October 31st, 2019

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Dear «Salutation»:

Thoughts About the Stock Market and the Economy

The S&P 500 eked out a modest increase in the third quarter, helping stocks hold on to their biggest year-to-date gains in more than two decades and prolonging the longest bull market on record. Since the market bottomed in March 2009, the S&P 500 has increased 448% (including dividends). It has gone from selling at a ridiculously cheap 10.3x forward earnings to 16.8x next year's earnings, which is slightly above the 25-year average of 16.2x. However, when you consider that the 10-year Treasury yielded a mere 1.7% at the end of Q3 (since 1958 the average yield has been 5.99%), stocks start to seem pretty cheap.

S&P 500 Returns Since March 2009

Source: Bloomberg Finance L.P.

The quarter certainly was eventful. The Fed cut interest rates twice, the yield curve inverted for the first time in over a decade (seen by some as a precursor to an upcoming recession), and Trump's trade war with China continued to weigh on investors' psyche.

Although U.S. markets are hovering near record highs, fewer individual stocks are contributing to the rally. The number of stocks reaching 52-week highs has fallen since June, when the S&P 500 kicked off its latest record-breaking rally. In late September, according to FactSet, 106 companies in the index set new 52-week highs, down from 293 in mid-June. Such a lack of breadth in a rising stock market is very often a troubling sign. In our opinion, wider participation is needed for this rally to continue.

This year was yet another when growth stocks simply trounced value shares. The outperformance was consistent across all market capitalizations. Through the end of the third quarter, large-cap growth shares had advanced by 23.3% versus 17.8% for value shares, mid-cap growth shares had gained 25.2% versus 19.5% for mid-cap value shares, and small-cap growth stocks were up 15.3% versus 12.8% for their value counterparts. On an absolute basis, value shares (just like before the dotcom crash) have posted respectable numbers but compared with growth stocks they have significantly underperformed.

As managers whose strategy is to try and purchase intrinsically undervalued stocks, we find it beyond frustrating to see the most expensive stocks increasing in value while the least expensive stocks continue to remain on the bargain basement table. Investors are hardwired to want instant gratification, and momentum investing can become a self-fulfilling phenomenon (until the bubble bursts). Leonardo da Vinci's centuries-old observation holds true today: "He who wishes to be rich in a day will be hanged in a year." We are still of the belief that in the long term, the tortoise outdistances the hare.

Source: Franklin Templeton Investments

In our previous letter, dated July 24th, 2019 we opined that

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.

We continued by pointing out that

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.

Value investors have a unique ability to foresee that a bubble is forming in a particular asset class. However, we are often early (many times by years), which leads us to stay on the sidelines, missing out on spectacular gains. More important, however, in our opinion, the discipline of not chasing the latest investment fad (which is often accompanied by sky-high valuations) protects us when the bubble eventually bursts.

This time, not only did we accurately predict the fall of the unicorns, but our timing couldn't have been better. Beyond Meat, for example, priced its initial public offering at $25 a share, but by the end of the first day of trading, its shares had reached $65.75, or 163% above its IPO price, making it the best-performing first-day IPO in nearly two decades. Its stock hit an all-time high of $239.71 on July 26, having soared over 820% since it went public on May 2—putting Beyond Meat's market capitalization at an incredible $13.85 billion. At that price its valuation was higher than those of 25% of the companies in the S&P 500 index, including decades-old stalwarts like Molson Coors and Viacom. As of October 22, its shares traded at approximately $106—55% below its all-time high, but still well above its initial public offering price of $25 per share. Its market capitalization now approaches $6.4 billion (about $1.4 billion more than the market capitalization of Wendy's).

<u>Beyond Meat Share Price Movement Since the IPO</u>

Source: Bloomberg Finance L.P.

Beyond Meat currently sells in excess of 18x revenue and continues to bleed money. Microsoft, by contrast, sells at ~8x revenue, is highly profitable, sports a 42% return on equity, and is one of just two companies to have a AAA bond rating.

Two other examples (and we could give many more) of unicorns recently gone public that have since fallen from grace are ride sharing companies Uber and Lyft. Uber's shares hit a high of $47.08 on June 28, but by October 22 they were selling for $32.53—a loss of roughly 30%. The company is currently unprofitable, but even after its large share price drop, it still commands a market value of roughly $55 billion (slightly more than the market capitalization of General Motors). Similarly, Lyft's shares fetched almost $89 per share on March 29, but its shares currently sell for $43.56—a loss of 51%.

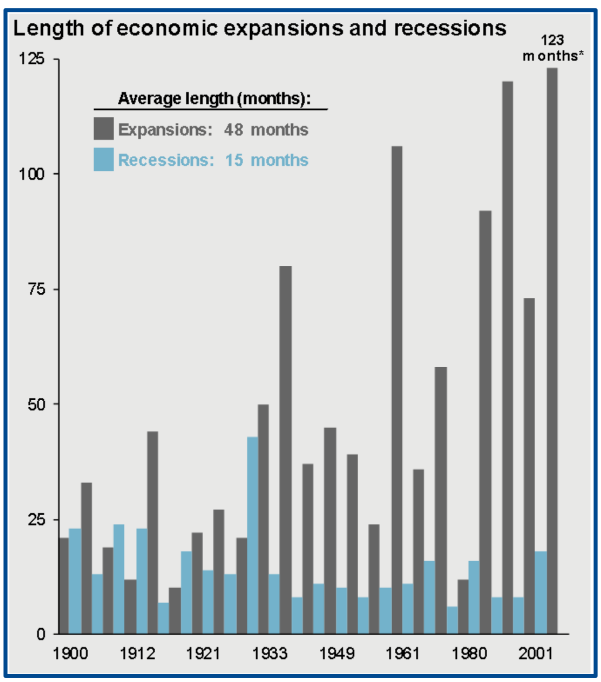
So far, 2019 is on track to become one of the biggest years for public offerings on record, measured by total money raised. As of the end of June, 108 companies had gone public in the U.S., raising $38 billion—the most by that point in the year since 2000, at the height of the dotcom boom.

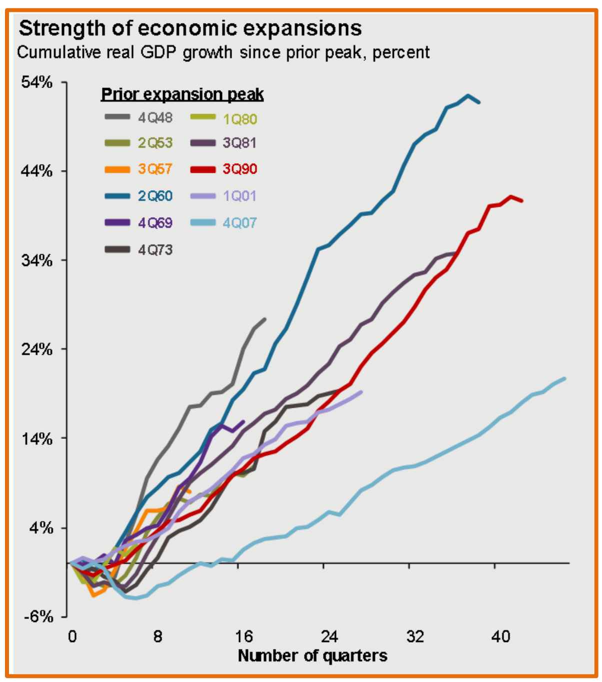
So why should investors be concerned with the huge amount of money flowing into the IPO market? Because a finite amount of money is earmarked for the U.S. stock market, a good portion of money placed in these new issues would likely have been invested in established businesses already trading on various exchanges. What's more, when investors lose a substantial amount of money during a short period, their appetite for risk diminishes. Extreme examples such as the dotcom bust or the financial crisis saw investors abandon the market, never to return. Even last year's fourth-quarter stock market swoon, when the leading averages dropped by 20%, saw many investors reduce or eliminate their equity exposure.

A possible positive outcome of these events could be a shift from speculation or momentum investing to value investing. Only time will tell. There are encouraging signs, though, with public investors having recently rejected WeWork's private market valuation of $47 billion as excessive—spurring the company to overhaul its governance, replace CEO Adam Neumann, and postpone its IPO. SoftBank is in the process of bailing out the company at a significantly reduced $8 billion valuation.

The WeWork example is particularly notable because, according to an article written by Andrew Ross Sorkin, Morgan Stanley once went so far as to speculate that a $100 billion valuation was in the cards. Perhaps the recent precipitous decline of other unicorn businesses that have mounting losses and sky-high valuations gave potential investors food for thought—but whatever the reason, unicorn companies are clearly going to have a harder time tapping the public market.

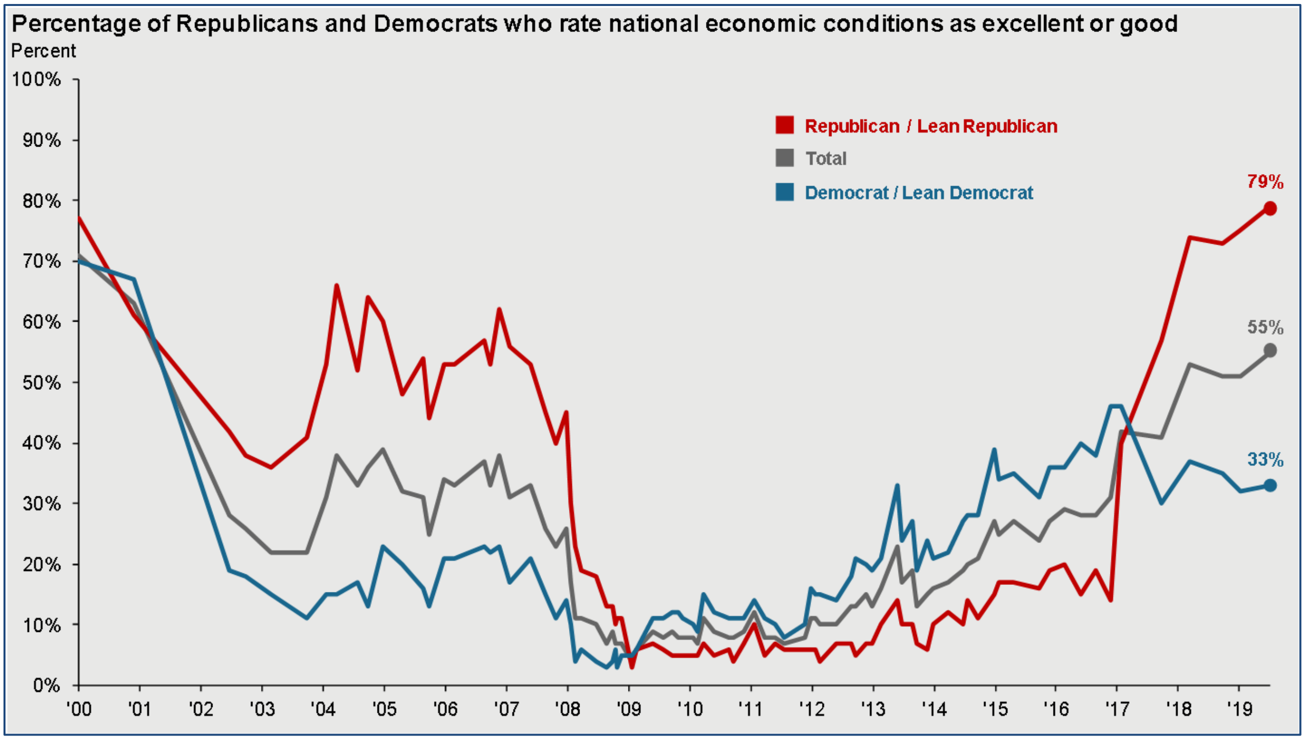
The current economic expansion, at 123 months, is certainly long in the tooth. (Previous expansions have lasted an average of 48 months.) However, as the following charts demonstrate, the current expansion has seen significantly weaker GDP growth. So although this expansion has been long by historical standards, because it has been muted compared to prior periods, and since major economic indicators such as unemployment (currently at 3.5% versus the 50-year average of 6.2%) are not raising any major red flags, we see no reason the expansion cannot continue to muddle along. That said, our economy is largely driven by consumer confidence, and if political conditions continue to worsen, that itself could drive us into recession.





Source: JP Morgan Guide to The Markets

Speaking of consumer confidence, it is interesting to note that your view of current economic conditions might well be dependent on your political views. According to the Pew Research Center, 79% of people who identify as Republican or lean Republican believe that the national economic conditions are excellent or good, compared with only 33% of Democrats and those who lean Democrat.



Source: JP Morgan Guide to The Markets

The Importance of Taking a Long-Term View

Although we've emphasized this concept in previous letters, it's important enough to mention again: One of the most important things an individual investor can do to help his or her chance of success is to take a long-term view. According to Dalbar, over the past 20 years the S&P 500 has advanced 5.6%, yet the average investor has gained a mere 1.9%. One of the main reasons for this underperformance is that investors let their emotions get the best of them and chase the latest investment fad—or sell when they should be buying.

Anyone who is investing in the stock market needs to take a multiyear view to tilt the odds of success in his or her favor. Since 1950, the range of stock market returns as measured by the S&P 500 (using data supplied by JP Morgan) in any given year has been from +47% to -37%, but over any 5-year period that range is +28% to -3%. For any given 20-year period, the range of returns contracts still further to +17% to +6%. In short, *since 1950, there has never been a 20-year period when investors did not make at least 6% per year in the stock market.* Although past performance is certainly no guarantee of future returns, history shows that the longer the time frame you give yourself, the better your chances of earning a satisfactory return.

Nine-Month Performance

The S&P 500 gained 1.7% for the third quarter, while the NASDAQ dipped 0.09%. The worst performer was the Russell 2000, an index of small-cap names, which shed 2.40%. According to JP Morgan research, the best-performing sectors were utilities (+9.3%), real estate (+7.7%), and consumer staple shares (+6.1%). It makes sense that these sectors led, as each of them sports attractive dividend yields at a time when investors are struggling for yield. However, investors are paying a high price to receive income: utility shares are selling at 20.5x trailing earnings versus the 20-year average of 14.9x, real estate shares are selling for 20.6x last year's earnings versus the 20-year average of 16.5x, and consumer staples are selling for 20.4x trailing earnings versus the 20-year average of 18.1x. The other notable outperformer was technology shares, which were up 31.4% through the end of the quarter. Interestingly, they are selling at 20.3x trailing earnings versus their 20-year historical average of 23.1x.

Our accounts have performed well on an absolute basis, but they continue to trail the S&P 500 owing to their lack of exposure to high-flying technology stocks, which have led the market higher, and, in many cases, to an elevated cash position. As we've already observed, the most expensive stocks continue to get more expensive, and the cheapest companies, using any acceptable metric, keep getting less expensive. At some point this trend will reverse course, as it always does. We just can't predict the timing.

Because the S&P 500 is a market-cap-weighted index, larger companies have a significantly greater impact on it than smaller companies do. It shouldn't come as any surprise, then, that five mega-cap companies (Microsoft, Apple, Facebook, Berkshire Hathaway, and Amazon) were responsible for ~18.5% of the index's gain. These companies had, on average, a 27% percent advance. It is interesting to note, the top 50 performers within the S&P 500 (which had an average gain of 57%) together accounted for only ~11% of the S&P 500's gain. In addition, while the S&P 500 advanced 20.55%, 265 companies had returns below that figure. The median return for those companies was a mere 6.1%. The above figures clearly demonstrate that this stock market rally has been far from democratic.

Some Additional Thoughts About the Market

First, the passive investing boom might be causing a market bubble, but not in the stocks most would expect. Ned Davis Research found that real estate and utilities stocks have benefited the most from the rise of passive investor vehicles such as exchange-traded funds. According to their research, ETFs hold more than 11% of the real estate sector, as well as 9.8% of the utilities sector. Tanager Factory Outlet Centers, a real estate company that invests in shopping centers, has had nearly 32% of its float taken over by ETFs—by far the most of any stock.

Microsoft, Apple, Amazon, and Facebook have been some of the best performers in recent years, and they hold the most weight in the S&P 500. However, ETFs own only a fraction of these stocks. Around 5% of Microsoft and Amazon's public float are owned by ETFs, a figure that stands at 5.4% and 4.8% for Apple and Facebook, respectively.

Sources: Ned Davis Research; Fred Imbert; Boyar Value Research.

Second, selloffs happen every year. Here are some interesting facts:

- Despite average intra-year drops of 13.9%, annual returns were positive in 29 of the past 39 years, according to JP Morgan Research. Clearly dramatic selloffs are not unusual—they're part of the experience of being invested in stocks. It's best to just put blinders on.

- October, for whatever reason, is thought to be a particularly bad month for the stock market. However, the average return in October is actually positive, despite record drops of 19.7% and 21.5% in 1929 and 1987, respectively.

- "Some of the worst starts to October have been followed by huge gains for the remainder of the year," Bespoke analysts wrote. "There have now been 14 instances of the S&P 500 falling more than 1% on the first day of October since 1928 . . . . The S&P 500 has gained an average of 3.75% for the rest of October when it started the month with a 1%+ decline. For the rest of the year, the S&P has been up 12 of 13 times after a 1% decline on the first trading day of October for an average gain of 7.22%."

Source: Yahoo Finance, October 3, 2019, Sam Ro, managing editor.

<u>Our Wall of Worry</u>

1. Failure to reach a trade agreement with China
2. Earnings expectations that fall short of consensus forecasts
3. Deepening inversion of the yield curve
4. Potential Brexit fallout
5. Impeachment proceedings
6. Escalation of Hong Kong protests
7. Further conflict in the Middle East
8. A misstep by the Federal Reserve

As always, if you have any questions, please feel free to contact us—we're always available for further discussion. Also please be sure to let us know if your financial circumstances change, so we can adjust your portfolio accordingly.

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.*