Boyar asset management

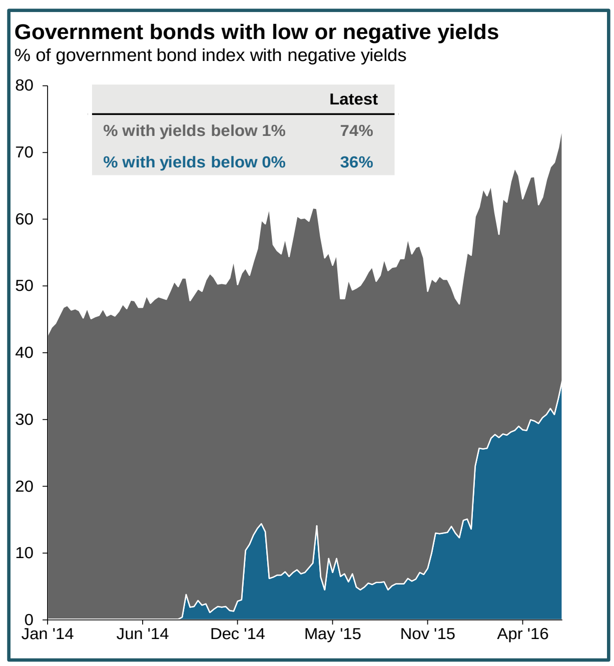
July 31st, 2016

Some Thoughts About The Market

The two-day decline in the U.S. stock market subsequent to Great Britain's decision to exit the European Union saw the Dow Jones Industrial Average plummet by 871 points. However, it climbed 809 points in the next four days and continued its ascent thereafter.

This leaves investors in a familiar quandary: Questioning what catalysts could spur the market to new highs. In our last quarterly letter, we mentioned the Federal Reserve had forecasted four interest rate hikes for 2016. We opined that in all likelihood there would be only one additional rate hike, and that might not come until after the presidential election. The fragile global economic outlook coupled with anemic domestic growth has caused the Fed to temper its interest rate outlook. With all the global uncertainties we believe there is a high degree of probability no rate increase will occur until at least 2017.

Interest rates worldwide are at historically low levels. From 1958 through the present, **the average U.S. 10-year treasury yield was 6.19% versus 1.49%** as of the end of the most recent quarter. Central Banks in an effort to stimulate their economies are driving interest rates lower and lower. **Amazingly, according to J.P. Morgan Asset Management, 74% of sovereign debt outstanding currently yields below 1% and 36% of government bonds have negative yields**.

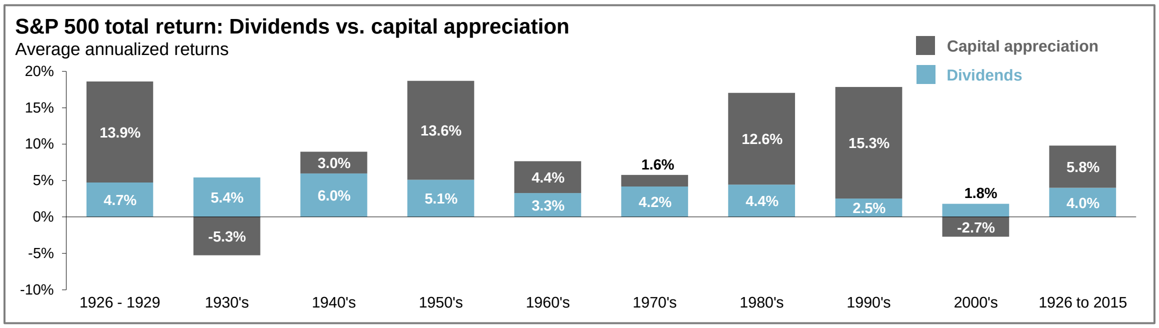


Source: J.P. Morgan Asset Management.

Dividend Income versus Fixed Income

It is highly unusual for dividend returns to be significantly higher than government bond yields. When it occurred in the 1950's, investors who bought stocks whose dividends yielded more than bonds were richly rewarded. We are confident that history will once again repeat itself, and patient long term investors who purchase a basket of dividend paying stocks that have the capability of increasing their payouts will significantly outperform bonds over the next five to ten years.

It is critically important for investors to understand the importance of dividend payments to long-term stock returns. **From 1926 to 2015, the S&P 500 increased on an annual basis by 9.8%: Dividends were responsible for over 40% of that appreciation.** While collecting dividends is not the most exciting/glamorous part of investing, they are one of the most critical drivers to generating long-term returns.

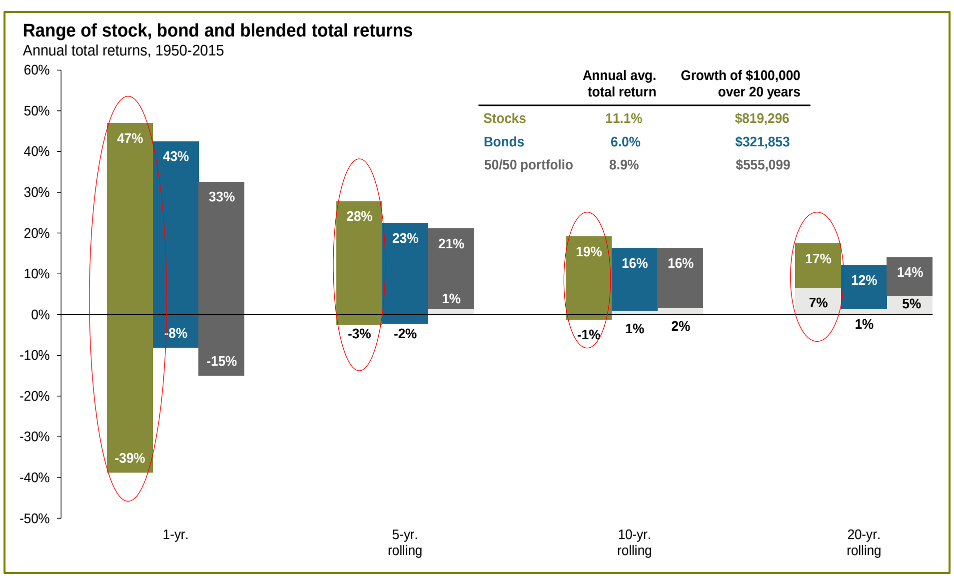


Source: J.P. Morgan Asset Management

<u>The Importance of Staying the Course</u>

We are currently facing a number of factors that might cause investors to question either their ability or even the wisdom of staying the course. Besides all of the negative headlines out of Europe, we are also approaching a contentious election in the United States. China still remains a concern, and the U.S. stock market continues to march lockstep with the price of oil. It is important to remember the best time to purchase common stocks is during times of uncertainty when share prices are falling. As the late Shelby Davis, an investor who amassed a sizable fortune, once said, "You make most of your money in a bear market. You just don't realize it at the time."

While it goes without saying that past performance is no guarantee of future results; history does have a funny way of repeating itself (or as Mark Twain said, at least rhyming). As the chart below demonstrates, in any one-year period since 1965, stocks have increased by as much as 47% in a single year and have decreased by as much as 39%. However, this wide range of investment returns narrowed significantly the longer an investor's holding period. Over a ten-year time frame, the stock market has advanced by as much as 19% per annum but the worst 10-year period produced a loss of only 1%!



Source: J.P. Morgan Asset Management.

If you look at any 20-year period, the results skew even more in investors favor with the highest average annual return being 17% and the lowest average annual return being a positive 7%! The key to having the best chance of long-term investment success is to have a plan with a strategy you believe in and stick with it through both good times and bad.

Performance

Most of our accounts underperformed for the first half of 2016. Our underperformance relative to the S&P 500 can be directly attributable to two factors.

1) The best performing sectors within the S&P 500 were utilities (up 23.4%) and telecommunications (advancing 24.8%) which our clients had minimal exposure to. Utilities are considered "safe stocks" due to their stable earnings and high dividend payouts. However, at the present time, the group currently sells at 22.1x earnings versus a historical average of 15.5x. We believe utility investors are being lulled into a false sense of security **and are solely focusing on the sector's current dividend rate and not the price they are paying to receive that payout**. When interest rates rise, enabling investors to receive an adequate yield from government bonds, we think individuals will flee utility stocks en masse (as they are currently investing in utility stocks mainly as a bond substitute). Our only advice: caveat emptor. **Remember, future investment returns are not only influenced by picking the right stock, but equally important is the price you pay for it.**

2) Financials (down 3%) were the worst performing sector in the S&P 500 further negatively impacting our returns. As we have stated in previous letters, utilizing almost any acceptable valuation methodology, financials have not been this inexpensive since 2008-2009. When interest rates begin to rise (and they will someday, it is just a matter of time) this group has the capability of handsomely rewarding patient investors.

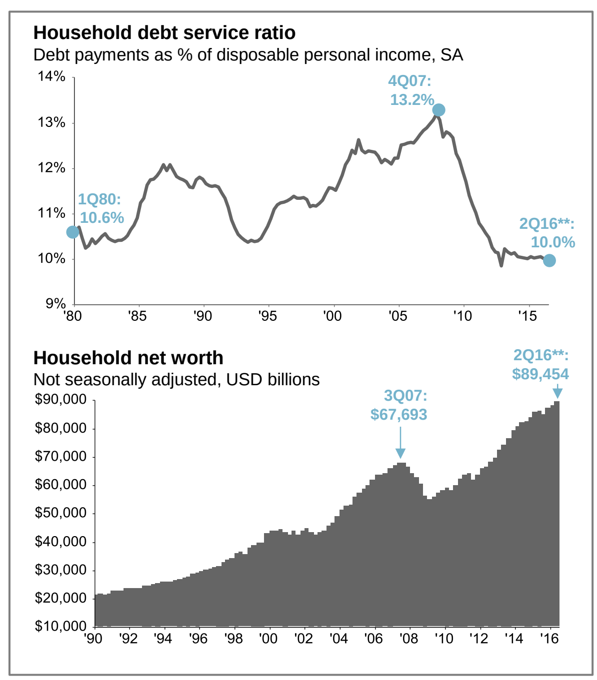
A Look Ahead

While the world continues to be a scary place and we would expect continued market gyrations going forward (especially in the run up to the U.S. presidential election), we are generally bullish about both the U.S. economy and the stock market from a long-term perspective.

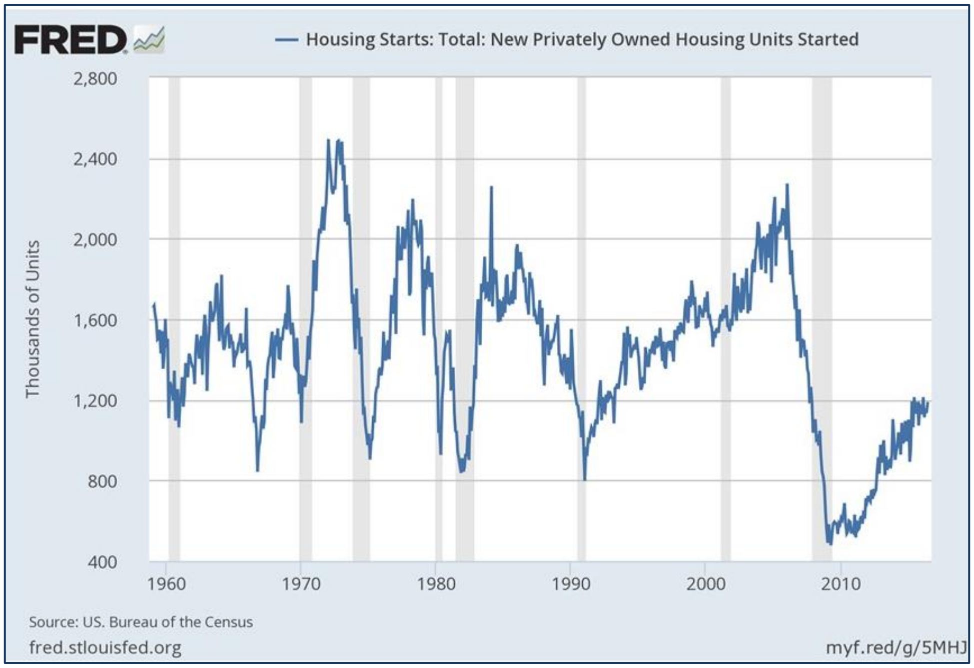
Some Reasons to be Bullish

1) The U.S. consumer is in reasonably good shape as household net worth has increased by almost 30% since 2007. According to J.P. Morgan, the average U.S. consumer has seven dollars of assets for every dollar of debt. At some point, he/she will begin to spend greater sums of money further stimulating the economy. In addition, one positive effect of the low yield environment is that households have either refinanced or purchased a new home taking advantage of historically low interest rates. This has resulted in household debt payments as a percentage of disposable income to be at a 35-year low.

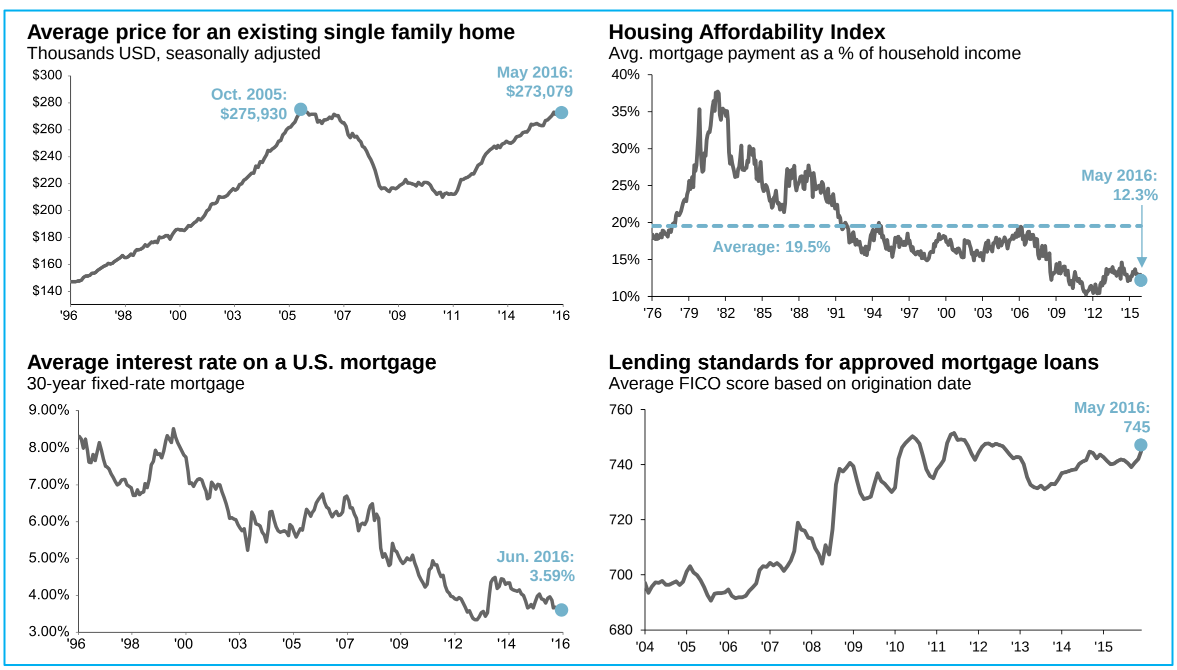
2) We believe U.S. housing will be a significant driver of the economy going forward as the current housing supply is low by historical standards. Since the 2008-2009 financial crisis, new home starts have been far below their long-term average of ~1.3 million homes per year. When new homes start to be constructed at a faster rate, this should provide the economy with a further boost.



Source: J.P. Morgan Guide to Markets



In addition, in most parts of the country, (with some major exceptions such as New York City, Miami, and San Francisco) housing is still affordable. As the charts below illustrate, the average price for an existing single family home is currently at 2005 levels and mortgage payments as a percentage of household income are close to an all-time low. What a great time to buy a home!

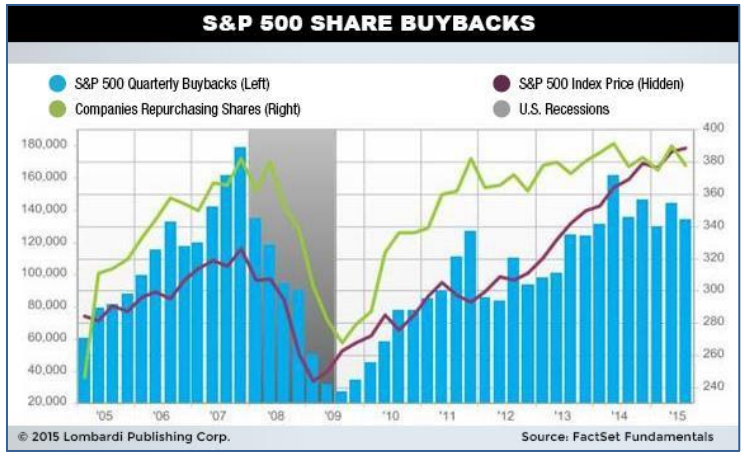


Source: J.P. Morgan Guide to Markets

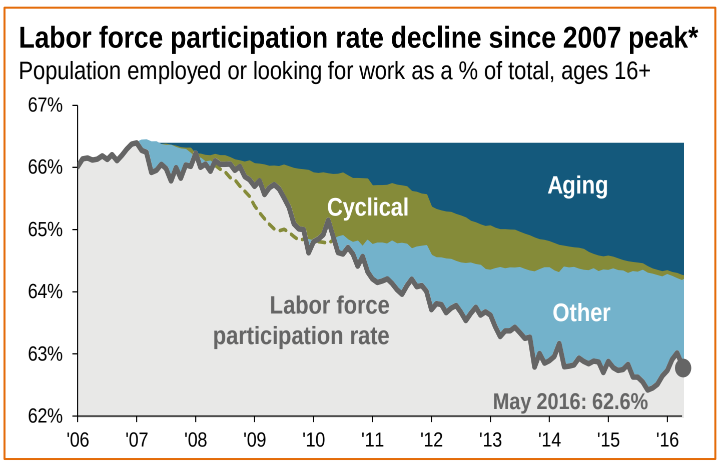
Some Causes of Concern

While we are generally optimistic about the economy and future long-term stock market performance, there are still some areas of concern.

1) Corporate buybacks are close to 2007 levels. Corporations like individual investors have the uncanny ability to buy high and sell low.



2) The economic recovery has not been democratic in terms of participation as anyone paying even the slightest bit of attention to the 2016 U.S. presidential election has observed. While the unemployment rate has decreased dramatically since President Obama took office, this does not tell the whole employment picture. This statistic is distorted by the decline in the labor force participation rate which has decreased from 66% to 62.6% (*remember the unemployment rate only measures individuals who are actively seeking employment and does not take into account the large number of people who have stopped looking for work*).



Source: J.P. Morgan Guide to Markets

3) China continues to be a concern for multiple reasons, one of which is that the massive debt load in their economy is unsustainable. As the following chart illustrates, China's debt-to-GDP ratio has increased rapidly in recent years. At some point there will be a day of reckoning and it is unclear how this will impact the global economy. However, given that China is responsible for ~50% of the world's consumption of commodities such as zinc, nickel, copper, and aluminum, the pain certainly will be directly felt in the commodity markets. Other areas of collateral damage are anyone's guess.

Fig. 13: China: Debt-to-GDP ratio (breakdown by sectors)

(%)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Government	39	40	41	40	43	41	49	49	50	52	53	58
Household	18	18	17	16	19	18	24	28	28	30	34	36
Enterprises - non-financials	109	103	95	100	97	98	99	101	124	113	128	123
Financials	9	9	11	12	13	13	15	13	16	18	18	18
Total	**175**	**170**	**164**	**170**	**172**	**170**	**187**	**192**	**204**	**215**	**221**	**236**
Cumulative change from 2003-2014 (ppt)												
Government		1	2	1	4	2	10	10	11	13	14	19
Household		0	-1	-2	1	0	6	10	10	12	16	18
Enterprises - non-financials		-6	-14	-9	-12	-11	-10	-8	15	4	19	14
Financials		0	2	3	4	4	6	4	7	9	9	9
Total		**-5**	**-11**	**-5**	**-3**	**-5**	**12**	**17**	**29**	**40**	**46**	**61**

Total debt was in decline until very recently

Source: Chinese Academy of Social Sciences (CASS), Wind data, Nomura research

But then it exploded higher

<u>After Fleeing the Nazis, a Legacy That Won't Run Dry Thanks In Part To Ben Graham and Warren Buffett</u>

Howard and Lottie were born in pre-Hitler Germany—he in 1909, she in 1916. But they met in America. With the rise of Nazism, both had the foresight, courage and good fortune to leave their native land before it was too late. In 1934, after Nazi goons murdered her brother outside their home in Linden, Germany, the 17-year-old Lottie persuaded her parents to allow her to go to the U.S.

Lottie's future husband was, by all accounts, a gifted dentist. After the election of Hitler in 1933, Howard made his way to Naples and a professional life there, only to find himself in jeopardy again in 1936, when Mussolini agreed to Hitler's demand that Italy expel all foreign Jews. As luck would have it, one of Howard's patients was the U.S. consul general and in an act of kindness, the official broke U.S. law by backdating the visa request to a period when transit papers were still available.

Arriving in America, Lottie spoke fluent German, French and English, and she developed secretarial skills in all three languages. This helped her get a job on Wall Street. There, she met Benjamin Graham, the legendary "father of value investing." Graham soon became smitten and proposed to her. Lottie—20 years his junior—declined. Even so, the friendship endured until Graham's death in 1976…

The Marcuses lived quietly and frugally. Their small indulgences included an occasional ski vacation with Ben Graham and his girlfriend (and future wife). One day, they asked their friend for investment advice. Graham told them about a student of his at Columbia Business School, a young man he thought a prodigy. He invited that student, Warren Buffett, to meet Howard and Lottie. They put most of their nest egg in Mr. Buffett's new partnership, which later became Berkshire Hathaway.

With annual compounding, that investment grew to millions and then to many millions. But the Marcuses continued to live modestly. No one who knew them had any idea of the magnitude of their wealth. In the late 1970s, they followed the advice of Howard's doctor and moved from New York to the warmer climate of San Diego. In retirement they pursued their interest in world affairs, which led them to believe that Middle East peace could be advanced if water scarcity were ameliorated there…

In 2005 Howard and Lottie, now 95 and 89, made the long flight—in coach—from California to Israel. They returned with clarity on what to do with their estate. Howard and Lottie loved America and often expressed gratitude for having been saved from certain death by the benevolence of their adoptive homeland. Yet they also often told friends that if Germany— "the most civilized nation in the world," in their words—could descend into barbarity and the mass murder of Jews, it could happen anywhere. A strong and secure state of Israel, they believed, would have saved their families from the Nazis and was essential for the future of the Jewish people. So the couple decided to give nearly all of their estate to Ben-Gurion University, with a special emphasis on its being used to further research into improving water management, conservation and irrigation for drylands agriculture.

Howard died in 2014, when he was 104. After Lottie's death in December 2015, at nearly 100, the gift will now be disbursed. It will more than double the university's endowment, and will likely turn the desert-based school into a global center for water research, further enhancing Israel's scientific reputation and helping people the world over…

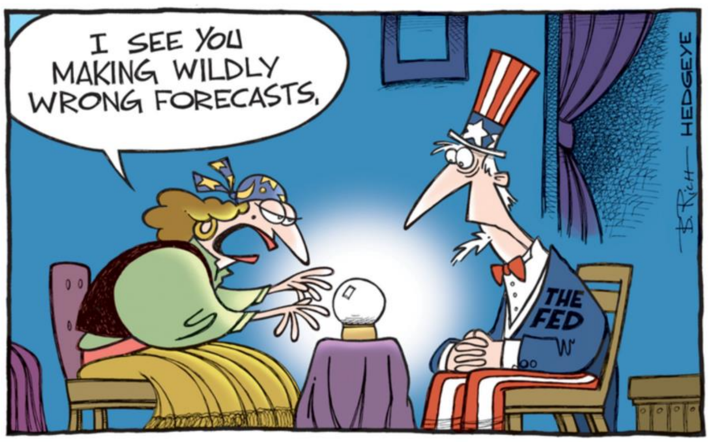
—Excerpt from the WSJ written by Seth Siegel on June 23, 2016

The End of Economic Forecasting

Why have economic forecasters recently been so wrong? Just two years ago, for example, the common perception was that the big emerging markets would drive global growth. That oil prices would remain above $100 per barrel. That interest rates would move higher. All of these predictions have been wildly wrong.
Yet these variances are neither a coincidence nor a temporary phenomenon. We have entered an age in which economic and financial forecasting is much harder and less reliable. Why? Because financial markets and financial investors are increasingly driving the world economy and it is inherently volatile.

Total global assets under professional management have now increased to an astonishing $75 trillion, according to Boston Consulting Group. These gigantic amounts are rocketing around the globe looking for returns. The result is that commodity markets, corporations, governments and other sectors are being relentlessly financialized— or tied to the fortunes of investments in markets—and thus less predictable.

Start with global growth. The International Monetary Fund's 2013 forecast projected that global growth would accelerate to 4.1% the following year, with emerging markets like Brazil and Russia projected to grow at 4% and 3.8%, respectively. The Federal Reserve published a similar forecast. But today the biggest economic story in the world is slowing global growth, not expansion. Both Brazil and Russia are in recession, i.e., negative growth. In other words, a huge miss…



Then, oil prices. Exactly two years ago, the Energy Information Administration, the world's best-known energy forecaster, projected in its reference case that oil prices would rise steadily from the mid-$90s over the next decade, while their low-bound projection didn't fall below $70. The consensus was that demand for oil would be consistently strong. Instead we've seen the opposite happen. Prices fell sharply over the past year, hitting $29 per barrel and now sitting in the upper $40s. These aren't obscure categories—growth, interest rates and oil prices. These normally are good forecasters.

Yet unpredictability may be the new normal, thanks again to finance, which increasingly is driving all global economics. Take the oil market. Approximately 80% of oil trading today takes place between financial institutions, not producers or users of the product. Oil has become a financial instrument, like gold. And it is subject to the same volatility which we see in the stock market, for example. Since many other commodity prices track oil prices and thus are tied to finance, too. Financial factors also are increasingly dominating corporations— and the result is very short-term behavior. The rise of shareholder activism, hostile takeovers and newer techniques of executive compensation have put managements and boards of directors under tremendous pressure to deliver returns to shareholders now. The result is increasing focus on immediate earnings and share-price movements.

Nearly 80% of respondents to a 2014 CFO survey in the Harvard Business Review said they would sacrifice "economic value" to meet Wall Street targets. This is why so much capital has been used for share buyback programs, rather than for long-term investment (emphasis added). With corporations themselves losing focus on the long term, it is harder for anyone to forecast their performance.

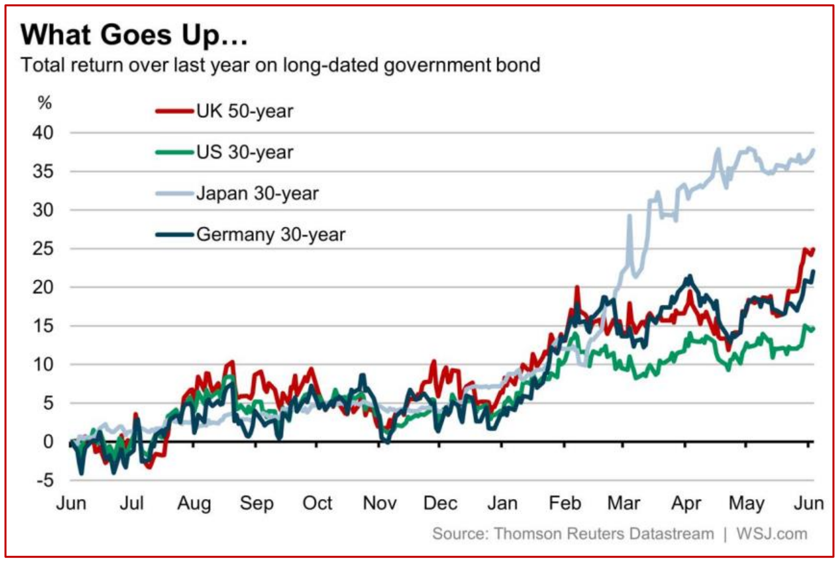
Financial markets are also encircling governments, as we've recently seen in China. For years, China's economic and monetary authorities were viewed as skilled and effective. Then last fall the Chinese stock markets became extremely volatile. The authorities alternatively closed the markets, reopened them, imposed various limits on them, suddenly revalued their currency and severely undermined global confidence in the country. In other words, China's authoritarian regime has been able to control almost everything, except the behavior of financial markets.

And why was Brazil's President Dilma Rousseff impeached in May? In part, because Brazil is a commodity centered economy and financial investors had driven down commodity prices and pushed the country into a deep recession…Finance now represents the most powerful force on earth, even beyond nuclear weapons. Commodity prices, corporations and governments are increasingly at its mercy. Which is why reliable economic and financial forecasting may be history.

—Excerpt from The Wall Street Journal written by Roger Altman

Bonkers: 50-Year Yield Under 2%

Big numbers lost their power to shock after $1 trillion became the standard bailout. Small numbers are rapidly losing their power to shock, too, as government-bond yields sink to nothing, or less, in the major developed markets.



Yet, sometimes we should stand back from the intraday charts and be astounded, and now is one of those times. British government bonds are yielding less than 2% for 50 years. ***That is locking up your money for 50 years at a yield less than the Bank of England's inflation target*** (emphasis added).

The drop is one part of a global race for yield that has pushed up the prices of long dated bonds and pushed down their yields rapidly since late January…

If the story were purely about flows of money, it would be a classic bubble. But it is confused by the weakening outlook for the global economy, at a time when several central banks have little scope to cut rates further.

A weaker economy justifies lower bond yields, but how much lower? There is no right answer, but the yields at present imply a really nasty outcome, even as many other assets rebound. Japan offers one model for investors. Holders of its 30-year bond made 32% in the past six months, the most since a 2003 bond bubble, when they made 28% as the yield dropped below 1% for the first time.

In the short run bonds look like a repeat of last year's mini bubble. German 10-year yields hit a low of 0.03% on Wednesday, so after inflation buyers are near certain to take a loss—and that doesn't count the bloodbath if and when rates eventually move higher.

—Excerpt from The Wall Street Journal written by James Mackintosh on June 8, 2016

Government Hits the Wall

Governments around the world are hitting the wall. Their inability to spur sustained growth subsequent to the financial crisis has ignited populist movements throughout the globe. Ronald Reagan in his first inaugural address in 1981, could not have been more explicit about what his election stood for: "in this present crisis, government is not the solution to our problem; government is the problem."

Brexit is shorthand for "government is the problem." In the United States the populist movement that is responsible for Bernie Sanders and Donald Trump can be directly attributable to an economy that has seen wages stagnate for more than a decade and a half. The conclusion one can draw from the British people's decision to leave the European Union was the political elites dropped their side of the bargain.

The only way the bargain can be sustained is if the administrative state produces or at least allows sustained national growth. The lackluster economy of the recent past has weakened feelings of national well-being. Anti-immigration is a subset of this failure.

The Maastricht Treaty was signed on February 7, 1992, by the 12 member nations of the European Union. The creators of this new treaty recognized that the economic underpinnings of the social compact were disintegrating. Everyone knew the purpose of this big step was summarized in a single, typically dry formulation: Each member would maintain "sound fiscal policies, with debt limited to 60% of GDP and annual deficits no greater than 3% of GDP."

It didn't work. Nearly all the members cheated on the benchmarks, economic growth weakened, and youth unemployment became chronic driving France's young men and women to London for jobs. What we are witnessing is a global government failure across Europe, the Middle East, in Beijing, Delhi, Tokyo and Washington, D.C. If votes were held today in Italy, Spain, France or Norway, many would vote to abandon the long postwar consensus on letting the bureaucracies decide how to simultaneously produce economic growth and social justice.

No better symptom exists of the compact breaking apart than the European Central Bank, the U.S. Federal Reserve and the Bank of Japan. They epitomize the exhaustion of the elite administrative intelligence. For more than seven years, they failed at restoring even average economic strength, disappearing now into a black hole called negative interest rates.

The Obama presidency has been an American version of the European Commission from which the Brits fled. Except that the courts still review, rather than rubber-stamp Obama's executive orders ranging across labor, the environment, the Internet, financial institutions and universities. Had U.S. courts not pushed back against many of the Obama government's rules and "guidance" directives, the famous "pen- and - phone authority" would have come close to putting the states in the same relation to Washington as that between the once sovereign states of Europe and Brussels.

—Summarized from a Wall Street Journal article penned by Daniel Henninger entitled "Government Hits the Wall."
Additional research provided by the Boyar Value Group.

Just one last point as a reminder. Our goal is not to beat the leading indices year in and year out but to buy good businesses at significant discounts to their intrinsic or private market value and hold them for extended periods of time thereby deferring the inevitable tax consequences as long as possible. Remember it is not only what you make that counts, but what you keep is equally important.

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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