



*"My largest positions are not the ones I think I'm going to make the most money from.
My largest positions are the ones I don't think I'm going to lose money in.*

— Joel Greenblatt

July 29th, 2015

Some Thoughts About The Market

In the June 22nd, 2015 edition of Barron's Ben Levisohn wrote a very interesting column that quite aptly describes the stock market's performance since the start of the year:

The Pause That Refreshes

Waiting can make something more exciting, but wait too long and anxiety sets in. That's true whether you're waiting for a loved one at the airport-or for the stock market to finally make a move. If it feels as if the Standard & Poor's 500 has been in a rut, well it has. No matter what has happened - an icy economy, oil's collapse, the dollar's rise - the market has kept us on the edge of our seats with its extended pause. That's starting to take a toll. Investors have lost that bullish feeling; at least one has gone so far as to buy massive amounts of insurance, in case the market finally heads lower. But here's the thing: The longer the S&P 500 stays in place, the more likely it is to head higher.

You're not imagining the malaise that has gripped the S&P 500. The index hasn't been down more than 3.2% or up more than 3.5% in 2015. That is the closest it has stayed to the starting line this far into the year, according to Bespoke Investment Group. In fact there have been just three years-1952, 1993, and 2004 - when the index hasn't been up or down more than 5% at any point through early June. And the little guy isn't feeling so great either: Just 25% of respondents to the latest American Association of Individual Investors sentiment survey called themselves bullish. That's the seventh week in a row that the percentage of bulls was under 30%, the longest such streak since 2003.

There might be something not nefarious at work. From 2012 through 2014, the S&P gained 18% a year, while earnings grew by just 5%, according to David Rosenberg, chief economist and strategist at Gluskin Sheff. The market is now in a resting period where the "E" (earnings) has to play some catch-up to the "P" (price), he explains... Paul Hickey of Bespoke Investment Group looked at the 10 years during which the S&P 500 stayed closest to where it had started during the first 117 days. He found that it has risen 6.6% on average, in the rest of those ten years. Says Hickey: "A sideways market can be a correction in time, not price. Expect things to drift higher from here." Good things come to those who wait"... Time will tell if that old adage holds true.

Second Quarter 2015 Performance

The stock market's second quarter performance was negatively impacted by a variety of factors including a tepid economy, a continuing weakness in the price of oil, the dollar's advance and of course Greece, a country whose population approximates 11 million (roughly the size of Ohio).



Utilities were the worst performing sector in the second quarter declining by 5.80%, followed by industrials which dropped by 2.23% and energy which fell by 1.88%. In a rising interest rate environment, utility stocks tend to significantly underperform. Last year when interest rates were more docile this sector advanced by 28.98%. Through June 30th, the utility sector has declined by more than 10%. Health care, consumer discretionary and financials were the best performers advancing 2.84%, 1.92% and 1.72% respectively. Five out of the ten sectors that comprise the S&P 500 were in the red.

The best performing index in Q-2 was the NASDAQ, a technology laden index which advanced by 1.75%, and the worst performer was the DJ Industrial Average which declined 0.29%. The S&P 500 posted a 0.28% gain.

A Look Ahead

In our first quarter letter we opined on a number of factors that we thought could influence the direction of the market during the remainder of 2015. We still believe these factors remain relevant, and thought it would be a good idea to revisit a few of them. We also thought we should comment briefly on Greece and China.

- *The Strong U.S. Dollar*

Although it is true the U.S. economy as a whole is not overly exposed to exports, however, many of our largest and most influential companies are. This could possibly lead to an erosion of confidence on the part of CEO's with the potential to slow both investment decisions and future domestic growth. As we indicated in last year's letter to clients, large U.S. based entities doing business abroad will be adversely impacted by a rising dollar. During the first half of the current calendar year a good many of these companies saw their common equity significantly underperform the Russell 2000, a basket of smaller businesses, who for the most part do little or no business outside the U.S. and are not faced with this headwind.

- *The Sharp Price Decline In Petro*



The dramatic and swift decline in the price of oil is a double-edged sword. Consumers have enjoyed a significant windfall during the past year saving them as much as \$75 billion. At some point this money will be spent. There is usually a lag time, however, before the consumer feels comfortable enough with this newfound wealth for them to actually spend it. Initially this money is saved. The U.S. savings rate has enjoyed a nice spike since the price of oil has nosedived. On the negative side, the slide in the price of oil has seen capital expenditures in this sector plummet, a reduction in oil related employment has commenced, and a slide in real estate prices in certain oil producing states has materialized. This is worrisome, since in the past few years some of the highest paying jobs have been created in the petroleum space.

- *Higher Interest Rates*

The Federal Reserve has made it abundantly clear that it intends to raise interest rates in the not too distant future. It has been widely thought the initial increase could come as early as September. However, the crisis in Greece may delay the first rate increase until the early part of next year.

- *Volatility*

During 2014 the U.S. stock market experienced some stomach-churning bouts of restlessness and at least three rounds of dips in the S&P 500 of more than 5 percent. The early part of October saw that index decline by almost 10%, before rallying to new all-time highs. During the first two quarters of the current year we have already experienced a number of 2%-3% declines...expect more of the same. One more point: although the S&P 500 is within a couple of percent of its all-time high, 100 of the 500 stocks that comprise that index have declined by 20% or more over the past year.

China and Greece

- *China*

We have been writing about the frothy housing market in China for quite some time. We indicated that the Chinese housing market currently has the same characteristics that the U.S. experienced in 2007: a significant oversupply of homes, coupled with home prices that are not affordable by the vast majority of Chinese citizens. In fact the average home price relative to what the average Chinese worker earns makes Beijing among the least affordable places to live on the planet.

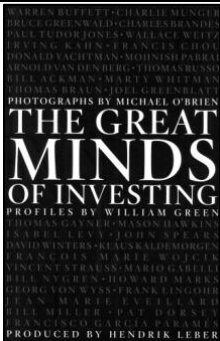


China is now faced with yet another potential bubble. The Shanghai stock exchange has rocketed more than 80% over the past twelve months. Since hitting a seven year peak of 5,166.35 on June 12th, the market has fallen ~1/3. The decline has been triggered by a host of factors, including an unwinding of margin trading and concerns over lofty valuations. With the Chinese economy already showing signs of dramatically slowing, China cannot afford to have two bubbles burst at precisely the same moment in time.

- *Greece*

The problem that Greece faces is more than five years old. In the simplest of terms Greece is bankrupt. Despite the latest “rescue” whether Greece remains in the European Union is anybody's guess. The bigger question is if Greece cannot resolve its problems will there be a contagion effect similar to what happened when the Federal Reserve let Lehman Brothers fail? Will Portugal and Italy, for example, experience the same fate as Greece? The entities with the largest exposure to Greek debt appears to be the European banks. There is a good chance we will see how well prepared they are for this crisis in the not too distant future.

The Great minds Of investing



Although I have not as yet read the recently published book "The Great Minds of Investing" penned by William Green, which profiles 33 renowned investors, an excerpt that appeared on CNBC's website peaked my interest. Throughout the years I forged business relationships and friendships with a number of those featured in the book. A couple of the authors' favorite lessons appear below:

Irving Kahn

I met Irving sometime in 1975 or 1976 when I was a young analyst, and he was already a legend on Wall Street. Irving died in February of this year at the ripe old age of 109. Irving pretty much went into the office each day, even towards the end of his life. My son Jonathan can attest to that since I arranged a meeting with the three of us about 1.5 years ago in his office.

In the late 1920's Irving served as a teaching assistant to Benjamin Graham at Columbia University. Graham, the father of value investing, taught disciples such as Kahn and Buffett to buy undervalued assets that offered a significant "margin of safety." Graham's risk-averse approach helped Kahn prosper through the Great Depression, World War II, Vietnam and many other tempestuous times.

What's his single most important piece of financial advice?

"Safety. Considering the downside is the single most important thing an investor must do. This task must be dealt with before any consideration can be made for gains. The problem is that nowadays people think they are pretty smart because they can do something quite rapidly. You can make the horse gallop. But are you on the right path? Can you see where you're going?"

Kahn said he learned from Graham that investors should focus first on preserving their capital, Instead of aiming to shoot the lights out. "If you achieve only reasonable returns and suffer minimal losses, you will become a wealthy man and will surpass any gambler friends you have."

Bill Miller

As the manager of Legg Mason Value Trust, Bill Miller achieved the historic feat of beating the market for 15 consecutive years. In one catastrophic year, however, everything came tumbling down. When the financial crisis struck, Miller was terribly exposed to some of the worst-hit areas of the market. Legg Mason Opportunity Trust plunged 65%. Investors fled in droves.

Yet what stands out most is Miller's emotional resilience in the face of adversity. As the market imploded, he didn't hide in a corner, nursing his wounds. He gathered all the cash he could muster and invested it in cheap stocks that have since surged. Miller didn't find it difficult to buy while others ran for cover.

"I'm contrary in the sense that paper losses, quotational losses, just leave me to think there's more opportunity," he explained. After all, "lower prices mean higher future rates of return. They don't mean higher risk." Intriguingly, Miller surmises that the best value investors are "wired differently" so that the part of their brain that registers financial loss doesn't react in the same way as it would the average investor. Miller describes himself as "very emotionless," and sees a similar lack of emotion in investors like Buffett.

Howard Marks

In 1995 Howard Marks co-founded Oaktree Capital Management, which has since grown into a behemoth with more than \$90 billion under management. His memos to investors have also earned him a reputation as a financial sage. One fan Warren Buffett, wrote: "When I see memos from Howard Marks in my mail, they are the first thing I open and read."

Marks said his investment success stems from a "moment of enlightenment" when he was a student at the University of Chicago. He learned there that it's hard to find bargains in a widely followed market, so he should focus instead on less efficient niches where hard work and skill were likely to pay off. This led him to invest in junk bonds in the late 70s when most investment firms thought they were too risky to touch. He then invested in the debt of bankrupt companies-a niche that many regarded as disreputable. The unpopularity of these assets created tremendous opportunities to find bargains.

When Lehman Brothers collapsed in 2008 and markets were in free fall, Marks wrote a memo cheerfully explaining his belief that this wasn't "the end of the financial system" but "just another cycle to take advantage of." While most investors were too scared to snap up the bargains, his firm invested about \$500 million a week as the market experienced a precipitous decline - and made a fortune as it recovered.

While acknowledging the importance of intelligence, diligence, and perseverance, Marks insists luck has played an equally crucial role in his life. For example, he attended the University of Chicago only because Harvard rejected him. And he would have worked at Lehman Brothers, but the partner assigned to inform him that he was being hired there had a hangover and failed to phone him. "I'm a big believer in randomness," Marks said. "I walk around with this incredible feeling that I'm a lucky guy."

Commentary by William Green, author of "The Great Minds of Investing," as it appeared in CNBC online. Additional information supplied by The Boyar Value Group.

A Fifth of Big Stocks are Currently in a Bear Market.

In the early stages of a bull market the vast majority of stocks perform very well. As the bull ages the number of stocks that continue to shine diminishes. It is during these uncorrelated periods that stock market indexing usually takes a back seat to active investing. Time will tell if this holds true in year six of this bull run.

In a CNBC online article written by Matt Krantz he opines - Investors are nervously awaiting the death of the bull market - and the start of the bear. That day will come. But it is already here for 20% of big companies. One hundred of the stocks in the S&P 500, including Delta Airlines, retailer Wal-Mart Stores and oil exploration firm Transocean, are down 20% or more from their 52- week highs. A drop of 20% or more is the unofficial definition of a bear market-the point that a stock drop gets especially painful.



What's even more worrisome is just how many stocks are falling apart. A year ago - only 21 stocks - or 4% - in the S&P 500 were down 20%. Seeing such a large erosion is a dramatic wake up call for investors - who have been lulled into thinking this market can soldier higher no matter what.

Market reversals are insidious in that they start to happen often long before most investors even notice. Gains or stability by stocks with the highest market values can easily mask the breakdown in a growing number of companies beneath the surface. The current market overall has been relatively stable. The S&P 500 in the aggregate is only a couple of percent from an all-time high and is up around 2% for the year so far. But that tranquility is little comfort for investors in the companies that are down the most from their 52- week highs.

CNBC online dated June 10, 2015 penned by Matt Krantz. Additional Research Boyar Value Group.

Chinese Equities: Caveat Emptor

The bull case for China as both an economic and military superpower is certainly nothing new. Napoleon famously said, “Let China sleep; When she wakes she will shake the world.”

China is in the midst of transferring from an export led economy to a consumer driven one. With 1.3 billion people and an expanding middle class it is not inconceivable that one day China could become an economic superpower. China through the leadership of President Xi has been reforming the economy to help make this occur. Recently there has been an historic crackdown on corruption as well as the implementation of various capital market reforms presumably to help attract foreign investment. However the recent actions of the Chinese government in an attempt to stabilize equity markets have dramatically delayed the above-referenced ascension to superpower status.

From July 2014 through June 12th 2015, the Chinese stock market experienced a spectacular bull run increasing in value by ~150%. Both state controlled media with editorials proclaiming “the good times were just beginning” and brokerage firms acting as stock market cheerleaders helped fuel the rally. The Chinese authorities according to an article penned by *Wall Street Journal* columnist Jason Zweig made a rising stock market such a priority that they even encouraged investors to buy shares on margin. The amount of outstanding



Chinese margin loans eventually exceeded \$320 billion. In fact, some investors called the stock market rally “a state bull market,” or an “Uncle Xi Bull Market,” implying it was a gift to the Chinese people by their benevolent leader.

Since the June 12th peak when stocks on the Shenzhen stock exchange were trading at ~69x earnings, the market has fallen ~1/3 and is now being valued at a rich ~45x earnings (the average price to earnings ratio of stocks globally is ~18.5x). Stock market corrections are an important part of the investment process and unfortunately cannot be prevented regardless of state action. What should give investors pause before investing their money in Chinese equities is how the government responded to this “normal” yet politically and economically painful event. Instead of letting market forces prevail and allowing a natural correction to occur, the Chinese government attempted to control the fallout with aggressive state intervention. Below is a list of some of the actions the government undertook to stop the bleeding:

- Suspension of initial public offerings
- Prohibiting short selling
- Easing the rules on margin loans allowing investors to use their homes as collateral
- Lowered interest rates and the amount of capital reserves banks needed to hold
- **Offered financial support to a group of 21 brokerages that have pledged to buy 120 billion yuan (\$19.3 billion) worth of shares and hold them for a year.**
- **Banned major shareholders and company executives from selling their shares for 6 months**
- **Trading of 1,300 stocks representing \$2.6 trillion of capital was halted (this is equal to ~40% of the entire Chinese stock market).**

Massive government intervention in capital markets in order to stabilize share prices does not have a successful track record. For example, after the Japanese stock market collapsed in 1990, the Japanese government bought billions of dollars’ worth of company shares. **However, the Nikkei is still 49% below its 1989 high.**

While the Chinese government may succeed in stabilizing the stock market temporarily (it is still too soon to tell), it has in our opinion taken a giant step back in making the country a place where foreign investors should feel comfortable allocating capital to. We are not alone in our negative assessment; BlackRock Chief Executive Larry Fink stated on his company's latest earnings call, "If they continue to prop it up artificially there are going to be fewer global participants when they open it. It is imperative that China continues on its path of reform and liberalization by allowing more people to participate." While the U.S. in times of financial panic (i.e. 2008) has taken *some* of the steps the Chinese undertook (lowering interest rates and prohibiting short selling in certain securities), the measures taken by the Chinese from an investor protection standpoint are downright scary.

One of the primary reasons investors are attracted to the stock market versus real estate or private equity is the liquidity factor. Even when an exogenous event occurs, such as the September 11th terrorist attacks, the NYSE opened a week later, knowing full well there would be enormous selling pressure. The fact that the Chinese government has effectively banned trading in approximately half of the publicly traded Chinese stocks and has forbidden major shareholders from selling shares for a fixed period of time is a dangerous precedent. It is also worth mentioning that by banning trading in certain company shares and not allowing major shareholders to trade, the government is greatly masking the true extent of the share price decline. Larry Fink in the above-referenced call summed it up well, "*We need scary weeks...Scary weeks make the market more secure. The absence of scary weeks leads to irrational exuberance.*"

The question for stock market investors with no direct Chinese equity exposure is could the Chinese stock market rout cause a worldwide contagion? After all, many U.S. and European companies are pointing to China for their future revenue growth. We think the odds of a significant contagion are somewhat remote for the following reasons:

- During the recent Chinese stock market rally economic growth actually moderated for the first time in 20 years.
- The value of freely floating shares is about 1/3 of Chinese GDP compared with more than 100% of GDP in most developed countries.
- Chinese equities account for just 15% of household assets.
- Margin debt only accounts for 1.5% of total bank assets.

The real issue is what has this massive government intervention done for future Chinese growth prospects? In order for the country to continue its rapid expansion, it needs access to equity capital. These recent moves will make foreign investors think twice before investing in the Chinese capital markets and they will certainly value their prospective investments accordingly to take into account this new political risk. The Chinese government now needs to prove to the world that they are committed to free markets before foreign investors will begin to commit capital again to help fund their economic expansion. In the meantime, at least in our opinion when it comes to investing in Chinese stocks *caveat emptor*.

Beware of Bond Funds!

At the risk of sounding like a broken record, we wanted to bring your attention to an article that appeared in the July 13, 2015 edition of Barron's that discusses the dangers of investing in bonds in general and in bond funds more specifically. Excerpts from the article are below.

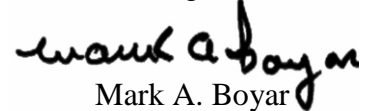
- "The absolute best-case scenario for bond investors is that rates remain low in the near future, which means your best hope is the status quo with no upside," says Robert Johnson, president and CEO of the American College of Financial Services. "If you lock in bonds at these levels, you're locking in a purchasing-power loss."

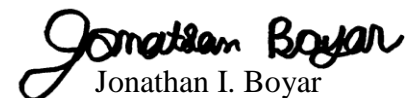
- When interest rates do finally swing the other direction, investors will most likely flock to newer, higher-yielding bonds, and the prices of today’s bonds will decline, perhaps precipitously. Investors who own individual bonds and hold them to maturity are insulated, of course; barring a default, they’ll still get their principal and interest. **Bond mutual funds and exchange-traded funds are a different story. These funds, by and large, don’t aim to hold bonds to maturity, and even if they did, the strategy works only if investors stay put. If fund investors run for the exit, managers have no choice but to sell into a declining market.** (*emphasis added*)
- Further complicating matters are growing concerns about liquidity in the bond market. Broker-dealers are no longer willing to buy bonds unless they have a buyer already lined up. Meanwhile, the proliferation of ETFs has paired ultra-liquid vehicles with not-so-liquid assets. “If you have a bond fund or an ETF, you don’t have any maturity. That’s not a bond; that’s a stock,” says Ron Weiner, CEO of RDM Financial Group, a wealth-advisory firm with offices in Connecticut and Florida. “There is a real, real risk in bond funds.”

Famed investor Carl Icahn seems to share our view. At the CNBC Delivering Alpha Conference on July 15th he called BlackRock, the world’s largest money manager, “an extremely dangerous company,” referring to the fact that it offers individual investors and institutions access to junk bond ETFs which he believes has contributed to a bubble in high yield bonds. He also stated that he believes junk-bond ETFs will be much harder to trade in the next downturn leading to big losses for individual investors.

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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