"This is very much like the bubble in synthetic asset-backed CDOs before the Great Financial Crisis in that price-setting in that market was not done by fundamental security-level analysis, but by massive capital flows based on Nobel-approved models of risk that proved to be untrue."

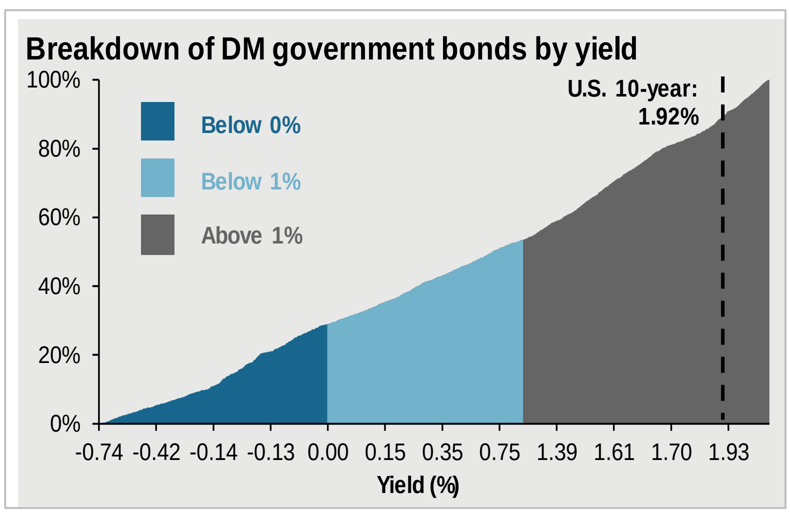
–Dr. Michael Burry on passive investing (September 2019)

January 27, 2020

What a Difference a Year Makes

In 2018 Wall Street posted its worst yearly performance since the financial crisis, with the S&P 500 losing 6.2%—its biggest annual loss since 2008, when it plummeted by 38.5%. For the first time in three years, the S&P 500 and Dow fell; the Nasdaq broke a six-year winning streak by losing 3.9%. It was a year of volatility, marked by record highs and sharp reversals. It was also the first time the S&P 500 had posted a decline after rising for the first three quarters of a year.

But 2019 was the polar opposite. Global markets enjoyed a fantastic run, gaining more than $17 trillion in value (starting the year just under $70 trillion and ending just above $85 trillion, according to Deutsche Bank). More than one factor fueled these gains, and more accommodative monetary policy certainly played a large part in the story. The Federal Reserve, for example, cut its benchmark interest rate three times in 2019—and has indicated that it will likely leave rates on hold in 2020. The 10-year Treasury ended 2019 yielding 1.92% (down from 2.7% at the end of 2018), compared with its historical average of 5.98%. What's more, levels of negative-yielding corporate debt reached an all-time high in 2019, pushing investors toward equities in a quest for satisfactory returns. Incredibly, as the chart to the right demonstrates, more than 40% of the world's government bonds yield less than 1%—and 20% are in negative territory.



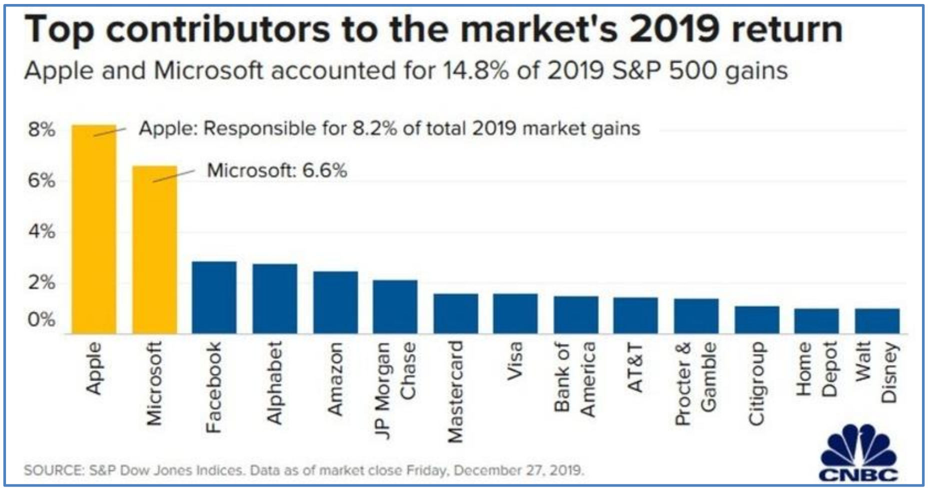
Source: JP Morgan Guide to The Markets

The outlook for global trade has become *somewhat* less muddy recently. Domestically, the House of Representatives passed the new North American trade deal, and the U.S. and China have reached a phase 1 trade agreement.

Mega-Cap Dominance

Mega-cap technology stocks were last year's star performers, playing a leading role in driving up the S&P 500 and the Dow. The S&P 500 technology sector rose by about 50%—by far the biggest gain among the index's 11 sectors. In fact, according to data from the S&P Dow Jones Indices, the technology sector alone was responsible for ~31% of the index's total return for the year, including dividends.

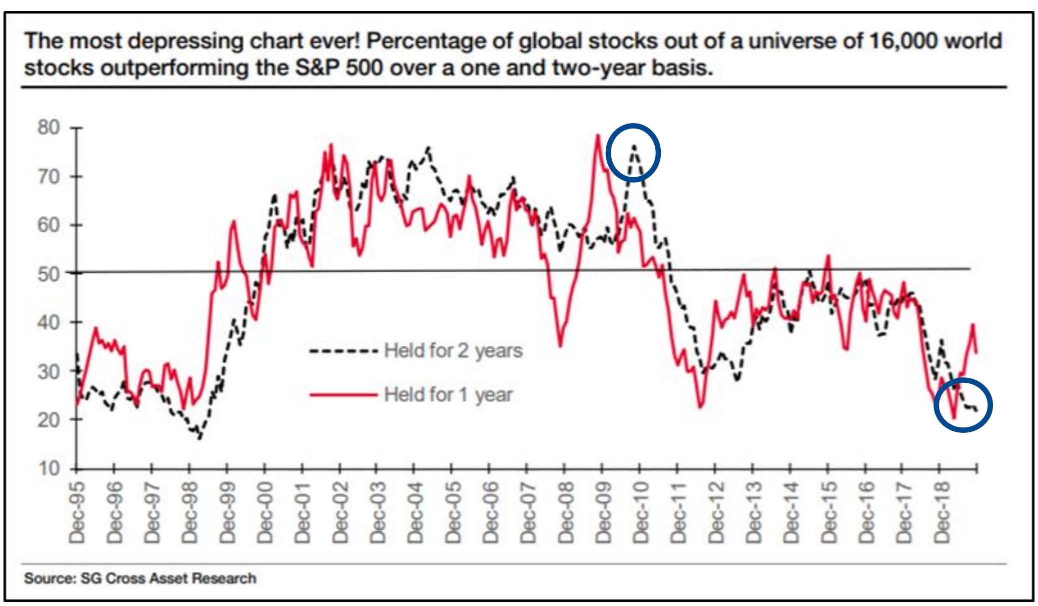
Nearly 25% of the Dow's 2019 gain came from Apple and Microsoft, which surged 85% and 55%, respectively. These two companies are the nation's largest publicly traded companies, with market values exceeding $1 trillion each, and together they were responsible for ~15% of the S&P 500's 2019 advance.



Much of the index's performance came thanks to just a few mega-capitalization stocks. The S&P 500 weights companies with greater market value more heavily, and the 10 largest companies in the S&P 500 represented more than 25% of the market value of the entire index—and were responsible for more than 27% of its 2019 gains.

These stocks' median return was ~28% last year (pretty close to the index's 31% gain) but gains within the index were far from democratic: the top 100 performers had a median return of ~57%, but the bottom 100 had a median return of negative 2.5%.

Lately the S&P 500 has been a hard benchmark to beat. As the following chart shows, over the past two years, out of 16,000 public companies worldwide, barely 20% have beaten the index (versus over 70% roughly a decade ago).



In our July 24, 2019 letter, we observed that:

> *"The new issue market today is reminiscent of the dot.com boom, and most of us remember just how badly that ended. Today's new issues generate significantly higher revenue and have been in business far longer, but their hefty valuations remain troubling."*

It didn't take long for individual investors to rethink their investments in initial public offerings. Most of the companies concerned were hemorrhaging money, were vastly overvalued, and were experiencing corporate government concerns. In January, a government shutdown halted IPOs, and in March and May, respectively, ride hailing companies Lyft Inc. and Uber Inc. debuted—only to see their share prices drop.

From there investors grew increasingly nervous about the remaining slate of IPOs, many of which were bleeding money. Companies such as Pinterest Inc., Slack Technologies Inc., and SmileDirectClub Inc. all saw their value drop after they started trading in the public markets. Then came the WeWork debacle, in which instead of taking the company public at a valuation as high as $100 billion (as some investment banks thought they could), controversial CEO Adam Neumann was forced out, leaving the company foundering amid a cash crunch from which it was rescued by SoftBank.

Most of the companies that did go public are now trading far below the valuations they fetched during their last private funding round, let alone pre-IPO pricing expectations. Shares of Smile Direct Club Inc., for example, are trading more than 43% below their IPO price, and Lyft trades more than 30% below its IPO price. Even so, 2019 was still one of the biggest years for public offerings on record, with more total money raised than any time since 2000, at the height of the dot-com boom.

So why should investors be concerned about the huge amounts of money that flowed into the IPO market? Because a finite amount of money is earmarked for the U.S. stock market, much of the money put into these new issues would likely have been invested in established businesses already traded on various exchanges. What's more, when investors lose a great deal of money in a short time, their appetite for risk diminishes. During the dotcom bust and the financial crisis, for example, many investors fled the stock market, never to return. Likewise, 2018's fourth-quarter stock market swoon, when the leading averages dropped by 20% from their highs, prompted many investors to reduce or even eliminate their equity exposure.

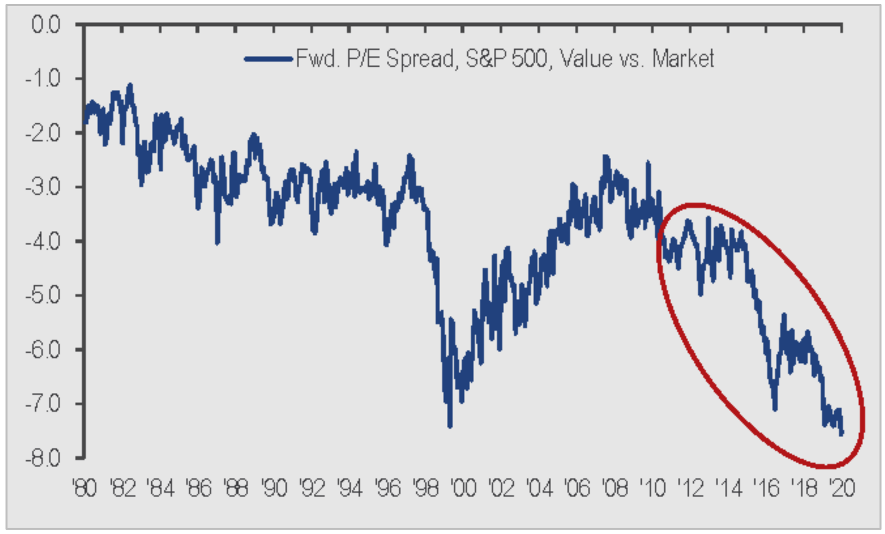
Recent events could signal a shift from speculative or momentum investing to value investing, but only time will tell. There are encouraging signs, though, particularly in the new issue market. Going forward, underwriters expect investors to remain discerning and wary of money-losing companies.

—Source: Maureen Farrell, "2019: The Year of IPO Disappointment,"
December 29, 2019, Wall Street Journal.

The Return of Value Investing?

We've been saying for some time that value investing is due for a renaissance. Looking at the stretched valuation of growth stocks and considering that value shares haven't been this cheap relative to growth stocks since the height of the dot-com bubble (see the following chart), makes us confident that soon it will be value's turn to shine.

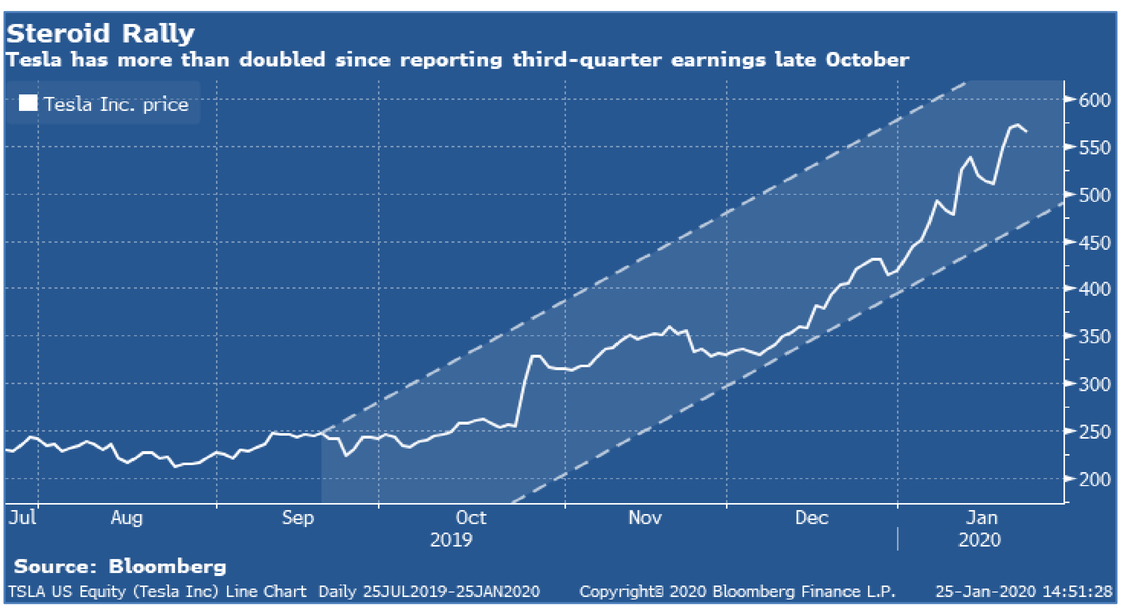
According to Savina Rizova, head of research at Dimensional Fund Advisors (as quoted in a *Wall Street Journal* article penned by Jason Zweig), this is not the first time that value has underperformed growth for at least 10 years. Value trailed for 10-year spans ending in the late 1930s, the late 1990s, and every year after 2010—about 15% of all periods. And over each decade following such poor returns, value has shown a tendency to bounce back sharply, beating growth by an average of more than 8 percentage points a year.



Source: JP Morgan Securities Research Report

Tesla

The Tesla story never ceases to amaze us. Tesla's current market value of over $100 billion exceeds those of Ford and General motors combined even though the company's revenue was ~$24 billion over the last 12 months, compared with Ford's ~$157 billion and GM's ~$144 billion. Telsa's shares have more than doubled since it reported earnings in late October, earning it the title of most shorted stock. According to S3 Partners, $14.5 billion worth of shares are currently borrowed (shares must be borrowed to be shorted), and sellers have racked up $2.8 billion in losses—making Tesla an expensive ride indeed!



Valuation

The S&P 500 ended 2019 selling at 18.2x earnings (fwd.), more than the 15.7x it sold for at its 2007 peak but far below the 27.2x it fetched before the dot-com bubble burst. With the 10-year Treasury significantly below its levels for those periods (1.9% at the end of 2019 vs. 4.7% in 2007 and 6.2% in 2000), the market might well continue grinding still higher as investors keep flocking to equities in the hope of increasing their returns.

As the chart below demonstrates, the cheapest area of the market is currently in small-cap value stocks, which sell for an average of 15.6x earnings versus their 20-year average of 16.2x. By contrast, the most expensive area is in small-cap growth stocks, which sell at a whopping 44.4x earnings versus their historical 20-year average of 29.7x. Mid- and large-cap growth names are certainly no bargain, either, selling at 25.2x and 23.1x versus their 20-year averages of 20.8x and 19.1, respectively.

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	15.2 / 13.6	18.2 / 15.5	23.1 / 19.1
Mid	15.3 / 14.1	18.2 / 16.1	25.2 / 20.8
Small	15.6 / 16.2	23.4 / 20.4	44.4 / 29.7

Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	111.9%	117.1%	120.8%
Mid	108.5%	112.6%	120.9%
Small	96.7%	114.8%	149.5%

Source: JP Morgan Guide to The Markets

In the current low and even negative interest rate environment, investors have embraced consumer staple and utility shares, seeing these traditionally "safe" stocks as a good bond substitute. As a result, consumer staple shares are selling for 20.2x and utility stocks for a rich 19.9x, versus historical averages of 16.8x and 14.4x, respectively. But if interest rates rise, investors who purchased these stocks as a bond proxy may find them not so "safe" after all.

Small-Cap Rally?

In *The New York Times*, Norm Alster noted that the Russell 1000 Growth Index (which indexes the largest growth companies) returned 15.2% per year over the past decade, while the Russell 2000 value index (an index of small-cap value companies) compounded at 10.6% over the same period. Despite this significant underperformance, looking at those two indices' performance since January 1979 reveals that small-cap value stocks, despite their recent decade of significant underperformance, have outperformed their larger counterparts. For those keeping score, from January 1979 to December 30, 2009, the Russell value index returned 13.2% annually (including dividends), versus 10.46% (including dividends) for the corresponding growth index. So if history is any guide, the previous decade of underperformance by small-cap value shares is setting up for a period of future outperformance.

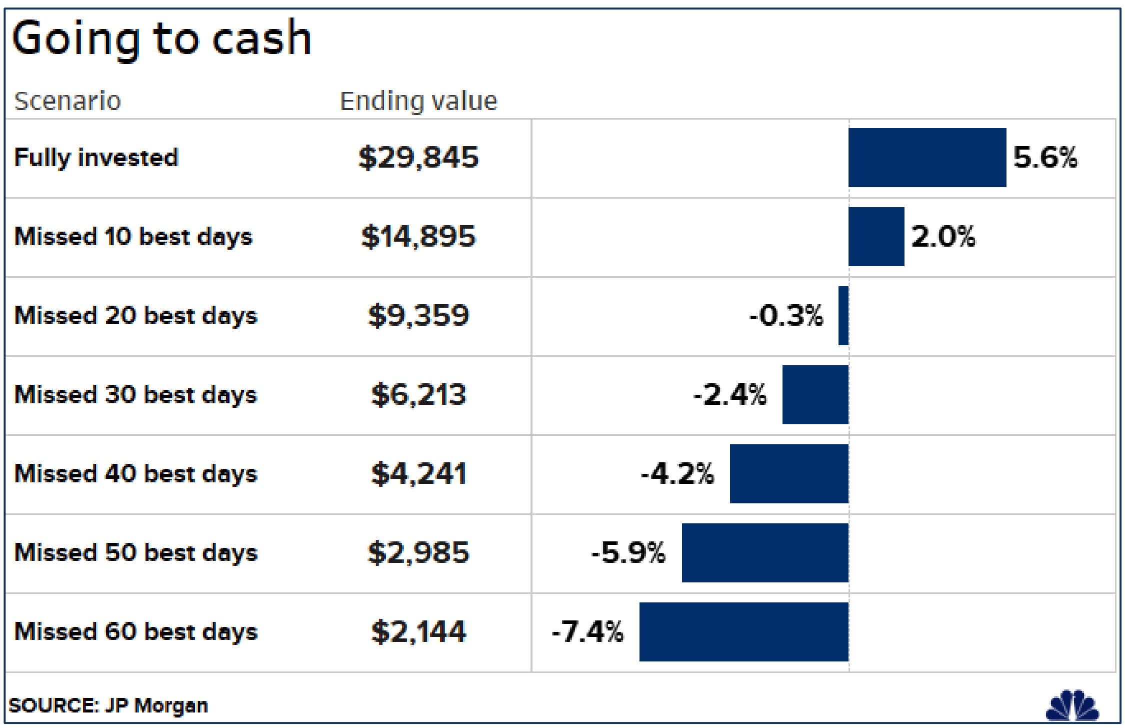
2019 Performance

In general, our accounts had solid absolute returns but trailed the major indices. This underperformance is directly attributable to our large cash position as well as our significant underweighting in technology.

The Importance of Ignoring the Noise

Those who sold equities a year ago are probably kicking themselves now. Of course, seller's remorse is nothing new—it follows each major stock market correction. After 2019's robust market advance, CNBC found that 33% of those surveyed deeply regretted not having been more aggressive with their investments. Had the survey been conducted a year earlier, however, with the market fresh from its worst year since the financial crisis, their responses would certainly have been quite different. Investors too often make decisions based on emotion, not on the fundamentals of the underlying business. Such emotion-driven decision making is part of why, according to Dalbar, the average investor has compounded at 1.9% over the past 20 years, compared with the S&P 500's 5.6% return.

Last year serves as the perfect example of why investors shouldn't let geopolitical or economic events dictate their investment decisions. There is always a reason why "now is not a good time to invest"—after all, the world is chock full of scary headlines. Investors would be better off putting on blinders and making their investments based on fundamentals, not on the headlines of the day. Last year, for example, the Fed quickly reversed course and decided to cut rates instead of continuing to raise them. Likewise, President Trump decided that he wanted a trade truce with China, despite some harrowing fits and starts along the way. Neither event was readily predictable at the beginning of the year, but both were big contributors to last year's outsized gains. And those sitting on the sidelines, worrying about how stocks would perform in a rising rate environment (as well as a trade war), missed out on some spectacular gains.



Going to cash may make you feel better temporarily but it could be an expensive proposition. This chart details how $10,000 invested in the S&P 500 would have performed from 1999-2018 if you missed the top performing days. While it is highly unlikely that someone would have such unfortunate timing, it demonstrates the important principal of not trying to time the market.

The same uncertainty surrounds stocks in 2020 and being in an election year only adds political volatility to the usual economic and policy variables. Will markets fall, at least temporarily, if Bernie Sanders or Elizabeth Warren appears likely to win the Democratic presidential nod? Nobody knows. Remember the infamous October 21, 2016, *Politico* article that began: "Wall Street is set up for a major crash if Donald Trump shocks the world on Election Day and wins the White House"? When those words were written, the S&P 500 was trading at about 2140. Now it stands above 3290.

Speaking of elections, presidential election years have historically produced solid stock market returns as the executive branch tries everything possible to retain the White House for its party. In the 29 U.S. presidential elections since the turn of the 20th century, the incumbent party has triumphed 17 times (bringing an average DJIA gain of 1.5% for the initial 5 months following). When the party in power was ousted, the DJIA declined an average of 4% over the ensuing 5 months, according to the *Stock Trader's Almanac*.

Since 1896, stock market losses of more than 5% have been seen only six times during presidential election years (with the incumbent party losing power in five of those elections). Stock market returns have been particularly strong when a president is running for reelection. Since 1900, the DJIA has gained 8.9%, on average, in election years when a sitting president is at the top of the ticket (versus only a 5.1% gain when both parties field a new candidate). But going long stocks in a presidential election year is not a formula for minting money: in 2000 (the bursting of the Internet bubble) and 2008 (the financial crisis), for example, the stock market suffered significant losses even during election years.

So let's put last year's advance into perspective. Yes, the market's gain in 2019 was well above average—but the year before, the market had a negative return. As a result, the S&P 500's returns over the past two years have not been materially higher, in aggregate, than its historical rate of return.

A banner year for stocks doesn't necessarily mean that the market is "borrowing returns" from the following year, a fact that has been underscored by research from Bespoke Investment Group. In years when the market has come off an annual gain of at least 20%, the S&P 500 has risen by an average of 6.58% the following year. Although this figure is slightly below the average return of 7.59% for all other years since 1928, a rise has been more likely in the year following a rise of at least 20% than it has in other years.

—Sources: Wall Street Journal Editorial Board, December 31, 2019; Boyar Research.

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

Best regards,

Mark A. Boyar

Mark A. Boyar

Jonathan I. Boyar

J 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.*