Boyar asset management

"Tesla is a testament to our ability to trust 10-year forecasts from people who can't get one-year forecasts right."
- Jim Chanos

January 25, 2018

A Look Back

Our performance for the fourth quarter of 2017 was satisfactory and partially made up for the poor start to the year. Although we are pleased with our results overall, we still trailed the S&P 500 for 2017. The S&P 500's superior performance has in part been driven by performance chasing individual investors embracing passive investment strategies. In the late 1990s, passive investing represented approximately 10% of U.S. equity assets; however, it now represents roughly 40% (when factor-based investing is included). This momentum has come at a cost to value investors, because most of the money that has flowed into index funds has been used to purchase growth stocks, which have the largest weightings in most of the major indices as well as ETFs. This has contributed to the outperformance of many of the most sizeable index/ETF components (which to a large extent are technology companies) and has become a self-fulfilling prophecy.

As stated in a recent Wall Street Journal article:

> *Investors who loaded up on U.S. and Asian stock index funds might be surprised to learn just what they own now: technology stocks—a lot of them... Led by Apple Inc., and its peers, the weighting of technology stocks in the S&P 500 index has climbed to 23.8% as of December 26, from 20.8% at the end of 2016, according to S&P Dow Jones Indices. Over the past 10 years, the weighting of the tech sector in the S&P 500 at year-end has averaged 19.6%.*

Furthermore, according to an article written in November by Rob Isbitts that appeared on Forbes.com nearly 50% of the S&P 500's return (through November 6th) had been generated by 17 companies, and more than half of those businesses are technology companies. He noted that the next 33 highest weighted companies contributed another 25% of the S&P 500's return. So essentially 50 stocks accounted for 75% of the S&P 500s gains.

A Look Ahead

As long as passive funds benefit from positive inflows, they should continue to perform well. *That said, what happens when redemptions exceed fund inflows?* In 2017, an S&P 500 index fund, run by PNC, experienced withdrawals of $63 million, representing 38% of its assets. Considering that this fund's mandate is to replicate a market capitalization-weighted index, it had no flexibility in terms of what assets to liquidate. Because Apple represented ~4% of the S&P 500, it had to sell ~4% of its Apple holdings (which have appreciated significantly over the past few years). It was unable to do what any tax-sensitive active asset manager would do— consider selling holdings that had gone down in value, thereby mitigating any taxes owed. *This lack of flexibility resulted in the fund paying out $4.19 in gains on a per-share basis, on a fund whose NAV was $19 per share, leaving investors with a significant tax bill.* Although this may be an extreme example, investors should be aware of the potential consequences of owning a passive investment vehicle.

During our respective investment careers (which, for one of us, has been for almost half a century), we have learned that when a particular investment style has caught the attention of a large group of market participants by capturing outsized gains, *investors should exercise extreme caution.* For example, during the 1960s and 70s, a group of stocks, affectionately dubbed the "nifty fifty," were in high demand. Companies like Polaroid and Xerox were considered one-decision stocks—in other words, investors could buy them and hold them forever—because they would be able to grow earnings regardless of economic conditions. The valuations of these companies soared; in fact, Polaroid was the first major company to command a P/E multiple of 100.

When the U.S. economy entered a severe recession in the early- to mid-1970s, the nifty fifty's profit growth faltered, and these stocks lost, on average, ~75% of their value. In addition, at the height of the dotcom mania, value-oriented investors were considered to be dinosaurs and underperformed the market for several years. However, they were eventually vindicated when the vast majority of dotcom companies crashed and burned, causing the tech-heavy NASDAQ to lose almost 80% of its value after peaking in March of 2000. In the era following the dotcom implosion, value investing once again regained its luster and handily beat growth stocks for a prolonged period of time. *We are confident this will eventually reoccur; we just cannot accurately predict the timing.*

Although normally we are bottoms-up stock pickers and do our utmost to ignore macro-economic data when analyzing individual stocks, certain economic factors/indicators exist that give us reasons for both optimism and caution. Some of these are detailed below.

U.S. Consumer Confidence Continues to Strengthen

U.S. consumer confidence is at a 17-year high (as measured by The Conference Board). However, we believe that another leg-up could come during 2018. The potential benefit of increased discretionary income for individuals via lower tax rates, as well as the broader impact of accelerating economic growth in the U.S should serve as positive catalysts for consumer confidence levels in the coming quarters. Further gains in confidence should bode well for the fundamentals of a range of sectors within the economy, such as consumer discretionary and retail. These positive tailwinds should improve the outlook for several companies owned by our clients, such as Kohls, Tapestry (formerly Coach), and Harley Davidson.

Foreign Investors are Piling into U.S. Stocks as Margin Debt Rises to a New Record

After four years of foreign investors pulling money out of U.S. stocks (2013–2016), overseas buyers pumped over $66 billion into these stocks between January and September 2017; *almost 40% of these inflows came in September alone*. This development is somewhat concerning for the 8+ year bull market because foreign investors have historically proven to be “the last group to the party” in a rising market. (Note that foreign money piled into U.S. stocks in 2000 and 2007 just prior to major selloffs.)

Of equal concern is that margin debt recently reached a record $560 billion (higher than previous bubble peaks). This statistic may, in real terms, understate the leveraged bets being made on a rising stock market, considering that the assets in Rydex bull funds currently outnumber those in Rydex bear funds by almost 30 to 1.

U.S. Margin Debt

Interest Rates

The Fed has indicated that it is set to raise interest rates three times in 2018. Additionally, it is already in the process of shrinking its balance sheet after pumping trillions of dollars into the financial system to help combat the global financial crisis. Although we believe that both are prudent long-term policy decisions, the Fed needs to be extraordinarily careful in implementing them. If it raises rates too quickly, this could have significant negative consequences for the economy. Our fear is that if the economy continues to improve, the Fed will implement additional rate hikes to combat inflation, potentially derailing the economic expansion. Although the situation is not completely analogous (as rates were much higher then), the Fed should be mindful of what happened in 1994, when a rise in rates caused a horrific corporate bond rout.

Presidential Election Cycle

While we take statistics about stock market performance and the presidential election cycle with a large grain of salt, what has occurred in the past is at least worth noting. If history is any guide, 2018 should be a rollercoaster ride in terms of stock market performance. In 9 of the past 14 midterm election years, bear markets either began or were already in progress. Since 1913, the Dow Jones Industrial Average has dropped by an average of 20.4% from its post-election year high to its subsequent low in the following midterm year, and since 1914, it has gained 47.4%, on average, from its midterm-year low to its subsequent high the following year. With the Dow trading near all-time highs, history tells us that 2018 could bring a bear market (or a significant market correction) followed by a relatively quick recovery, creating a tremendous opportunity for opportunistic investors who are brave enough to "buy the dip." *However, because the current administration has deviated so significantly from prior presidencies in so many ways, past performance may not be indicative of future results in this instance.*

**Note: These Presidential Election Cycle statistics were provided with permission by Jeffrey Hirsch of the Stock Trader's Almanac. The 2018 edition can be found at www.stocktradersalmanac.com.*

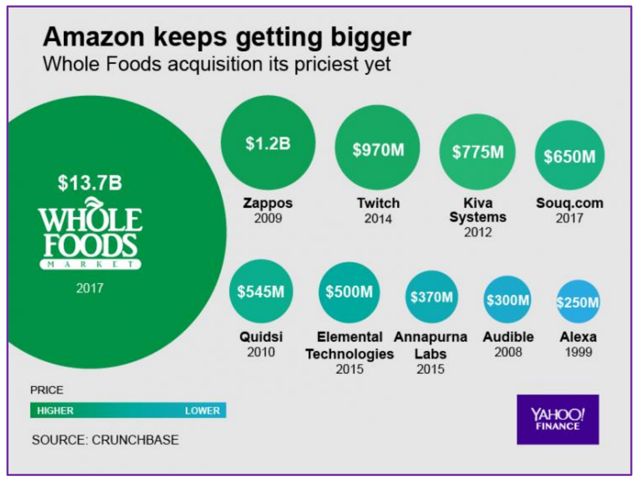
Could we be Experiencing a Market Melt-Up?

We believe the chances are better than average that the stock market is currently experiencing a market melt-up, which could culminate in a major decline in 2018. We have been calling for a correction for well over a year, and obviously we have been wrong/early. However, the longer the market advances without a meaningful decline, the greater the likelihood that the loss will be of a significantly higher magnitude. Remember, market corrections are an integral part of the investment process, and without them an investor could not capture future outsized gains. Having cash during these periods allows an individual to take advantage of the bargain basement prices that occur at such times; this should also make up for the underperformance resulting from holding an asset that demonstrates little or no return for a number of years (i.e. cash). As we have frequently noted, if we had not had cash in 2008 and 2009, we could not have taken advantage of the once-in-a-generation opportunities that arose then.

Amazon Antitrust Action?

One of the companies that helped lead the S&P 500 to record highs in 2017 was Amazon. However, could there be an antitrust case on the horizon? Although Amazon does not fit the traditional definition of a monopoly—its overall share of total U.S. retail sales is relatively small at ~5% (excluding food)—its market share of online sales is ~44%, according to eMarketer.

With current antitrust doctrine focusing mainly on consumer prices as evidence of sound competition, it does not appear that Amazon should have a legal problem because the company has caused the prices of most goods to decrease. Although Amazon probably does not have a bona fide legal issue, it certainly is faced with a significant political problem. It is no secret that President Trump is no fan of Amazon founder Jeff Bezos. In a 2016 speech, Trump stated, "If I become President—oh, do they have problems. They're going to have such problems." In a television interview, meanwhile, he said: "He (Bezos) thinks I'll go after him for antitrust . . . because he's got a huge antitrust problem, because he is controlling so much—Amazon is controlling so much—of what they are doing."



It appears that Trump believes Bezos to be using the *Washington Post* (which he controls independently of Amazon) to protect the online retailer from both IRS and antitrust scrutiny. Amazon has a clear history of engaging in anticompetitive behavior. For example, after initially expressing a desire to buy Quidsi (the owners of Diapers.com as well as other online retailers) and being rebuffed, Amazon lowered the price of diapers so significantly that, by some estimates, it lost $100 million in three months on diapers alone.

This put so much pressure on Quidsi that it had no choice but to sell itself to Amazon. Not surprisingly, after purchasing Quidsi, Amazon stopped discounting the items over which it had competed with Quidsi. This is only one of many examples of Amazon using aggressive pricing to destroy its competitors as well as scare away new entrants.

Will the Trump administration convince the Justice Department to pursue Amazon? At least one well-known investor thinks so, with Doug Kass of Seabreeze Partners stating:

> *I am shorting Amazon today because I have learned that there are currently early discussions and due diligence being considered in the legislative chambers in Washington, D.C., with regard to possible antitrust opposition to Amazon's business practices, pricing strategy and expansion announcements already made (as well as being aimed at expansion strategies being considered in the future).*
>
> *If I am correct, word of this could lower Amazon's shares by 10% overnight. And if expansion or pricing prohibitions are attacked for antitrust reasons (or for other reasons), a far more severe market impact is possible.*

Some will argue that because Amazon's stock price increased ~58% in 2017, the market considers the threat of government action to be remote. However, it is worth remembering how tight the deal spread was for the Time Warner/AT&T combination (another merger Trump vowed to oppose) before, apparently out of nowhere, the Justice Department sued to block it for what many view as politically motivated reasons.

Should you have any questions, we are always available.

Best regards,

Mark A. Boyar

Jonathan I. Boyar

Below, please find summaries of recent articles that we found interesting and wanted to share with you.

<u>How to Lose 93% of Your Money… And be Happy About It</u>

Imagine losing 80% or more while, all around you, investors are basking in the glory of one of the biggest bull markets in history. Imagine racking up year after year of losses while stocks are going up nearly 400%.

That's what it's like to run a short-selling fund that hedges against the risk of a falling stock market. If you're a contrarian who is naturally attracted to parts of the market that have been losing money on the grounds that they are ripe for recovery, bear this in mind about these funds: On average, in the long run, you will lose money if you hold them…

"I'm pretty sure that 99.9% of our investors understand that the fund is designed to make money when the market goes down," says Mohsen Fahmi co-manager of the $2.1 billion Pimco Stocks Plus Short Fund. "Perhaps, after nine years of a bull market, if any didn't know what they were getting into, they do now…"

Ever since stocks began trading in Amsterdam around the beginning of the 17th century, some investors have sought to profit when the market falls. Bears or short sellers typically seek to borrow stock, sell it and then buy it back at a lower price, locking in the difference as profit. That works brilliantly when stocks drop. In 2008, the average bear-market fund gained 30%, according to Morningstar, even as the S&P 500 stock index fell 37%.

If you'd invested in the average bear fund on Sept. 15, 2008, the day Lehman Brothers collapsed, and then sold your position on March 9, 2009, the absolute bottom of the financial crisis, you would have gained 58.5%. Meanwhile, the S&P 500 lost 45.1%.

What if you had hung on? From March 9, 2009, through this past week, the average bear fund lost 92.9%, according to Morningstar. Over the same period, the S&P 500 is up 389.6%, including dividends. On average, bear funds have lost money nine straight years — exactly as they should have in a rising market. Every single one of the 64 such funds with assets of at least $2 million had negative returns in 2017, according to Thomson Reuters Lipper…

Is Mr. Fahmi bothered that Pimco StocksPlus Short has lost money nine years in a row? "Sorry to disappoint you," he laughs. "It doesn't cause [me] any sleepless nights. I'm very proud of our performance." The fund has done its job — and then some. It lost 14% last year, even as the S&P 500 went up 21.8%. A direct bet against the S&P should go down by about the same amount as the market goes up, so a loss of only 14% is impressive. Pimco StocksPlus Short gained 48.6% in 2008, the last time the S&P had a down year…

[The Grizzly Short Fund], unlike the Pimco portfolio, doesn't short the S&P 500. Rather, it bets against specific companies based on such factors as how much stock management is selling, whether the supply of shares outstanding is growing, and the extent to which other short sellers are angling for the price to fall. Investors looking for cheap companies nowadays might as well be opening hens' mouths looking for teeth. But bears seeking to profit when overpriced stocks collapse need at least as much patience — or uncanny clairvoyance — along with a high tolerance for pain.

— Excerpt that appeared in The Wall Street Journal on January 12th, written by Jason Zweig.

For Tesla, Deliver, Don't Promise, in 2018

Elon Musk is best when he sketches out Tesla Inc.'s distant future. In 2018, Mr. Musk should focus on the mundane present. The new year will present Tesla's greatest operational challenge. Rather than issuing promises of an electric semi-truck, a new sports car and a pickup truck, as he did in recent months, Mr. Musk needs to figure out how to produce hundreds of thousands of mass-market sedans at a profit. If he can't, Tesla could find itself trying to raise capital in a less-friendly market, meaning his highly loyal shareholders could be hurt by a wave of stock issuance…

Tesla delivered just 220 of its Model 3 mass-market sedans in the third quarter, well below its forecast of 1,500. Tesla, which will report fourth-quarter deliveries next week, said in November that it hopes to achieve a production rate of 5,000 cars a week by late in the first quarter of 2018, after previously predicting it would hit that milestone this year…

The Model 3 was supposed to generate big profits for Tesla but is nowhere close to doing that. Analysts expect an adjusted loss of $8.76 a share in 2017 and $3.81 a share in 2018, according to FactSet. A year ago, those analysts expected a loss of 97 cents a share in 2017 and a profit of $1.59 a share in 2018.

Tesla investors have always been willing to forgive overly aggressive forecasts. But heavy capital spending to bring the Model 3 online, as well as Tesla's 2016 acquisition of SolarCity, have strained the balance sheet. That, along with fresh electric-car competition from rivals, means increasing urgency to actually deliver on these promises.

The stock has sold off nearly 20% from September's recent high. Tesla needs to keep its share price high, since it uses the capital markets to fund its operations. More debt doesn't seem like a practical solution—Tesla issued $1.8 billion in bonds due in 2025 over the summer; those bonds now trade below par. And the lower the stock price, the more any new equity raise would dilute existing shareholders.

Don't underestimate the challenges Tesla faces. The company has never produced a fraction of the cars it needs to deliver, and it has never made a profit while selling far more expensive vehicles…Mr. Musk has taken this company farther than almost anyone expected. In the coming year, he will be judged on operations, not hype.

—Excerpt that appeared in The Wall Street Journal on December 30th, written by Charley Grant.

<u>**David Rockefeller's Rolodex was the Stuff of Legend. Here's a First Peek**</u>

Some might say David Rockefeller, a scion of America's greatest fortune and the veteran chief executive of Chase Manhattan Bank, was a dedicated networker long before the age of Facebook. That would grossly understate his horizons. Mr. Rockefeller recorded contact information along with every meeting he had with about 100,000 people world-wide on white 3-by-5-inch index cards. He amassed about 200,000 of the cards, which filled a custom-built Rolodex machine. He kept the 5-foot high electronic device at his family's suite of offices in New York City's Rockefeller Center for about half a century…

Mr. Rockefeller's legendary Rolodex was a closely guarded trove of information. Now, nearly nine months after his death at 101—and long after many of his contacts have also died—The Wall Street Journal got a private peek. Overall impression: The Rockefeller Rolodex collection embodies the ultimate expression of communication in the analog age. It provides a unique time capsule of modern history, both idiosyncratic and revelatory.

As a grandson of oil baron John D. Rockefeller Sr. and a prominent philanthropist, David Rockefeller enjoyed access to virtually everyone in the ruling and financial elite. He kept track of countless connections with the rich and famous across borders, disciplines and interests, from fellow business titan Bill Gates to the shah of Iran, President John F. Kennedy, Pope John Paul II and Neil Armstrong, the first man to walk on the moon…

Even if Mr. Rockefeller hadn't seen someone for years, "he was able to pick up as though he had seen you the week before,'' said James Wolfensohn, a friend and former World Bank president who was introduced while a Harvard M.B.A. student in 1959. "It was because of this extraordinary record system." Henry Kissinger, a former secretary of state, garnered the most cards because he was among Mr. Rockefeller's best friends, said Peter Johnson, the Rockefeller family historian. Close behind was Gianni Agnelli, the Italian industrialist who ran Fiat…

During a lunch at his estate in 2015, Mr. Rockefeller gave Mr. Kissinger a copy of his 35 Rolodex cards. They contained descriptions of their hundreds of encounters since they first met in 1955. "I am astonished that we have seen each other so much,'' Mr. Kissinger recalled telling his friend. Having a record of their frequent times together over the years "meant a lot to me," he said in an interview…

Mr. Rockefeller learned the importance of contacts while an Army intelligence officer overseas during World War II, according to his memoir. “My effectiveness depended on my ability to develop a network of people with reliable information,’’ he wrote. Joining Chase after the war, Mr. Rockefeller visited 103 countries and met more than 200 heads of state during his 35-year career. He stepped down as CEO in 1980 and chairman in 1981. He traveled for Chase, now part of JPMorgan Chase & Co., into the 21st century, Mr. Johnson said, working several days a week until his late 90s.

In August 2015, Rockefeller staffers tossed the oversize Rolodex machine and stored its cards in the mildewed basement of a building on the banker’s estate in Pocantico Hills, N.Y. They now nearly fill a wall of filing cabinets at Kykuit, the nearby estate built by his grandfather. Mr. Rockefeller’s will requires that the cards and the rest of his papers remain hidden from public view for a decade after his death…

Mr. Rockefeller even saved acquaintances’ cards postmortem. Former President Gerald Ford died in late 2006, but his Rolodex card stated that Mr. Ford’s widow, Betty, continued to receive Christmas greetings from the billionaire until 2008.

“He didn’t like to throw things away,” Mr. Johnson said.

—Excerpt that appeared in The Wall Street Journal on December 5th, written by Joann Lublin.

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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 is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The NASDAQ Composite is a market-capitalization weighted index of the more than 3,000 common equities listed on the NASDAQ stock exchange. The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ. The volatility of the above-referenced indices may be materially different from that of your account(s), and the holdings in your account(s) may differ significantly from the securities that comprise the above-referenced indices. Your results are reported gross of fees. The collection of fees produces a compounding effect on the total rate of return net of management fees. As an example, the effect of investment management fees on the total value of a client's portfolio assuming (a) quarterly fee assessment, (b) $1,000,000 investment, (c) portfolio return of 8% a year, and (d) 1.50% annual investment advisory fee would be $15,566 in the first year, and cumulative effects of $88,488 over five years and $209,051 over ten years. This material is intended as a broad overview of Boyar Asset Management's, philosophy and process and is subject to change without notice. Account holdings and characteristics may vary since investment objectives, tax considerations and other factors differ from account to account.*