"You *can't put a price on the sense of relief many feel when they abandon their investment principles to join the herd. Actually, you can put a price on it and it may turn out to be a very costly decision"*

–Eric Cinnamond on The Acquirer's Multiple Podcast

October 16, 2020

Boyar Asset Management, like most companies, continues to work remotely. In all other respects, though, it's business as usual: we are in constant contact, with our analysts working diligently to uncover bargains we can add to the portfolio and stress-testing existing positions. We look forward to returning to our New York City office as soon as circumstances allow.

Third Quarter Equity Performance

U.S. stocks turned in a second consecutive quarter of dramatic gains, continuing a historic stock market recovery that few predicted during the depths of the March downturn. These advances built on even bigger gains experienced during the prior period, adding up to the best two-quarter performance since 2009. Growth stocks kept outperforming value stocks during the third quarter, and by a wide margin. However, U.S. stocks also recorded their worst September in nearly a decade, with value stocks outpacing growth stocks for the month as investors turned away from the fast-growing technology companies that had long driven the market higher.

The Election a Catalyst for the Return of Value Investing?

Many have speculated about how the stock market will react to the outcome of the upcoming presidential election. We have heard equally convincing arguments for the market's rising or falling if either party takes control of the White House. Simply put, no one knows how a market will react to the results of an election; instead, investors should focus on buying good businesses at reasonable prices that can compound nicely regardless of who resides at 1600 Pennsylvania Avenue.

Some have suggested that a "blue wave" may put the Democrats in control of the House of Representatives, the Senate, and the presidency. History offers some insights into past market responses to a single party's control of both the executive and the legislative branches.

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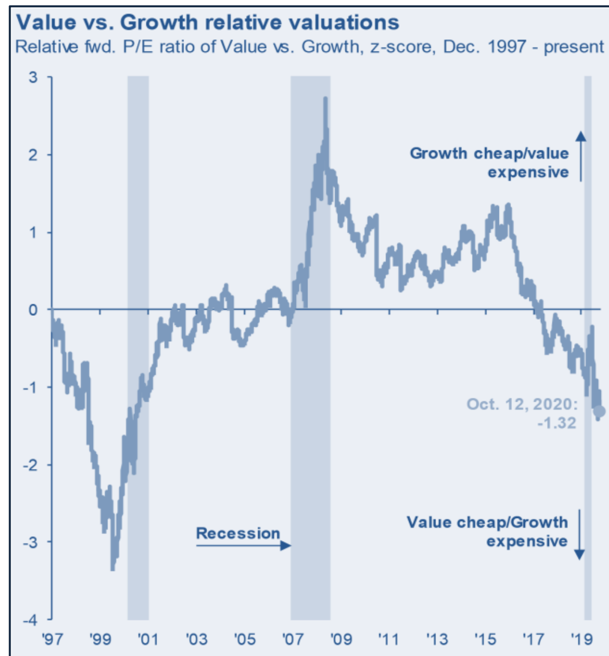
According to FactSet, since 1948 Republicans have controlled both branches 11% of the time, with the S&P advancing 12.9% on average, and Democrats have controlled both 27% of the time, with the S&P 500 returning 9.8%. Interestingly, the worst stock market returns have come during periods of divided government, at an average of 7.8%.

Ksenia Galouchko, writing in *Bloomberg*, suggests that a victory by Joe Biden could begin a rotation toward parts of the market that have lagged. Goldman Sachs similarly predicted that a U.S. Democratic sweep would favor both European cyclicals and value stocks. It is worth noting, that value stocks have not been this cheap versus growth stocks since prior to the dotcom meltdown. After which, value stocks made up for lost time.



Source: JP Morgan Guide to the Markets.

The State of the U.S. Consumer

During the quarter, people took advantage of historically low interest rates to purchase new homes. Purchase mortgage applications, after having declined by 35% Y/Y during the height of the pandemic, are currently up 21% Y/Y. People are also refinancing their existing mortgages at extremely low rates, which in effect increases their current disposable income. According to an article on CNBC.com, refinancing volume was 50% higher than a year ago. Incredibly, the average rate for a 30-year fixed mortgage with a conforming loan balance was a mere 3.01%.

Not only are consumers saving on their interest payments, but dramatic decreases in the price of oil have also extended a virtual tax cut to American consumers. As of October 12, 2020, a barrel of oil sold for $39.43, versus $76.41 in October 2018. Although people are admittedly driving less amid the lockdowns, decreases in oil prices and mortgage interest expenses are a boost to consumers.

The economy remains far from rosy, of course, with perhaps years needed to return to pre-pandemic economic levels, but certain data points show that the economy has improved remarkably just since March and April. For example, at one-point U.S. seated dining places (people eating in restaurants) were basically shut down, but their current year-over-year percentage change is now "only" down 38%. At one-point hotel occupancy decreased 69% year over year, but now that figure stands at a negative 30%. No one would call these figures anything but dire, but at least we're now heading in the right direction.

High-Frequency Data Year-Over Year % Change

	Min.	Current
Purchase mortgage applications	-35%	21%
Consumer debit/credit transactions	-36%	-2%
Hotel occupancy	-69%	-30%
Travel and navigation app usage	-82%	-38%
U.S. seated diners	-100%	-38%
TSA traveler traffic	-96%	-61%

Source: JP Morgan Guide to the Markets.

As we've already noted, the near-term economic outlook is far from rosy. The third quarter of 2020 was the worst on record for bankruptcies. This year has seen 199 bankruptcy filings so far by companies with more than $50 million in liabilities—the most for any comparable period since 2009 according to *Bloomberg*. The damage was even worse for smaller businesses: bankruptcy filings for companies of all sizes in September increased 78% compared with the same month last year. Fitch ratings has warned that its 3-year 2020-2022 cumulative U.S. default rates for term loans and high-yield bonds now stand at 17%-20% and 15%-18%, respectively.

Credit Markets

The long-term results of the Federal Reserve's actions are unknowable, but we think its dramatic and decisive actions averted a potential Great Depression. Unlike in 2008, the credit markets did not freeze. In fact, corporate bond issuance was up dramatically from the prior year. Through August 2020, according to J.P. Morgan, corporate bond issuance totaled $1.4 trillion and high-yield bond issuance $279 billion, compared with $771 billion and $173 billion, respectively, for the same period in 2019. The Fed's actions could certainly bring plenty of future negative consequences, but we think its actions kept the economy afloat.

Investor Euphoria?

Retail investors have jumped on the stock market bandwagon, summoning memories of the dotcom era, when many people left their jobs to become day traders. According to *Bloomberg Intelligence*, retail investors now account for about 20% of equity trading—a figure that investment bank Jefferies puts as high as 40%. Many suggest that this rise in trading has been fueled by zero-commission trades as well as boredom amid the COVID-19 lockdowns.

According to Sarah Ponczek and Vildana Hajric, writing for *Bloomberg*, in September clients of TD Ameritrade increased their market exposure for a fifth consecutive month. Indeed, the firm's measure of client positioning was at its most bullish in 2 years. In September, the most popular stocks were Tesla, Apple, and Amazon (all of which dropped at least 16% during the September selloff).

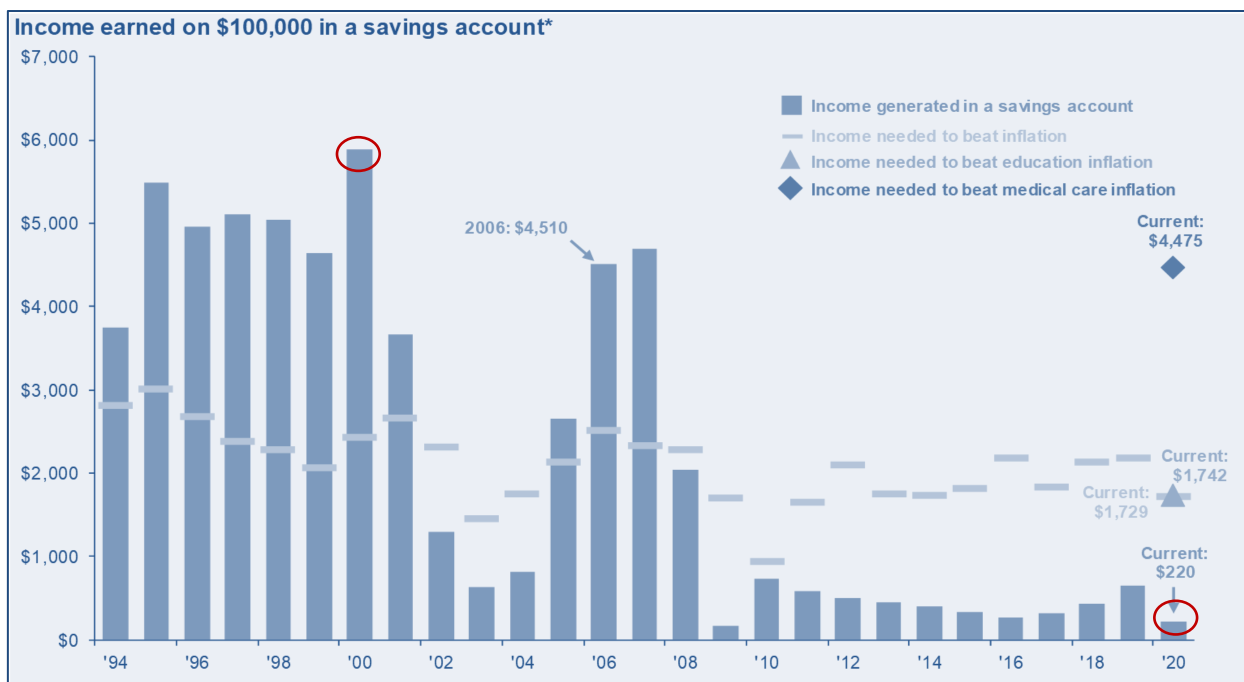
We see other signs of frothiness in the marketplace, such as the proliferation of SPACs, or special purpose acquisition companies—sometimes referred to as blank-check companies. These shell companies have no operations yet plan to go public, intending to acquire or merge with a company using the proceeds of their initial public offering. A number of these businesses have soared to dizzying heights, fueled by nothing more than hopes and dreams.

According to Renaissance Capital, 168 IPOs have been priced this year, a +31.3% change from last year. Proceeds totaled $57.0 billion—a 36.0% rise. This year's 209 IPO filings represent a 18.8% advance from a year ago, and we have seen 142 SPAC IPOs—the most in any sector. Because only a finite amount of money is earmarked for the U.S. stock market, any significant increase in the number of new issues brought to the marketplace can diminish the funds allocated for businesses that are already trading.

Some might interpret this speculative fever as a sign that significant amounts of money have poured into the U.S. stock market, but the reverse is true: during the third quarter alone, investors withdrew a net $121 billion from stock mutual funds and exchange-traded funds, according to Investment Company Institute estimates. Interestingly, even amid historically low interest rates, investors added a net $218 billion in bond funds during the quarter. That said, investors have an uncanny ability to zig when they should zag. Historically, bull markets do not end when investors withdraw from the stock market; they end with investor exuberance.

Outlook

As of October 12, 2020, the S&P 500 sold for 22.1x forward earnings, far above its 25-year average of 16.49x, according to J.P. Morgan Asset Management. Amid a global pandemic that has brought significant unemployment and caused record numbers of bankruptcies, we can think of more than one reason the market might sell at elevated levels—most notably historically low interest rates. Thanks to unprecedented actions taken by the Federal Reserve, the 10-year Treasury yields a measly 0.8% versus its historical average of 5.91% (since 1958). Faced with such low rates, retirees and pension funds cannot earn acceptable returns via traditionally "safe" vehicles. In 2000, for instance, a saver could expect to earn slightly less than $6,000 for every $100,000 in a savings account, but today that figure is a measly $220. These negligible returns have forced investors to purchase risk assets such as equities, a trend that has driven their prices to artificially high levels.



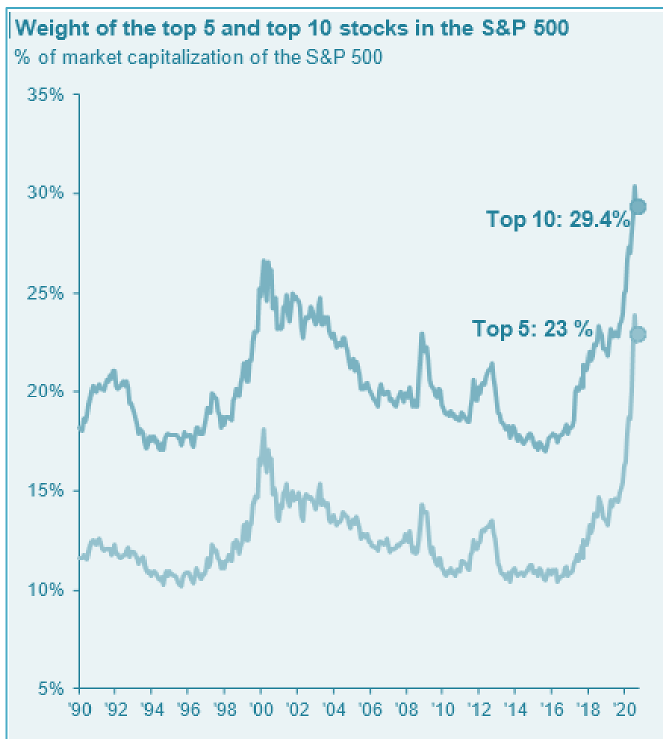
Source: JP Morgan Guide to the Markets.

The S&P 500's current high valuation does not bode well for future index returns. When the S&P 500 has sold at 22.1x earnings or more, future 5-year returns have been either muted or negative. **Remember the biggest determinant of future equity returns is the price paid**. It is no coincidence in our view that the two times the S&P 500 sold at ~11x, the next 5 years' annualized returns were in the high teens.

As we've mentioned in past letters, the S&P 500's returns have been driven largely by a handful of stocks, mostly in the technology sector. The S&P 500 hasn't been controlled by so few companies since at least 1990. Today the S&P 500's 5 largest components represent 23% of the index, and the top 10 companies represent 29.4%.

The index hasn't always been this concentrated, though. In 1990, the top 5 companies represented about 12% of the index and the top 10 only ~18%. Today, however, with so few companies having such a large weighting, returns are more reflective of the 20 or 30 highest-weighted stocks, giving short shrift to the 480 or 470 other companies that make up the index. Even so, the S&P 500's top-heaviness is nothing compared with that seen in the Chinese stock market. According to Shuli Ren of *Bloomberg*, as of August 31, 2020, the top three stocks (Alibaba, Tencent, and Meituan Dianping) in the benchmark MSCI China Index had more than a 38% weighting.

While the S&P 500 sells for 22.1x earnings, companies within the Information Technology sector (which has advanced 36% YTD) trade for 27.5x earnings versus their 20-yr average of 18.9x, according to data from J.P. Morgan. Facebook, Alphabet, Apple, Microsoft, and Amazon which in total comprise ~23% of the index sell for an average of 40.4x times earnings (Amazon's 81x earnings skews the average a bit, but even the group's median multiple of earnings is an elevated 32.5x) and are up an average of ~47% this year.

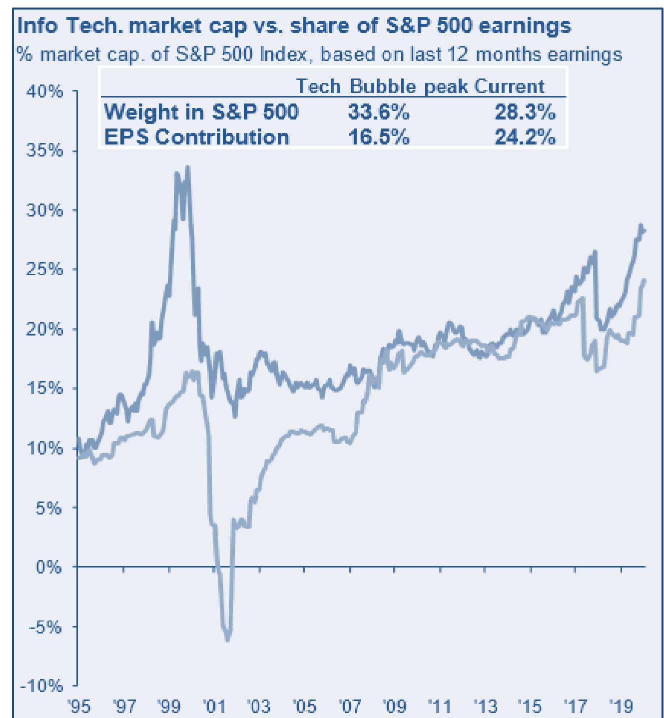


Source: JP Morgan Guide to the Markets.

We don't expect extraordinary future returns from the S&P 500 based on current valuation levels, **but we do believe that future satisfactory returns can be achieved by looking outside the index or by investing in certain companies within it that have underperformed the index.** Although the index's return has been driven largely by a handful of highflying technology companies, we're not predicting a widespread dotcom-style meltdown: today's technology companies are significantly better businesses than their counterparts from that bygone era. We just do not believe they will continue to be the market leaders.

Today's information technology companies have a smaller weighting than we saw at the height of the technology bubble, but they contribute far more to the S&P 500's earnings than their counterparts did during the tech bubble.

We expect that over the next 3-5 years, shares in select companies and sectors that have been out of favor (while still selling for reasonable valuations) will make up for lost time, and technology companies will underperform the market.



Source: JP Morgan Guide to the Markets.

Where Do We Go from Here?

So where do we go from here? During our combined 60+ years in the investment business, growth has trounced value for extended periods on more than one occasion. The two most extreme cases came during the 1960s, with the emergence of a group of stocks affectionately dubbed the Nifty Fifty, and the 1990s, when Internet stocks were all the rage. In both cases, these market darlings significantly outperformed most stocks for multiple years while value stocks lagged badly.

The P/E ratios accorded the Nifty Fifty were significantly higher than the market in general, with one member reaching more than 100x. Just like today, this small group of stocks drove the bull market of the late 1960s and early 1970s—but it all came crashing down in the 1973-1974 bear market. Many of these stocks lost 60%-70% of their value and never recovered to their 1969 highs.

The dotcom craze began in the mid-1990s and continued virtually unabated for roughly 5 years. Many dotcom companies had no earnings yet saw their valuations increase multiple times. Then the NASDAQ index, which had risen fivefold between 1995 and 2000, tumbled from a peak of 5,048 on March 10, 2000, to 1,139.90 on October 4, 2002—a decline of 76.81%.

In both these cases, value stocks regained their luster, and during the years that followed they demonstrated some of their best relative and absolute outperformance. Conventional investment theory suggests value stocks start to do better when the economy begins to recover from a downturn. That is because many value stocks are particularly sensitive to the ebbs and flows of economic activity.

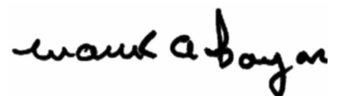
Recently Goldman Sachs Group chief U.S. equity strategist David Kostin penned these words: "In our view the extreme valuation gap between the most expensive and least expensive stocks will most likely be closed when an improving economic environment causes low valuation stocks to 'catch up' with the current market leaders."

We're reminded of Mark Twain, who wrote that "history doesn't repeat itself, but it often rhymes." With that thought in mind, we share the aim of hockey great Wayne Gretzky: to "skate to where the puck is going to be—not where it has been."

As always, we're available to answer any questions you might have. If you'd like to discuss these issues further, please reach out to us at jboyar@boyarvaluegroup.com or 212-995-8300.

Best Regards,

Mark A. Boyar



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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® Value Index measures the performance of small-cap value segment of the US equity universe. It includes those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth values. *The S&P 1500 Value Index measures value stocks using three factors: the ratios of book value, earnings, and sales to price and the constituents are dawn from the S&P 500, S&P Midcap 400 and the S&P SmallCap 600. 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.*