"Any good value investor knows how to suffer."

—Patrick O'Shaughnessy
Portfolio Manager at O'Shaughnessy Asset Management.

October 22, 2018

A Look Back

As we observed in recent quarterly letters, market returns have continued to be dominated by 4 companies from the group that CNBC's James Cramer has dubbed the FAANG stocks: during the first 9 months of 2018, Facebook, Amazon, Netflix, and Google accounted for a majority of the S&P 500's gains. Together with Microsoft and fellow FAANG member Apple, these stocks accounted for the entire positive performance of the index over that period. More broadly, the top 10 contributors for the S&P 500, virtually all of them high-multiple technology businesses, were responsible for more than 110% of the indices' gain for the first 9 months of 2018.

Several factors have contributed to this concentrated advance. Most important, individual investors and hedge funds love to chase performance: they tend to load up on whatever is working to the detriment of whatever is not in vogue. A look beneath the surface, however, shows that trouble is already brewing. The S&P 500, inclusive of dividends, advanced 10.56% for the first 9 months of 2018, but this movement was driven by a dwindling number of stocks. Indeed, shares of about 200 of the companies included in the S&P 500 have declined this year, and many of them have entered bear market territory, having declined by at least 20% from their peak. In short (as of the end of the 3rd quarter), about 40% of the companies in the S&P 500 are in negative territory—in a market that gained 10% for the first 9 months of the year. Clearly this advance has not been democratic.

Much has been written about the high level of concentration that has stimulated this rally, and although it is unusual, it is not without precedent. What worries us are the outsized valuations of the vast majority of companies that make up this group, which have drawn comparisons to the technology bubble of the late 1990s. Although there are similarities between now and that period, some major distinctions are worth mentioning. First and foremost, today's market leaders, such as Facebook and Google, are cash flow machines, whereas the dotcom companies were, for the most part, profitless. In addition, today's market leaders have developed significant competitive advantages, such as network effects and tremendous scale, that most of the leaders in the late 1990s simply did not possess. In short, many of the current market darlings have what Warren Buffett likes to refer to as a "moat."

A more apt analogy to today's market, in our opinion, would be the "Nifty Fifty," a group of stocks compiled by Carl Hathaway of Morgan Guaranty Trust in the early 1970s. These businesses, which were considered the market leaders of their day, the best of their breed, included such high flyers as Polaroid, Avon Products, and Xerox. Notably, Polaroid was the first large capitalization company to command a price earnings multiple of 100x. The group had higher growth rates than the S&P 500 but commanded a P/E ratio in excess of 40x, versus 19x for the S&P 500 in 1972-1973. Some referred to such stocks as "one-decision stocks": you could buy them regardless of price, their proponents argued, because these companies would be able to grow their earnings regardless of what happened to the economy.

These stocks were indeed the market leaders for quite some time: they not only trounced the performance of the S&P 500 but also were the last to crash during the brutal bear market of 1973-1974. But as their earnings failed to grow in line with analysts' forecasts, their share price declined far more dramatically than the S&P 500, and as a group they materially underperformed that index over the next decade. In fact, a number of these companies never recovered to their 1972-1973 highs. History has shown that the single biggest factor affecting future equity returns is the price paid for a stock—and just as investors once did with the Nifty Fifty, today's investors are paying a very high price for both quality and growth. Time will tell if today's stock market leaders are doomed to the same fate as the Nifty Fifty.

A Change in Stock Market Leadership?

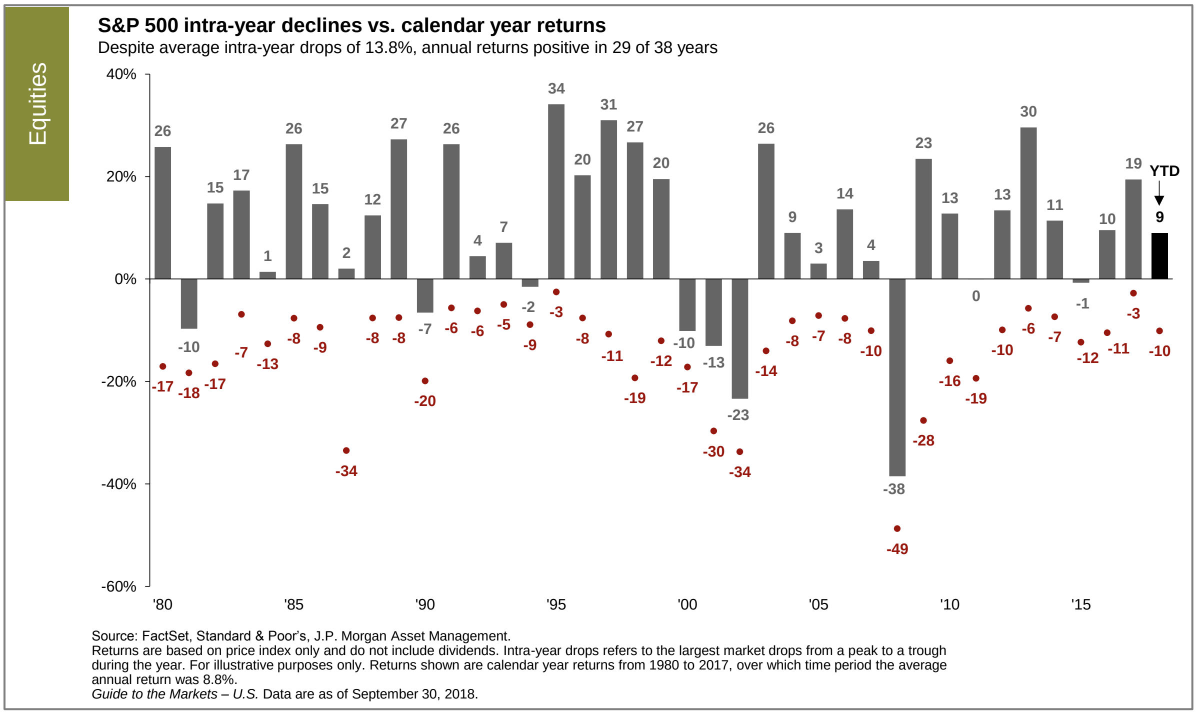
We have reason to suspect that a change in stock market leadership could be coming which should benefit value investors. Netflix is a company that sells for roughly 157x earnings, and its share price has advanced about 73% year to date. After having reached an all-time high of $423 on June 21, however, its share price has declined ~23%. Facebook, likewise, saw its stock soar to a high of $218 on July 25, but as of mid-October its stock traded for $155, a decline of more than 28% from its peak. Tesla, another market darling, although not a FAANG stock, saw its share price reach almost $388 on August 7, but by mid-October, after a series of controversies surrounding CEO Elon Musk (including his smoking marijuana during an interview and relinquishing the chairmanship of Tesla in the wake of a serious SEC investigation of tweets he made about taking the company private), its shares fetched approximately $256, a decline of ~34%. Tesla has no earnings and has significant debt. By comparison, General Motors, whose stock sells for less than 8x earnings, has a similar market capitalization. One other observation worth mentioning that highlights the absurd price at which investors are currently valuing Tesla: *General Motors generates $144 billion in revenue, whereas Tesla's sales approximate $13 billion.*

In our previous letter as well as earlier in this report, we have indicated that the narrowness of the stock market leadership is worrisome. Even more troubling, however, is that the vast majority of today's market leaders have valuations that are among the highest of all U.S. stocks. As Bob Dylan wrote in his classic song "The Times They Are a-Changin'," "the loser now will be later to win." This principle holds true in the stock market as well: all you need is patience.

Are We About to Enter a Bear Market?

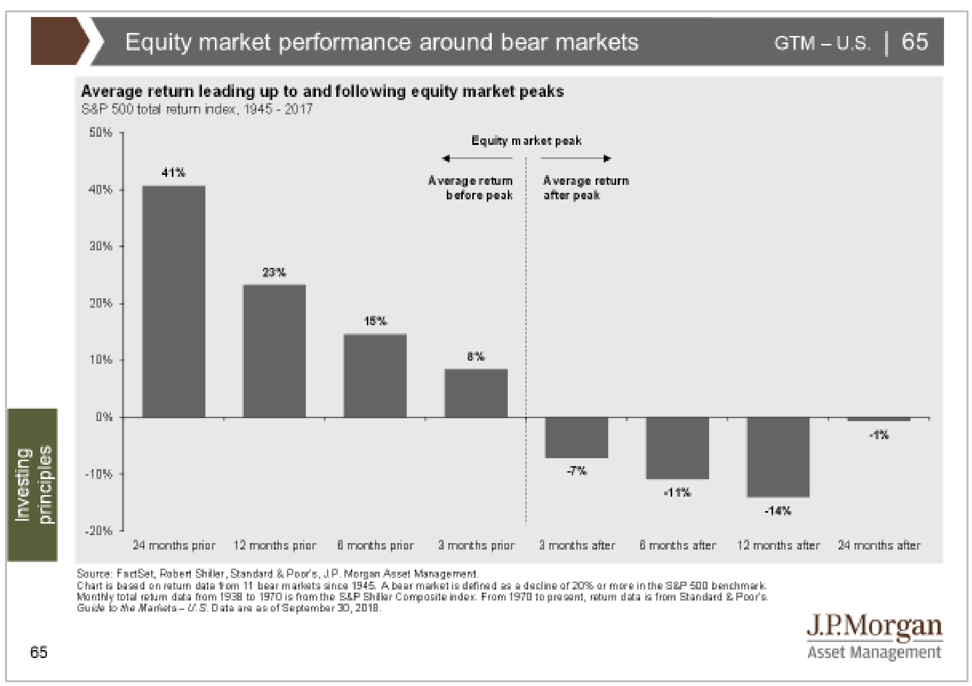
The 4th quarter has gotten off to a terrible start, with the S&P 500 losing 4.7% through October 19th. Because of the severity and swiftness of this decline, some market pundits are beginning to predict the start of a new bear market. Perhaps they are correct and equities will decline by a meaningful percentage; however, it is important to remember that stock market corrections are perfectly normal. According to JP Morgan, the S&P 500 declines by almost 14% at some point during a typical year. Despite such a large average intra-year drop, the S&P 500 has increased in value during 29 of the past 38 years. ***Market corrections should be viewed as an integral part of the investment***

process, without them, outsized gains are not possible: these corrections create the opportunity to buy stocks at bargain basement prices. During corrections the most important thing to do is to stay the course and not panic. While declines in a portfolio are emotionally painful, it is worth remembering that corrections are usually short-lived. According to Yardeni Research, there have been 36 stock market corrections (defined as the S&P 500 losing 10% of its value) since 1950, lasting an average of about 196 calendar days apiece.



Source: J.P. Morgan

For those who are hesitant to enter the market after a massive bull run, history shows that trying to time the market can be extremely costly. As Peter Lynch famously said, "far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." Since 1945 there have been 11 bear markets (defined by a drop of 20% from the market peak), but the average return 24 months *prior* to the bull-run ending has been a 41% advance and the average return for the last 12 months of the bull market has been an increase of 23%. **The resulting losses, however, are much less dramatic.** The average return 1 year after the market peaks is -14%, but on average investors recoup their bear market losses 2 years after the start of the stock market's decline. Remember—it's time in the market, not market timing, that counts.



Performance

Every account at Boyar Asset Management is treated individually, so we always have a significant degree of performance dispersion, depending on clients' individual mandates. For the most part, however, our accounts did reasonably well for both the quarter and the first 9 months of 2018, especially given our lack of FAANG exposure.

Some Comments About the Market and Our Biggest Worries

We vividly remember that during the depths of the financial crisis, when the stock market was in free fall, a good many investors sold their stocks because they could no longer tolerate the steep losses they were experiencing. Throughout the current bull market, which has seen the Dow Jones advance from a low of 6,443.27 on March 6, 2009, to over 26,000 today, a good many individuals who left the market never returned: they chose to put their money in bonds or money market funds, accepting paltry interest rates in return for presumed safety. But in a rising interest rate environment such as we are currently experiencing, investors are realizing that bonds are not a sure thing.

With the stock market at what seem to be elevated levels, can you purchase stocks and expect satisfactory returns? The answer depends upon your time horizon.

History doesn't repeat itself, Mark Twain once said, but it sure does rhyme. Consider CNBC's analysis of what would have happened had an investor purchased an S&P 500 index fund on the eve of the Lehman crash:

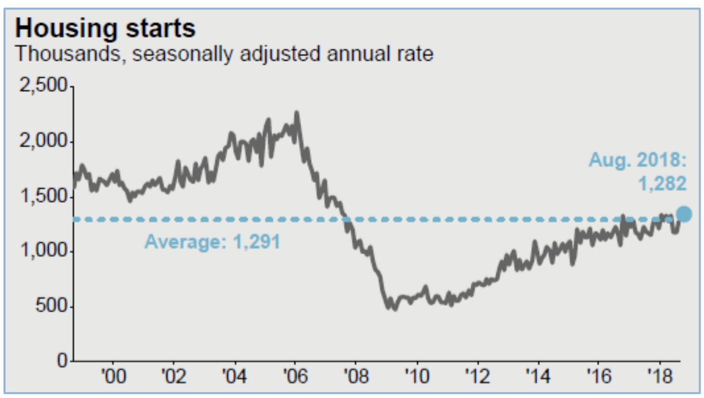
> "For the next six months, buying right before the crisis crescendo would feel disastrous. A year later, it still felt premature. Even after three years, loading up on stocks in September 2008 seemed more headache than home run but from the advantaged vantage point of today, buying on Lehman eve has been redeemed and rewarded by the passage of time, the resilience of corporate America and the durability of the bull market that followed.
>
> The S&P 500 closed at 1,251 the Friday before the Lehman bankruptcy, down from the October 2007 high of 1,565. In the 10 years since then, the S&P 500 is up 130 percent, an annual gain of 8.7% percent and a yearly total return (including dividends) of 11 percent. Those numbers are right around the very long-term average annual equity performance."

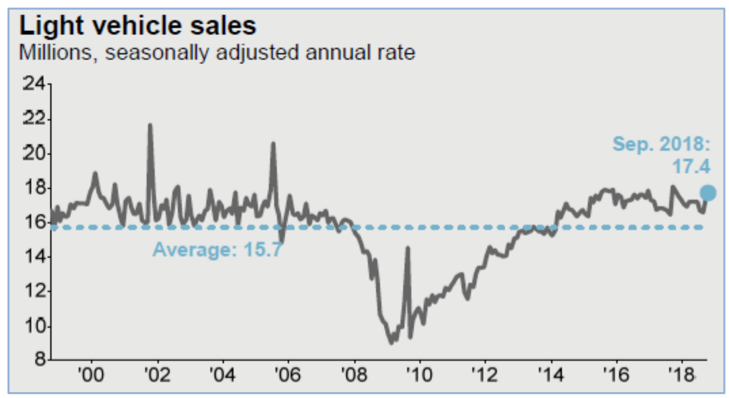
Although we are bottoms-up stock pickers and do our best to ignore macroeconomic noise when selecting our investments, we do not live in a vacuum, and certain economic factors are currently giving us pause. These concerns center mainly on interest rates and on whether the Fed can successfully guide the economy out of an unprecedented low-interest-rate environment without derailing the U.S. economic expansion. As Steve Einhorn, vice chairman of Omega Advisors, recently said on the *World According to Boyar* podcast, "bull markets do not die of old age, they are murdered by the Federal Reserve." The Federal Reserve used extremely aggressive monetary policy to bring us out of a deep recession that, some have argued, would have turned into a depression without such intervention. Whether a depression would have occurred is debatable, but extremely low interest rates certainly helped jumpstart the economy. Now that interest rates appear to be headed north, one question remains: how will a rise in interest rates impact the U.S. consumer?

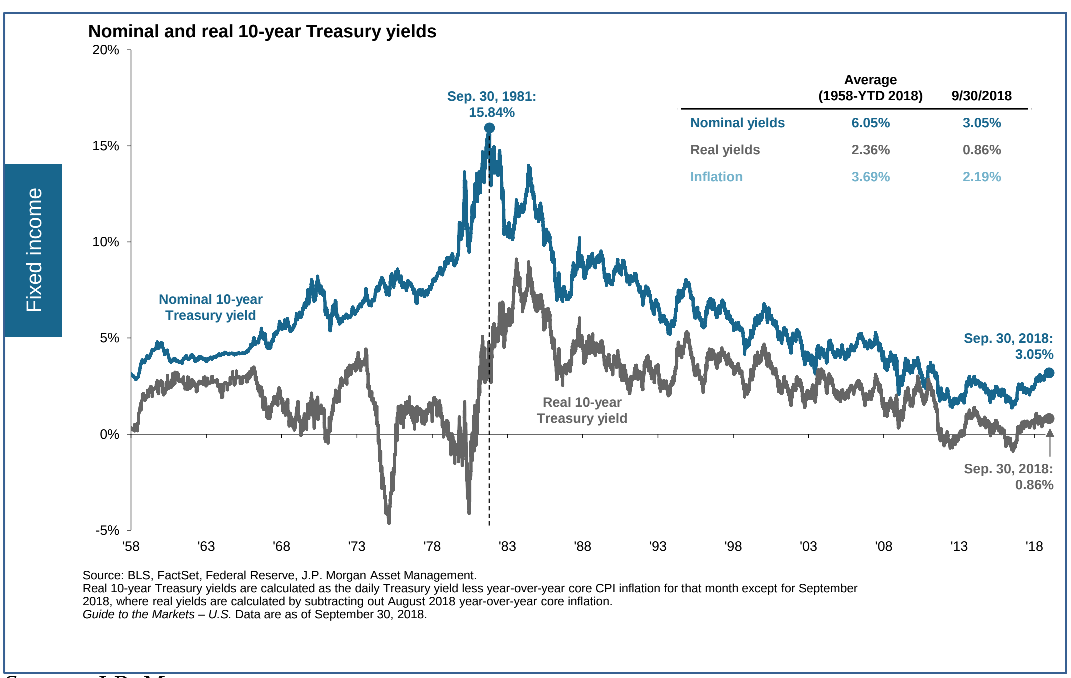
U.S. automobile sales have rebounded significantly from their lows during the global financial crisis, in part thanks to aggressive financing packages provided by automobile manufacturers that have made monthly payments quite affordable and thus stimulated sales. As interest rates have risen, however, it has become increasingly expensive for automobile manufacturers to provide such rock-bottom financing. According to

Adam Lee, chairman of Lee Auto Malls, as quoted in an article that appeared in the October 7 issue of the *Wall Street Journal*, written by Adrienne Roberts, "For a long time, everything was 0%. There are fewer and fewer of those deals now." According to the same article, in September 5.3% of cars were financed with an interest rate of 1% or less, down from 11.7% in September 2016, when U.S. automobile sales peaked. Zero-interest loans have decreased from 9.1% in 2016 to 3.4% currently. The average interest rate for purchase of a new car is 5.75%, up from 4.82% just 2 years ago. These rate hikes have significantly increased the monthly cost for consumers to purchase an automobile. How, then, will consumers respond? Will they hold onto their cars longer? Will they buy used cars? Either behavior would slow down the economy, as the U.S. automobile sector is responsible for almost 3 million jobs, according to the Bureau of Labor Statistics.

The U.S. housing industry will also be negatively impacted by a rise in interest rates. Like the automobile industry, the U.S. housing industry, which is responsible for roughly 8 million jobs, was buoyed by an extended period of extraordinarily low interest rates that made monthly housing payments more affordable. However, with the dramatic rise of interest rates this year, monthly payments for houses have gotten more expensive. The average rate for a 30-year fixed-rate mortgage is now 4.9%, according to Freddie Mac, compared to a little less than 4% at the beginning of 2018. Although by historical standards 4.9% is not a high rate (in the 2000s, before the housing bubble burst, rates were in the 5%-7% range), this is still a painful adjustment for potential homebuyers, who have grown accustomed to rates in the 3% to low 4% range.



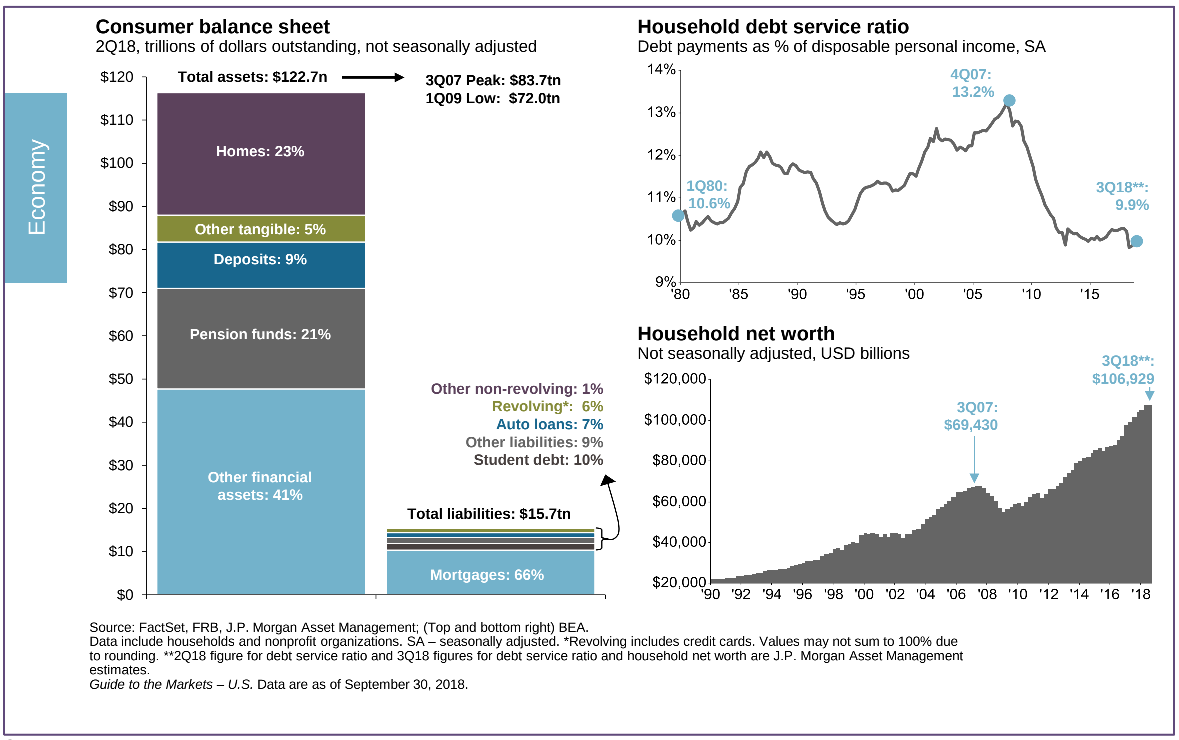




Source: J.P. Morgan

On a Positive Note

While a sharp rise in interest rates could create a bump in the road to economic recovery, it is important to note a few things. Although interest rates have risen quite substantially in a short time, they are still incredibly low from a historical perspective. The average yield of a 10-year Treasury since 1958 has been 6.05%, according to JP Morgan; yet at the end of the 3rd quarter it was 3.05%. Consumers will simply need time to adjust to a higher-interest-rate environment. In addition, the U.S. consumer is in terrific financial shape: according to JP Morgan, households have more than $7 in assets for every $1 of liabilities. In addition, consumers are well positioned for a rising-interest-rate environment, as household interest-bearing assets are roughly 3x household interest-bearing liabilities. Furthermore, 66% of household liabilities are mortgages, and more than 90% of mortgages are fixed-rate. Accordingly, as rates rise, consumer interest income (e.g., from CDs and savings accounts) will rise more quickly than consumer interest expenses do. It is also worth pointing out that household net worth has increased dramatically over the past decade: in the 3rd quarter of 2007, the average household's net worth was ~$69,000, but today it is over $106,000.



Source: J.P. Morgan

Should you have any questions, we are 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.*