Boyar asset management

"Value investing is, at its core, the marriage of a contrarian streak and a calculator."

–Seth Klarman

July 12, 2023

A Look Back

There is an old Wall Street adage that markets like to climb a wall of worry, and the price action thus far in 2023 seems to exemplify that. Despite concerns among investors over the fallout from the regional banking crisis, uncertainty about the future direction of interest rates, continued fears of recession, and a debt ceiling standoff, the S&P 500 advanced by 8.7% for the second quarter of 2023, bringing its total gain for 2023 to 16.9% as of June 30, 2023. Simply put, investors' obsession with AI's potential (and willingness to bid up shares of index heavyweights poised to benefit from it, such as Nvidia and Microsoft) seems to outweigh any (and indeed all) of these fears.

The S&P 500 ended the quarter selling for 19.1x (fwd.) earnings, an elevated valuation by historical standards. (The 25-year average is 16.8x.) However, the index is still selling for ~8% less than it did on January 3, 2022, when it traded at 4,797, or 21.4x earnings. While 19.1x is a high multiple, back in March 2000 the S&P 500 traded for 25.2x (though it then lost 49% of its value over the following 2 calendar years). It is worth noting that the S&P 500 equal weighted index currently sells for a more modest 14.8x (fwd.).

Three sectors advanced by double digits during the second quarter: Technology (+17.2%), Consumer Discretionary (+14.6%), and Communication Services (+13.1%). Only two sectors were in the red: Energy (-0.9%) and Utilities (-2.5%). For the first half of the year, Technology shares led the way, advancing a whopping +42.8%, followed by Communication Services (+36.2%) and Consumer Discretionary (+33.1%). Four sectors were in the red for that same period, including Energy which declined by 5.5% for the first half of 2023. This is a stark contrast to 2022, when Energy was the market leader advancing over 65% in a year when the S&P declined by 18%. In fact, energy shares have been far and away the biggest winner since the March 2020 stock market bottom, advancing by 300% compared to the S&P 500's 109% gain over the same period.

Mega-cap technology names were the stars of the first half of 2023. According to Rita Nazareth, writing for Bloomberg, the tech-heavy Nasdaq 100 posted its best first half ever (advancing almost 40%), with nearly $5 trillion in market capitalization added to the values of its listed companies. During the first half of 2023, Microsoft, which has a market capitalization of ~$2.4 trillion, gained ~42%; Apple, with a market cap of ~$2.9 trillion, advanced ~49%; Tesla, which is worth $855 billion, gained ~113%; Meta Platforms, with a market value of $764 billion, gained ~138%; and Nvidia, which is worth over $1 trillion, advanced an unsustainable 189%.

So Where Do We Go from Here?

If history is any guide, the NASDAQ 100's blowout start augers well for the remainder of 2023. According to data compiled by Bloomberg, years where the Nasdaq 100 rallies at least 10% (for the first half of the year) have produced average returns of about 14% over the second half of the year (or 8.3% when the

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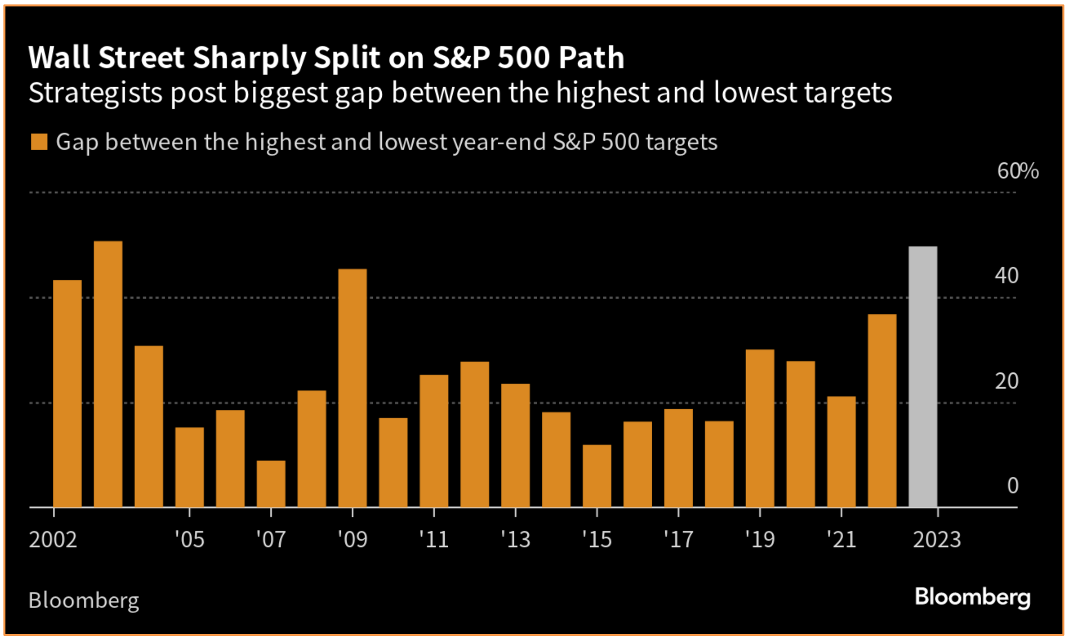
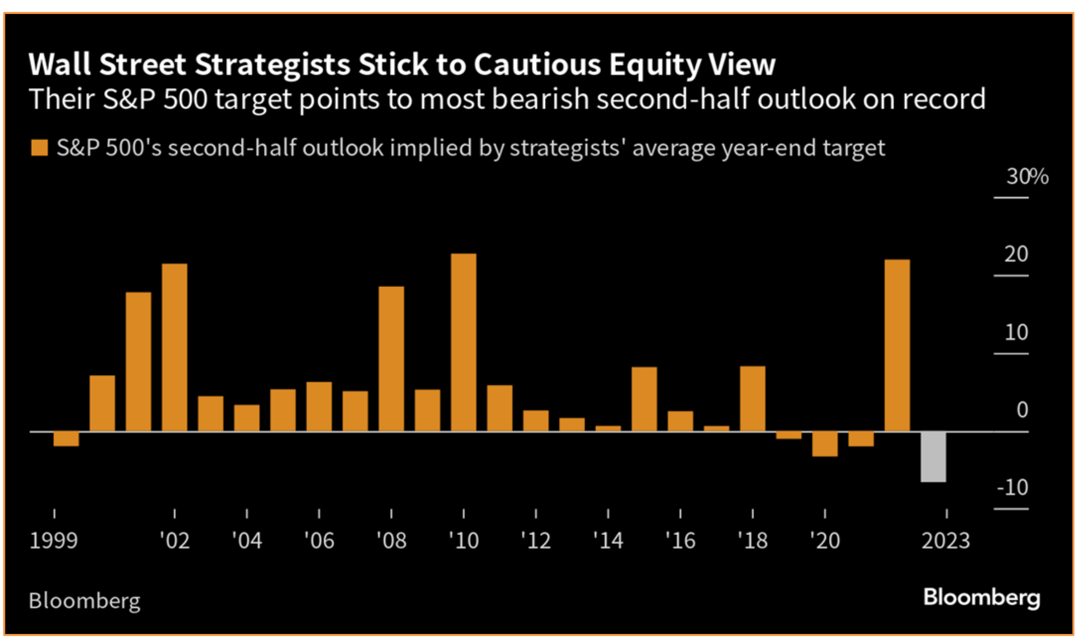
first half gain exceeded 20%). Positive first-half gains for the S&P 500 are also bullish for the remainder of the year. According to Sam Stovall of CFRA Research, since 1945, the S&P 500 has risen an additional 5% when the index recorded a positive return in the first part of the year. What's more, when the index gained 10% or more during the first half, the gains in the back half of the year averaged 8%.

Wall Street "strategists" (who started 2023 for the most part quite bearish on equities) have not been this divided at the midpoint of the year **on how stocks will perform for the remainder of the year in two decades**. There is a 50% difference between the most bullish forecast from Fundstrat (which forecasts a ~10% additional gain for 2023 with the S&P ending at 4,825), and Piper Sandler (which believes the S&P will decline 27% to 3,225) according to data from Bloomberg.



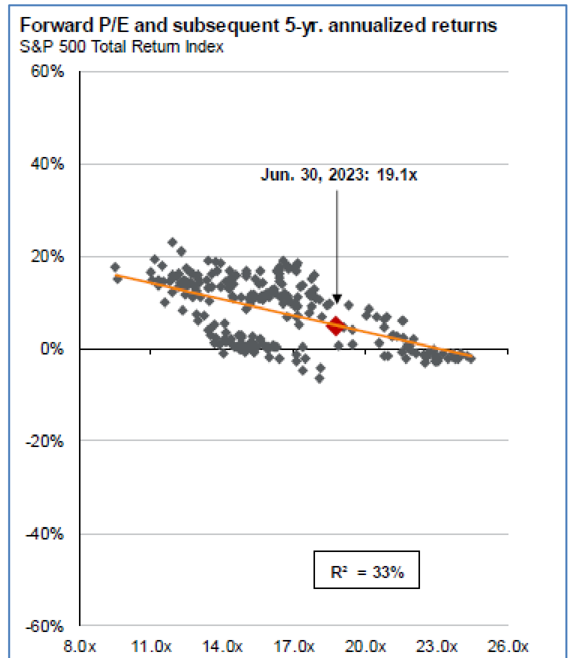
Overall, the average strategist is still bearish on equities (the average strategist's year end forecast predicts a decline of approximately 8% for the S&P 500 for the 2nd half of 2023).



A New Bull Market

The S&P 500 has advanced by 24% since its low on October 12, 2022, officially putting us in a bull market. Historically, the start of a new bull market has been a positive signal for future short-term returns. According to Bank of America Research, utilizing data dating back to the 1950s, the S&P 500 rose 92% of the time over the 12 months following the start of a bull market, with an average return of 19%.

As we have repeatedly noted in these letters, the best indicator of future stock market returns is the price paid. And as the following chart shows, stock market returns (as measured by the S&P 500) have historically been pedestrian with valuations similar to current levels. However, we believe that investors have significant opportunities to do quite well investing in stocks outside the S&P 500.



Source: JP Morgan Guide to the Markets

Growth Investors Beware!

After a stellar 2022 for value investors, 2023 has seen the high-flying growth names return as the market leaders. Growth stocks (represented by the Russell 1000 growth index) are selling ~ 6 multiple points higher than their long-term average (dating back to 1997), with value shares (represented by the Russell 1000 value index) selling slightly above their long-term average. May 2023 was a particularly bad month for value shares. According to Lu Wang and Carly Wanna, writing for Bloomberg, the Russell 1000 value index *fell* 4% in May, compared with a similarly sized *gain* for the Russell 1000 growth index—growth's largest outperformance since 2000.

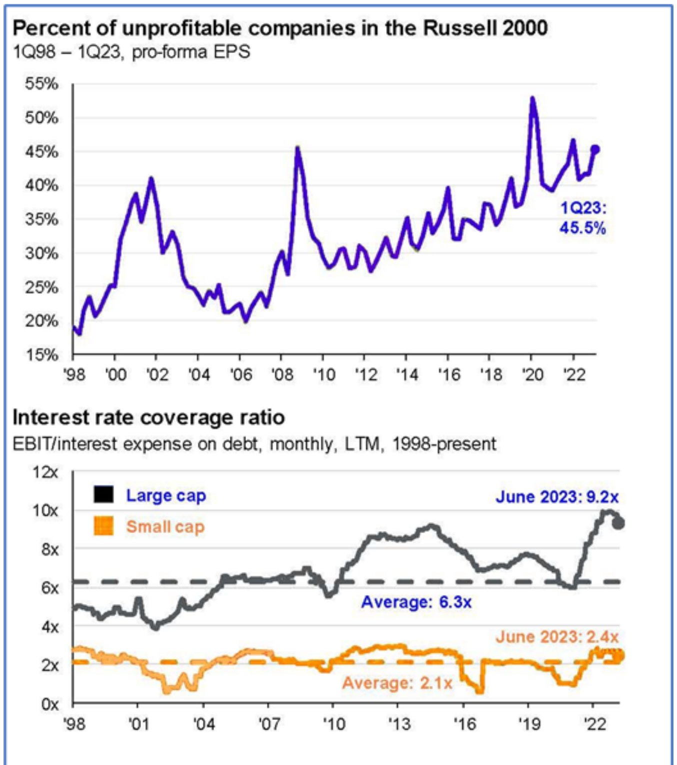
	Forward P/E		Div. yield**	
Style	Current	Long-term avg.*	Current	Long-term avg.*
Value	14.48x	14.09x	2.40%	2.59%
Growth	27.01x	20.79x	0.82%	1.34%

Source: JP Morgan Guide to the Markets

For the first 5 months of the year, growth outperformed value by 23%, the biggest divergence in 44 years of data. Investors are voting with their wallets and have pulled more than $15 billion from ETFs with a focus on value, the fastest withdrawal since at least 2016.

Small-Cap Opportunity?

Small-cap value is the cheapest area of the U.S. market (selling at 14.9x vs. its 20-year average of 16.8x), and it is where we see the biggest opportunities for future outsized gains. **The Russell 2000 (an index of smaller company shares) is down 24% from its 2021 highs and has lagged larger stocks by more than 7 percentage points annually over the past 5 years. According to Charley Grant of the *Wall Street Journal*, that underperformance is among the worst relative 5-year returns since 1926.** Investors are starting to warm up to the opportunity in small-cap shares, with about $3.5 billion having flowed into small-cap stock ETFs since the start of the year.



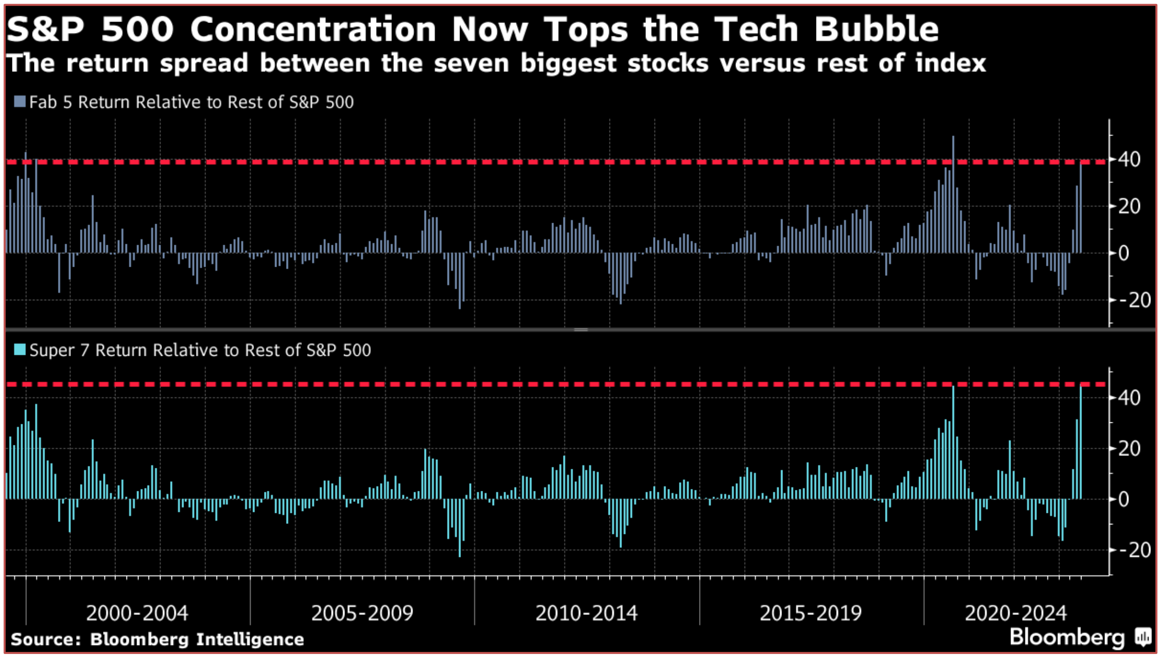
Source: JP Morgan Guide to the Markets

However, investors in small-cap companies need to be especially wary of potential minefields in this area of the market: 45.5% of the companies contained in the Russell 2000 are unprofitable, and their EBIT covers a much smaller percentage of their interest expense than is the case for their large-cap brethren (see the accompanying chart for further details). Partly this is because smaller-cap companies rely much more on floating rate bank debt than large cap companies do (since they don't have the same access to the bond markets). If banks continue to tighten credit, some unprofitable companies could be in for a lot of pain. As a result, it is especially important to be selective and conduct extensive research when investing in this area of the market.

Bad Breadth: Is It a Problem?

Much has been made of the market's lack of breadth (according to Bank of America Research only 25% of stocks outperformed the broader market index during the first half of 2023). Valuation is also a concern for us. As of June 30, 2023, the top 10 stocks in the S&P 500 were selling for 29.3x earnings (fwd.), compared with an average valuation of 20.1x since 1996. The weightings of the S&P 500's top 10 stocks are also at a multidecade high. As of June 30, the S&P 500's top 10 stocks accounted for 31.7% of the index weight, a figure that in 1996 was only ~18% (and that even at the peak of the dotcom bubble was roughly 27%).

Also worryingly, the S&P 500's remaining stocks (outside the top 10) are not cheap, either, selling for 17.8x versus an average of 15.7x since 1996. Interestingly (demonstrating the market's lack of breadth), for the first half of the year, according to Bloomberg Intelligence the return spread between the seven largest stocks in the S&P 500 compared with the rest of the index hit the widest since the dot-com bubble. If you excluded the top seven largest stocks from the S&P 500, the index would have returned a mere 6.3% for the year (still not a bad return!), instead of 16%.



The Nasdaq 100 has become so concentrated that the index provider has announced a "special rebalance" of the weightings of its components. Under Nasdaq rules, if the index's stocks with a weighting of 4.5% or more exceed 48% of the index, those components are rebalanced until they represent only ~40%. Such a rebalancing has happened twice before, in December 1998 and May 2011. As Eric Savitz notes in *Barron's*, a rebalancing is no small matter: hundreds of billions of dollars are invested in funds that track the Nasdaq 100, and the upcoming rebalancing could create temporary downward pressure for index heavyweights such as Microsoft, Apple, and Nvidia.

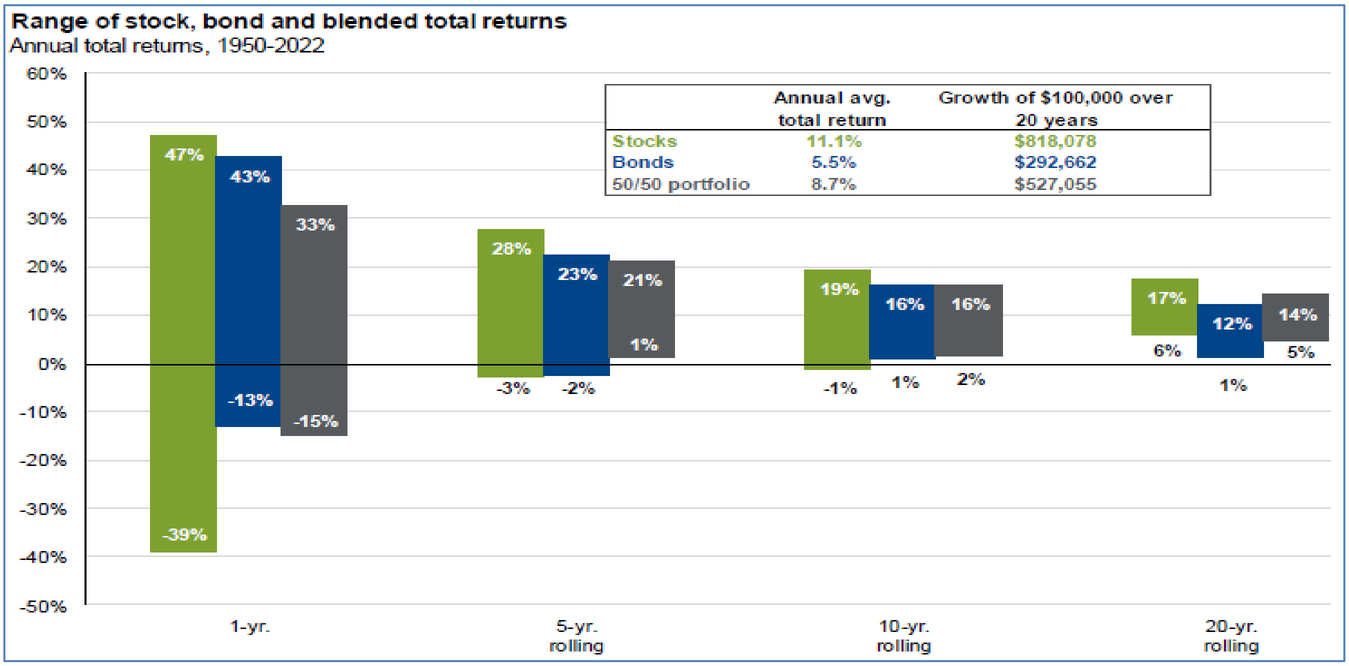
A Painful Year for Short Sellers

2023 has not been kind to short sellers (investors who wager that individual stocks will lose value). According to Jack Pitcher, citing data from S3 Partners and writing for the *Wall Street Journal*, total short interest in the U.S. market was over $1 trillion in June (the highest level since April 2022), after starting the year at $863 billion. According to data from S3, short sellers have incurred approximately $120 billion in mark-to-market losses this year, including $72 billion in the first half of June alone. Short sellers wagering against Tesla are down about 78%, and those unfortunate enough to have bet against Nvidia are down ~105%. (When shorting stocks, the potential for loss is theoretically unlimited, since investors whose short positions go against them must post more collateral to remain in those positions.) Indeed, the *Wall Street Journal* points out that a Goldman Sachs index that tracks the 50 most shorted stocks in the Russell 3000 has advanced 20% in 2023 (as of mid-June).

The Wisdom of Taking a Long-Term View

We've said it before, and we'll say it again: individual investors stack the odds of investment success in their favor when they stay the course and take a long-term view. Yet data from Dalbar tells us that over the past 30 years, when the S&P 500 averaged a 9.65% annual advance, the average investor gained a mere 6.81%. Why such a degree of underperformance? Partly because investors let their emotions get the better of them and chase the latest investment fad (or pile into equities at market peaks and sell out at market troughs)—and partly because they sell for nonfundamental reasons, such as a rise in a company's share price (or in an index).

But history tells us that taking a multiyear view instead would tilt the odds of success in investors' favor. According to data from JP Morgan, since 1950 annual S&P 500 returns have ranged from +47% to -39%. For any given 5-year period, however, that range narrows to +28% to -3%—and for any given 20-year period, it is +17% to +6%. In short, since 1950, there has never been a 20-year period when investors did not average a gain of at least 6% per year in the stock market.



Source: JP Morgan Guide to the Markets

Past performance is certainly no guarantee of future returns, but history does show that the longer a time frame you give yourself, the better your chances become of earning a satisfactory return.

As always, we're available to answer any questions you might have. In addition, please contact us if your financial circumstances have changed so that we can adjust your portfolio(s) accordingly. You can reach us at jboyar@boyarvaluegroup.com or (212) 995-8300.

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® Value Index measures the performance of the small-cap value segment of the U.S. equity universe. It includes those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth values. The S&P 1500 Value Index measures value stocks using three factors, the ratios of book value, earnings, and sales to price, and the constituents are drawn from the S&P 500, S&P Midcap 400, and S&P SmallCap 600. 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 materially differ from that of your account(s), and the holdings in your account(s) may differ significantly from the securities that constitute 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, with 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.*