*"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."*

*— Peter Lynch*

April 24, 2017

## A Look Back at the First Quarter

The Dow Jones Industrial average surpassed two historic milestones during the first quarter—20,000 and 21,000—as it advanced 5.19%. This is quite remarkable considering that the index eclipsed the 19,000 mark for the first time on November 22, 2016. The first quarter also saw a change in stock market leadership: last year's leaders (financials and energy stocks) were among the laggards, with energy shares declining by 6.7% and financials advancing by a mere 2.5%. Technology shares, however, continued their winning streak, advancing 12.6% after having gained nearly 14% in 2016.

The S&P 500's 6.07% rise in the first three months of the year extended postelection gains that have sent major U.S. indexes to record levels. The NASDAQ, which was the worst-performing index in 2016—returning only slightly more than 7%—reversed course and advanced by 9.82% during the most recent quarter. This was the tech-laden index's best showing since the fourth quarter of 2013, when it gained 10.7%. A significant portion of the robust gains came courtesy of the so-called FANG stocks: Facebook, Amazon, Netflix, and Google (now known as Alphabet). Facebook rose 24% for the quarter, Amazon 18%, Netflix 19%, and Alphabet 7%.

Apple was also one of the biggest beneficiaries of this renewed appetite for technology shares. It was the best performer of the 30 stocks that constitute the Dow Jones Industrial Average, contributing 191 points, or about a fifth of the total gains for the quarter. Fledgling electric car manufacturer Tesla, a company with no earnings and a highly-leveraged balance sheet, now has a larger market capitalization than the 100-year-old Ford Motor Company and earlier this month briefly surpassed General Motors to become the largest automobile manufacture in the United States by market capitalization.

The Russell 2000, an index of small-capitalization stocks, returned 21% last year. Notably, a number of market strategists opined at year's end that this outperformance would continue into 2017, and performance chasers piled in with fresh capital. Historically, both of these occurrences have been excellent contrary indicators: not surprisingly, this index returned 2.47% for the quarter, significantly trailing all the other major indices.

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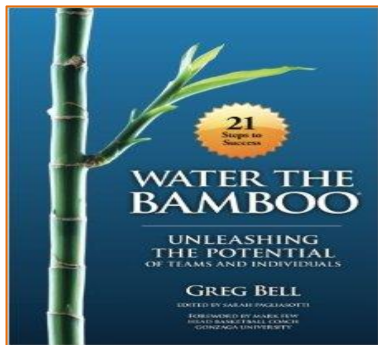
## First-Quarter Performance and Some Thoughts about the Market

Most of our accounts trailed the major indices. Our results were negatively impacted by large cash positions. In a robust bull market, cash will in all likelihood impede performance, particularly in a low interest rate environment. So why keep all this cash? There are a number of reasons, but one is particularly important: we want the optionality that cash provides.

If we don't have cash when the stock market suffers a tremendous dislocation—as it did in 1975, in 1987, or during the most recent financial crisis—then we won't be able to take advantage of the incredible bargains that become available. In 2007 and 2008, for example, CBS sold for under $10 per share and Saks Fifth Avenue for less than $2—and both went on to increase in value more than fivefold. If we are fully invested during these periods, we can't take advantage of such opportunities.

We are willing to let cash weigh on our performance in bull markets. True, we might underperform the leading indices temporarily, but we believe that good investors can more than make up for this during severe market disturbances. Indeed, market corrections are an investor's best friend: without them, we could never buy high-quality businesses at bargain basement prices. Compounding capital at a satisfactory rate requires more than just buying a good business: equally important is the price one pays.




This approach takes a great deal of patience and discipline. Unfortunately, most investors do not have the temperament to adhere to such a philosophy. In his book *Water the Bamboo*, Greg Bell used giant timber bamboo as a metaphor for success: even with regular watering, it makes no visible gains for its first three years of life—but then, suddenly, it sprouts 90 feet in two months. Bell's college roommate, Mark Few, made 19 consecutive NCAA appearances with the Gonzaga Bulldogs before taking the team on its first trip to the finals. Patience is one of the most important elements of successful investing.

As we have indicated in previous letters, this bull market is long in the tooth. However, bull markets do not normally expire due to old age. Rather, they usually end because of overvaluation or when an exogenous event occurs. Certainly, many stocks are overvalued, but many others, particularly those that are not part of a major index, remain neglected and thus are relatively cheap. Using the S&P 500 as an example, it is neither inexpensive or blatantly overvalued. In a relatively low interest rate environment, coupled with low inflation it is quite possible for the market to trade at 22x or 23x earnings. It now sells at ~18x.

We haven't experienced a market correction for quite a while, and it would not surprise us to see one in the near future.

As Michael Farr, a well-known investment manager recently said, "Market corrections are like dental work, you dread it. You don't want to get it, but your glad when it's over and you feel better."

As the chart on the right indicates, in the absence of a bear market or during a recession, corrections are usually short and sharp, with most losses recovered within three months. Remember the most important thing to do during a correction is not to panic (using your cash hoard to take advantage of bargain prices comes a close second).

**What Goes Down Often Comes Up**

History suggests that corrections—in the absence of bear markets or recessions—tend to be short and sharp, with much of their losses recovered within three months.

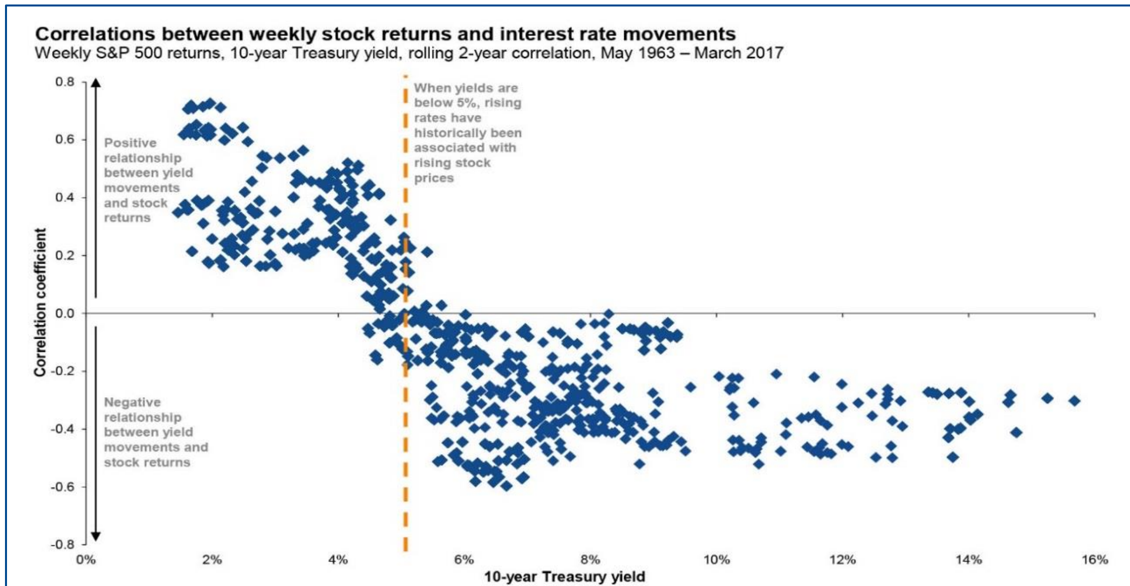
**Market-corrections since 1989, on average**

| | Correction magnitude | Duration (months) | Three-month change from end of correction |
|---|---|---|---|
| Recession corrections | -25.3% | 2.4 | 10.9% |
| Bear-market corrections | -22.3% | 4.8 | 10.6% |
| Oher corrections | -14.2% | 2.4 | 16.5% |

*The Wall Street Journal*

## The Federal Reserve Raises Interest Rates

In March the Federal Reserve raised interest rates for the second time in three months. Market participants expect two more rate hikes in 2017. Some investors are nervous about what this will mean for future stock market performance. Since interest rates are quite low by historical standards, we do not believe that a small rise in rates will derail the current bull run. Historically, as the chart below demonstrates, when treasury yields are below 5%, rising rates have been associated with rising stock prices.

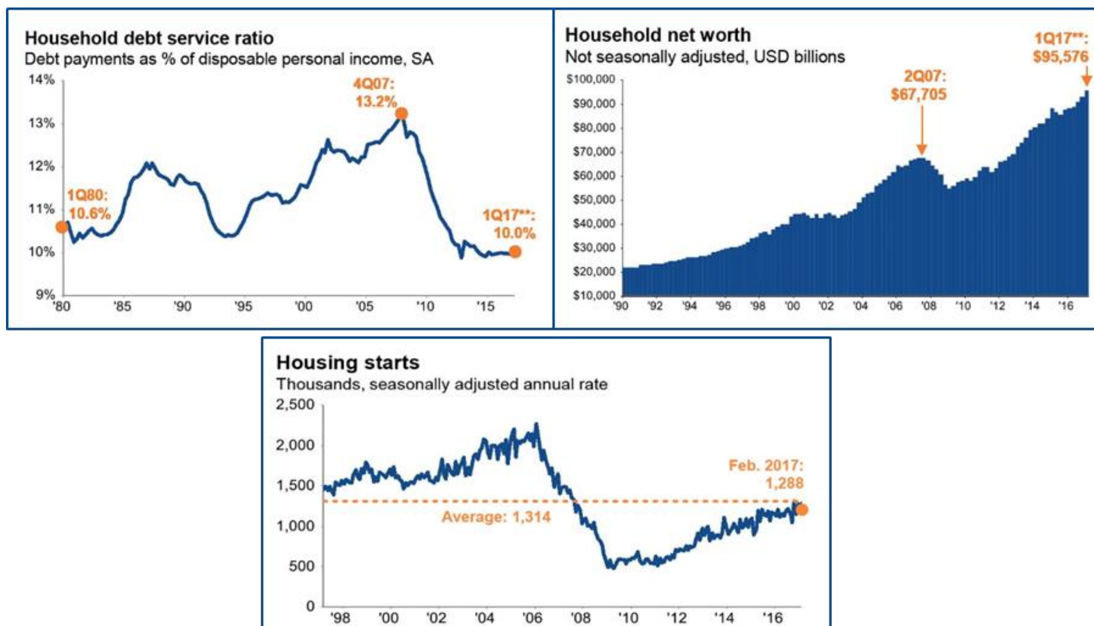



*Source: JP Morgan Presentation: Guides to Markets, 2Q 2017*

## The Consumer and the Economy

Despite the current political rhetoric, the economy and the U.S. consumer are in generally good shape. Households have historically low debt payments as a percentage of their income, and their net worth has never been higher. Both of these factors should lead to continued above-average levels of consumer confidence, which in turn should increase consumer spending. Since consumption represents 69% of GDP, this bodes well for future economic expansion.

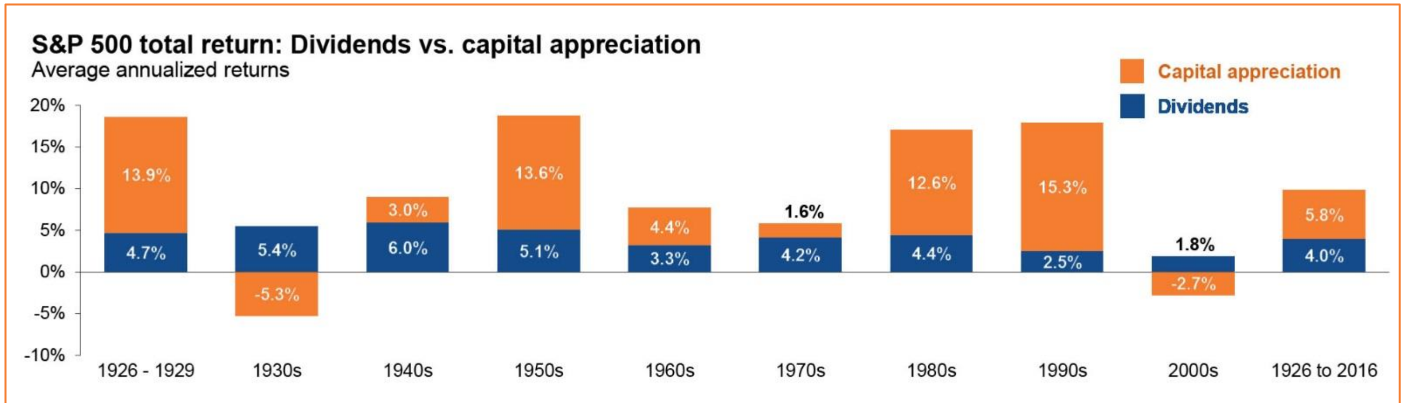
After many years of underbuilding—which, admittedly, followed a period of significant overbuilding—the housing market, as represented by new home construction, is increasing at a healthy pace. However, new home construction is still below its historical average. If new home construction continues to rise, this could further stimulate the economy. While there might be temporary “blips”: We do not see any signs that the housing market is slowing down, as housing in most areas is still quite affordable.




*Source: JP Morgan Presentation: Guides to Markets, 2Q 2017*

## The Importance of Dividends

While it may seem stodgy, dividends are an extremely important component of an investor's total return. Understandably individuals are more excited to see large stock gains in their portfolio rather than a steady stream of dividends. However, since 1926 dividends are responsible for ~40% of stock market returns. They are especially important in periods of low (or negative) stock price returns such as the 1930s, 1970s and the 2000s. There are many high-quality companies that we follow that yield over 2.5% that not only have the capability of increasing their dividends but the potential for capital appreciation as well.

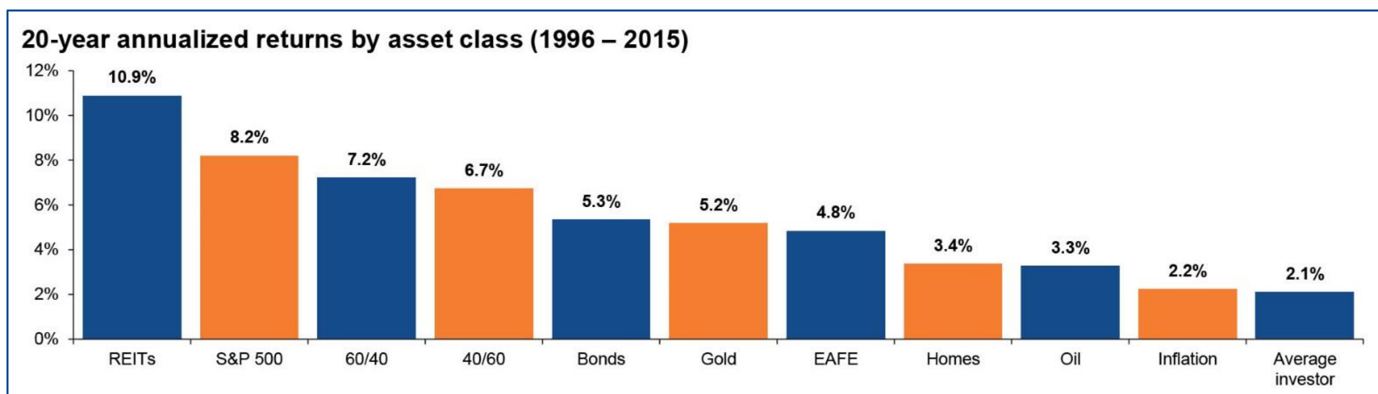



*Source: JP Morgan Presentation: Guides to Markets, 2Q 2017*

## Why do Individual Investor's Consistently Underperform the Market?

It is well known among investment professionals that individual investors are terrific contra indicators. When they zig, odds are it is probably a good time to zag. From 1996 through 2015, the S&P 500 has returned roughly 8.2%, bonds have returned 5.3%, and an investor who purchased a 60/40 mix of stocks and bonds returned 7.2%. **However, over that same period, the average investor returned just 2.1%. This ends up being lower than inflation!**

There are many reasons for this phenomenon but it probably can largely be explained by two related concepts: behavior psychology and people's desire to invest in whatever recently has increased in price (i.e. performance chasing). In the runup up to the dotcom bust, investors piled into technology shares with no earnings and questionable growth prospects simply because they were going up as they did not want to miss the party. When the party abruptly ended, many investors panicked (after suffering large losses) and left the market and did not return until well after the October 2002 market lows. Subsequently investors got burned by the 2008-2009 financial crisis and most likely were on the sidelines for a large portion of the 249% increase in the S&P 500 from the March 2009 lows. **Investors would have been much better off not panicking during the above-referenced pullbacks and just staying the course as from 1996 through 2015 the S&P 500 increased from 620 to over 2,000**.




*Source: JP Morgan Presentation: Guides to Markets, 2Q 2017*

## Article Excerpts and Commentary

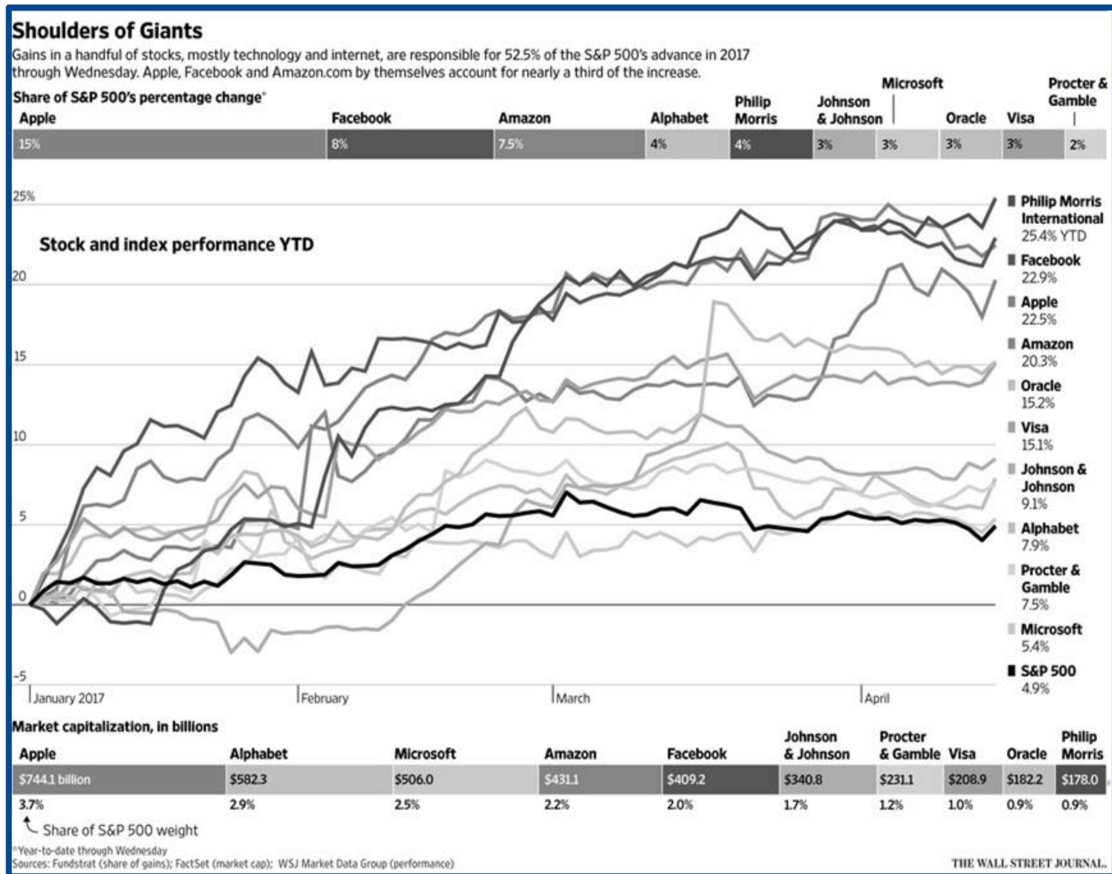
In the following section, you'll find excerpts from three articles we recently read that we think you'll find interesting.

### Investors Follow the Herd as 10 Big Stocks Power Market's Gains

Ten big stocks are exerting an unusually large influence on the S&P 500 in 2017, the latest sign that the herd instinct is alive and well on Wall Street. Those 10 large stocks have powered nearly 53% of the S&P 500's 4.7% advance this year, according to Fundstrat Global Advisors' data through the middle of last week. During an average year, the 10 stocks with the greatest impact typically account for only 45% of the market's price moves, according to analysis of data from AQR Capital Management…

The recent strength in tech and internet companies marks a reversal from late last year, when investors piled into banks, industrials and small-cap stocks in the weeks following November's U.S. elections. They bet that Republican control of Congress and the White House would lead to pro-growth policies. But as investors began to lose confidence that the policies would be enacted quickly, these sectors have trailed the S&P 500 in recent months. Instead of focusing on companies that could outperform during faster economic growth, many investors returned to large-cap favorites with a track record for boosting revenue during slower growth periods…

Big-cap tech and internet stocks have been popular even though they look pricey based on earnings expectations, which has turned off some investors. Facebook, for example, trades at a multiple of 24.3 times analysts' earnings expectations over the next year, well above the 17.6 for all tech stocks in the S&P 500, according to FactSet.




Some investors say that the popularity of low-cost index-tracking funds that assign greater heft to the market's largest companies helped boost the most widely held stocks. Some $2.1 trillion in assets were directly linked to the S&P 500 at the end of 2015, according to the most recent data available from S&P Dow Jones Indices. Still, some analysts consider this high concentration in broad-based index funds as a potential vulnerability, since the few large companies that have lifted the market could drag the index lower during the next downdraft.

*Excerpt from an article that appeared in The Wall Street Journal on April 18, 20017 written by Chris Dieterich*

**Obama's Debt Interest Bomb**

President Obama left his successor many time bombs—think chemical weapons in Syria and the collapsing Affordable Care Act. But a burning fuse that gets less attention showed its first signs of the explosion to come in Friday's Congressional Budget Office budget review for March: Rising net interest payments on the national debt.

CBO reported that the federal budget deficit rose $63 billion in the first half of fiscal 2017 (October-March) to $522 billion from a year earlier. But here's the especially bad omen: Net interest payments rose $7 billion, or 30%, in March from a year earlier. If that seems small, consider that interest payments rose $28 billion for the six months of fiscal 2017 to $152 billion. That's a 22.2% increase, among the biggest in any single spending item highlighted by CBO…

While Mr. Obama was doubling the national debt over eight years, the Fed's monetary policies spared him from the fiscal consequences. The Fed's near-zero policy kept interest rates at historic lows that reduced net interest payments even as the overall debt increased.

This not-so-free Fed lunch is starting to end. CBO estimates that $160 billion more spending will be required each year over the next decade if interest rates are merely one percentage point higher than in its current projections. As interest rates rise, the Fed will also have to pay banks more to keep excess reserves parked at the central bank. After its latest rate increase in March, the Fed now pays banks 1% on reserve balances or about $20 billion a year, and that will go up.

Fed officials are also now hinting that this year they may finally stop buying new securities when the current bonds on its balance sheet come due. This is necessary and long overdue, but it will mean smaller Fed contributions to the federal budget than the more than $90 billion the Fed has turned over in recent years. All of this is set to explode on President Trump's watch, and it will complicate the task for Republicans as they try to reform the tax code within tighter budget constraints.

*Excerpt from an editorial that appeared in The Wall Street Journal on April 10, 20017*

**<u>First Snap, Now Canada Goose: Warning Signs for Trendy IPOs</u>**

Disappearing messages are so two weeks ago. Now it is pricey parkas that have captured Wall Street's attention as the next big investment opportunity. Canada Goose Holdings Inc. is set to start trading on the public markets Thursday, just two weeks after Snap Inc. made its splashy debut…

Snap's 44% surge in its first trading day stoked the get-rich-quick mentality that has surrounded initial public offerings since the technology boom. But the messaging company's slide since its debut also highlights the inherent danger in chasing easy money, particularly for individual investors who buy in the secondary market and don't get to reap the benefits of a company's first-day pop.

Gauging how new companies will perform for those not entitled to Wall Street's golden tickets may be a matter of timing, but not in the way most would assume…

Since 1995, U.S.-listed IPOs have averaged a 16% gain on their first day of trading, according to data provider Dealogic. Those same IPOs averaged a 20% gain over their first 12 months of trading. That means that four-fifths of a company's first-year gain has been concentrated in its first day of trading. What is left over is hardly worth the risk for investors.

But these numbers vary drastically depending on market conditions. During the manic tech bubble in 1999 and 2000, the two biggest years for IPOs by deal value, companies averaged a 59% first-day IPO pop. Twelve months later, these stocks were up by 29% on average. That means any investor who bought and held after the first day's action lost money.

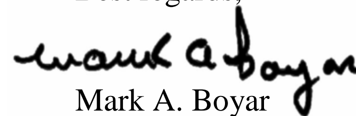
In other market environments, though, the trends were much more favorable for IPO investors. In 2002 through 2006, the average first-day IPO pop was only 10%. That was arguably because those companies were more mature and ready for the public spotlight as opposed to others that were trying to ride the dot-com wave. The average 12-month return for those companies was 28%...

The question is, where are we today? In the ninth year of a bull market and valuations around 13-year highs, messaging and coat companies have retail investors excited. While it isn't the craziest of times, the experience of those who jumped on the Snap bandwagon may not be a one-off.

*Excerpt from an article that appeared in The Wall Street Journal on March 15, 20017 written by Steven Russolillo*

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

Best regards,



Mark A. Boyar

Jonathan I. Boyar

## IMPORTANT DISCLAIMER

***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.*