1st Quarter Commentary

April 2017

We're Going Mainstream

> ***Part I:*** *Going mainstream, A – what do you get with the S&P 500 today? And why you probably won't get even 5%.*
>
> ***Part II:*** *Going mainstream, B – paying a visit to a large- cap value manager and a large-cap growth manager.*
>
> ***Part III:*** *Going mainstream, C – are indexes subject to relative-performance pressure, too? And how do you dismiss the index for style drift?*
>
> ***Part IV:*** *Why, for more than 5%, you have to leave the indexation valuation vortex. Another few companies that have favorable, not unfavorable future return prospects.*

In past reviews, we've titillated you with some of the more startling and story-worthy examples of the distortions caused by the indexation vortex, as we sometimes call it. Such as the iShares Frontier Markets ETF (FM), labelled as 91% lower risk[1] than the S&P 500, because of its Beta of 0.09. That magic number says you can ignore the 10% weighting in Pakistan, which is now contemplating the greater wisdom of a nuclear first-strike strategy against India, as well as the 20% in Kuwait, smaller than New Jersey and surrounded by Saudi Arabia, Iraq and, 5 miles off its Persian Gulf coast, Iran. Or that almost 50% is in financial stocks. Another was the iShares Italy ETF (EWI), fascinating for the fact that seven of the top 10 holdings get an average 72% of their sales from outside Italy.

Why choose examples like those? To direct one's attention, through all the noise of conflicting information from the financial news media, toward the bubble conditions that ETFs have wrought. We're in a dangerous period. But I fear that these examples from the edge might have been too easily ignored or forgotten precisely because they focused on more marginal sectors of the markets.

Because how many readers thought that those examples really applied to them, either at all or more than peripherally? How relevant were they to your portfolios? We know that other people drive distracted and too fast on highways late at night, but not us.

So, in this letter we'll go mainstream and see what's going on in the most basic portfolio building blocks, the bread and butter asset classes: first, the S&P 500 itself, and then a typical mainstream growth fund and a mainstream value fund that an everyman or everywoman would use. The kind of fund that *is* relevant.

The Broad Market – The Active and Passive Camps Agree

We had the privilege of debating with the esteemed Vanguard Group founder Jack Bogle several weeks ago at the Grant's (Interest Rate Observer) Spring Conference. The discussion mostly circled the advisability of index funds for the average investor and the prospective returns they should expect. Oddly enough, we agreed on just about every point. Mr. Bogle is America's most ardent advocate of investors making a virtually singular asset allocation decision: buy the appropriate X% and Y% in stocks and bonds; make it categorical by buying the broad market, like the S&P 500; and stay there for the long haul, without any fancy footwork. He's a true believer in equities. Yet, even he publicly cautions that if they're looking forward 10 years, investors should no longer expect more than about 4% from stocks. We're in general agreement, but perhaps less optimistic. Here's why.

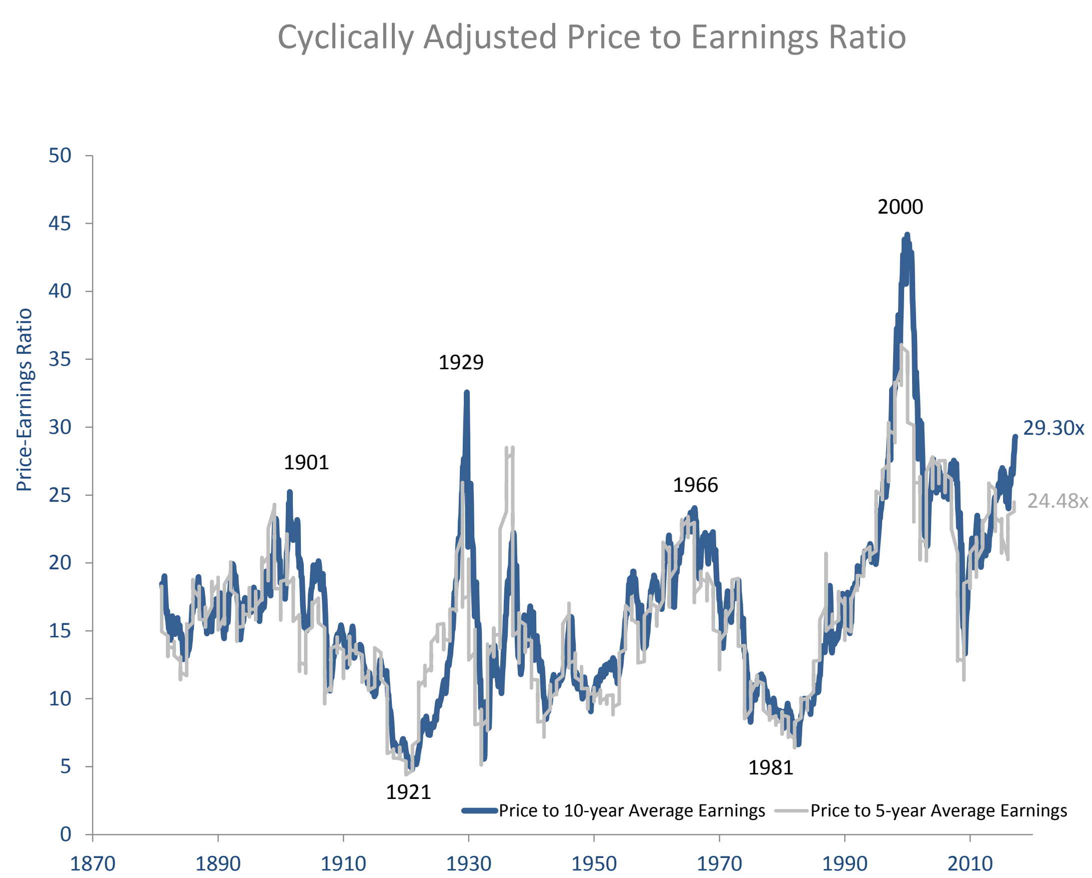
[1] iShares fact sheet, as of 3/31/17.

Problem #1: Valuation

Using the broadest, most straightforward measures, the market is a hair's breadth away from historically peak valuations, the aftermaths of which were disastrous.

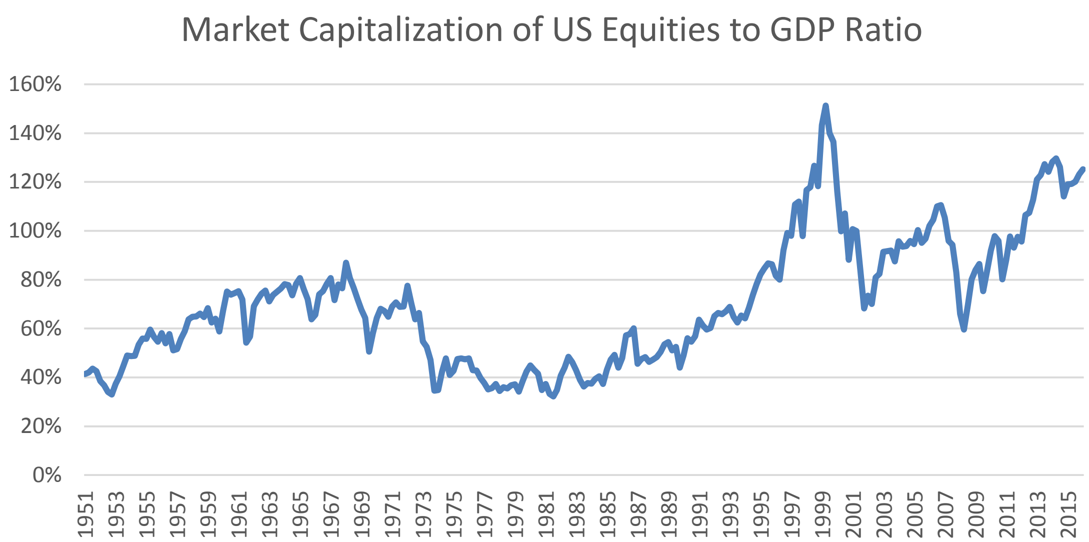
- *Current Price-to-Earnings Ratio and Average P/E Ratio* The S&P 500 now trades at 23.4x trailing 12-month reported earnings (as opposed to analyst-doctored 'operating' earnings that exclude accounting charges and the ever-recurring non-recurring 'items'). Paying almost 24 years' worth of earnings for a basket of mega businesses is understood to be really high, but this level has often been exceeded due to the significant variability in reported earnings in any given year.

  The approach preferred by many economists and chief investment strategists uses price relative to the average earnings of the prior 5 or 10 years, in order to smooth out temporary and episodic noise; they find it more reliable. By this measure the S&P 500 trades at 29x earnings, which has been exceeded only twice before in the past 130+ years: in 2000, the Internet Bubble Peak, and in 1929.



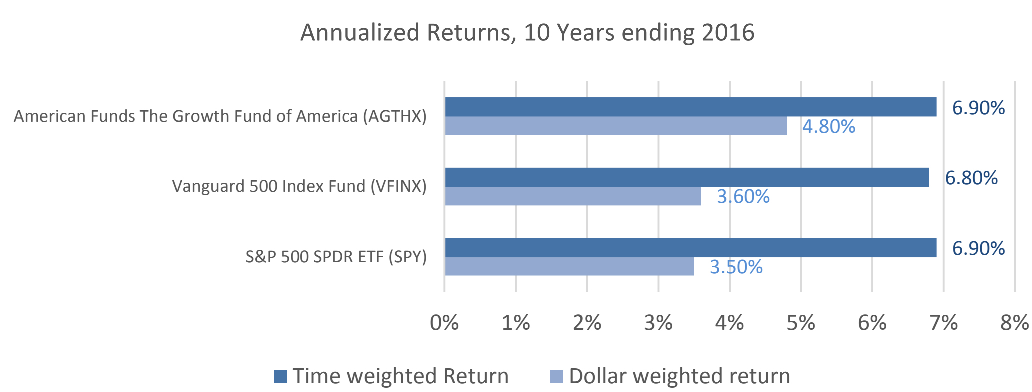
Source: http://www.econ.yale.edu/~shiller/

- *Total Market Capitalization-to-GDP Ratio* Even simpler, more understandable and less arguable than P/E is this measure. The combined market value of all U.S. stocks, as measured by the Federal Reserve, is now near the 2nd highest on record. At 125% of GDP as of October 2016, it was just below the level reached in early 2000, the peak of the Internet Bubble. If one considers the market's appreciation since October 2016, the ratio may have exceeded the 2000 level.



Source: Federal Reserve Bank of St. Louis

To suggest that this will iron out over time, irrespective of valuation, is a spurious interpretation of indexation. Today, just over 17 years after the Internet Bubble peak in March 2000, and after an 8-year bull market, the S&P 500 returned 4.7% a year. And those results, such as they are, only pertain if everybody stayed in, which they didn't. How could they, when the turnover of SPY is 1,900% a year. That's 100% every three weeks.



Source: Credit Suisse Research

A variety of studies have measured that, because of their own market timing decisions, the average investor in an S&P 500 index fund gets but a small fraction of the return of the index. A relatively short-term example from Credit Suisse: the published return of the index over the past 10 years might have been 7%, but because of people putting money in following market appreciation and taking it out following market declines, the return on the average dollar invested in the index was more like 3 ½%.

Problem #2: Age – Of the Index, That Is

The growth profile and earnings power of the S&P 500 and other large-cap indexes has changed beneath our feet; it is no longer what it once was, and the historical result cannot be replicated.

- *Future growth from the top of the index:* The money flows of mass market indexation have created structurally automatic bids for the major index companies. These, particularly the branded consumer products businesses like Coca-Cola and Procter & Gamble, are mature and generally have stagnant or declining revenues. They represent the great bulk of the value of the S&P 500.
- *Future growth from the bottom of the index:* Historically, the smaller companies in the S&P 500 represented the future growth. While their early weightings and market capitalizations were small, they were sufficiently large relative to the balance of the index that they could ascend in position and have a meaningful impact on the index return. Today, though, the high weightings of the mature companies are largely fixed in place, and their presence suppresses the earnings growth *from the bottom of the index*.

A Visit With A Mainstream Value Manager and Growth Manager

Based on financial news articles and television shows, everyone should be aware that money is being constantly withdrawn from active managers and placed into ETFs and other index funds. This has been happening since 2007. Undoubtedly, the active managers are striving with even greater urgency to beat the indexes against which they are judged. They are seeking some edge. Here are two typical large-company, blue-chip strategies. One is value oriented. For this one, the idea is that the manager selects, only from within the benchmark index, those stocks that are the least expensive or which the market has undervalued. It is generally agreed to be a lower-risk approach.

The other basic strategy, of course, is growth oriented, and it also chooses stocks only from within the index. It presumes that even if a higher price is paid, the higher growth rates of those companies will more than make up for the greater valuation risk.

Let's take a look at two such funds, each of which draws its holdings exclusively from within the S&P 500. The managers simply select the cheaper stocks, on the one hand, and the higher-growth stocks on the other. Both have been very successful in terms of asset gathering, with about $15 billion in AUM apiece.

The companies in the value fund trade at 18.0x trailing earnings and at 2.0x book value. Whether one thinks this is expensive for a value fund or not, it is certainly quite a discount to the growth fund P/E of 23.7x and price/book ratio of 5.0x. So, at least the valuations make sense relative to one another.

Now for the make-up of each fund. Their industry sector allocations are shown in the accompanying tables. You might not pay particular attention, on such short notice, to the largest sector weightings, but you should.

In the **Value Fund**, 26.48% is invested in Financials. Now, Financials are typically cheaper than the rest of the stock market, so one can see why they might be in a value fund. Of course, there's a good reason they're cheaper, which is that they are highly leveraged: the typical bank has at least 8x more liabilities than its shareholders' equity or book value. This means that although Citigroup's provision for loan losses last year was only 0.4% of its assets, it was equivalent to 3.0% of its book value. In a deteriorating economy or poor credit environment, a seemingly modest increase in loan losses could have a dramatic impact on the bank's balance sheet, earnings and creditworthiness.

	Manager A: Value Fund
Consumer Discretionary	6.93%
Consumer Staples	11.67%
Energy	11.37%
Financials	26.48%
Health Care	12.21%
Industrials	8.62%
Information Technology	7.23%
Materials	3.45%
Real Estate	1.81%
Telecommunications	3.97%
Utilities	6.02%
Cash, futures, other	
Total	100.00%

Source: Manager fact sheets, as of 3/31/17

Anyway, is 26.48% in Financials a lot or a little? It seems like a lot to me, but it's tough to know without some reference points. The current weight of Financials in the S&P 500 is 14.2%. So, the Value Fund's weighting is almost twice as high as that. But is it alarmingly high? Maybe we need another reference point. The highest weight that this sector ever recorded in the S&P 500 Index was at the end of 2006, on the eve of the Financial Crisis. At that time, the S&P Financials' weight was 22.27%. The Value Fund's weight is 26.48%.

It's actually higher than that. The reason is that until last September, Standard & Poor's included the real estate stocks in the financial sector, since these also share the characteristic of leveraged balance sheets. But, Standard & Poor's wanted to reduce the apparent size of the sector, for whatever good reasons they might have had. So as of September, real estate is shown separately. *To make a proper comparison, by adding back the Value Fund's 1.8% real estate investments, it has 28.3% in Financials, compared to the S&P 500's all-time pre-Financial Crisis Bubble-weight figure of 22.27%.*

The **Growth Fund's** largest sector is Information Technology, at 34.53%. The same question: is this low, average, or high? The current S&P 500 weighting is 21.99%, so the Fund's exposure is 50% higher. How about historically?

	Manager B: Growth Fund
Consumer Discretionary	16.83%
Consumer Staples	7.26%
Energy	2.52%
Financials	4.09%
Health Care	15.28%
Industrials	11.27%
Information Technology	34.53%
Materials	2.32%
Real Estate	3.88%
Telecommunications	1.04%
Utilities	0.79%
Cash, futures, other	
Total	100.00%

Source: Manager fact sheets, as of 3/31/17

In March 2000, at the white-hot finale of the Internet Bubble, Information Technology was 34.81% of the S&P 500. At 34.53%, we're not quite, but just about there. But wait, there's more. It is only by an accident of classification that Amazon is a member of the consumer sector despite its ownership of Amazon Web Services. Amazon Web Services is by far the largest cloud computing and storage company, way ahead of Microsoft and IBM and Google. More relevant, this division accounted for over 100% of Amazon's earnings last year and is growing more rapidly than the rest of the company. Since Amazon has a 3.2% weight in the Growth Fund, *if Amazon were classified as a member of the technology sector, this fund's technology weight would comfortably exceed the S&P 500 record set during the Internet Bubble.*

The Question Is: Would You, or Should You, Dismiss One or Both of These Value and Growth Managers? Would You Even Own Such a Fund, Knowing their Financial and Tech Sector Weightings?

Some more information before you make a decision. The preceding discussion engaged in a small deception. They are actually the iShares S&P 500 Value ETF (IVE) and the iShares S&P 500 Growth ETF (IVW). So, these are not really actively managed funds run by two different portfolio managers desperate to keep assets from leaving; they are index funds desperate to bring more assets in.

They do, though, give a nod toward active management in that they are what are known as "smart beta" funds, which has become the fastest growing category of ETFs.

The idea of smart beta is to isolate a particular variable that has been demonstrated in statistical back-tests to add a valuable characteristic, such as higher returns or the diversifying benefit of a different pattern of returns. The value versus growth categories are a standard for evaluating managers and also for establishing structural diversification within a stock portfolio; the large cap versus small cap categories are similar in that way.

On May 12, 2016, BlackRock issued a press release, which said: "BlackRock projects smart beta ETF assets will reach $1 trillion globally by 2020 and $2.4 trillion by 2025." It went on to state, "With current smart beta assets of $282 billion, this reflects an annual growth rate of 19%, double the growth rate of the overall ETF market."

In the case of these two iShares ETFs, a stock is determined to fall into the value or growth category based on its price-to-book value ratio. Essentially, if all stocks are ranked according to their book value multiple, those with price-to-book-value ratios below the median or middle value are known as value stocks, and those with ratios above the median value are the growth stocks.

The returns for each of these two ETFs for the past five years is now shown, so we can see what the diversification or return divergence between the two has been. Unfortunately, not only don't the returns differ from each other; beyond a rounding error, they hardly differ from the S&P 500 ETF itself. The figures are 14.59%, 14.48% and 14.33%.

Value Indexes vs. Growth Indexes, Large Cap
Annualized Returns, 5 Yrs. Ending 12/31/16

IVV	iShares Core S&P 500 ETF	14.59%
IVE	iShares S&P 500 Value ETF	14.48%
IVW	iShares S&P 500 Growth ETF	14.33%

Source: iShares

Maybe we will have more luck uncovering the diversification or return divergence between the value and growth extremes with the small capitalization stocks. The iShares Russell 2000 ETF earned 14.51%. Note the similarity of the return, incidentally, to the large capitalization stocks. It is four basis points removed from the S&P 500 return of 14.59%.

Value Indexes vs. Growth Indexes, Results, Small Cap
Annualized Returns, 5 Yrs. Ending 12/31/16

IWM	iShares Russell 2000 ETF	14.51%
IWN	iShares Russell 2000 Value ETF	14.95%
IWO	iShares Russell 2000 Growth ETF	13.89%

Source: iShares

As an aside, 4 basis points is below the human physiological capacity for perception. In psychophysics, a just noticeable difference, or JND, in the ability to differentiate between two items of different weight is about 5%, which, in finance argot, would be 500 basis points. For sound perception, depending on the frequency of the tone, the threshold is about 0.06%, which would be 6 basis points.

Risky Overweightings Aside, Do We Yet Know Enough to Know Whether to Buy the Value or Growth ETF?

Maybe, but here's more data. It is interesting to note that despite the titles, the iShares S&P 500 Value ETF has 353 holdings, while the Growth ETF has 321 names. How is it possible to divide the S&P 500 along the fault line of price-to-book-value and emerge with two funds that collectively hold 674 S&P names?

Sometimes mathematical logic must give way to practical business reality. Generally speaking, the high price-to-book-value names have more trading liquidity than the low price-to-book-value names. If one maintained a formalist approach, the value index would be less liquid in terms of aggregate trading value and therefore, could accommodate less in the way of assets that could be managed than the growth index.

Consequently, the value and the growth indexes share a certain commonality of names, such as Johnson & Johnson, General Electric, Procter & Gamble, Pfizer, Merck, Verizon, and Disney, among others. Even Trip Advisor is part of the S&P 500 Value ETF, even though it trades at 4.19x GAAP book value and more than 10x academic book value (shareholders' equity less intangible assets). It also trades at 52.5x trailing 12-month earnings. In the past few months, the earnings estimate for 2017 has been reduced by 23%. The estimates for 2018 have been reduced by 25%. The shares now trade at 34x the 2017 earnings estimate, although there can be no assurance that this estimate will be achieved. Trip Advisor is also, of course, in the iShares S&P 500 Growth ETF.

The answer to why there are 674 S&P 500 names between the two ETFs is that, contrary to the entirely natural assumption that each index is defined by the division between high and low valuation multiples of the individual companies, they're actually differentiated not by security, but by the weights assigned to different sectors. Where there's a will, there's a way. Which would bring us back to the beginning of this review, with those remarkable industry sector weighting tables of the two ETFs.

It also brings us back to the question of whether to dismiss what might have been the active managers of these growth and value funds, who, in their thirst for extra performance, established historically record high weightings in the financial and technology sectors. Professional asset allocators and performance evaluators monitor managers very vigorously, to ensure that there is no style drift under the pressure to beat their index and raise more assets. As we see, though, style drift in the index for exactly the same reasons is quite permissible. That is a very interesting situation, to say the least.

One last item here. Although it might seem like an aside, to miss this is to miss what's behind the entire ETF phenomenon and the absurd and dangerous fund structures being placed into asset allocation programs and robo-advisor apps. It's about the business of asset gathering and the ETF price war.

Value Indexes vs. Growth Indexes, Fees

IVV	iShares Core S&P 500 ETF	4 bp
IVE	iShares S&P 500 Value ETF	18 bp
IVW	iShares S&P 500 Growth ETF	18 bp

Source: iShares

Recall that in one of the preceding tables, both the iShares S&P 500 Value and S&P 500 Growth ETFs underperformed the S&P 500 by an exceedingly modest degree. And that difference is almost entirely accounted for by the difference in fees: the iShares S&P 500 (IVV) charges a 4 basis point fee, which is 4/100ths of 1%, while those two smart beta funds charge 18 basis points. It's a small difference, perhaps, to the buyer, but it's a 3 ½x greater fee for the manager. iShares has about $30 billion in assets in these two ETFs.

What's this about? Paradoxically, it's an unintended consequence of Vanguard's strategy of driving fees on bread-and-butter indexes like the S&P 500 and the Russell 1000 down to the 5 basis point range. Advisors – whether human or robot – are not going to guide investors there; they can't live on 5 basis points. And since for-profit fund companies can't compete with Vanguard head to head on the S&P 500 battlefield, they will collect their higher fees elsewhere. Through product differentiation. Ergo, not only the oft-mentioned iShares Frontier Index, with a 79 basis point expense ratio, and the Italy ETF, with a 48 basis point fee, but also smart beta funds.

The challenge to the rational practice of indexation is the profit motive. Index funds are, by definition, commoditized products: one S&P 500 or Russell 1000 fund can be no different than another. And it is wholly rational that the for-profit companies that promote index funds try to avoid selling near-zero-fee products. The use of marketing to promote the sense of product differentiation to the customer in order to secure a higher price is not new: it's done for vodka, cigarettes and shampoo. As the examples above illustrate, the ETF industry has hijacked traditional indexation and distorted it to a dangerous degree. One cannot even be sure that when one buys a country fund, one even gets that country.

The Unavailability of Alternative Asset Classes/Sectors

Let's suppose that it dawned on some modest proportion of investors that, though they thought they were attending an academic symposium, they were actually in the midst of what had devolved into a wild party. They decided it was time to leave. To go where? Small-capitalization stocks, a traditional alternative, are no longer a practical alternative. Because of the $1+ trillion that has flowed into ETFs since the Financial Crisis, in practical terms, ETF organizers could only accommodate this magnitude of demand with stocks that have substantial trading liquidity. They necessarily promoted large-capitalization indexes. Accordingly, over 80% of the stock market is invested in large-cap stocks (greater than $10 billion[2]). Only 4.6% of the stock market, by value, are companies less than $2 billon in size. They simply cannot absorb a sufficient portion of the equity pool; they cannot be a functional alternative.

Real estate, perhaps the largest industry in the U.S., should be an alternative, at least in principle. Yet, publicly traded real estate is only 4.1% of the stock market. On a practical basis, it is not available either. Moreover, publicly traded real estate likewise trades near all-time high valuations. Private real estate, unfortunately, is the virtual antithesis of the safety and reliability of broad-based indexation. It poses unacceptable risks and limitations on a public policy basis: illiquidity; no objective valuation mechanism; absence of financial and management transparency and accountability, including compensation and self-dealing; debt leverage risk; complexity of corporate and tax structure; and excessive Wall Street underwriting fees if engaged to create and offer any standardized or pooled securities.

[2] CRSP U.S. Total Market Index, as of 3/31/17, comprising over 3,500 companies and $26.9 trillion.

Accordingly, investing must now take place outside of the indexation sphere of focus. While that can't take place for the majority of investors, it can for a small minority. In a way, one can no longer afford to be broadly diversified. One needs be less diversified, so that one doesn't overlap into the same systemic risks. Fewer securities, but with sufficient idiosyncratic features and optionality. Paradoxically, that is now what true diversification is.

An Update From Last Quarter

Gaumont SA (GAM FP)

It is safe to assume that non-French speakers and those who don't spend a considerable amount of time in France, have not heard of Gaumont, save for our review of the company in last quarter's commentary. It is held in the Research Strategy. Yet, it is one of the largest television and film production companies in Europe, and owns 34% of Les Cinémas Gaumont Pathé, a leading movie theater operator in Europe. American audiences may be most familiar with the company's recent Netflix television series, *Narcos*.

At the end of 2015, with a market cap of €215 million, the company traded at more than a 20% discount to its book value. An important attribute was a very significant dormant asset: nearly 80% of the company's book value was related to its minority interest in the cinema chain; this means that Gaumont's stock market value was no greater than the book value of its investment in that operation. And the cinema chain's book value (as a substitute for stock market value, since it was a private entity) was only 6x its operating income. Of greater interest was the theater portfolio in Paris alone, which included a facility with 6 screens and nearly 1,600 seats on the Champs-Élysées. This can be compared to Fifth Avenue in Manhattan just south of Central Park, where commercial rents are as high as $3,400 per square foot. Thus, the properties were likely worth far more than the cash flow of the theaters suggests.

The stock rose a modest 4.5% in 2016, slightly underperforming the French CAC 40 Index and dramatically below U.S. small cap indexes. However, early this year, Gaumont announced an agreement to sell its stake in the theater chain for €380 million; this was about 10.8x trailing operating income. Now with an abundance of cash, this month Gaumont issued a tender offer for nearly 40% of its shares, at a price of €75; this is roughly a 35% premium to the last traded price. Should the offer be accepted by outside shareholders, the inside ownership will amount to nearly 100%, effectively taking the company private.

The positive experience with Gaumont, which was first purchased in the Research Strategy last July, occurred far more quickly than is typical with long-term value investments. This highlights the episodic nature of such an investment strategy, since dormant assets can remain dormant for a long time. The company itself was not dormant, since it was quite profitable and traded at only about 13x trailing earnings. In this case, a company ignored by the investing public at large, much less index investors, monetized its significant asset base strategically.

Three Additional Names to Review

Lionsgate Entertainment Corp. (LGFA/B)

Lionsgate Entertainment should perhaps be called New Lionsgate, because of its December 2016 acquisition of Starz, the John Malone-controlled cable channel company. This significantly enhanced its size and economic profile. Lionsgate produces both motion pictures and television programming, including the recent *La La Land,* the *Hunger Games* series of movies, *Orange is the New Black,* and the vampire-themed *Twilight* series. Film production revenues and earnings are highly variable, which is why such companies often trade at a low valuation. The business does, though, contain an often undervalued asset, which is its content library. When an older title is re-released or otherwise licensed, there is very little expense associated with these long-term future revenues, which make them quite profitable. And each new release, whether blockbuster or not, increases the content library.

Starz, on the other hand, distributes third party content through cable television, satellite and other platforms, and is the second largest premium pay cable network, only behind HBO. This is largely a subscription-based model that produces consistent revenues. The merged entity should not only have more stable and predictable cash flow, but greater profitability through joint comparative advantage. Lionsgate gains a controlled distribution outlet and subscriber base for its content – the 31 million subscribers of the Starz and Encore package of channels; Starz can rely less on the increasing cost of third-party content, and focus on utilizing the Lionsgate library and its film studios to expand its originally produced content portfolio.

Pre-merger Lionsgate		**Post-merger with Starz**	
Revenue Contribution:		Revenue Contribution:	
Motion Picture	61%	Media Networks	63%
Television Production	39%	Motion Picture	23%
		Television Production	14%

Nevertheless, Lionsgate is no higher than it was in late 2015, and only 3% higher than in late 2013[3]. This is odd, since the Starz transaction enabled a considerable improvement to Lionsgate's business model and financial prospects. On the other hand, given what we know about the manner in which the ETF industry, with its requirement for industrial-scale trading liquidity, has distorted or sabotaged the price discovery mechanism, this is not entirely surprising.

Prior to this transaction, neither Starz nor Lionsgate were noticeable beneficiaries of the flow of assets to passive management. Although Lionsgate was a $5 billion market cap media company with no shortage of Wall Street earnings estimates, over 30% of the shares were held by insiders; Starz shares were over18% held by insiders, who had over 50% voting control. Lionsgate is not even included in the lone traditional media ETF, the PowerShares Dynamic Media Portfolio (PBS). Is this not another example of the increasingly bizarre divergence between the labelling on the ETF/index packaging and the presumptive business characteristics of the package contents?

[3] Measured by its stock market value rather than price, to account for the shares issued in the transaction.

To make clearer the selective blindness of the ETF manufacturers, here are two other companies with similar stock market values: Ralph Lauren, at $6.6 billion, #489 in the S&P 500, and H&R Block, at $5.0 billion and #492. Ralph Lauren is in 78 ETFs, and H&R Block is in 80.

To value Lionsgate, one might use the trailing three-year operating income records of both companies to accommodate the up-and-down nature of Lionsgate results. If that appears reasonable, if perhaps overly simplistic, then a combined basis Lionsgate could earn approximately $1.55/share. In addition, there are likely to be redundant costs that could be eliminated over time. If the company were able to reduce overall expenses by merely 5%, this could add $0.52/share of incremental after-tax earnings. Thus, in the absence of aggressive or unrealistic expectations, Lionsgate could earn over $2/share. Relative to the non-voting Class B share price of $26, the implied P/E multiple is roughly 12.6x.

Another way to think about whether such a valuation is high or low, 13 times earnings is also the equivalent, as there are no meaningful capital expenditures, to an 8% free cash flow yield as if, in theory, the company were to distribute all of its free cash flow as a dividend. The S&P 500, based on estimated GAAP earnings, trades at 24x trailing earnings, and 20x expected 2017 earnings.

This valuation does not include some other considerations. Lionsgate owns about one-third of a premium cable network company called EPIX. On April 5th, Lion's Gate and other minority co-owners of EPIX agreed to sell their interests in the company to Metro-Goldwyn-Mayer Studios for an aggregate price of $1.031 billion; nearly $400 million of that is attributable to Lionsgate upon closing.

Secondly, Lionsgate has over $500 million of U.S. net operating loss carryforwards that may be used to reduce future income taxes. It seems almost certain that John Malone, who previously owned 3% of Lionsgate and now owns over 12%, will utilize these tax advantages to the fullest extent, as he is probably one of the most skilled applied tax strategists in U.S. corporate history. From a strategic perspective, he owns major interests in quite a variety of other companies with content assets and distribution platforms.

Civeo Corp. (CVEO)

This is a new Core Value holding. First, a few distinguishing characteristics, as they relate to indexation. These purely statistical characteristics – apart from measures of business profitability or value – determine that Civeo is an invisibility, a complete non-entity as far as the trading liquidity and marketability statistics needs of the ETF business. They are not why we buy Civeo, but they partly explain why Civeo is priced the way it is.

A brief bit of compare and contrast: Civeo has a stock market capitalization of $425 million[4], and its average daily trading volume is $2.8 million. The market cap of the last company in the S&P 500 is 9x larger, at $3,970 million; it has a daily trading volume that is 11x larger. And even that company has a weighting in the index of only 2 basis

[4] Market capitalization and trading volume data as of 4/17/2017. Index weights as of March 31, 2017. Source: Bloomberg and providers of ETFs tracking the indexes.

points. The last company in the S&P Mid-Cap 400 Index has a market value of $1,343 million and an index weight of only 8 basis points. There are 4 published earnings estimates on Civeo, although from firms you might not be familiar with: Scotia Howard Weil, a U.S. sub-division of Scotiabank of Canada; RBC Capital Markets, a division of Royal Bank of Canada; Craig-Hallum Capital Group, a Minneapolis based investment bank; and Loop Capital Markets.

It does interest us that Civeo was a spin-off, because these transactions are prone to pricing inefficiencies. For instance, look at Civeo on a financial website, and you will note that it does not have a Beta measure of volatility, because this requires at least three years of data, and the spin-off occurred in May 2014. It can't even be searched for by Beta, which is what ETF manufacturers do. Nor does it have a P/E ratio, since it had negative GAAP, or stated, earnings last year, so it doesn't show up on those searches. Which is not the same thing as not having real cash earnings, which the company does have.

Civeo provides accommodation services for workers on natural resource projects in remote areas. These are modular-construction facilities that can be temporary or more permanent. They are essentially turn-key, with the longer-term "villages" including landscaping and common social areas and services such as cafeterias, laundries, fitness centers, pools and even taverns. In Canada, the company has nine villages, with an aggregate 14,000 rooms and six open camps (typically short-term) with 1,300 rooms; in Australia there are 10 villages with 9,200 rooms; the U.S. is a small market currently, with 700 rooms.

With the decline in oil prices, demand for these types of services has collapsed. Revenues were $397 million in 2016, down 64% from 2012. The shares are down almost 90%. The revenue decline, though, appears to have largely abated.

Civeo lost $96 million on a GAAP basis in 2016, but earned $245 million in 2012. So, its entire stock market value is less than 2x the amount the company earned in one year in better times.

As to the loss in 2016, some of it was due to a fixed-asset impairment charge. As well, the company's non-cash depreciation expense of $131 million vastly exceeds its capital expenditure requirements, which were $20 million last year, such that Civeo actually had free cash flow of $56 million. The company anticipates a somewhat lower level of capital expenditures in 2017.

What this means is that the Civeo shares trade at 7.6x trailing free cash flow. It is reasonable to assume that this is sustainable, since the calamity in commodities (coal, metals, and oil) has already occurred. So, say one bought this and held it for an eventual earnings improvement, even if only to one-third of the 2012 level. That would be $81 million of earnings. At a P/E multiple of 12x, it would have a $972 million stock market value, or 2.2x the current price.

There's another aspect to the return profile. The balance sheet is leveraged: the company has $22 million of net current assets, as against $338 million of long-term debt. But it paid down $43 million of debt last year. If it were to continue to pay down that amount each year, even if the Enterprise Value multiple doesn't change, the market value of the shares should increase by at least that amount, which is 10% per year; if all of its free cash flow went for debt reduction, that would be 13% per year[5]. We don't know if Civeo will do well or not. However, the shares have a reasonable opportunity and legitimate reasons to do very well, a level of optionality the major indexes no longer have.

Also, I apologize for the long discourse. It was not long because this is the best investment idea we have, nor because it's a major position, because it isn't. And it's not because this was a detailed, 'deep dive' analysis, as they say. It was fairly superficial. But how else does one explain the basic, relevant characteristics, valuation and return potential of a business? Frankly, I'd rather have just given you the trailing P/E, analysts' consensus year-forward P/E, and Beta, the way indexes do. But they don't exist.

Royce Micro-Cap Trust (RMT)

The Royce Micro-Cap Trust is an actively managed, value-oriented closed-end fund that invests in micro-cap stocks. It has underperformed its broad small cap benchmark in each of the last 3, 5 and 10-year periods and charges a management fee of nearly 100 basis points. Thus, we as active managers are paying a fee to another advisor – one that has underperformed its benchmark. In a world in which financial advisors, individual investors and, now, regulators, have assigned low fees primacy above all else in investing, how can this exposure be justified? What is the logic?

First, some easy facts. The Fund's net asset value exceeded the share price by over 15% at quarter's end. This discount obviates over a decade's worth of fees. At a portfolio level, the Fund holds 349 securities with an average market capitalization of slightly less than $400 million. Recall that ETF demand for even small cap companies, defined as those under $2 billion, is effectively nil. In terms of valuation, the Fund's weighted average price-to-earnings and price-to-book value ratios are at over a 10% discount to the small cap index used as the benchmark, and the discount to the S&P 500 index is even greater.

Thus, the Fund owns a diversified portfolio of true micro-cap stocks that trade at a considerable valuation discount to its small cap benchmark and which, moreover, can be bought at a further discount through the Royce Micro-Cap shares. Further, despite the recent underperformance, the Fund NAV has outperformed by nearly 200 basis points, annualized, over the last 20 years (a difference of over $24,000 on a $10,000 investment).

If that establishes a fundamental basis to justify such a holding, it bears mentioning that the portfolio manager, Chuck Royce, has managed the Fund since inception, has 54 years of investing experience, and is considered

[5] This is the operation of the Modigliani-Miller Capital Structure Invariance Theorem, which basically states that the enterprise value of a company (the sum of its stock market value and debt) is invariant to changes in its capital structure. If a certain leveraged company's enterprise value is deemed by the market to be appropriate, then as the company repays debt through earnings, the equity value should increase by the same amount, maintaining a constant enterprise value. If that didn't happen, then the enterprise value would contract as the debt is repaid, even though that debt repayment reduces the balance sheet leverage and improves post-interest expense. It would be as if the company is being punished for becoming less risky and more profitable.

among the best small cap value investors in the world (though, obviously, he has not been immune to index security inflation).

The skill of the manager aside, this particular portfolio provides two forms of risk diversification. Most obvious is that it is sufficiently diversified within the portfolio, the largest position being 1.1%, and without egregious industry sector overweightings. It is also an important diversifier relative to virtually all of the other asset classes, which have been priced to historic extremes by near-zero interest rates, the desperation for yield, and the ability of ETFs to provide immediate access to those assets. Bonds, whether investment grade or junk, domestic or emerging market, real estate, junior gold miners, large-cap stocks, dividend stocks, even volatility, via the VIX ETFs, are trading at extremes. They are all tied, irrespective of their formal categorization as differing from one another, to certain common systemic risks and don't, among themselves, offer any risk diversification.

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Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security, and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable. There are risks associated with purchasing and selling securities and options thereon, including the risk that you could lose money.

The S&P 500 Index represents an unmanaged, broad-based basket of stocks. It is typically used as a proxy for overall market performance. Index returns assume that dividends are reinvested and do not include the effect of management fees or expenses. You cannot invest directly in an index. This report mentions several exchange traded funds, which are investable products owned by the respective managers mentioned herein. For additional information about such products, you should consult the specific exchange traded fund prospectus. Comparisons of exchange traded funds to indexes is imperfect in that exchange traded funds have fees and expenses and indexes do not.

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