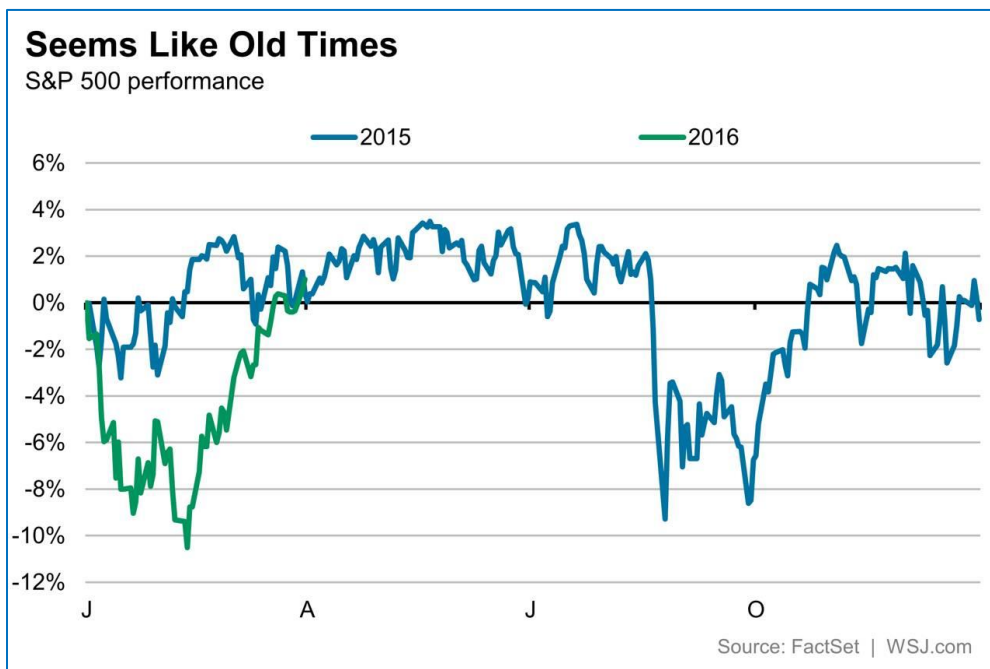


April 30th, 2016

A Look Back

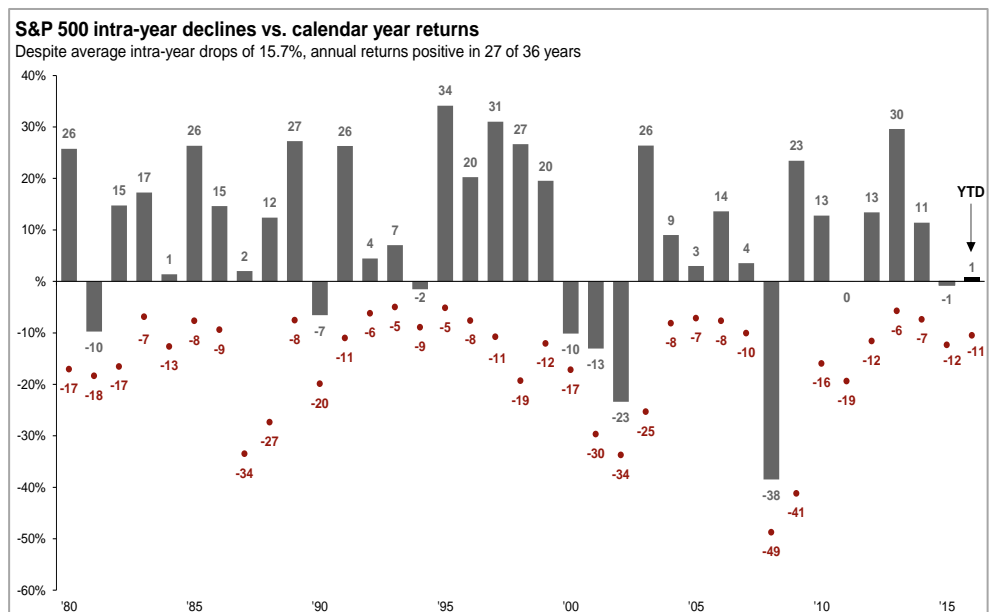
As the late great Yogi Berra once said: "It's déjà vu, all over again." For the first quarter of 2016, the performance of stocks mimicked what transpired during the first three months of 2015. The beginning of 2016 saw the S&P 500 plunge 11% by Feb 11th before staging a sharp rally and eventually advancing by 1.35% for the quarter.



However, extrapolating the recent results may be somewhat premature as only one of the S&P 500's 20 top performing stocks for 2016 finished 2015 in positive territory. We have seen similar drops since the market bottomed in 2009, all of which in hindsight proved to be fabulous buying opportunities. From a historical perspective dramatic price drops are not unusual: **In fact, over the past 36 years, the average intra-year decline has been 15.7% and even with these sizeable temporary losses the S&P 500 posted positive returns 75% of the time.**

Of the ten sectors that comprise the S&P 500, telecom was the best performer advancing 17%, closely followed by utilities which increased by 16%.

The two worst performing components were financials (which dropped 5%) and health care lost 6% (after advancing 126% over the past 5 years). It is not unusual for health care to lag in a presidential election year due to worries about increased government regulation.

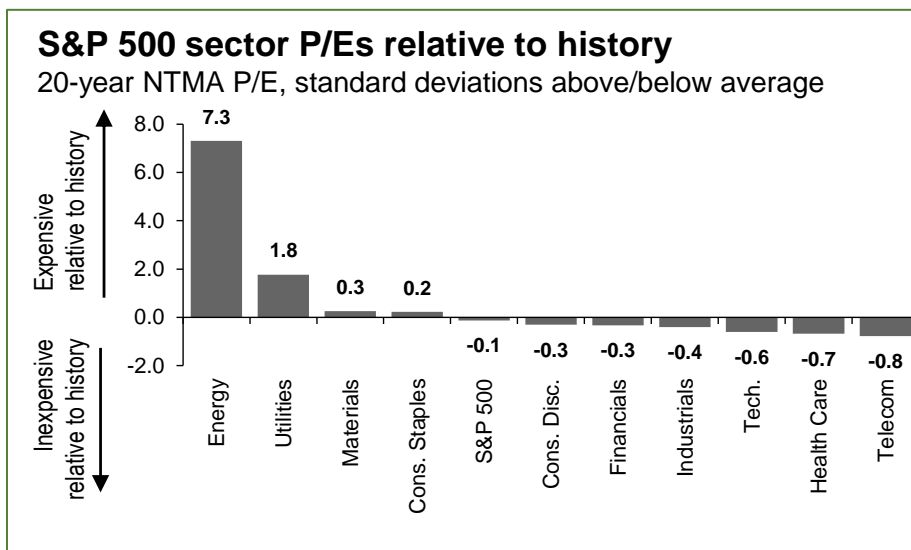


Source: JP Morgan Asset Management

After declining 4.8% in 2015, stocks classified as midcap value reversed course and were the best performers for the 1st quarter of 2016 advancing 3.9%, while small cap growth stocks fared the worst with a 4.7% pullback after losing 1.4% in 2015.

As illustrated by the chart below, the cheapest sectors of the market compared to their historical valuations are consumer discretionary names, financials, industrials, technology, health care and telecom. Energy, utilities, materials and consumer staples are the most expensive sectors.

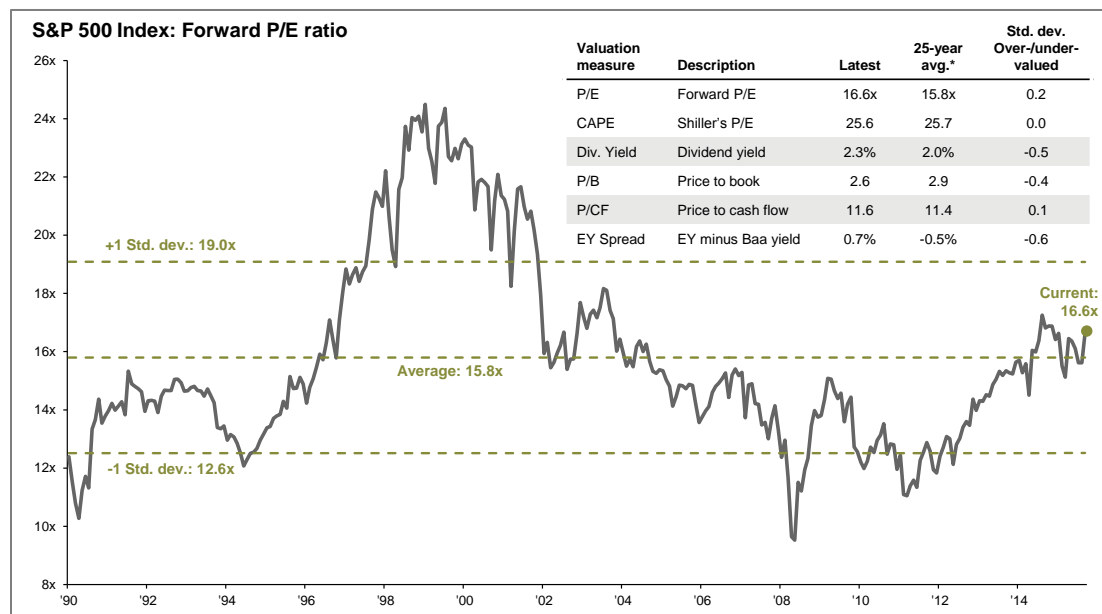
It is worth noting that while energy is trading at 62.5x forward earnings compared to its historical average of 16x, these are arguably depressed earnings due to the collapse of the price of oil. While we are not proponents of purchasing cyclical stocks such as energy related names, usually the best time to buy these types of companies is not when they look statistically cheap but when they look expensive as often times the P/E ratio is calculating depressed earnings.



Source: JP Morgan Asset Management

Is The Equity Market Expensive (A Look Ahead)?

While stocks are clearly not on the bargain basement table, they are not expensive by historical standards either. We are now in the 86th month of the bull run that began in 2009 and the stock market has advanced by ~200%. However, the S&P 500 is trading at ~16.6x earnings compared to its 25-year historical average of 15.8x. For followers of Robert Shiller's CAPE which averages earnings over a 10-year cycle, the market is currently selling close to its 25-year average of 25.7x.

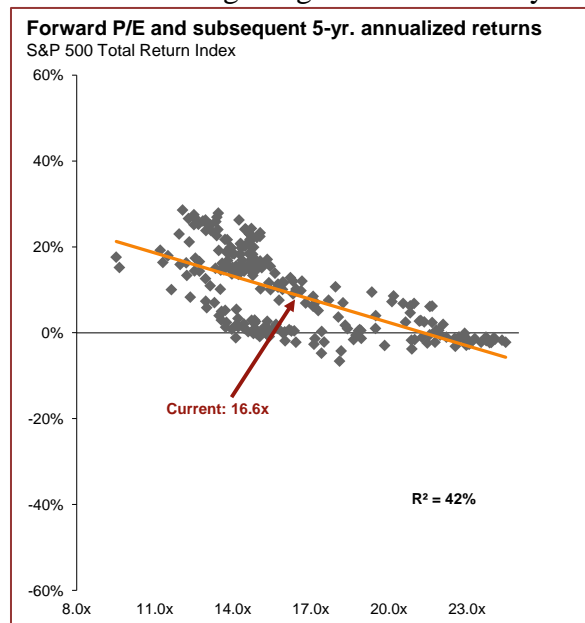


Source: JP Morgan Asset Management

So what are we to make of this current valuation dynamic and how will it potentially impact future equity returns? Historically when the S&P 500 trades at valuation levels that we are currently experiencing, the subsequent five year returns have been moderate but positive.

Some investors worry that this 86-month bull run that has seen a 200% advance is getting old as historically the average bull market gain has been 152% and has lasted 54 months. However, the length and magnitude of the advance we have recently experienced is not without precedent. The bull market that started in October of 1990 lasted for 115 months and registered an increase of 417%.

Our performance was negatively impacted primarily due to financial and health care holdings, two of the worst performing sectors within the S&P 500. In our opinion, financial stocks utilizing almost any recognized valuation methodology have not been this inexpensive since the financial crisis. When interest rates begin to rise (and they will someday) this group has the capability of handsomely rewarding patient investors. **Remember the average yield of a ten-year treasury from 1958 to 2016 has been 6.21% compared to the 1.78% rate the ten year yielded as of March 31st 2016.**

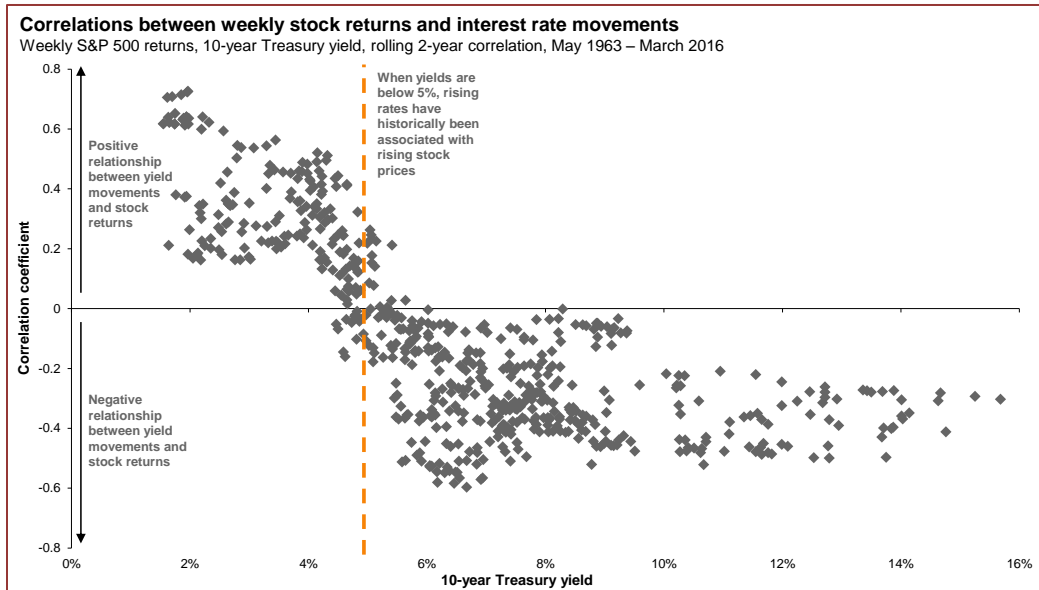


Source: JP Morgan Asset Management

What Happens to Stocks if Interest Rates Rise?

Initially the Fed had telegraphed four interest rate hikes for 2016. Because of the fragile world economy, coupled with anemic domestic growth, the Fed has tempered their interest rate outlook. There is a good likelihood there will be only one additional rate hike, and that might not come until after the presidential election.

However, a rise in interest rates might not necessarily derail the bull market due to the current low rate environment. Since 1963, when rates were below 5% and have increased it has generally meant positive returns for equities. From a historical perspective, it is only when rates eclipse 5% that rate rises spell trouble for equities.



Source: JP Morgan Asset Management

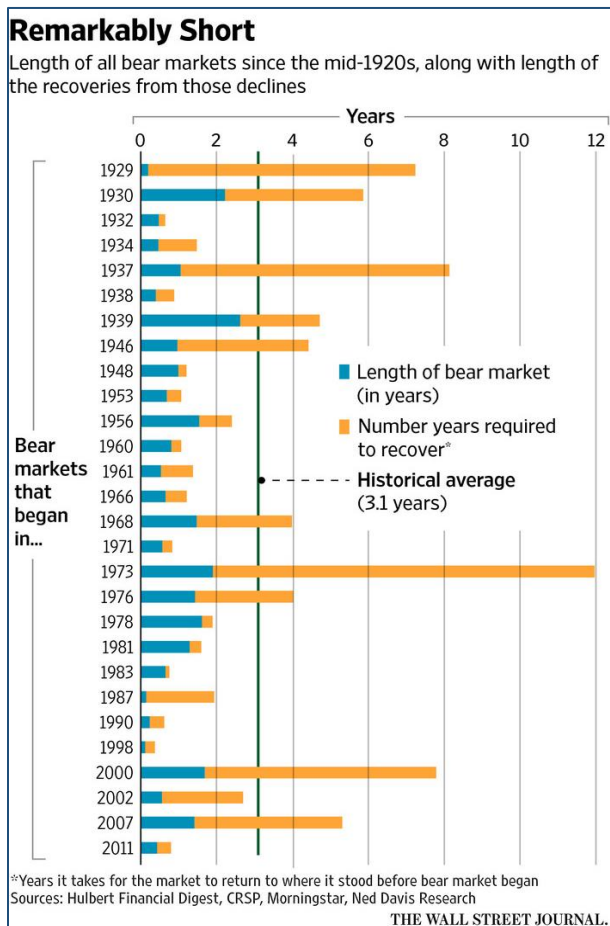
*With the sharp stock market correction during the 1st quarter of 2016, many people (especially those approaching retirement age) were no doubt questioning their current equity exposure. Many investors were asking themselves, “When will I make back my money and do I have enough time to eventually recover from the (hopefully temporary) financial losses I am suffering?” While it is one thing to say you will stay the course during times of financial stress, doing so takes exceptional discipline as every bear market feels like “this is the worst one yet.” **The temptation to jump into the safety of cash can feel overwhelming. However, it is worth noting that historically the average time it takes for an investor to recoup their losses from a bear market is a surprisingly short 3.1 years.** As Mark Hulbert points out in the article excerpted below, “There is no denying that bear markets are painful affairs. Furthermore, because there is no guarantee that the future is going to look like the past, they will tempt you to throw in the towel and dump your stocks. However, if you do that and if history is any guide, odds are overwhelming that you will eventually regret your decision.”*

Investors in or approaching retirement are among those who have the most to lose in a bear market. Their investment horizons might not be long enough to recover from the losses. But how long must your horizon be to have a rational expectation of recovering from a bear market? The answer might surprise you: The typical recovery time is relatively short, in terms of years...

On average, it takes just 3.1 years after a bear market begins for stocks to battle back to where they stood before it began. That 3.1-year period encompasses both the initial bear market, which on average lasts almost exactly one year, and the subsequent recovery, which lasts another 2.1 years...

But it's important not to exaggerate the length of even these longest of recoveries. Consider the recovery from the 1929 crash, which many consider a nightmare scenario: The Dow Jones Industrial Average didn't surpass its September 1929 peak until November 1954, more than 25 years later.

But the Dow in that case paints a distorted picture, since it reflects just 30 stocks rather than the entire stock market. What's more, it doesn't take dividends into account, which were significant during the Great Depression, when the Dow's dividend yield reached as high as 14%. Nor do the Dow numbers reflect the greater-than-30% deflation that occurred in the 1930s, one consequence of which was that the dollar increased significantly in value.



Properly adjusting for all of these factors, I found that the stock market by March 1937 had battled back to its September 1929 peak. Though that seven-year seven-month recovery time is longer than the historical average, it's a lot better than 25 years.

Solace also comes from the speediness of the recovery from the recession of 2008-09, which many consider to be the worst since the 1930s.

By January 2013, the stock market's inflation-and-dividend-adjusted level had risen back to where it stood at its October 2007 peak. That was just over four years after the bear market's bottom in March 2009, and a little more than six years from the market's pre-bear-market level.

The longest recovery time since the mid-1920s was from the 1973-74 bear market: It wasn't until December 1984 that the inflation-and-dividend-adjusted level of the stock market was back to where it stood in January 1973.

But a big contributing factor to that lengthy recovery was that era's double-digit inflation, and one could argue that inflation is unlikely in coming years to be as big a headwind for equities....

—Excerpt from the Wall Street Journal written on March 6th 2016 by Mark Hulbert

Valeant a Wall Street Soap Opera and Cautionary Tale

One of the most fascinating business stories of the past six months has been the dramatic fall from grace of once highflying pharmaceutical company Valeant whose controversial business model (that has been a lightning rod for criticism in the current U.S. Presidential election cycle) was largely predicated on using its high priced stock as a currency to purchase other pharmaceutical companies where they significantly cut costs such as research and development and raised prices on the drugs they acquired.

Due to the tremendous investment banking fees Valeant generated, the company became a Wall Street darling and even in March of 2016 after the shares had imploded, 21 of the 23 analysts covering the company had buy or hold recommendations.

Valeant's stock price which was once as high as \$263 a share is now ~\$34. This saga is especially noteworthy as it involves respected money managers who made massive concentrated wagers on the company; a particularly bitter and thwarted hostile takeover of rival pharmaceutical company Allergan; a controversial CEO who on paper lost billions of dollars, was subjected to an embarrassing margin call on company stock that he had pledged as collateral, was forced to take a prolonged leave of absence due to serious health problems and was shortly fired upon his return.

To further add to the intrigue, a well-known short seller has alleged fraud at the company and compared the company to Enron. This is one stock we are glad we are on the sidelines for!

It is quite rare that so many prominent value investors have been caught up in such an unmitigated investment disaster. Pershing Square led by William Ackman in one day alone suffered a paper loss of over \$1 billion. Value Act, a well-known activist hedge fund with board representation, owns almost 15 million shares.

Ruane Cunniff & Goldfarb, one of the most storied mutual fund firms in history that boasts early ties to Warren Buffett, has suffered massive investor outflows as at one time ~30% of its portfolio was in Valeant shares, and John Paulson who is well known for making a fortune during the subprime crisis, has as of the most recent public filings over 13 million company shares.

Some people (especially after periods like the 1st quarter of 2016 which saw the MSCI Emerging Markets Index rise by 5.7%, compared to a modest gain for the S&P 500) question us on why we do not invest in emerging markets. After all, how could the returns in the U.S. whose GDP is growing in the low single digits compete with the fast growing economies of India, China and Brazil in terms of future investment riches? As investors who are most interested in investing with a margin of safety, we are content "playing" emerging markets by investing in U.S. based companies that will benefit as emerging markets develop. In addition, as Jason Zweig of The Wall Street Journal discusses in an article excerpted below, investing in the U.S. when it was an "emerging market" did not give equity investors any better of a return than the returns investors received once the U.S. was a developed nation.

The government massively overinvested in transportation and land development. The banking system was inefficient and corrupt. State governments gorged on debt, then defaulted on it with aplomb. The stock market was crooked, rife with cronyism and insider trading. Stocks shot up and down like yo-yos.

China? No, that's the U.S. in the 19th century, but it has lessons for investors looking at China and other emerging markets. Financial history shows that the return on U.S. stocks during the country's own emerging-

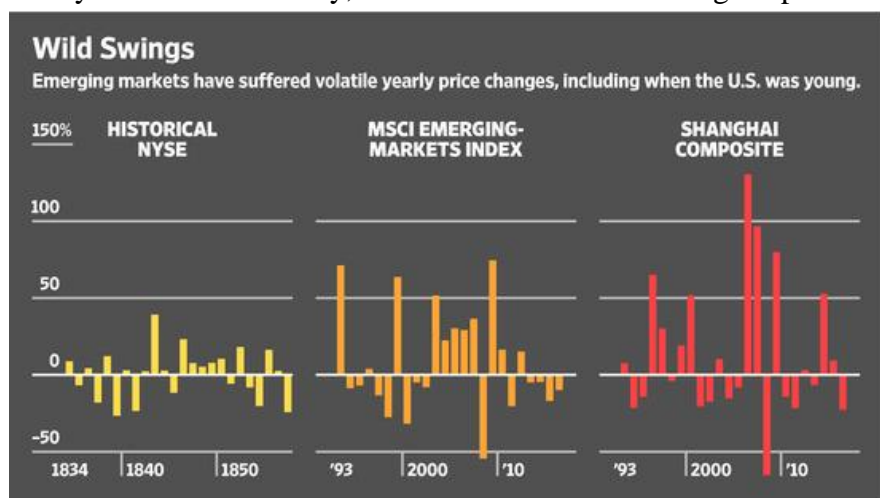
market period was no higher than it has been since World War II. The lesson: Emerging markets aren't lucrative investments just because they are "emerging." They deliver higher returns only after they have been battered, as China is being battered now.

British investors learned and relearned that lesson the hard way in the 19th century, when they poured today's equivalent of tens of billions of dollars into U.S. stocks and bonds.

They were driven by the epic, generation-long decline of U.K. bond yields from about 5.5% in 1816 to less than 3% in 1845, and again from roughly 4% in 1866 to 2% in 1897. With money so cheap, British investors helped fund the Erie Canal, successful railways and thriving telegraphs. Those who came in on the crests of euphoria lost fortunes on steamboats, mines and even municipal bonds, as state after U.S. state repudiated its debt...

Emerging markets don't offer higher returns merely because they are growing faster. Stocks gained an average of 6.7% annually after inflation between 1802 and 1870 when the U.S. was an emerging market. They've returned 6.9% on that basis since 1926. And the 19th century returns might well be overstated by at least a percentage point annually, given the difficulties of measuring the performance of the thousands of stocks that disappeared without a trace in those days.

Early in the 19th century, middle-class Americans began speculating wildly on stocks, egged on by financial promoters publishing tout sheets that hyped the hot stocks of the day, like the Morris Canal & Banking Co. Kickbacks and favors flew as local and state officials, as well as the federal government, pumped public funds into companies run by their cronies.



Sources: International Center for Finance, Yale School of Management (NYSE); FactSet

Note: 2016 annual returns are through Jan. 27
THE WALL STREET JOURNAL.

Stock exchanges sprang up everywhere from Norfolk, Va., to Virginia City, Nev., and foreigners soon followed the locals in the speculation.

China's evolution as an emerging market has thus far followed a similar path.

As a nation that aspires to be a developed market but is still emerging, China remains subject to the wrenching volatility and wild swings of sentiment that have always characterized young and rambunctious markets.

Countries learn from their mistakes," says Antoine van Agtmael, the pioneering investor who coined the term emerging markets in 1981. "So will China." Investors will learn, too, if slowly. A study of more than a century's worth of investment returns shows that emerging markets deliver their best results not when hopes are highest, but after they break investors' hearts...

During an election year, Wall Street makes for an easy target for politicians. Economic populism is great for scoring both headlines and votes as the population at large who has largely not participated in the economic recovery is understandably frustrated and is looking for a scapegoat. However, while Wall Street like any industry certainly has its fair share of bad actors who have caused innocent people serious financial harm, it has and continues to receive a disproportionate amount of blame for the financial crisis. While certain financial executives lied on conference calls about their leverage ratios and sold products they did not entirely understand, the root cause of the financial crisis lies with politicians and regulators. The excerpted editorial below that appeared in the Wall Street Journal by Phil Gramm and Michael Solon does an excellent job of outlining the true causes of the financial crisis and the subsequent weak economic recovery.

When the subprime crisis broke in the 2008 presidential election year, there was little chance for a serious discussion of its root causes. Candidate Barack Obama weaponized the crisis by blaming greedy bankers, unleashed when financial regulations were “simply dismantled.” He would go on to blame them for taking “huge, reckless risks in pursuit of quick profits and massive bonuses. “That mistaken diagnosis was the justification for the Dodd-Frank Act and the stifling regulations that shackled the financial system, stunted the recovery and diminished the American dream.

In fact, when the crisis struck, banks were better capitalized and less leveraged than they had been in the previous 30 years. The FDIC’s reported capital-to-asset ratio for insured commercial banks in 2007 was 10.2%—76% higher than it was in 1978. Federal Reserve data on all insured financial institutions show the capital-to-asset ratio was 10.3% in 2007, almost double its 1984 level, and the biggest banks doubled their capitalization ratios....

Virtually all of the undercapitalization, overleveraging and “reckless risks” flowed from government policies and institutions. Federal regulators followed international banking standards that treated most subprime-mortgage-backed securities as low-risk, with lower capital requirements that gave banks the incentive to hold them.

Government quotas forced Fannie Mae and Freddie Mac to hold ever larger volumes of subprime mortgages, and politicians rolled the dice by letting them operate with a leverage ratio of 75 to one—compared with Lehman’s leverage ratio of 29 to one. Regulators also eroded the safety of the financial system by pressuring banks to make subprime loans in order to increase homeownership. After eight years of vilification and government extortion of bank assets, often for carrying out government mandates, it is increasingly clear that banks were more scapegoats than villains in the subprime crisis....

Another myth of the financial crisis is that the bailout was required because some banks were too big to fail. Had the government’s massive injection of capital—the Troubled Asset Relief Program, or TARP—been only about bailing out too-big-to-fail financial institutions, at most a dozen institutions might have received aid. Instead, 954 financial institutions received assistance, with more than half the money going to small banks.

Many of the largest banks did not want or need aid—and Lehman’s collapse was not a case of a too-big-to-fail institution spreading the crisis. The entire financial sector was already poisoned by the same subprime assets that felled Lehman. The subprime bailout occurred because the U.S. financial sector was, and always should be, too important to be allowed to fail.

Consider that, according to the Congressional Budget Office, bailing out the depositors of insolvent S&Ls in the 1980s on net cost taxpayers \$258 billion in real 2009 dollars. By contrast, of the \$245 billion disbursed by TARP to banks, 67% was repaid within 14 months, 81% within two years and the final totals show that taxpayers earned \$24 billion on the banking component of TARP. The rapid and complete payback of TARP funds by banks strongly suggests that the financial crisis was more a liquidity crisis than a solvency crisis.

What turned the subprime crisis and ensuing recession into the “Great Recession” was not a failure of policies that addressed the financial crisis. Instead, it was the failure of subsequent economic policies that impeded the recovery.

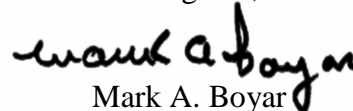
The subprime crisis was largely the product of government policy to promote housing ownership and regulators who chose to promote that social policy over their traditional mission of guaranteeing safety and soundness. But blaming the financial crisis on reckless bankers and deregulation made it possible for the Obama administration to seize effective control of the financial system and put government bureaucrats in the corporate boardrooms of many of the most significant U.S. banks and insurance companies.

Suffocating under Dodd-Frank’s “enhanced supervision,” banks now focus on passing stress tests, writing living wills, parking capital at the Federal Reserve, and knowing their regulators better than they know their customers. But their ability to help the U.S. economy turn dreams into businesses and jobs has suffered.

In postwar America, it took on average just 2 1/4 years to regain in each succeeding recovery all of the real per capita income that had been lost in the previous recession. At the current rate of the Obama recovery, it will take six more years, 14 years in all, for the average American just to earn back what he lost in the last recession. Mr. Obama’s policies in banking, health care, power generation, the Internet and so much else have Europeanized America and American exceptionalism has waned—sadly proving that collectivism does not work any better in America than it has ever worked anywhere else.

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

Best regards,

Handwritten signature of Mark A. Boyar in black ink.

Mark A. Boyar

Handwritten signature of Jonathan I. Boyar in black ink.

Jonathan I. Boyar

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