

“Any year in which the S&P 500 jumps 32 percent and the NASDAQ 40 percent while corporate earnings barely increase should be a cause for concern, not for further exuberance.”

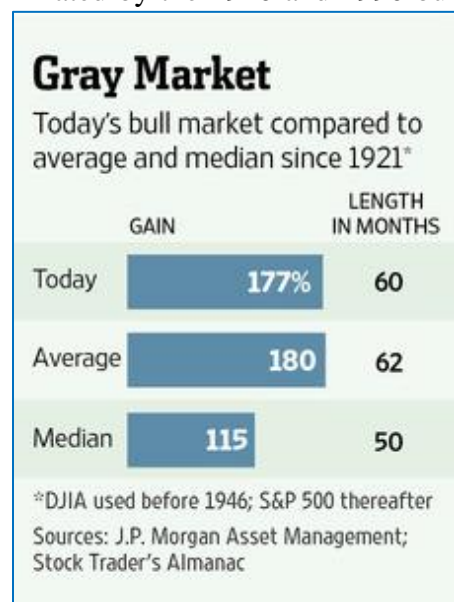
—Seth Klarman , in a recent quarterly letter

April 30, 2014

A Look Back

For a good portion of 2013, we voiced our concern that the stock market has not had a meaningful correction for a prolonged period of time. So far this worry has not materialized. Although stocks are not on the bargain basement table as they were in 2008 and 2009, the market as measured by the S&P 500 is not blatantly overvalued either. Normally, before bull markets end and bear markets begin stock market valuations reach excessive levels.

Having said that in terms of magnitude and longevity this bull is somewhat long in the tooth. The current bull market has advanced by approximately 177% since the March 2009 lows, compared to the average 180% return since 1921, according to J.P. Morgan Asset Management. In terms of duration this "bull" is 60 months old, while the average bull market has lasted 62 months since 1921. Even more worrisome, these statistics are inflated by the 1920 and 1990 bull runs. The median bull market performance and duration is 115% and 50 months respectively.



There are other warning signs that keep us up at night. For example, there currently exists a bifurcated stock market in terms of valuations, similar to what we experienced during the internet craze of the late 1990's. Clearly today, the numbers of companies in this category are far less than they were then, but the nose bleed valuations are troublesome. As savvy, value investor Seth Klarman recently wrote,

"When the markets reverse, everything investors thought they knew will be turned upside down and inside out." Buy the dips, "will be replaced with "what was I thinking?"... Anyone who is poorly positioned and ill prepared will find there's a long way to fall. Few, if any, will escape unscathed."

After being net sellers of stocks in 2008 and 2009, individual investors began returning to the equity market towards the later part of 2013, with their purchases accelerating during the initial quarter of 2014. Unfortunately retail investors usually get to the party late. Adding fuel to the fire is that a moderate amount of these purchases are being made with borrowed money. In fact, margin debt hit a record level during January.

A spike in margin debt fueled by individual investors' appetites for common stocks has historically been a reliable contra indicator for future stock market direction. Furthermore, with interest rates at historically low levels for a prolonged period of time: Investors have been willing to purchase riskier debt in order to enhance their returns. While we would never entertain buying a 10 year treasury bond yielding ~2.64 (yield as of 4-16-2014), we think the fact that Spanish government 10 year bonds are yielding 3.06% demonstrates investors are taking a lot more risk for very little incremental return. In our opinion, this is a recipe for disaster.

In addition, recently debt investors have been abandoning normal creditor protections on certain leveraged buyout loans as they snap up riskier securities at a faster rate than at the peak of the credit bubble. The revival of these riskier loans, which fell out of favor after the financial crisis, are perhaps early indications of the excessive risk-taking that brought the global banking system to the brink of collapse. These "cov-lite" loans remove the early warning signs and protections that lenders would traditionally expect. These include the obligation to maintain certain performance and financial ratios, which if breached allow banks to request cash or a debt restructuring.

Another sign that usually occurs prior to a stock market swoon is a substantial pick up in the new issue market. Since the amount of capital that flows into the stock market is not infinite, the issuance of additional shares by new businesses becomes a direct competitor to established companies already trading in the marketplace. Although the number of new issues that came to market in 2013 which numbered 230, was significantly less than the frothy dot.com era when 536 new issues were sold to the public in 1999, it was significantly higher than any year in more than a decade. This trend continued in the first quarter of the current year when the U.S. IPO market showed more activity than any other first quarter since 2000 as 64 companies raised \$10.6 billion according to Renaissance Capital IPO intelligence. This is more than double the number of IPOs in the first quarter of 2013.

Normally, prior to a bull markets conclusion, or just before a significant correction occurs the stock market takes on a more speculative tone. Small cap growth stocks, technology businesses with little or no earnings for example, grab investor's attention. Both the NASDAQ, a technology laden index, and the Russell 2000 index, a collection of small capitalization stocks led the way last year and were in the forefront in Q1 of this year.

There are more than a few companies that have become the darlings of the hedge fund crowd and sell at unfathomable valuations. Up until early March these "momentum" stocks could do no wrong. Tesla Motors



TESLA MOTORS

common stock for example, has advanced ~326% over the past year. The companies' shares have gained ~36% from December 31, 2013, through April 21st 2014. However since March 5th, its shares have declined by ~19%. Tesla has no earnings, but sports a market capitalization of ~\$26 billion.

Netflix shares have risen more than 110% over the last twelve months. Its shares command a P/E multiple of ~175x, and has a market capitalization of roughly \$22 billion. Its common equity has also suffered a significant setback recently, losing approximately 17% in value since March 7th. These are just two examples of businesses whose valuations we have a very difficult time quantifying. In our opinion, there are quite a few

more companies that fit into this category. Time will tell if we are right. In the meantime, will the buy the dip crowd step in and support these stocks at current levels, or is this correction, in these type of names, the start of something bigger?

In terms of performance for the quarter, the S&P 500 index outdistanced the DJIA, the Russell 2000 and the NASDAQ, returning 1.81%. The Dow Jones Industrial average lagged the group losing 0.15%. In terms of the ten sectors that comprise the S&P 500, the one that worked the best last year, consumer discretionary, which advanced 43% was the laggard during the initial quarter of 2014 losing 2.80%. Last year's worst performing group, utilities, jumped to the head of the class returning 10.09%.

A Look Ahead

We have been talking about a stock market correction for more than a year. So far, our concern has been proven wrong. As a result, our larger than normal cash position has inhibited our performance.

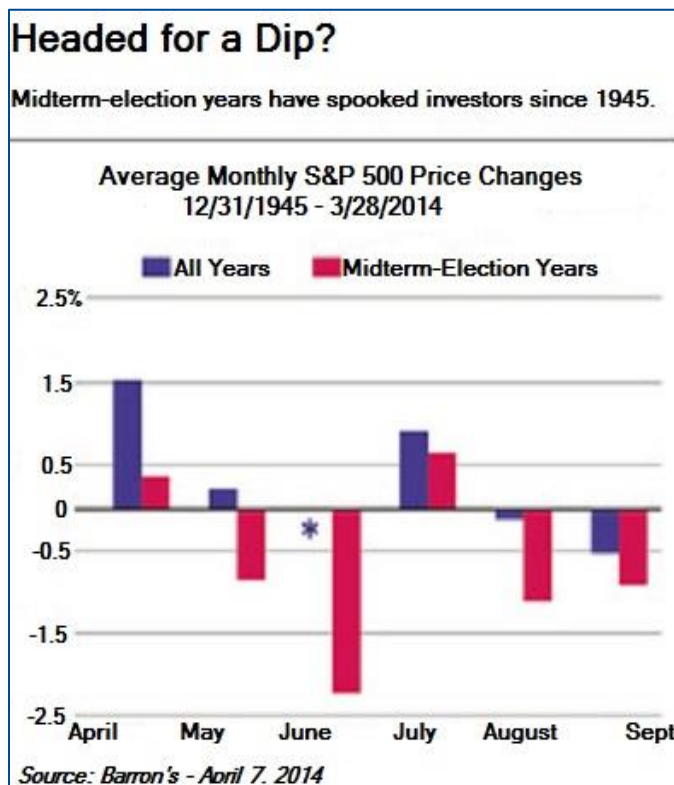
In a rising stock market void of any significant pullback, cash with little or no current return will detract from results. On the other hand, when stocks correct, as they inevitably will, there is a good likelihood our cash position will cushion the blow.

Furthermore, the longer the market advances without a material decline, the higher the probability the drop will be more pronounced. Cash at such inflection points, if utilized properly, results in outsized gains, and more than offsets the period of time when the large cash position inhibited results.

Think of all the opportunities that presented themselves in 2008 and 2009, without cash one would never have been able to take advantage of those bargains.

In the Look Back Section, we opined on a member of issues that usually surface prior to significant stock market corrections. Some of them are currently present and others have begun to surface.

The Chinese economy in general and their real estate market in particular, where a real estate bubble of epoch proportion could burst at any moment greatly concerns us. The European economy is still quite fragile. On top of that, we are faced with midterm elections in the United States. Since 1970, based on total returns, the average second quarter in a midterm - election year produced a 2.5% decline in the S&P 500, versus an average gain of 2.7% during the second quarter for all years, according to Sam Stovall, Chief Equity Strategist for S&P IQ.



Drama, Fear and Gallows Humor as Fed Confronted Lehman's Implosion

We have repeatedly stated that letting Lehman Brothers fail was a terrible mistake that exacerbated the effects of the financial crisis. Two of the government's reasons for allowing it to go into bankruptcy were: Rescuing the bank would create a moral hazard encouraging future risk taking. In addition, government officials have also advanced a legal argument that the Treasury Department did not have the authority to put government money into the firm or provide for its obligations, and that the Fed could not lend money to Lehman Brothers because the bank did not have sufficient capital. We view these reasons with suspicion and believe the decision was extremely short sighted and much of the pain of the financial crisis could have been avoided if the Treasury Department and/or the Federal Reserve orchestrated a rescue of the investment bank. The recently released minutes of the Federal Reserve from five years ago (around the time of the Lehman bankruptcy), shows that the "experts," at the Federal Reserve had absolutely no idea what they were doing or the magnitude of the crisis they were facing.

Below are excerpts from an article that appeared in the Financial Times:

When Lehman Brothers collapsed, the US Federal Reserve struggled to comprehend the danger facing the global economy, according to one of the most detailed portrayals of the fear and confusion that reigned in the autumn of 2008. Transcripts of the Fed's 2008 meetings, released on Friday, show policy makers were split on what to do with interest rates at their September gathering, just days after Lehman's failure heralded the biggest financial crisis since the Great Depression.

According to the transcripts, Fed officials were divided over the merits of looser monetary policy because some worried about high inflation.

"Overall I believe that our current funds rate setting is appropriate, and I don't really see any reason to change," said Mr. Bernanke. "On the one hand, I think it would be inappropriate to increase rates at this point. It is simply premature. We don't have enough information," said Mr. Bernanke. "Cutting rates would be a very big step that would send a very strong signal about our views on the economy and about our intentions going forward, and I think we should view that step as a very discrete thing rather than as a 25 basis point kind of thing."

Janet Yellen, then president of the San Francisco Fed and now chairwoman of the Fed board, introduced a note of gallows humor. "My contacts report that cutbacks in spending are widespread, especially for discretionary items . . . East Bay plastic surgeons and dentists note that patients are deferring elective procedures," she said. "Reservations are no longer necessary at many high-end restaurants. And the Silicon Valley Country Club, with a \$250,000 entrance fee and seven-to-eight-year waiting list, has seen the number of would-be new members shrink to a mere 13."

Excerpt from an article written by Robin Harding of the Financial Times on 2-22-14

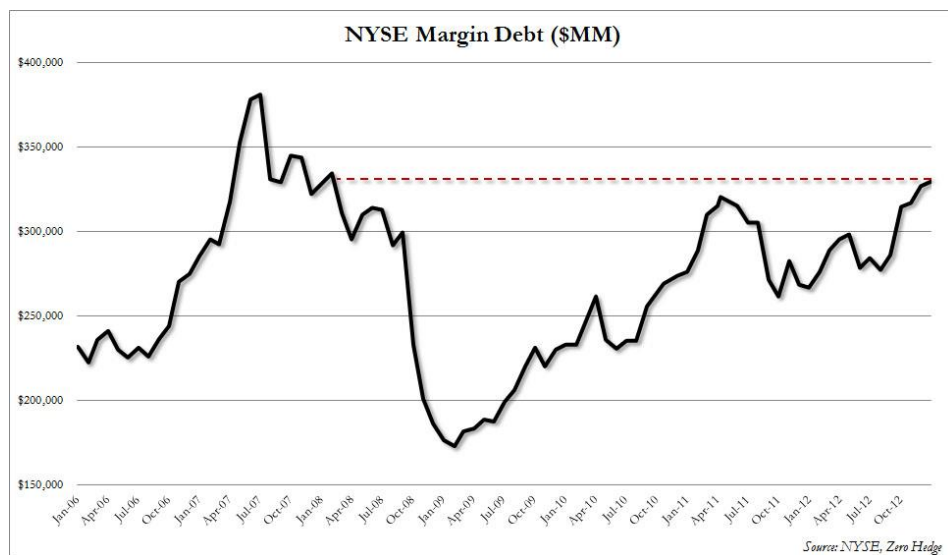
Is There Danger Ahead?

As mentioned in the early part of this letter, we are quite concerned with current segments of the stock market and would not be surprised if a material pullback took place. Two of the reasons we believe this may occur has to do with stock market history as well as the level of borrowed money permeating the market.

Below is an excerpt of an article written by Michael Mackenzie of the Financial Times from March 3, 2014:

US stocks are being propelled to fresh highs by investors borrowing a record amount of money in a high stakes gamble that is raising concerns over the potential for a sharp correction in the five-year bull run. With the S&P 500 registering a fresh closing peak of 1,859.45 last week, margin debt – money borrowed to buy stocks – hit a record level in January, according to data from the New York Stock Exchange.

Peaks in the use of borrowed money have in the past been a precursor to big bear markets and viewed as a warning sign. Though margin debt has been hitting record highs in recent months, it now stands at \$451bn on the NYSE, a rise of more than 20 percent over the past year and above 2007's peak of \$381bn. Five years ago it hit a low of \$173bn. In past market peaks, excessive levels of margin debt exacerbated the subsequent slide in stocks, as investors were forced to quickly sell their holdings as prices fell, sparking a nasty downward spiral.



As Mark Twain once said, "history does not repeat itself but it sure does rhyme." That is why we look at stock market history to help guide our investment outlook. How to invest when the market has advanced materially from its March 2009 lows is quite a challenging task. How much cash should a portfolio have? What type of stocks should we be investing in at this point in the economic cycle? Do we trim existing positions? These are questions we are constantly asking

ourselves. In an article written by Spencer Jakab of the Wall Street Journal on March 5, 2014, he put this bull market into a historical context which we found to be especially interesting. He wrote,

Strategist Sam Stovall of S&P Capital IQ points out that when bull markets reach their fifth anniversary—as the current one will this week—they have historically clocked another 26% gain, on average, if they survived for another year. That would, given today's level, create up to an additional \$5 trillion in U.S. stock-market value. But the same people who suggest that history might repeat, or at least rhyme, ignore less pleasant parallels. The last time pundits trotted out similar measures was in October 2007 when that bull market turned five. It ended just days later. Those who suggested the market could rise into 2008 and beyond had convincing arguments. The market's trailing price/earnings ratio was 16.9 times—actually lower than at the start of that bull run. And stocks had merely doubled from the bottom, a lower increase than in a typical bull market.

Most convincingly, the Federal Reserve had the market's back. Less than a month earlier, it had reduced rates by half a percentage point. Deeper than expected, that cut catapulted the Dow higher by 336 points on the

day. Trimming half a percentage point seems positively quaint compared with trillions of dollars in quantitative easing recently. But it would be foolhardy to assume that monetary policy has rendered bear markets extinct. And for what it's worth, the current bull market has seen the S&P 500 rise by 177%. Today's trailing P/E ratio of 17.9 times, meanwhile, is a full point higher than in October 2007.

Froth in the Market

There are certain sectors of the market (social media, and biotechnology in particular), that has gotten us as a firm particularly concerned. While it has not reached 1999 levels, the similarities between today and the dot.com era are beginning to get strikingly similar. Companies with unproven business models are being given \$10 billion plus valuations, tech companies are paying ridiculous amounts of money for acquisitions for companies with little or no revenues (especially in relation to the price being paid).

As Tim Bradshaw of the Financial Times wrote on March 21st, 2014:

Airbnb is set to join Dropbox and WhatsApp in Silicon Valley's \$10bn valuation club with a private fundraising that will price the upstart home-rental site at \$2bn more than the InterContinental hotel chain. Worth just \$2.5bn after its last round two years ago, the sharp rise in Airbnb's valuation to \$10bn is seen by supporters of the sharing economy as a big endorsement of a new business model. However it also comes amid increasing concerns that a dangerous bubble is building in the valuations of technology start-ups. Airbnb, which takes a commission on every booking made through its site, has never disclosed its revenues or profitability.



Its fundraising follows Facebook's acquisition of WhatsApp for up to \$19bn and, in January, Dropbox raised \$250m in a round valuing it at \$10bn... Airbnb's rise has been meteoric. Founded in 2008 by roommates who rented out beds to help pay for their San Francisco loft, the company said at the end of last year that it has hosted more than 11m guests in 34,000 cities around the world. As well as joining

that elite group of private technology companies in the US to attain an 11-figure valuation, Airbnb is the latest to seek private equity funding that will allow it to delay an initial public offering.

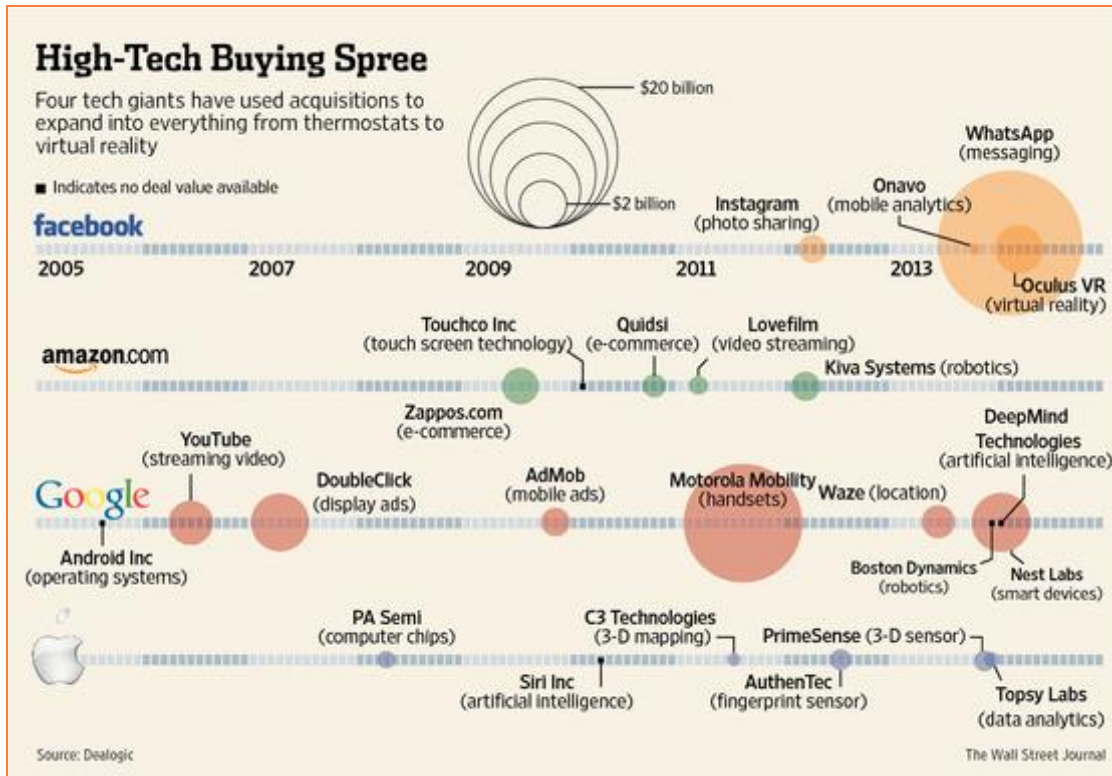
Social media companies such as Facebook have tremendous cash hoards and a valuable currency in the form of an overvalued stock price which they are using to make \$1 billion+ acquisitions at what can only be described as insane valuations. The prices being paid cannot be justified using any traditional valuation technique. To us this spells trouble.

As Reed Albergotti and Rolfe Winkler of the WSJ wrote in a piece on March 27, 2014

Facebook Inc. is spending \$2 billion to get into virtual reality. In the real world, the deal highlights a high-stakes race among the tech industry's giants for continued dominance over a rapidly changing digital landscape. **The acquisition of Oculus VR Inc. comes just weeks after Facebook agreed to buy mobile-messaging company WhatsApp for \$19 billion** [emphasis added]. Google Inc. recently paid \$3.2 billion for Nest Labs, which makes Web-connected home gadgets.

From messaging to watches and thermostats, Facebook and Google, along with Amazon.com Inc. and Apple Inc., each want to own the digital platform where people communicate, shop and seek entertainment. The competition is driven by their ability to pay—their combined market capitalization exceeds \$1 trillion—and long memories of faded tech stars that didn't evolve quickly enough.

This combination of fear and primal ambition is leading to one of the biggest buying and investing sprees since the dot-com era of the late 1990s. Facebook and Google, in particular, have enjoyed wide latitude to make big investments, thanks to their booming stock price and their founders' super-voting shares.



Facebook Chief Executive Mark Zuckerberg "is aware of all the big companies that died because they rested on their laurels," said Jeff Richards, a managing partner at venture-capital firm GGV Capital. "It once took decades to build a company as large as Facebook. Now it takes 10 years," he said. Facebook has been drawn to social networks with huge user bases, as it seeks to pull more people into its sphere and gather more knowledge about them for advertising purposes. In 2012, Facebook acquired photo-sharing app Instagram for \$1 billion. It followed that up with the WhatsApp deal last month.

Why do so Many Investors Invariably Get it Wrong?

Study after study demonstrates that the typical investor doesn't do nearly as well as the typical investment. So, why does this underperformance occur? The easiest response would be to blame it on someone else, perhaps your broker. The truth of the matter is we perform less well because we do it wrong.

Our first major flaw is that we buy and sell too often. In 2000, Brad Barber and Terrence Odean studied the trading performance of more than 65,000 retail investors with accounts at a large discount broker. Looking at the early 1990s- happy days for investors - Barber and Odean found that while an index reflecting US stock markets returned 17.9% a year, the investors who traded most actively earned just 11.4% per annum - a huge shortfall that becomes even more dramatic after a few years of compounding. The investors who hardly traded at all were rewarded with market-matching investment performance.

Our second tragic flaw is our tendency to buy high and sell low. When things look the bleakest investors tend to flee from the market. For example, in 2008 and 2009 in the midst of the financial crisis, when stocks



were on the bargain basement table, investors were net sellers by a wide margin. They fled the market in droves, investing their money in the presumed safety of bonds, that were yielding a paltry couple of percent. Towards the end of 2013 and the first quarter of 2014, after the U.S. stock market had advanced by roughly 170% since 2009 they became net buyers of equities. As we have said on numerous occasions, investors have this uncanny ability to zig when they should zag.

Meanwhile the works of Stefan Nagel and Ulrike have discovered that stock market returns in our formative years shape a lifetime of investment behavior. An awful bear market scares away a generation of young investors, just as they are being presented with a buying opportunity.

Two tragic flaws are probably enough but here is a third: Odean also showed, in 1998, that investors had a tendency to sell shares that had risen in value while holding on to losing investments, despite tax incentives pushing in the opposite direction. In Odean's sample of investors, this bias has pulled down investors' returns. These flaws are very fixable. Buy stocks for the long term. Purchase them when they are out of favor, preferably during periods when things look the bleakest. Sell them only if they get blatantly overvalued. Remember, every time you sell shares, your partner, Uncle Sam, takes his cut, and your investable capital is reduced by a minimum of 25% of your gain. By deferring your gains as long as possible your after tax returns are significantly enhanced. Remember, it's not only what you make, it is what you keep.

Unfortunately, this advice is difficult to adhere to in the modern world. We are exposed to too much noise. Social media and financial broadcasting among others has created a herd mentality. They tend to both excite and frighten investors, certainly not conducive to long term investing. Warren Buffett, a great long term investor, whose ideal holding period is "forever," lives in Omaha, and not New York for a reason. So, when the inevitable bear market arrives, don't panic, embrace it. Everyone loves sales, except when it pertains to the stock market. Don't let your emotions get the better of you. When you get that awful feeling in the pit of your stomach, that is the time to load up on equities. Conversely, when you feel euphoric, watch out! Remember, bear markets are an inevitable part of the investment process, without them outsized gains will never occur.

*Condensed from a Financial Times Article, penned by Tim Hartford, dated March 30, 2014
Additional information provided by the Boyar Value Group.*

Is Value Investing Bred in the Bone?

Some people become value investors. Some might be born that way. Consider Benjamin Graham, Warren Buffett's mentor and the author of "Security Analysis" and "The Intelligent Investor." Graham's widowed mother was a small-time speculator; she was wiped out during the Panic of 1907, when he was 13 years old. Graham never forgot the "humiliating" moment in his childhood when his mother sent him to cash a check and the bank teller asked the manager if Mrs. Graham was "good for five dollars." Graham grew up to favor companies so universally despised by investors that the stocks were, as he liked to say, "worth more dead than alive." He resoundingly beat the market over his multidecade investing career.

Or take the late Sir John Templeton, who grew up the son of a country lawyer in Winchester, Tenn. Templeton's father also was a speculator, trading cotton futures. He arrived home one day and told his young sons, "Boys, we've lost it all; we're ruined." Templeton worked odd jobs to scrounge his way through college and graduate school. In 1939, at age 27, Templeton told his broker to buy him \$100 worth of every listed U.S. stock trading for \$1 a share or less; he quadrupled his money in four years.

"People are always asking me where the [investing] outlook is good, but that's the wrong question," Templeton once said. "The right question is: Where is the outlook most miserable?" Their experiences might have shaped Graham and Templeton to favor cheap "value" stocks over fast-moving "growth" stocks. But that preference might also have been encoded in their genes.

In a speech at Babson College in 2010, the renowned value investor Seth Klarman remarked that research on fruit flies showed that most of them will swarm toward a light—but that a small minority appears to be genetically programmed to stay away from it. Mr. Klarman, president of the Boston-based Baupost Group, which manages \$26 billion in hedge-fund assets, jokingly called these flies "tiny contrarians," the insect equivalents of "deep value investors..." A new study finds that many investors may in fact have a genetic predisposition to hunt for bargains in the stock market—although the environment you grew up in also powerfully shapes the kind of investor you become.

In the study, three economists—Henrik Cronqvist and Frank Yu of China Europe International Business School in Shanghai and Stephan Siegel of the University of Washington—examined the genetic makeup and investment portfolios of 35,000 twins in Sweden. Identical twins share 100% of their DNA, while fraternal twins share about the same amount as brothers and sisters. The researchers compared the similarity of the portfolios held by identical twins and by fraternal twins. That enabled the economists to estimate the extent to which the same combinations of genes were associated with similar portfolios.

The analysis shows that the average stock held by these investors traded at a price/earnings ratio of 23 times. Only a 10th of the investors—call them "deep-value hunters"—held stocks with an average P/E of 11.6 or lower. One quarter of all the investors—hard-core growth seekers—held stocks trading at an average of 28.6 times earnings or higher...

According to the study, up to 24% of the differences in the degree to which investors favor value or growth stocks can be explained by variations in their genetic code. It appears that favoring cheap value stocks or fast-moving growth stocks isn't just a preference; "it is at least partly an innate tendency," says Prof. Siegel.

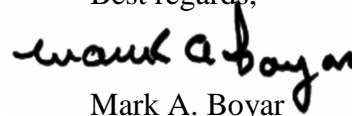
Environmental influences also help explain the "tilt" toward value or growth investing, the researchers found. For example, if the economy was in a severe recession when an investor was between the ages of 18 and 25, or the investor's parents were relatively poor, he is more likely to prefer investing in cheap stocks...

But the new findings suggest that you should ask financial advisers and investment managers: What adversity have you had to overcome in your life? And what does being poor mean to you? After all, a financial adviser or investment manager who has never overcome a serious obstacle might not have what it takes to hold on to cheap stocks when they get a lot cheaper in a hurry. A value investor who can't withstand pain isn't a value investor at all.

Excerpt from an article written by Jason Zweig of the WSJ from 2-22-14

If you have any questions or comments, please do not hesitate to call.

Best regards,



Mark A. Boyar



Jonathan I. Boyar

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