

4th Quarter Commentary

January 2017

What We Do When We Come to the Office

Sometimes due diligence teams from other investment firms for which we manage client funds come to our offices. There are the audit types of questions about internal controls, and trade and execution protocols. To these, there is, properly, only one of two answers, yes or no. Do you time stamp each trade, maintain a permanent accessible trade record, or observe a randomization protocol for the order in which purchases are allocated to client accounts?

Then there are the questions closer to what they really want to know. How do we select securities; what is our process? Now, *their* process in trying to elicit *our* process is still based on the checklist approach. What market capitalization range defines a given strategy; what valuation parameters qualify a buy, hold, or sell; if it is earnings-multiple based, what is the average weighted P/E of the portfolio; what is the maximum weighting of a position; what is the maximum cash position; what precisely determines the maximum cash weight; what maximum time limit to invest a new portfolio; what is the minimum number of positions; what is the maximum number of trading days to exit any position? They want to confirm that the process is defined, consistent, repeatable – in a sense, a scientific methodology reducible to a spreadsheet that is an efficient tool for comparing to other managers in the present, and comparing to the same manager over time. This is just the warm-up.

There are the broader questions about how the philosophy is implemented in a consistent quantitative fashion. An appropriate form of answer might be: we employ a searchable database of the 1,000 largest companies in the U.S.; we screen them on such and such parameters, such as a minimum market cap of \$1 billion, a minimum 5-year dividend growth rate of X%, a maximum P/E of Y, maximum debt-to-equity ratio of Z. We then end up with 200 candidates to which we then apply further screens to arrive at our priority list of 100, and so on. And we apply that consistently, so that whatever the market conditions, we don't stray from our process and we always select the top 10 percentile of companies from that universe of 1,000. They want to make sure a manager who buys smaller companies one year doesn't buy larger companies the next. If a manager hasn't held cyclical companies in the past, it would be a methodological danger signal to buy cyclical companies in the future, because that is not a documentable or repeatable process. Do that and you're on the watch list, if not dismissed outright.

And while this is the approach that, obviously, indexation epitomizes with perfection, it is also the rule amongst active managers who practice particular strategies. They come into the office and work hard to be consistent to their methodology. Even as the market changes. If high quality stocks become more expensive, it is important to continue to own the best of them. They know what they're going to do every day. We don't. We don't know what we're going to do, because we do not struggle against the market. We accept the market. Or, rather, ***we take what the market gives us, not what it doesn't.***

Once upon a time, Horizon Kinetics wasn't known at all. We had no due diligence teams visiting us. And there came a time, 1999 or so, when the market became enamored of technology and internet and unregulated utility



Preface: *Why we don't know what to do when we come to the office every morning.*

Part I: *Indexation's supply/demand imbalance has inflated valuations to dangerous levels – we've been told we've beaten this topic to death. Favorably reinterpreted: we've established a firm basis from which to depart, and can now address the important follow-on questions.*

Part II: *So how or when does it stop, and what happens then?*

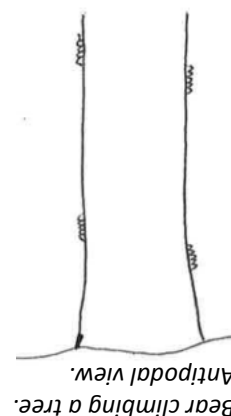
Part III: *What rate of return to expect from stocks? Accepted reality is based on 100 years of history, the famous 10% expected return. But what if it's the wrong 100 years? Now there's a different 100 years. It says something else.*

Part IV: *And how will one earn an acceptable return?*

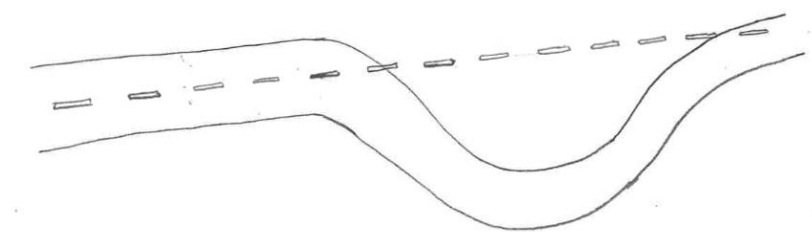
stocks. They went up and up and up. That didn't give us anything but risk. So we continued to hold what the market had given us a few years earlier: really high quality blue-chip companies that were extremely profitable, like big drug companies and American Express and AIG. Each, in their turn, had disappointed and become cheap. And as the internet stocks went up, these bluechips went nowhere and then, as the internet stocks went up some more, nowhere again. And then as the bubble began to collapse, the flight to quality made those hapless blue chips we held soar, and they became their own bubble, at 30x earnings. So we gave them back to the market. Which meant we raised a lot of cash, And we kept that cash, because the market didn't give us anything else that we wanted. Some more time passed, and by early 2003, when the dust of the internet bubble settled, there were the most extraordinary gifts lying there, discarded by the market: bonds of certain distressed/recovering utilities and other corporate victims of that party, trading at 50¢ on the dollar, even 20¢. We took it. Then Horizon Kinetics became just a bit better known.

If there had been any due diligence teams evaluating us at that time, each of those actions violated any acceptable process that would have been documented. First, with our high quality value names, we underperformed our peers who dipped a toe or two in the frothy waters of the bubble sectors; then we changed our asset allocation, never before having had anything like plenty of cash; then we violated our asset class category by purchasing fixed income securities in equity accounts. We wouldn't have been allowed to do any of it. Nevertheless, in the aftermath, we now had due diligence teams visiting us, because we didn't collapse during the bubble; in fact, we had positive returns.

So, we don't know what to do or buy when we come into the office – we can only take what the market gives us. The scientific method applied to the securities markets is a dangerously fallacious approach. It presumes a linear type of repeatability; whereas, the marketplace is fluid, reflecting the endless capacity of humans to interact and respond. Any fixed rule or process is reacted to and gamed and, ultimately, doomed. You don't fight that, you use it. To express it visually, here's a warm-up exercise – a kid's puzzle, really – having to do with adaptive versus categorical thinking. It's the picture on the right. What is this a picture of?



That was the warm-up. Here, below, is the one we're interested in. What's this?



This is a road painted by a sober painter according to the engineer's blueprints, but paved by a drunken paver. You can be sober and precise and process consistent, and it can work for quite a while. But the road, the market, eventually turns, and a straight line will take you right off the road.

The next couple of sections are simply to confirm that the market as people generally understand it probably isn't giving you much anymore, at least not sustainably. It's important to realize that, because once you do, you can figure out when and how to take what the market is offering or will offer.

Part I: The Departure Point

This past year was interesting on so many more fronts than 2015. And this coming year could be more interesting still. In 2016, the financial markets saw all sorts of records and precedents – and not in a good way.

- Record low yields in the investment grade bond market, with a 2.2% yield for an 8-year average maturity.¹
- \$8.1 trillion of global sovereign debt traded at a negative yield², equal to about 20% of total sovereign debt.
- Total sovereign debt-to-GDP, on a global basis, reached a record 89.5%³ as of 2014.
- The U.S. debt/GDP ratio reached 105%⁴, not a record. But when the last record was set in 1946, after the massive spending for World War II, the nation was primed to unleash all the war-time capital and technology investment upon 17 years of pent-up demand. For those unaware, as of 1942, food and other goods were rationed; without a ration booklet, you couldn't buy meat, milk or sugar. There followed a stunning level of growth.⁵
- By contrast, in 2016, revenues of the largest publicly traded companies were essentially flat, as they have been for several years. They are mature and have largely saturated their markets. Simultaneously, a record \$280 billion flowed into index funds in 2016. In turn, index demand for those shares has priced them at the bull-market valuations ordinarily reserved for growth companies.
- The true emergence of “semantic” investing – ETFs with false exposures. Being restricted to a limited supply of companies sufficiently large to accommodate the new money, and with no mechanism to assess valuation and underlying economics, we now have ETF package labelling that has little to do with the contents:
 - o A major “value” ETF⁶ comprised of companies with no revenue growth yet which trades higher than the long term average P/E of the entire S&P 500.
 - o A U.K. ETF⁷ filled with global multinationals that derive 64% of their revenues from outside the U.K.; a Spain ETF⁸ with companies that get 53% of their revenues from outside Spain.
 - o A Frontier Markets ETF⁹ with large positions in Argentina, Kuwait and Nigeria (home of Boko Haram), labelled *less risky* than the S&P 500! Statistically true, due to a 0.66 beta. Also statistically true: with a little excitement in one or two of those nations, the new beta will quickly be greater than 1.
 - o An emerging markets bond ETF¹⁰ (meaning Russia, Brazil, Lebanon and Turkey) with yields lower than a U.S. High Yield Bond ETF. Could there arise a little excitement in any of those places?

¹ The iShares Core U.S. Aggregate Bond ETF (AGG), \$41.6 billion AUM. Data as of December 31, 2016.

² <https://www.bloomberg.com/news/articles/2016-11-15/negative-yielding-bonds-plummet-to-8-7-trillion-after-trump-win>

³ <http://wdi.worldbank.org/table/4.12>

⁴ Source: Federal Reserve Bank of St. Louis as of Q3 2016.

⁵ In 1947, GNP was 13% above the record peacetime peak of 1946, and industrial production was 23% higher.

The U.S. alone turned out well over 50% of the world's known industrial production compared with 30% before the war.

⁶ The Vanguard U.S. Value Fund (VUVLX), \$1.5 billion AUM, 19x P/E ratio

⁷ iShares MSCI United Kingdom ETF. Percentage of revenues from outside the U.K. is for the top 10 positions as of 12/31/2016.

⁸ iShares MSCI Spain Capped ETF. Percentage of revenues from outside Spain is for the top 10 positions as of 12/31/2016.

⁹ iShares MSCI Frontier 100 ETF (FM), \$0.5 billion AUM.

¹⁰ The iShares Emerging Markets Bond ETF (EMB), had a 30 Day SEC Yield, as of December 31, 2016, of 5.28%; the iShares High Yield Corp Bond ETF (HYG) had an SEC Yield of 5.46%.

- The same major U.S. High Yield Bond ETF¹¹ with a 5.46% yield. *Which is not high yield.* Nor will that yield ever be realized, since the average bond price is above 100 and that yield presumes that there will be no defaults. *There are always defaults.*
- An international government bond ETF with a 0.38% SEC yield, an almost 10-year average maturity, and 36% of which is in negative-yielding sovereign debt.¹² This is considered prudent within the asset allocation model of investing.
- We could go on. But we've beaten that topic to death. Now we get to the next part.

Part II, a: So What Makes it Stop?

Why is the 9-year flow-of-funds chart that we've presented before so important? Not only to show how the money flows into index funds pushed up the prices of the index-centric securities. Simultaneously, the outflow from actively managed funds – which has been the 'bank' for the inflows – has forced active managers to sell and push down the prices of that which they own. Both are 'artificial' – which means both danger *and* opportunity.

We know that the flow of assets out of active management must eventually cease. There's a finite supply of actively managed assets. Therefore, the out-flows will eventually exhaust active management assets. Accordingly, the market is not in a state of equilibrium. Here's a way to get a handle on what the limit might be.

There were \$4.26 trillion of actively managed equity mutual funds at year-end 2015. This compares with \$1.79 trillion of *indexed* equity mutual funds. Add that latter figure to the \$1.23 trillion of domestic equity ETF assets and together that's \$3.02 trillion of publicly indexed domestic equities versus the \$4.26 trillion of actively managed equity funds. 2016 figures were published after this writing, which will be interesting to see. That is a very large share of publicly measurable equity that is indexed, and it does not include privately indexed equity, such as in-house pension fund money.

Five Largest Index Managers and Their Equity Index Assets¹³

	<i>(\$ in billions)</i>
BlackRock Inc.	\$2,217
Vanguard Group	2,019
State Street Global Advisors	1,293
Northern Trust Asset Management	347
Legal & General Investment Management	<u>272</u>
<i>Total</i>	<i>\$6,148</i>

Source: Pension & Investments (November 2, 2016). Data as of June 30, 2016

And here's another way. Just the five largest index managers have a total of \$6.1 trillion of equity AUM. Although the market capitalization of the S&P 500 is \$18.9 trillion, Sibilis Research states that the float of the S&P 500 – that is, excluding shares held by insiders and which are unavailable for trading – is \$18.377 trillion, which means that the top 5 indexers alone equal 33% of the S&P 500 float. And obviously there are many more indexers, both with publicly available data and those without; every large institution and pension plan has an index division. Viewed through this window, it is clear why a few observers believe that the present direction of investing is unsustainable and that there is a supply/demand issue even with an index as large as the S&P 500. That's a new phenomenon.

¹¹ The iShares High Yield Corp Bond ETF (HYG), \$18.9 billion AUM

¹² The iShares International Treasury Bond ETF (IGOV), \$0.7 billion AUM

¹³ Source: Pensions & Investments (November 2, 2016), <http://researchcenter.pionline.com/rankings/index-manager/datatable>. Data as of June 30, 2016.

Those were stand-still figures. Here are dynamic figures. In 2016, ETF net inflows set a record, at over \$280 billion. Although much of that was allocated to bonds, indexed mutual funds receive nearly as much flow as ETFs. Using figures through November, about \$225 billion¹⁴ will have been withdrawn from equity mutual funds in 2016. You might think, well that's still quite a number of years until the active equity 'bank' runs dry.

But long before such exhaustion of the pool of actively managed equity mutual fund AUM, those outflows must decline significantly. They don't just continue at a steady rate, then stop on a dime. Moreover, there is some significant number of investors who prefer and will maintain their actively managed assets. Is it 10%, 30%, 40%, of the total equity? So the limit is even closer. And it's even closer than that, because to keep the perceived equilibrium going, the index fund organizers need to go beyond merely continued net inflow; they need proportionately increased flow, because the market value of everything they are buying is going up; it's a law of large numbers dynamic. They need more and more money to hold the prices where they are, but the inflow is being drained from a shrinking pool of non-indexed AUM. That's how all bubbles work.

We do not know where the tipping point is. But the minute the inflows slow meaningfully, whether that takes three years or ten, the index will no longer set the price, the ETFs will no longer be setting the prices of the winners. At that point, the baton passes to the active managers, and they will set the marginal price. The remaining active managers, the Mario Gabellis and David Einhorn of the world, do not pay 22x earnings for mature companies like Procter & Gamble, nor 128x estimated earnings for growth companies like Netflix or 37x for a retailer, like Under Armour. At that point, the equity market might suddenly become quite efficient.

Part II, b: What Happens Then? Can Indexation Exist On its Own?

As an aside, one could take the extreme position that all money management will be done through a quantitative, automated security selection framework. This is not even asserted by the major proponents of indexation, such as the esteemed John Bogle who created Vanguard, who understand the free-rider principle. But even if that could come to pass, it would mean an entire market with no mechanism for price discovery, which is what active investors try do, whether they do it well or not. It's difficult to imagine what that would imply for valuations, knowing the extremes that have been reached even in markets with the participation of active management. Remember the Nifty Fifty? And if not, surely the Internet Bubble? In a profound sense, indexation requires the existence of active management – so that if one is an indexer, the free-rider, you can be reasonably certain that you're getting fair value. If investors suspect not, then what would be the point of owning the index?

But it is not even possible to have a scenario of 100% indexation. Below the high liquidity threshold required by indexation – the ETF Divide – there is a very large universe of less-liquid securities that are simply not fit, on a practical basis, for index inclusion. They are already priced at historically low valuations. They might become cheaper, still. But that simply means they will eventually outperform, if only because extra-market participants, like the company managements themselves or LBO firms, will ultimately be enticed to take them private and own the high financial returns directly. Ultimately, a sufficiently low price becomes its own valuation catalyst. Paradoxically, that would make the non-indexed companies the outperformers, reversing the post-Financial Crisis trend.

This is not an argument against index-based investing. In normal circumstances, these are instruments that belong in a portfolio. We'll even review some later that would benefit a portfolio now. We're simply at an extreme at

¹⁴ Source: www.ici.org – Trends in Mutual Investing November 2016

which indexation has interfered with, even overwhelmed, market efficiency, the efficiency that comes about from the contest between different active investors over the proper valuation of securities.

Yet, Is the Public Trapped Inside the Indexation Box With No Exit Door?

A thought challenge for the future. For the future, because the public has yet to confront it. Historically, how did investors know they should withdraw capital from an active manager or mutual fund? The only reason money would be withdrawn is if the return was unsatisfactory: either because it was negative, or it was positive yet inadequate relative to some benchmark. So, the money is withdrawn and transferred into an index fund.

Now it's in the index fund. Some time passes, and let's say the *index* is down 1%. The investor exclaims, "I have been with you three years, but my money is down 1%." *Now*, though, the rejoinder is different: "Well, what do you want from me? I do not make the index returns. You got the exposure you wanted, and you got, with computer precision and hardly any fee, the return that you should have gotten, which is negative 1. So what's the problem?"

Index investors and asset allocators are caught in a logic trap. They have no mechanism by which to decide when or how to withdraw. Once one accepts indexation as the methodology for investing, it is like a trapdoor, because whatever the returns happen to be, the S&P 500 or some other index, *is* the benchmark. Any return the index gets is, by definition, the return you should get. There is no definition of an *inadequate* index return.

A natural response might be, "Then I need to take money out of equities" and allocate it to some other asset class. But in today's environment, what would that possibly be? Bonds? Money market funds, with their zero yields? By the way, bond investors would say their returns don't look that robust either. What are *they* going to do? There is no place to go because the only two asset classes large enough to accommodate the bulk of the enormous quantity of indexed financial assets are equities and bonds. Everything else is of marginal market capitalization.

A further response – we didn't make these questions up, by the way, they're real questions from real clients – is if the indexes do start becoming negative, isn't cash the alternative? Why can't we just buy money market funds?

That, unfortunately, is impossible. Say there are \$4 trillion in cash-equivalent instruments, and that the aggregate market value of the S&P 500 is \$18 trillion. What if half of those who own equity index funds said, "You know, these guys at Horizon Kinetics, they said these things. At first, I thought it was crazy, but now it actually makes some sense. I'm going to take my money out of the index. And I told my friends, we want out, we want the cash." Add them all up, and if it's 50%, that would be \$9 trillion. How are you going to get the cash? Somebody has to give it to you, they have to be willing to buy your \$9 trillion of stocks, and why should they?

First of all, they do not have \$9 trillion. In fact, the mere act of asking for it guarantees you are going to lose your money. These ordinary tax-paying Americans would say to the asset allocators: "We would like our money out. Isn't this a liquid investment?" "Absolutely, I understand that you want your money out. I would strongly recommend you don't do that, though, because if you try to take \$9 trillion out, I will have to call up the SEC, and I will get them to close the equity market. If you actually try do that, you're not going anywhere. Because that amount of money is too large for the market to handle." That is what happens when the free-rider population exceeds its natural threshold. No more free ride.

The problem was never the stock selection. The problem was that the index fund and ETF organizers are not investors, they are asset gatherers. Therefore, they've corralled all these assets through a one-way trap door, with

no way out. There might be good news, though, of a sort. Since there's no way out, it is less likely that equity valuations collapse. Alas, it doesn't mean they can go up on a sustainable basis. Let's continue with that thought.

Part III: What Rate of Return to Expect From Stocks, or The Other 100 Years

A groundbreaking set of research was just completed. It is probably more important than any other single set of data that can affect your future financial decisions. This is the 2016 edition of the *Stocks, Bonds, Bills, and Inflation (SBBI) Yearbook*¹⁵. The original 1979 publication marked a seminal moment in modern financial management. In December of that year, the Dow Jones Industrial Average was trading between 2,600 and 2,700, more or less the same level it had reached in December 1952, 27 years earlier. There was great doubt as to the viability of large-capitalization stocks as an asset class.

It was thus a great shock to read that large-capitalization stocks had returned an annualized 9.0% from the end of 1925 to the end of 1979. This was despite their 26.9% annualized loss from the end of 1929 to the end of 1932. It is arguable that indexation as conceptually understood today is inconceivable without this Ibbotson study. That study, updated year by year, is the basis for all the academic and investment strategies and modelling that involve assumed rates of return from large-cap stocks, small-cap stocks, Treasuries and corporate bonds. It's baked into your private advisor and robo-advisor recommended asset allocation pie-charts, your universal life insurance presentations of expected returns and your pension fund calculations.

To see just why the roughly 10% expected return from large-cap stocks is so powerfully ingrained in the psyche, just skim the accompanying table. It shows rates of return of large-capitalization stocks for 62 different periods of increasing length, starting from 1926-1954, then 1926- 1955, and so on, all the way to the period 1926-2015. And the data span so many environments, including two world wars, inflations and recessions.

Large Capitalization Stocks' Total Returns

Multi-Year Periods	Annualized ROR	Multi-Year Periods	Annualized ROR
1926-1954	9.6%	1926-1985	9.8%
1926-1955	10.2%	1926-1986	10.0%
1926-1956	10.1%	1926-1987	9.9%
1926-1957	9.4%	1926-1988	10.0%
1926-1958	10.3%	1926-1989	10.3%
1926-1959	10.3%	1926-1990	10.1%
1926-1960	10.0%	1926-1991	10.4%
1926-1961	10.5%	1926-1992	10.3%
1926-1962	9.9%	1926-1993	10.3%
1926-1963	10.2%	1926-1994	10.2%
1926-1964	10.4%	1926-1995	10.5%
1926-1965	10.4%	1926-1996	10.7%
1926-1966	9.9%	1926-1997	11.0%
1926-1967	10.2%	1926-1998	11.2%
1926-1968	10.2%	1926-1999	11.3%
1926-1969	9.8%	1926-2000	11.0%
1926-1970	9.6%	1926-2001	10.7%
1926-1971	9.7%	1926-2002	10.2%
1926-1972	9.9%	1926-2003	10.4%
1926-1973	9.3%	1926-2004	10.4%
1926-1974	8.4%	1926-2005	10.4%
1926-1975	9.0%	1926-2006	10.4%
1926-1976	9.2%	1926-2007	10.4%
1926-1977	8.9%	1926-2008	9.6%
1926-1978	8.9%	1926-2009	9.8%
1926-1979	9.0%	1926-2010	9.9%
1926-1980	9.4%	1926-2011	9.8%
1926-1981	9.1%	1926-2012	9.8%
1926-1982	9.3%	1926-2013	10.1%
1926-1983	9.6%	1926-2014	10.1%
1926-1984	9.5%	1926-2015	10.0%

Source: 2016 *Stocks, Bonds, Bills, and Inflation (SBBI) Yearbook* (Appendix C-1(1))

¹⁵ 2016 *Stocks, Bonds, Bill, and Inflation Yearbook*, by Roger G. Ibbotson, Roger J. Grabowski, James P. Harrington, and Carla Nunes.

You can see how stable the number is, basically between 9% and 10%. Also, how including one or even several few more years of data that are outside the historical norm, even disastrous years like 2008, wouldn't alter the overall results of such a long time series. Decades of data would be needed to change the view to one that the S&P 500—large-capitalization stocks—does not generate a 10% annualized rate of return. That's why it is accepted as a reliable model of reality. It's almost a century of proof. In fact, using the additional data from the 2016 Yearbook, we can get a full 100 years, and here it is: the 100-year large-capitalization stock ROR for 1915-2015 was 9.9% annualized.

Now someone else might come along, like these guys at Horizon Kinetics, for instance, and they say they have reason to believe that maybe large-cap stocks won't even return 5% in the next 10 years or even 20 or 50 years. Stocks might not even return 3%. In fact, they might not produce any capital appreciation at all, and the only substantive return will be from the dividend yield which, if we're using the S&P 500, is only 2.07%. Now, the capital allocators would say that's ludicrous, since there is 100 years of data and academic review that collectively say it's ludicrous. On what grounds can a claim like that be made?

And that someone else might respond, "We grant you that 100 years of experience, particularly encompassing all the traumas of intervening historical events, is an almost overwhelming statistical proof of the expected rate of return. We concede that. Just one question, though. Which 100 years?"

To which, "What do you mean, which 100?" To which, "Because there's this new *Ibbotson* study that collected the data for the prior 100 years, from 1824 to 1924. It couldn't be properly done before, but now with technology that can scan and read and cross-reference a great variety of sources, from newspapers and magazines and books, those older historical securities prices could be collected and consolidated. That 100 years."

Here's how that 100 years looked. The return from stocks was 7.3%. BUT, only 1.1% of that was capital appreciation; the rest was from dividends. If only 2 years are excluded, 1862 and 1863, in which stock prices doubled due to the Civil War stimulus, the 98-year annualized appreciation was only 0.56%.

Capital Appreciation of Large-Cap Stocks, Without Income, From Selected Periods in US History

Multi-Year Periods	# Years	Annualized	
		ROR	Event
1824-1876	52	0.06%	Post Civil War Reconstruction costs
1865-1920	55	0.48%	End of Civil War to 1920: emergence of US as a great power
1900-1920	20	(0.86)%	Early decades of 20th century, including WWI
1900-1941	41	0.07%	Turn of the century to U.S. declaration of war in WWII

Source: 2016 *Stocks, Bonds, Bills, and Inflation (S&P)* Yearbook, (pp. 11-8)

Or, extend the whole time frame, without any exceptions, from 1824 to 1941, the annual appreciation over those 117 years was only 0.8% per year. That's almost two full lifetimes. There were two separate periods exceeding 50 years, one through the end of the Civil War, the other from the end of the Civil War through the emergence of the

U.S. as great power in 1920, which saw virtually no capital appreciation whatever. The 41 years from the turn of the century to the beginning of the U.S. involvement in World War II, saw no capital appreciation in stocks.

It wasn't quite as bleak as that – though it was pretty bleak – because stocks did provide a return during those periods. But it came almost entirely from dividends. And the starting point today is not a 6% or 7% yield, but 2%. So, if one is buying general market securities, such as via ETFs, one has to prepare for the possibility of an extended period of insufficient general market yields. And, for reasons we don't have time to address today, it might be a very long time before governments are willing to raise the level of interest rates substantially.

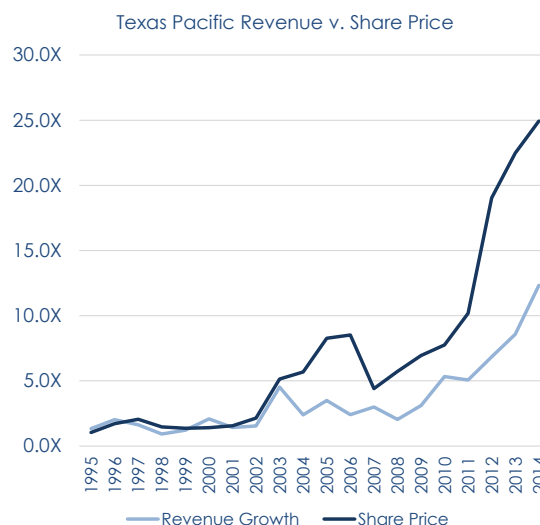
Accordingly, in the contemporary era, we have the historically unprecedented phenomenon of low inflation and low yields on stocks. Since it lacks historical precedence, perhaps the accepted historical data will not be a good predictor of the future. And one has to prepare for the possibility, if one is invested in the broad, index-centric market, that a reasonable level of income return might end up being the most important component of the totality of one's returns.

Part IV: How Will One Earn An Acceptable Rate of Return

Fortunately, one needn't be restricted to the broad market. It's not giving you anything. But the indexation flows did create an artificial downdraft among the thousands of non-indexation securities. That is where the companies with less systemic risk will be found. There will be more in the way of idiosyncratic investments with the opportunity for true optionality. Based on the Other 100 Years' experience, one really does want securities with the potential for true optionality, not merely "exposure". Perhaps portfolios will have to have fewer, but more selective securities.

This will require a different process than the habitual ones that brought us here. Take what the market gives you. But that requires flexibility. Here's an example of the conflict that can arise when exercising flexibility. Some of our strategies hold **Texas Pacific Land Trust**, which has appreciated mightily since the last update we wrote 12 years ago. It is now well in excess of a 15%, even 20% position in some individual account strategies and in a number of fund formats. We have elected to not reduce it each time it rises, counter to the accepted process.

Some institutions have requested that we reduce the position, noting that it is imprudent to not take profits when a company's shares have tripled in three years. That's an interesting statement, since it does not mention valuation. How does one judge if something has risen too much if you don't know its valuation? You can't; so you automatically reference general experience. General experience says that the undervalued cyclical that fell by 50%, like a steel or auto maker, can experience a cyclical recovery and become popular again – it doubles, but one knows it is simply rising to a relatively known valuation limit. Consequently, if it triples it is probably overvalued. But what if the value itself has become higher as well? That's the role of analysis.



In the three calendar years through 2015, while oil prices fell 50%, Texas Pacific Land Trust's revenues from oil royalties and oil-related land leases and sales rose by 140%. And it's repurchased 10% of its shares since then. Compare these two sets of figures: 1) in the last several years, the Trust has sold non-strategic land at roughly \$1,000 per acre; based on the current share price, and its total market value is equivalent to roughly \$2,900 per acre. 2) In the past year or so oil exploration companies have paid in excess of \$50,000 per acre and \$100,000 per acre for land similarly situated to the Trust properties. A proviso: that last item is an entirely inaccurate mode of comparison, because it does not distinguish acreage with royalty rights from those without.

But knowing just these few facts, would one still feel comfortable concluding that the tripling of the TPL share price in the last few years is an indication of overvaluation? That requires analysis. An example of true fundamental analysis will be found on the last page of this review. It is the front page of an annual report from a TPL-related company 61 years ago, and which has particular bearing on the valuation today. The mere act of tracing the Trust's history to understand that this document could be important is a notable act of creative analytical thinking by a Horizon Kinetics analyst. The further act of locating this document required more than a little creativity and rugged persistence. It may well be the world's only copy of this document in active circulation.

Whatever the outcome from here forward, though, it is entirely fair to say that TPL the business and TPL the share are very unlike the broad market and not apparently driven by, limited by or threatened by the same factors. That is diversification and that is optionality. And that is becoming ever more valuable in any portfolio.

Here are some thumbnail reviews of a range of holdings in our equity strategies. They will generally be found to be distinctive in some important fashion as to valuation, optionality, and disengagement from the primary systemic risks the market faces. They are diversifying elements.

A P Mollar-Maersk, founded in 1904, is a Danish conglomerate with a \$33 billion stock market capitalization. Both of its two largest businesses have been in severe cyclical decline: container shipping, Maersk being the world's largest publicly traded line, with a 14% world market share; and oil drilling and exploration. The founding Maersk family, represented by Vice-Chairwoman Ane Maersk Mc-Kinney Uggla, owns 53% of the company.

Remarkably, in two industries that are about as challenged as they can get, the company is profitable and has a strong balance sheet: \$1.7 billion of net current assets and \$43 billion of property and equipment, as against \$13 billion of debt. It trades below book value. It repurchased \$1.25 billion of shares since year-end 2014.

Moreover, last month, following the container shipping industry's first major bankruptcy in mid-2016, Maersk announced the acquisition of the world's seventh largest container liner, Hamburg Süd. This will add about 3 percentage points to Maersk's market share. As in past cycles, the company should emerge from this one in a stronger competitive position. When shipping rates rise, whenever that might be, it can be quite fast and sharp. As well, after decades of operating under a holding company structure, in June the company announced its intention to separate the energy and shipping operations. The two resultant businesses would then, as industry-specific offerings, be much more suitable material for index inclusion, which would be a significant valuation catalyst. We can't know if Maersk will be successful, time will tell. But, tell us that this isn't an economically and operationally idiosyncratic company with high optionality.

AMC Networks is a cable network provider that owns a valuable content library; titles include Mad Men, Walking Dead, and Breaking Bad. AMC is in a period between blockbuster programs, so earnings are not growing, ergo it trades at a P/E of 10x the current year earnings estimate. However, if the company can develop the next commercially successful program, earnings should rise substantially. Importantly, in 2014, it acquired a collection of international cable networks from Liberty Media, as a platform to distribute its US programs to a global audience.

Currently, this international division is only marginally profitable, so it is an unproductive asset. If it were ever to achieve the profitability of its U.S. operations, total earnings per share could be closer to \$7 (versus the current \$5.60). As one scenario, if those potential earnings were priced at a P/E of 15x, AMC would be worth \$109 per share, nearly double. As for so many of these companies, the market capitalization is fairly modest, at \$4 billion.

Associated Capital was spun out of Gabelli Asset Management (“GAMCO”) near year-end 2016. It has two lines of business: institutional research (a mature, low-growth business dependent on brokerage commissions); and GAMCO’s alternative investments business, focusing on merger arbitrage and event-driven value strategies.

Although Associated has progressively increased its AUM, it still lacks sufficient scale to generate any meaningful net income. This is why it was spun off debt-free and with a substantial amount of liquidity: about \$1.0 billion of capital, roughly 40% cash, 40% investments and 10% in a GAMCO note receivable. The company’s market capitalization is only about \$875 million, so it trades at about a 12% discount to NAV. In the simplest sense, this is an investment vehicle of the esteemed investor and controlling shareholder Mario Gabelli, who has repeatedly used spin-offs to isolate undervalued assets that can be expanded significantly.

As an investment manager with only \$1.2 billion of AUM, the scale at which Associated can operate, if successful in gathering assets, can be enormously higher. As a manager of alternative strategies, it is well positioned, since these are becoming more attractive to asset allocators as prospective returns in conventional investments diminish – arbitrage strategies are inherently low-volatility, which is an attractive attribute. Further, merger/arbitrage spreads are wider when interest rates are higher – they’ve been suppressed in recent years due to near zero interest rates – so Associated should be an earnings beneficiary of a rise in interest rates. Moreover, its strategies are eligible to earn performance fees. In essence, we believe Associated represents a low-risk, long-term call option on an asset allocation shift toward alternative strategies, and it has the respected GAMCO value reputation behind it.

DISH Network is the satellite television provider. It has 13+ million Pay-TV subscribers. The stock market capitalization is \$29 billion, and 48% of that is owned by founder and CEO Charles Ergen and his family. DISH is another example of the expensive/cheap dichotomy, the key to which is fundamental analysis; indexes don’t analyze.

The company has lost 1.9% of its subscribers over the past year, yet the shares trade at 23x estimated earnings for 2017. That’s expensive. However, an as yet dormant asset is the over \$15 billion the company spent since 2008 on wireless spectrum licenses, some at auction, some by acquiring companies in bankruptcy that owned such licenses. There is information content in the fact much of the wireless spectrum available for purchase in the past decade has been acquired by owner-operator companies, including Sirius XM Holdings (John Malone). The motive is the presumption that the rapid growth in mobile data usage will not stop, that current usage today is but a fraction of what it will eventually be. Owner-operators are willing to hold these without any current return.

If they prove correct, then those licenses, when in operating mode, will be very profitable. Even though they are not being used now, their market value, reflected in auction prices for new spectrum, has risen markedly. Estimates of the value of spectrum are highly technical and variable, but one middle-of-the-road multiple suggests that DISH's spectrum, net of DISH's debt, is worth roughly \$46 billion. Which is more than the market capitalization of the entire company.

Gaumont SA is a French producer and distributor of films and television shows. It serves the 270 million French speakers worldwide. It also owns a library of over 1,000 films and 17,000 documentaries. The catalogue itself could be worth well more than the company's current market value. It recently established a U.S. subsidiary that has created a number of original series for streaming and television for Netflix and NBC. This is a qualitatively significant enhancement to its business.

The shares trade at 13.3x 2015 earnings, which was a particularly bad year for the film segment. In the first half of 2016 earnings are roughly 3x higher; it could be trading at a single-digit P/E of 2016 earnings. We'll know shortly. The company also trades at 0.87x book value, and it is unlikely that book value includes the proper value of the real estate housing its theater on Avenue des Champs-Élysées in Paris. To the degree this is properly comparable, NBC Universal paid 3.25x book value for DreamWorks Animation. Gaumont has only a \$225 million market value.

Howard Hughes is an excellent example of the equity yield curve in action: valuable dormant and developing balance sheet assets not yet visible as earnings on the income statement, ergo, not valued by time- and relative-return-sensitive investors. The share price was unchanged last year, despite the company making substantial progress on developments in New York City, Houston, Honolulu and Columbia (Maryland). We believe the company is nearing an inflection point where income-generating properties will begin to dominate the portfolio for the first time, while its large undeveloped land bank and transitional strategic assets will continue to provide opportunities for capital deployment.

Eventually, since it will soon have to contend with substantial taxable income, Howard Hughes will be incentivized to separate its income generating assets into a tax efficient structure. The opening, this summer, of the South Street Seaport in lower Manhattan may mark the start of that pressure. We believe that the market vastly underappreciates the potential of this project, and assigns virtually zero value to the development rights in adjacent parcels. Ultimately, if investors value the stabilized operating assets in line with peers (which is conservative, given asset quality) and the remaining properties at a typical multiple of book value, the shares should trade substantially higher. Additional opportunities include reducing the company's cost of capital by replacing corporate level debt with property level financing after the Seaport opens.

Stolt-Nielsen Ltd. a Norwegian shipping company operated by the Stolt-Nielsen family, who own just over 50%. It provides transportation, storage and logistics services related to its particular segment of shipping: bulk liquid chemicals, ranging from edible oils to industrial acids, as well as clean petroleum products like lubrication oil. Accordingly, it operates specialized container tankers and storage terminals.

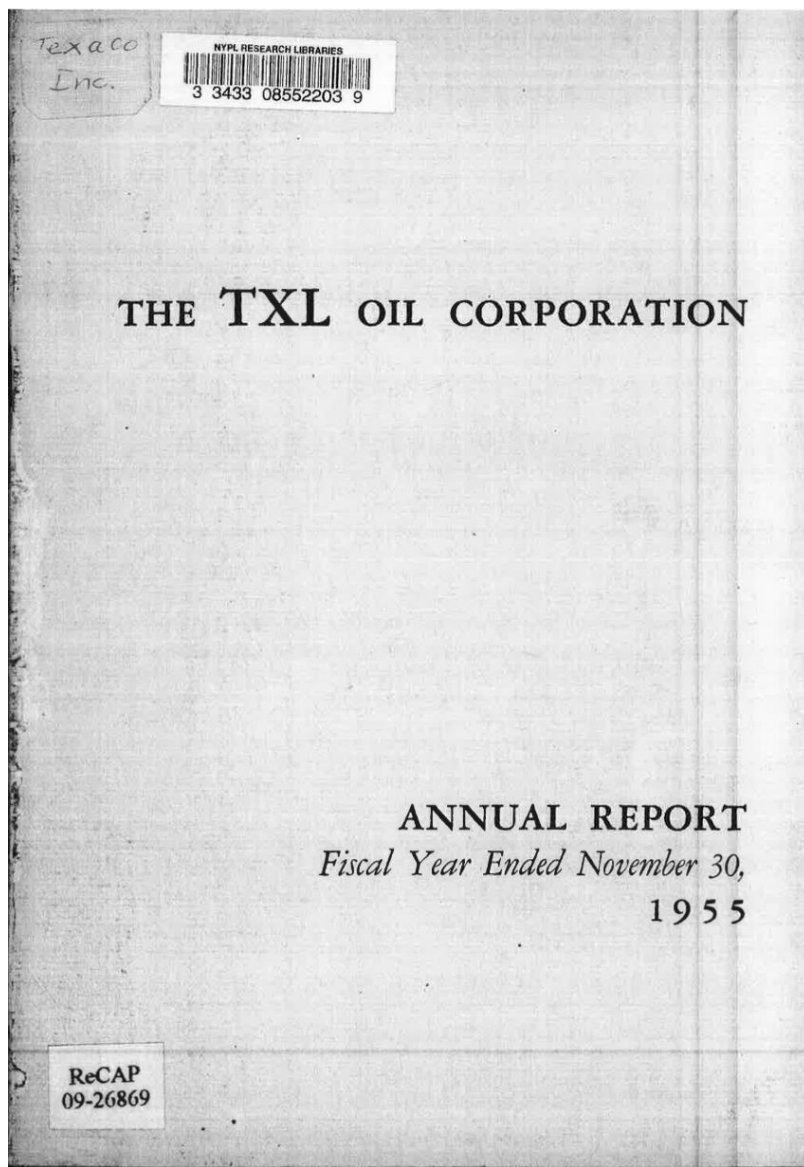
Despite the dramatic declines in global shipping volumes and pricing, Stolt-Nielsen has maintained, remarkably, stable revenues and rising earnings. It has been profitable in each of the past 10 years. The shares trade at 6.5x 2016 run-rate earnings and at 57% of book value. As well, since it has paid a \$1/share dividend since 2006, it yields 7%. One gets more than adequate payment to await a recovery in its industry.

Wendy's, study in what either is or is not expensive.

Wendy's was first bought in accounts in 2012, at an initial price of about \$6, versus \$13.8 now. It traded at about 37x earnings, but was cheap at the price. The purchase was not based on Wendy's sales growth or profitability; rather, on the lack of it, since it was the least profitable of the large fast-food chains. All that was required for investment success was for Wendy's to achieve average profitability. Earlier, in 2011/2012, activist investors Nelson Peltz and Peter May established a control position and put forth a long-term transformation plan centered on three initiatives: 1) upgrading the restaurants to a slightly more upscale, "fast casual" layout – an expensive undertaking, with full remodeling costing up to \$750,000 per store; 2) selling a significant portion of company-owned restaurants to franchisees; thereby, swapping capital-intensive, low margin property for the asset-light royalty stream of the franchise model; and 3) with no presence outside North America (versus over two-thirds of revenues for McDonald's and Yum! Brands), expanding internationally.

Five years into this transformation strategy, Wendy's has completed its program to reduce the number of company-owned stores to its target of 5% at the end of 2016 vs 22% in 2012. Net profit margin for the first nine months of 2016 increased to 8.9% compared to 5.4% the prior year and 2.1% in 2011. Yet, Wendy's operational transformation is still a work in progress, with only 28% of its North America restaurants upgraded, versus a target of 60% by the end of 2020. It is now at an important inflection point: the substantial expenditures for store upgrades mask much of the profitability improvement in the remodeled stores, but these expenditures are peaking and should decline rapidly starting next year. Free cash flow should increase substantially thereafter.

Anticipating the upcoming cash flow generation, the company has repurchased over 30% of its shares over the past year and a half, using cash from the sale of owned restaurants to franchisees as well as proceeds from a \$2.275 billion securitized financing facility. The additional interest expense is negatively affecting earnings and free cash flow due to higher interest expense, but the repurchase program will be accretive on a per share basis in the future. Therefore, while Wendy's continues to appear expensive, with a P/E of 30x this year's expected earnings, its price/free forward free cash flow is lower than that of the typical company.



What Do You Get From Research?

This is the front page of a 1955 annual Report of TXL Oil Corp. Chevron recently established a massive drilling program on land very near Texas Pacific Land Trust (TPL) land, and its acreage distribution looks remarkably like that of TPL's, which has an unusual checkerboard pattern. Horizon analyst James Davolos determined to trace the origin of that acreage through historical financial filings.

He discovered that it was acquired when Chevron purchased Texaco. Continuing the exercise, it appears that Texaco acquired the acreage when it purchased a company known as TXL Oil. Therefore, it is a TXL Oil annual report that would be expected to describe, perhaps explain, various pertinent details related to the origin and nature of that acreage. Unfortunately, TXL Oil, a subsidiary buried within a subsidiary hasn't been public in six decades.

Thus armed, Mr. Davolos located two copies in the public record: one at Stanford University and the other at the Midland County (Texas) Petroleum Museum. Short of traveling to either destination, and after persistent requests, he was able to have a copy made available at New York Public Research Library which, with some further urging, permitted him to copy it on their premises

with the appropriate number of quarters.

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