slightly more than +4% in April, declining -6.35% in May, and advancing +7.05% in June—quite the roller-coaster ride.

Although the major indices have seen spectacular gains thus far this year, these gains do not tell the whole story. According to an article published in the *Wall Street Journal* on July 21, Microsoft, Apple, Amazon, and Facebook have accounted for 19% of the S&P 500's total returns this year—a proportion roughly in line with that seen not only in 2017 as well as (until the market rolled over in the 4th quarter) last year. Additionally, the author of the article Amrith Ramkumar pointed out that, 7 of the S&P 500's 11 sectors are not selling close to record highs, and small-cap stocks are also well south of their recent highs. Essentially, we are being told a tale of two markets: a select few high-flying technology stocks . . . and all the rest (with some one-off exceptions).

The buy-technology-stock strategy has turned into a very crowded trade (usually a bad sign for future performance). The widely cited Bank of America Merrill Lynch survey ranked U.S. tech stocks as the second most crowded trade, after only U.S. Treasuries. As we have repeatedly stated, investors in technology shares should proceed with extreme caution.

While our accounts achieved respectable absolute results for both the 2nd quarter and the first half of the year—in a market that is led by high flying technology stocks (with little regard to valuation), we will not be able to outperform. While it is certainly frustrating to underperform and we have a significant case of "FAANG envy," we refuse to deviate from a style that has worked well for so long to simply keep up with an index.

Some Thoughts About the Market

- With interest rates at very low levels, investors are piling into the areas of the stock market that offer the highest yields, with little regard for valuation. Doing so has become a very popular trade, and when sentiment shifts—as it inevitably will—investors will be surprised by the magnitude of their losses. For example, the companies that make up the real estate sector of the S&P 500 (whose shares yield 3.3% on average) have advanced 20.4% through the end of the 2nd quarter and are selling at 19.4x trailing earnings, versus a historical average multiple of 16.4x

- With approximately 60% of the market on autopilot (according to JP Morgan research), the stock market is much more volatile than when most trades were made by active managers. For example, we believe that a significant portion of the 6.35% decline seen in May can be directly attributed to computer-driven volatility-targeting funds, which generally scoop up riskier assets such as stocks during calmer periods, hoping to gain as the market grinds higher. When volatility hits, however, their mandate dictates that they sell a portion of their holdings immediately and move into safer assets, such as Treasuries. Because the markets have been so quiet this year, such funds had above-average exposure to stocks in May, when volatility spiked, causing a sharp loss in equity values as they were forced to liquidate their holdings. If we experience another prolonged period of calm in the market (causing volatility funds to continue buying risk assets such as equities), then an increase in volatility could bring another period marked by sharp decreases in stock prices.

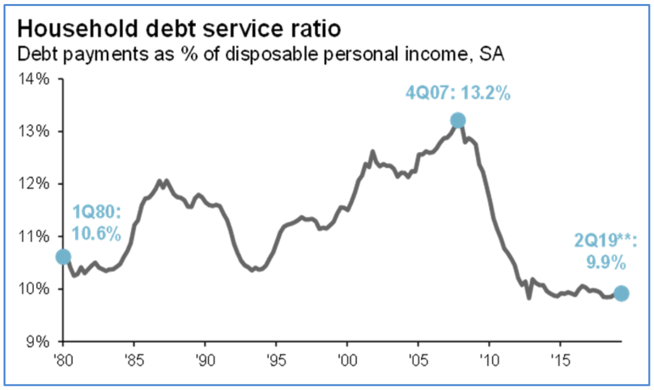
- The S&P 500 fell 6.2% in 2018, notching its biggest single-year decline since the financial crisis. Annual declines aren't all that rare—they have occurred about a third of the time since 1927—but over the past 92 years, only four periods have seen consecutive yearly losses.

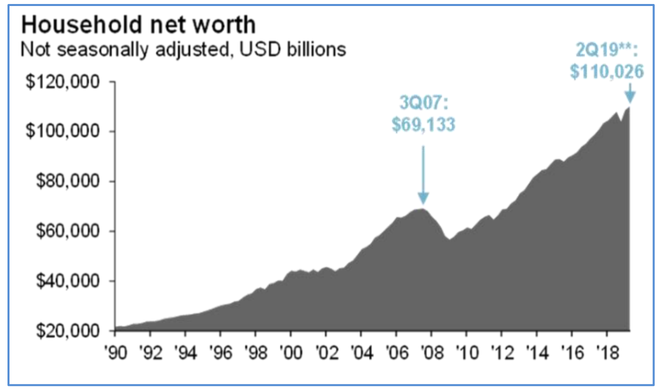
- Individual investors have been fleeing the stock market in droves since the financial crisis. Recently equity outflows have accelerated, nearing record levels. Puzzlingly enough, with interest rates at historically low levels, these same investors have been pouring their money into bond funds, perhaps not fully realizing the severity of the losses they risk if interest rates suddenly climb.

- Historically, investor sentiment has been a very good contraindicator of the direction of the stock market. According to the Conference Board, a growing number of Americans are contemplating dumping stocks as they sit at record levels. According to *Bloomberg*, the number of individual investors expecting equities to decline during the course of the following year jumped the most since 2007 and, for the first time since January, exceeds the number of those expecting gains. As a result, 33% of investors have a bearish view, compared with 31% who predict an advance—the sharpest drop in 8 years.

- Although it seems likely that the Federal Reserve will make multiple rate cuts in 2019, the fundamentals of the economy remain relatively robust. As the chart on the following page indicates, the U.S. consumer is in fairly good shape: debt payments as a percentage of disposable personal income are close to all-time lows, and household net worth is close to all-time highs. With 67% of U.S. GDP consisting of consumption, these are important indicators that consumers will keep right on spending.

- Although the economy is by no means perfect, a recession does not appear imminent. With the 10-year Treasury yielding virtually nothing (after inflation), investors are being forced into risk assets, a trend that bodes well for future returns for equities.





Source: JP Morgan Guide to The Markets

- A number of events could derail the market during the second half of the year, including the following:
    - Failure to reach a trade agreement with China.
    - A more severe decline in earnings expectations than currently forecasted.
    - An inversion of the yield curve, which occurred on March 22, is a somewhat reliable predictor of an upcoming recession. However, according to Tony Dwyer, chief U.S. markets strategist for Canaccord Genuity, over the past seven economic cycles, the median S&P gain from inversion to the cycle peak has been 21%, with a recession coming a median of 19 months after the initial inversion.
    - A government shutdown.
    - Potential fallout from Brexit.
    - Impeachment proceedings.

If you have any questions, we're always available.

Best regards,

Mark A. Boyar

Jonathan I. Boyar

IMPORTANT DISCLAIMER

Past performance is no guarantee of future results. Investing in equities and fixed income involves risk, including the possible loss of principal. *The S&P 500 Index is included to allow you to compare your returns against an unmanaged capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks representing all major industries. The Russell 2000 is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The NASDAQ Composite is a market-capitalization weighted index of the more than 3,000 common equities listed on the NASDAQ stock exchange. The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ. The volatility of the above-referenced indices may be materially different from that of your account(s), and the holdings in your account(s) may differ significantly from the securities that comprise the above-referenced indices. Your results are reported gross of fees. The collection of fees produces a compounding effect on the total rate of return net of management fees. As an example, the effect of investment management fees on the total value of a client's portfolio assuming (a) quarterly fee assessment, (b) $1,000,000 investment, (c) portfolio return of 8% a year, and (d) 1.50% annual investment advisory fee would be $15,566 in the first year, and cumulative effects of $88,488 over five years and $209,051 over ten years. This material is intended as a broad overview of Boyar Asset Management's, philosophy and process and is subject to change without notice. Account holdings and characteristics may vary since investment objectives, tax considerations and other factors differ from account to account.*