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# THE DEVIL'S ADVOCATE REPORT COMPENDIUM

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September 2012

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## Featured Companies

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*Lockheed Martin Corp. (LMT)*  
*Huntington Ingalls Industries Inc. (HII)*  
*United States Steel Corp. (X)*  
*AK Steel Holding Corp. (AKS)*



*Exclusive Marketers of  
The Devil's Advocate Report*

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## *Murray's Musings*

### VICTIMS OF LOW INTEREST RATES

A low interest rate environment may be conducive to economic growth as reckoned by economists. However, it is essentially a transference of wealth from creditors to debtors. Historically, debtors vastly outnumbered creditors so that one could orchestrate such an occurrence without too much ill effect. Unfortunately, in the contemporary era, the number of debtors has vastly increased, as is readily observable and, consequently, one should not be too astonished to learn that the increased number of debtors has been funded by an increased number of creditors.

For instance, the bond market debt outstanding in the U.S. in 1980 was \$2.5 trillion, according to the Securities Industry and Financial Markets Association (SIFMA). At the end of the first quarter of 2012, that number had risen to \$36.9 trillion, an increase of 8.7% per annum.

According to the 2012 Investment Company Fact Book, 90.4 million individuals owned mutual funds at the end of 2011. Of the households that owned mutual funds, median mutual fund assets were \$120,000. U.S. retirement assets were \$17.9 trillion. In 1980, 3% of the assets of U.S. households were in mutual funds. At the end of 2011, the comparable figure was 23%.

U.S. mutual funds owned 13% of all U.S. Treasuries, 26% of all municipal bonds, 43% of all commercial paper, and 15% of all corporate and international bonds. The U.S. mutual fund market, in terms of assets, equals \$11.6 trillion. Approximately 23% of that is money market funds. Approximately 25% is bond funds and their allocation has been increasing. For instance, in 2012 to date, the increase has been about \$157 billion.<sup>1</sup>

Consequently, it is rather difficult to resist the conclusion that the income paid to the retirement community from investment assets has been vastly reduced given the low level of interest rates. A good measure of the return on fixed-income securities in the U.S. is the yield to maturity of the iShares Aggregate Bond ETF (AGG), which was 1.36% as of this writing.<sup>2</sup>

Of course, individuals are not the only victims. According to the 2010 Pensions & Investments study of the asset mix of U.S. defined benefit plans, approximately 40.5% of assets were invested in U.S. fixed income, global fixed income, or cash.

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<sup>1</sup> Investment Company Institute: [http://www.ici.org/pdf/2012\\_factbook.pdf](http://www.ici.org/pdf/2012_factbook.pdf)

<sup>2</sup> Week of July 19, 2012

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According to a January 2012 study from Towers Watson, U.S. defined benefit plans are 43% invested in bonds. It should be obvious that if 43% of the assets of defined benefit plans are invested in securities that essentially produce no rate of return, the remaining plan assets must produce a truly extraordinary return with some degree of consistency to generate the actuarially assumed rate of return. Of course the remaining assets will not, in the aggregate, produce consistent, extraordinary rates of return. Ergo, companies with underfunded benefit plans may ultimately face problems. They are among the victims of low interest rates, or victims of the Credit Crisis of 2012. In this crisis, creditors cannot achieve a rate of return as opposed to the credit crisis of 2008 in which borrowers could not obtain funding.

## *Industry Thoughts*

### UNFUNDED PENSIONS

This section will focus on companies in the S&P 500 with large unfunded pension and/or Other Post-Employment Benefits (OPEB), specifically Boeing, Caterpillar, DuPont, Deere, Dow Chemical, Ford, General Electric, Hewlett Packard, IBM, Kraft, Lockheed Martin, Pfizer, Raytheon, AT&T, Verizon, U.S.Steel, and Exxon.

Of that group, one can make a sharp division between those companies with unfunded plans that would have no difficulty funding them if required, and those companies for which funding might be somewhat problematic. For instance, one might place Exxon in the former category. It has a \$17 billion benefit obligation in its U.S. plan, a \$29 billion benefit obligation in a non-U.S. plan, and a \$7.9 billion post-employment benefit obligation. As of December 31, 2011, according to Exxon's Form 10-K, its U.S. plan had assets of \$10.7 billion; its non-U.S. plan had \$17.1 billion; and its post-employment benefits plan had \$500 million.

Table 1: Exxon's Pension Shortfalls  
(*\$ in billions*)

	<u>Obligations</u>	<u>Assets</u>	<u>Shortfalls</u>
U.S. Pension Plan	\$17.0	\$10.7	(\$6.3)
Non-U.S. Pension Plan	\$29.0	\$17.1	(\$11.9)
Post-Employment Benefits	\$7.9	\$0.5	(\$7.4)
Total Equity Gap			(\$25.6)

*Source: Company reports as of 12/31/2011*

As you can see in the accompanying Table 1, Exxon had a \$7.9 billion in post-employment benefits obligation with \$500 million actually deposited in the plan. To fund that

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obligation would require some really extraordinary rates of return. There is a total funding gap of \$25.6 billion. However, Exxon has \$40 billion of earnings power per year so, if needed, it could make substantial fund contributions.

Notably, Exxon uses a 5.5% discount rate on the value of its pension liability; therefore, these liabilities are the present value figures. They are not, by any stretch of the imagination, the ultimate liability, which will be much greater. Nevertheless, even given the much greater number which, incidentally, corporations choose not to disclose, Exxon probably would have very little difficulty funding it; such funding might impact earnings, which could be problematic for the stock, but not in an existential sense for the company.

Incidentally, the company also assumes a 7.5% rate of return on funded assets. It's difficult to imagine how such a rate of return can be achieved. Exxon also estimates that its long-term rate of compensation increase, that is compensation paid to employees, will be 5.25%, and that has some bearing on what the ultimate liability in the plans will be. Nevertheless, Exxon has the resources to ensure its pension earnings will be paid.

Other companies are perhaps more problematic. Lockheed Martin, for instance, had an accumulated pension benefit obligation of \$40.6 billion at the end of 2011. In addition, it also had a liability of \$3 billion for post-retirement healthcare.

At the end of 2011, the pension plan had \$27.3 billion in assets and the healthcare plan had \$1.7 billion in assets. Hence, the pension fund is \$13.3 billion underfunded and the healthcare plan is roughly \$1.3 billion underfunded.

Table 2: Lockheed Martin's Pension Shortfalls  
(*\$ in billions*)

	<u>Obligations</u>	<u>Assets</u>	<u>Shortfalls</u>
Pension Plan	\$40.6	\$27.3	(\$13.3)
Post-Retirement Health Care	\$3.0	\$1.7	(\$1.3)
Gap			(\$14.6)

*Source: Company reports as of 12/31/2011*

Rightly or wrongly, the discount rate used to calculate the liability is 4.75%. Using current interest rates, the discount rate probably should be lower. However, companies won't be using a materially lower discount rate, because Congress has passed legislation, which the President is almost certain to sign, that will enable companies to choose a 25-year average of rates. If that weren't the case, and companies were forced to continue the current practice of a two-year average, the liabilities would increase tremendously. Those increases would be balance sheet events for companies. Not wishing to cause more balance sheet events, Congress changed the rules.

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Using the discount rate of 4.75%, the liability on Lockheed Martin's pension would increase by \$1.93 billion simply as a function of the discount rate used. That amount is approximately 7.06% of pension fund assets so, if the return on the pension fund assets were actually 7.06% per annum, the funding gap would stay the same. To narrow the funding gap without contributions, Lockheed would need a yet higher rate of return, much more than appears reasonable, given the currently available very low rates on bonds.

No reasonable person should assert that Lockheed Martin is an insolvency risk. However, Lockheed Martin has only \$1.5 billion of shareholders' equity. If its pension liability alone is increasing by more than \$1.9 billion, that might be somewhat problematic. The company has annual earnings power of \$2.6 billion, assuming there are no meaningful cuts to any Lockheed defense programs, which may or may not be a reasonable assumption. In fact, some might say that it's not a good assumption at all. In any case, of the company's \$2.6 billion of earnings power, Lockheed currently maintains a 50% dividend payout ratio. Consequently, assuming no reduction in earnings and no change in its dividend policy, the company has \$1.3 billion per year with which to make contributions to its plan, but liabilities are increasing by more than \$1.9 billion.

A failure to earn about 7%, or several years of negative rates of return, could result in serious problems for shareholders. The irony is that investors believe that the key variable to understanding Lockheed Martin is U.S. defense spending. It is an important consideration, but a much more important variable may be the pension fund liability. A negative rate of return of 5%, along with the operation of the 4.75% discount rate, would raise the unfunded portion by more than \$3.5 billion.<sup>3</sup> A 5% negative rate of return has happened before to many pension funds and is likely to happen again. If the discount rate should decrease, the obligation would increase yet more.

The point of this discussion is that the S&P 500 has two categories of firms with pension problems: those with pension fund obligations that are unlikely to be problematic, and those for which the obligations may one day become problematic. It appears that Lockheed is in the latter category, and we'll look more closely at it in the *Featured Companies* section of this report.<sup>4</sup>

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<sup>3</sup> One year of operation of the discount rate means that the pension/post retirement obligations increase by \$43.6 billion x 4.74%, which equals \$2.1 billion. One year of negative 5% return on the plan assets means \$29.0 billion x 5%, which equals \$1.45 billion. These figures total \$3.55 billion.

<sup>4</sup> For further details, please refer to the Devil's Advocate Report on Lockheed Martin published 8/20/2012.

## *Facts and Figures*

### PENSION DISCOUNT RATES

Standard & Poor's studies aspects of the S&P 500 that individuals might not ordinarily consider. Its 2010 Market Attributes study—the most recent as of this writing—included data on the historical pension discount rate, which is an aggregate for all the companies in the S&P 500, from 1998 to 2010, and on pension return assumptions for the same period of time.

Table 3: Historical Pension Discount Rates and Return Assumptions

<u>Year</u>	<u>Historical Pension Discount Rates</u>	<u>Pension Return Assumptions</u>
2010	5.31%	7.73%
2009	5.81%	7.83%
2008	6.29%	7.95%
2007	6.13%	8.02%
2006	5.75%	8.03%
2005	5.11%	8.13%
2004	5.80%	8.27%
2003	6.09%	8.38%
2002	6.64%	8.63%
2001	7.13%	9.15%
2000	7.43%	9.17%
1999	7.44%	9.13%
1998	6.72%	9.06%

*Source: S&P Market Attributes, 2010 study*

As you can see from the accompanying table, in 1998, the historical pension discount rate was 6.72%. In 2010, it was 5.31%. From my own reading of the 2011 Form 10-Ks from 2011, I would suspect the 2011 number is not radically different. Numerous companies support discount rates of 5.25% to 5.5%.

The 2010 discount was 5.31% and the 2005 discount rate was 5.11%. It seems bizarre that the 2010 discount rate—and probably the 2011 rate—should be higher, not lower, than the 2005 number.

In 1998, the actuarial rate of return, or the pension return assumption, was 9.06% and, at the end of 2010, it was 7.73%. Clearly, there must be some relationship between the discount rate, which is merely a reflection of the prevailing level of interest rates, and the

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pension return assumption, which must incorporate the possible returns of the bond market and the prevailing interest rates. One can only wonder how the pension funds assume that a 7.73% annual rate of return is achievable, given that 42% of pension funds are invested in bonds yielding nothing close to 7.73%.

Another issue is that this analysis is somewhat flawed, because the figures available are nothing other than the present value of the liability, not the contractual liability in its nominal terms, which is the liability corporations actually face. Why don't companies disclose the ultimate liability instead of this discounted liability?

## UNDERFUNDED PENSIONS AND OTHER OBLIGATIONS

Another table, also from S&P Market Attributes, looks at pension underfunding and Other Post-Employment Benefits, referred to as OPEB.

Table 4: S&P 500 OPEB and Pension Underfunding

	(\$ in billions)
2010	(455.02)
2009	(475.32)
2008	(565.66)
2007	(205.76)
2006	(334.03)
2005	(461.35)
2004	(451.26)

Source: S&P Market Attributes, 2010 Study

In 2010, OPEB and pension underfunding added up in aggregate to a negative \$455.02 billion. As of this writing, we don't have a 2011 number yet but, based on my own reading of Form 10-Ks, I don't think the 2011 number will be radically different from the 2010 number. Note that some pension funds are not underfunded, but most are.

The most recent numbers are even more interesting in another context. The liability, calculated in 2004, was \$451 billion. In other words, all these years of contributions and returns have not materially changed that number. Returns have not been good, the discount rate in 2010 was lower, and there were many other factors involved. In any event, the number was unchanged.



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## BALANCE SHEET CASH

The following statistics are also from the S&P Market Attributes Study. They are derived by taking all the companies in what's called the S&P Industrials (including the non-financial companies, excluding banks, insurance companies, and utilities) and adding up all the cash on the balance sheets collectively.

Table 5: Cash Levels of S&P Industrials

		<i>(\$ in billions)</i>
2010	4Q	\$940.2
	3Q	902.4
	2Q	842.5
	1Q	836.8
2009	4Q	831.2
	3Q	820.3
	2Q	772.7
	1Q	664.8
2008	4Q	654.6
	3Q	647.8
	2Q	648.4
	1Q	615.5
2007	4Q	609.7
	3Q	622.8
	2Q	602.8
	1Q	606.6

*Source: S&P Market Attributes, 2010 Study*

The number in the fourth quarter of 2010 was \$940.2 billion. That's a number frequently quoted in newspapers. Some people regard it as excessive conservatism and others regard it as a measure of the balance sheet strength and creditworthiness of those industrial companies. Another number worth considering, even though it isn't entirely comparable, is the sum of all corporate debt, including financial debt, which will be examined in the next paragraphs.

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## CORPORATE DEBT

According to SIFMA, as of the first quarter of 2012, the sum of all the corporate debt in America was \$8.098 trillion.

Table 6: U.S. Corporate Debt

	<i>(\$ in trillions)</i>
2007	\$6.064
2008	\$6.317
2009	\$6.991
2010	\$7.643
2011	\$7.921
2012 Q1	\$8.098

*Source: SIFMA*

That level of corporate debt represents an increase of \$2 trillion since the end of 2007. In other words, from the end of 2007—the eve of the credit crisis—to the end of the first quarter of 2012, U.S. corporations, including the financials, which are all supposed to be collectively deleveraging, have increased their debt by \$2 trillion. They don't appear to be deleveraging as far as can be ascertained.

## DEFENSE SPENDING

According to the United States Defense Budget, defense spending in 2010 was \$729.8 billion. In 2012, the Department of Defense projects it to be \$655.9 billion, and \$613.9 billion in 2013.

Table 7: U.S. Defense Spending

	<i>(\$ in billions)</i>
2010	\$729.8
2011	\$711.1
2012	\$655.9
2013	\$613.9

*Source: <http://comptroller.defense.gov/defbudget>*

The number is clearly projected to decline, but the question is what specific parts of that budget will be cut? The aggregate number will decline, assuming the projections are correct; however, the reality can be quite different, so a word of caution is required. Nevertheless, it is the intention of the executive branch of the government to reduce defense spending in the next fiscal year by \$42 billion. From where that reduction will come is an important question.

One of the areas to be cut is aircraft spending, which is being reduced from \$54.2 billion to \$47.6 billion. The Air Force will eliminate seven transport squadrons that utilize C-130 aircraft made by Lockheed Martin. The Joint Strike Fighter program is going to lose \$75 million, a relatively small amount of funding, which is also made by Lockheed Martin. The F-22 Raptor fighter will lose \$8 million of funding, the E-2 Hawkeye \$66 million of funding, and the MH-60R Multi-mission Helicopter, \$150 million. On the other hand, the C-5 Galaxy Transport, also made by Lockheed, will pick up \$115 million in funding. The cuts are not all in Lockheed programs, but some of this company's programs are vulnerable to reduction. More comments follow in the *Featured Companies* section.

## *Featured Companies*

### LOCKHEED MARTIN (LMT)

Based on its current earnings, Lockheed Martin has a 10.5x price-to-earnings ratio, a \$28.5 million market capitalization, and a 4.5% dividend yield. It is, and should remain, a great company. As just one measure of its scale, this company has a \$76 billion program backlog. Another measure of its success is that in the past 10 years it has repurchased roughly one-third of its shares outstanding and has only slightly more debt than it had 10 years ago. However, a decade ago it had \$6 billion in net assets and that figure is now closer to \$1.5 billion. It also has only \$1.5 billion in shareholders' equity.

Apart from defense spending, Lockheed appears to have two problems. The first is that it has pension and post-employment liabilities of \$43.6 billion and plan assets of \$29 billion. According to the discount rate used by Lockheed, which is 4.75%, the liability will therefore grow by that percentage. The question is, how much return can be generated by \$29 billion? If there is a shortfall and, of course, there can easily be a shortfall for a variety of reasons, Lockheed would be forced to contribute to the plan.

How would it manage to do so? Lockheed has well over \$2 billion of current earnings power, half of which is paid out in the form of dividends. The earnings power might be vulnerable to defense cuts under some circumstances. That situation could happen and needs to be factored in, but it's difficult to do so because all the planned reductions are nothing but plans, and they're preliminary estimates at best.

What if something amiss were to occur in capital markets instead of in the defense market? Let's say that defense spending on Lockheed's products were cut by 10%, 12%, or 15%. Would that be worse than a 10% or 15% negative rate of return on \$40 billion of pension fund assets? Arguably, defense cuts would not be nearly as bad. A negative event in the stock and bond markets would be a Lockheed Martin problem. Furthermore, that problem would be compounded by the fact that the liability will increase by at least 4.75% per

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annum, and Lockheed Martin doesn't have the flexibility that a typical industrial company would have in terms of reducing its staff. After all, it has a \$76 billion program backlog and there are only a small number of people, relatively speaking, in the United States who have the skill set to produce the equipment required by the U.S. military. The company can hardly do mass layoffs without disrupting the delivery program of that equipment.

A second problem revolves around the \$76 billion of backlog. The company is contractually obligated to tens of billions of dollars in capital expenditures over the next decade to acquire the capital equipment and parts necessary to build those deliverables. Ordinarily, the company would have about \$2.4 billion of free cash flow available to itself, after dividends and inclusive of depreciation expense. That, however, assumes no decrease in earnings because of defense spending cuts. What if earnings were to decrease because of defense spending cuts? How can a material shortfall in the pension fund be met? In the long run it's probable that the earnings power is not sustainable and perhaps not even the dividends are sustainable. In the longer run, it seems likely that there'll be an episode of negative rates of return—perhaps deeply negative rates of return—in the pension fund.

A dozen years ago, as a much smaller company, Lockheed had capital expenditures of \$700 million a year. Today, with a \$76 billion backlog, its capital expenditures run about \$800 million a year. We can calculate \$2.6 billion of earnings power minus \$1.3 billion of dividends paid to shareholders, plus \$1 billion of depreciation and amortization expense, minus \$800 million capital expenditures, leaving \$1.5 billion available. It doesn't seem like a lot, but factoring in the pension liability rising by about \$2 billion a year, the sale of Lockheed Martin is advised.

## HUNTINGTON INGALLS INDUSTRIES INC. (HII)

Huntington Ingalls is a recent spinoff of Northrup Grumman. It has a \$1.9 billion market capitalization. This company has many virtues. It is the only firm in the United States that builds nuclear aircraft carriers and it is currently working on two of them. One, the Gerald R. Ford (CVN 78), will be delivered in 2015; another, the John F. Kennedy (CVN 79), has an uncertain delivery date. Huntington Ingalls is also the only firm in the United States that overhauls U.S. Navy nuclear vessels, such as aircraft carriers and submarines. It also works on decommissioning aircraft carriers, especially of the nuclear variety. Decommissioning a nuclear aircraft carrier can generate contractual revenues of between \$600 million and \$700 million a year.

Huntington Ingalls is also the sole supplier to the U.S. military of amphibious assault vehicles and Coast Guard cutters. It is one of only two firms that supply the Arleigh Burke class of destroyers, and the government is increasing components of that budget by about \$100 billion in 2013, so the business is not bad. The government is also increasing its spending on Aegis Class destroyers in 2013 by \$1.5 billion; most of that increase will go to General Dynamics, but Huntington Ingalls will get some of it. On the other hand, the

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government is decreasing its expenditures on Virginia-class submarines by about \$540 billion, and most of that decrease will go to General Dynamics as well.

The company is likely to get new contracts in the Carrier Refueling Complex Overhaul program for nuclear carriers. Many nuclear carriers will be overhauled, with expenditures rising by about \$1.1 billion and that will all go to Huntington Ingalls. The company's stock trades at about 10x 2013 estimates. Unlike Lockheed Martin, Huntington Ingalls' earnings are not problematic and are not likely to decline, at least for the foreseeable future.

The problem, though, is that the company's pension plan and its other post-retirement benefits are underfunded by about \$1.64 billion. The present value accumulated benefit obligation is \$4.877 billion. The company uses a 5.23% discount rate and an 8.5% assumed return on pension assets. To deal with some of the contracts likely be awarded, Huntington Ingalls will have to call back some workers, so the pension benefits obligation is likely to grow at a rate above 5.23%.

If one uses the discount rate alone on that accumulated benefit obligation, in other words, 5.23% on nearly \$4.9 billion, the annual increase in benefit obligation is 20% more than the projected earnings. That means the company will have to earn a very high rate of return on its funded assets, but even if it does so, the accumulated benefit obligation exceeds funded assets, so the assets are merely chasing the liability. The pension liability is increasing faster than the profits of the company and that liability will continue to grow for decades.

However robust the Huntington Ingalls earnings might be in 2013, those earnings will not continue to grow. Ultimately, there could be a problem and it's worth noting that expenditures on defense platforms like aircraft carriers are known to be highly cyclical and highly variable. Therefore, Huntington Ingalls is recommended for a sale.

## UNITED STATES STEEL CORP. (X)

U.S. Steel, with a \$2.7 billion market capitalization, is a legend in the world of steel making. At the moment it has 29 million tons of annual steel-making capacity, mostly in North America, although it also owns some steel capacity production in Slovakia. It also operates two iron ore mines and is the eighth largest steel company in the world.

U.S. Steel, however, has three sets of problems, with the third set arguably the most serious. The first concerns lower demand for U.S. Steel's products. The commercial construction market worldwide, and especially in the United States, is very weak. That market uses steel and the demand for steel simply isn't there. The automobile market is very weak, so the demand for steel from that area is also feeble. The rig count, because of the collapse of natural gas prices, has been decreasing; therefore, the oil industry's demand for tubular goods using steel is very weak as well.

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According to consensus estimates, the company trades at 12.3x 2012 estimates and 6.8x 2013 estimates. Those estimates are perhaps highly questionable. They are revised downwards virtually every week and, for most of the period subsequent to 2008, the company has been losing money.

The second set of the problems that U.S. Steel faces that it is currently unprofitable and has been unprofitable for roughly two-thirds of the quarters since 2008. It's hard to see how the company could become profitable unless current trends are reversed, and it seems hard to imagine that happening. Some of the most worrisome trends are related to the balance sheet rather than earnings, which brings us to the third set of problems: pension liabilities.

The benefit obligation for Other Post-Employment Benefits (OPEB) as of year-end 2011 is \$4.186 billion, but the fund assets are \$1.473 billion, or roughly one third of the required amount. The total present value of the unfunded liability is \$5.13 billion and the company uses a 5% discount rate. Clearly, the liability will increase by more than \$250 million a year.

Table 8: U.S. Steel Pension Benefit & Other Post-Employment Benefits

Pension Benefit Obligation 12/31/2011	<i>(\$ in billions)</i>
Obligation	\$10.77
Fund Assets	8.65
Unfunded Liability	\$2.12
Other Post-Employment Benefits (OPEB) 12/31/2011	<i>(\$ in billions)</i>
Obligation	\$4.186
Fund Assets	1.473
Unfunded Liability	2.713
<i>Total Present Value Liability</i>	<i>\$5.13</i>

Source: Company Reports

The firm has to earn a very robust rate of return on its pension fund assets just to meet that obligation, but the assets available to it are far lower than the liability and the company loses money. To merely prevent a deterioration, the return on the pension fund assets must be truly extraordinary. How can the company extricate itself from these circumstances in the long run? It's extremely difficult to see how that might happen. The worst problem is not even analyzable, since all we have available for calculation purposes is the present value, not the actual liability. It cannot be calculated, because no one really knows what the lifespan of the workers will be. We can also make estimates of what the healthcare costs will be, and we can note that working full time in a steel mill is usually not conducive to a state of robust health.

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## AK STEEL HOLDING CORP. (AKS)

AK Steel, with a \$580 million market capitalization and a dividend yield of 3.65%, is much smaller than U.S. Steel and does not have the obvious economies of scale of U.S. Steel. It operates seven steel plants located in Indiana, Kentucky, Ohio and Pennsylvania. Unlike U.S. Steel, which has been unprofitable two-thirds of the time since 2008, AK Steel has been consistently unprofitable since 2008. Nevertheless, it pays dividends to its shareholders.

At year-end 2007, shareholders' equity was \$877 million and working capital was \$1.4 billion. As of the most recent reckoning, shareholders' equity was negative \$360 million and working capital was \$400 million. This situation was a consequence of losing money with consistency and paying a dividend with consistency while losing money.

The company's biggest problem is not necessarily the deterioration of the balance sheet, although one should pay close attention to that circumstance and also to the declining fundamentals of the steel business. The company's most serious problem is in the pension area. Its pension benefit obligation, as calculated by the company at year-end 2011, was \$3.539 billion. The assets available to pay that obligation were \$2.377 billion, causing an unfunded gap of \$1.161 billion. It's worth noting that the unfunded status of the pension fund is 2x the market capitalization of the company.

The company also had an accumulated obligation of \$713.2 million in other post-employment benefit obligations and had nothing set aside for that purpose. Therefore, by definition, the unfunded component of its OPEB is \$713 million, for a total obligation of \$1.874 billion.

Table 9: AK Steel Pension Benefit & Other Post-Employment Benefits

Pension Benefit Obligation 12/31/2011	<i>(\$ in millions)</i>
Obligation	\$3,539
Fund Assets	2,377
Unfunded Liability	\$1,161
Other Post-Employment Benefits (OPEB) 12/31/2011	<i>(\$ in millions)</i>
Obligation	\$713.2
Fund Assets	0.0
Unfunded Liability	\$713.2
<i>Total Present Value Liability</i>	<i>\$1,874</i>

Source: Company Reports

To make it a little worse, the retired element of the work force is a bit older than might be the case in a company such as Lockheed and there is a contractual payout commitment from the pension funds exceeding \$400 million in the next five years.

In the prior examples, we did not consider the contractual payout obligation; we only did the calculation based on the assumed liability increase. However, we should be mindful that the contractual payout obligation is not uniform for pension funds. AK Steel is one of the more serious instances. In principle, AK Steel has the assets, at least on the pension side, to make the required payments. In that case, however, the funding capital will increase and, since the company is not profitable, it's difficult to see how it can repair that increase in deficiency. Therefore, this may well be a problematic company. In any event, it's hard to imagine how this company can fund its pension liabilities and its post-employment benefit liabilities when it has set aside no assets for that purpose. How can it continue to pay a dividend when it loses money? Therefore, the sale of this company is recommended.

## *Post-Musings*

### NEGATIVE INTEREST RATES

Based on recently auctioned two-year debt, six nations now have negative short-term government bond rates. Those six nations are Germany, Finland, Denmark, Switzerland, the Netherlands and Austria. The United States has negative yields on Treasury Inflation Protected Securities.

Some would assert that those negative yields were actually a deflationary forecast. In response to such an assertion, one can only say that during a period of actual deflation, as occurred in 1930 and beyond, the United States did not have negative nominal interest rates. Therefore, it doesn't appear likely that the negative yields represent a deflationary forecast. One might presuppose that it has something to do with the modern world of structured products and indexation. There are many products in which one makes an investment in a derivative security, usually on multiple levels of margin, and the principal or collateral is held for safekeeping in some high-quality bond instrumentality. From my point of view, that practice appears to have more influence on the situation than anything else.

There is a current need to invest money to get a guaranteed rate of return, however small. Of course, in the case of negative interest rates the guaranteed rate of return is obviously negative. If someone requires a guaranteed positive rate of return, selling short a high-quality instrumentality with a negative yield would accomplish that goal. If any of the nations that have negative real rates turns out to be a deteriorating credit, then the yield would be even higher. As a result, we are in the process of creating a very bizarre world, much of which has to do with the role of computers and mathematics in investing as opposed to human instinct and thought.



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## THE DEVIL'S ADVOCATE REPORT COMPENDIUM

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*Q: Did you perform an analysis of those companies that have cash on the balance sheet with which to fund their pension obligations and those that do not?*

**A:** I merely looked at a number of companies and observed that some have, in my estimation, very large unfunded pension liabilities, but appear to be able to meet them with little difficulty, while others would probably have difficulty funding them.

It seems bizarre that a company with a very large unfunded liability that is increasing at a rate of 5% or more would leave money in cash earning a zero rate of return when it could reduce its ultimate liability by contributing to the pension fund. Why would it not do that? Perhaps the reason is that contributions to a pension fund represent a diminution of earnings. In the modern era, pension events of the positive or negative variety are balance sheet and income statement events. To keep cash on the balance sheet when there is a large unfunded pension liability appears to be a bizarre choice, unless the company is interested in reporting a very high earnings number. Companies have a vested interest in taking that approach because, if the management reports a sufficiently high return on equity, it is apt to be compensated for it, although the long-term rate of return to the shareholders is clearly going to be negatively impacted. It's one of the many examples of what's known as the agency problem in economics. It is available for view to anyone who cares to look at it, and it's astonishing to see. It's an issue that involves literally hundreds of billions of dollars.

**WEALTH INDEX (Ticker: RCH Index)***As of June 30, 2012*

<b>No.</b>	<b>Ticker</b>	<b>Security Name</b>	<b>Individual Name</b>	<b>Position</b>
1	AE	Adams Resources & Energy Inc	Kenneth S. Adams Jr.	Chairman/Chief Executive Officer/Founder
2	ARG	Airgas Inc	Peter McCausland	Chairman/President/Chief Executive Officer/Founder
3	ALX	Alexander's Inc	Steven Roth	Chairman
4	AHGP	Alliance Holdings GP LP	Joseph W. Craft III	Chairman/President/Chief Executive Officer
5	ARLP	Alliance Resource Partners LP	Joseph W. Craft III	President/Chief Executive Officer
6	AMZN	Amazon.com Inc	Jeffrey P. Bezos	Chairman/President/Chief Executive Officer
7	AMCX	AMC Networks Inc	Charles Francis Dolan	Chairman
8	AFG	American Financial Group Inc/OH	Carl H. Lindner III	Co-President/Co-Chief Executive Officer
9	ARII	American Railcar Industries Inc	Carl C. Icahn	Chairman
10	AMKR	Amkor Technology Inc	James J. Kim	Chairman
11	AXE	Anixter International Inc	Samuel Zell	Chairman
12	APOL	Apollo Group Inc	John G. Sperling	Chairman/Founder
13	AN	AutoNation Inc	Edward S. Lampert	Director-by-Proxy
14	AZO	AutoZone Inc	Edward S. Lampert	Director-by-Proxy
15	BRK/B	Berkshire Hathaway Inc	Warren E. Buffett	Chairman/Chief Executive Officer
16	BX	Blackstone Group LP	Stephen A. Schwarzman	Chairman/Chief Executive Officer/Founder
17	BOKF	BOK Financial Corp	George B. Kaiser	Chairman
18	BXP	Boston Properties Inc	Mortimer B. Zuckerman	Chairman/Chief Executive Officer/Co-Founder
19	BRCM	Broadcom Corp	Henry Samueli	Director/Founder/Chief Technology Officer
20	BRO	Brown & Brown Inc	J. Hyatt Brown	Chairman
21	CVC	Cablevision Systems Corp	Charles Francis Dolan	Chairman
22	CPB	Campbell Soup Co	Mary Alice Dorrance Malon	Director
23	CCL	Carnival Corp	Micky Meir Arison	Chairman/Chief Executive Officer
24	CBS	CBS Corp	Sumner M. Redstone	Chairman
25	CETV	Central European Media Enterprises Ltd	Ronald S. Lauder	Chairman/Founder
26	CERN	Cerner Corp	Neal L. Patterson	Chairman/President/Chief Executive Officer
27	SCHW	Charles Schwab Corp/The	Charles R. Schwab	Chairman
28	CHK	Chesapeake Energy Corp	Aubrey K. McClendon	Chairman/Chief Executive Officer/Co-Founder
29	CFX	Colfax Corp	Mitchell P. Rales	Chairman/Co-Founder
30	CLNY	Colony Financial Inc	Thomas J. Barrack	Chairman
31	CMCSA	Comcast Corp	Brian L. Roberts	Chairman/President/Chief Executive Officer
32	CLR	Continental Resources Inc/OK	Harold G. Hamm	Chairman/Chief Executive Officer/Founder
33	CVA	Covanta Holding Corp	Samuel Zell	Chairman
34	DHR	Danaher Corp	Steven M. Rales	Chairman/Co-Founder
35	DELL	Dell Inc	Michael S. Dell	Chairman/Chief Executive Officer/Founder
36	DISH	DISH Network Corp	Charles William Ergen	Chairman/Co-Founder
37	DOLE	Dole Food Co Inc	David H. Murdock	Chairman
38	DRC	Dresser-Rand Group Inc	William E. Macaulay	Chairman
39	EBAY	eBay Inc	Pierre M. Omidyar	Chairman/Co-Founder
40	SATS	EchoStar Corp	Charles William Ergen	Chairman
41	ETE	Energy Transfer Equity LP	Kelcy L. Warren	Chairman/Chief Executive Officer
42	ETP	Energy Transfer Partners LP	Kelcy L. Warren	Chairman/Chief Executive Officer
43	ELS	Equity Lifestyle Properties Inc	Samuel Zell	Chairman
44	EQR	Equity Residential	Samuel Zell	Chairman
45	EL	Estee Lauder Cos Inc/The	William P. Lauder	Chairman
46	EXPE	Expedia Inc	Barry Diller	Chairman
47	FDO	Family Dollar Stores Inc	Howard R. Levine	Chairman/Chief Executive Officer
48	FAST	Fastenal Co	Robert A. Kierlin	Chairman/Founder
49	FDML	Federal-Mogul Corp	Carl C. Icahn	Chairman
50	FDX	FedEx Corp	Frederick Wallace Smith	Chairman/President/Chief Executive Officer
51	F	Ford Motor Co	William C. Ford Jr.	Chairman
52	BEN	Franklin Resources Inc	Charles B. Johnson	Chairman
53	GPS	Gap Inc/The	Robert J. Fisher	Director
54	GRMN	Garmin Ltd	Min H. Kao	Chairman/Chief Executive Officer
55	GOOG	Google Inc	Lawrence E. Page	Chief Executive Officer/Co-Founder
56	GLRE	Greenlight Capital Re Ltd	David M. Einhorn	Chairman/Co-Founder
57	HPQ	Hewlett-Packard Co	Margaret C. Whitman	President/Chief Executive Officer
58	HTH	Hilltop Holdings Inc	Gerald J. Ford	Chairman
59	HST	Host Hotels & Resorts Inc	Richard E. Marriott	Chairman
60	HHC	Howard Hughes Corp/The	William A. Ackman	Chairman
61	H	Hyatt Hotels Corp	Thomas J. Pritzker	Chairman
62	IACI	IAC/InterActiveCorp	Barry Diller	Chairman

## WEALTH INDEX (Ticker: RCH Index)

As of June 30, 2012

No.	Ticker	Security Name	Individual Name	Position
63	INTC	Intel Corp	Gordon Earle Moore	Chairman Emeritus/Co-Founder
64	IBKR	Interactive Brokers Group Inc	Thomas Peterffy	Chairman/President/Chief Executive Officer
65	INTU	Intuit Inc	Scott D. Cook	Director/Founder
66	JNY	Jones Group Inc/The	Sidney Kimmel	Chairman
67	KMP	Kinder Morgan Energy Partners LP	Richard D. Kinder	Chairman/Chief Executive Officer
68	KMR	Kinder Morgan Management LLC	Richard D. Kinder	Chairman/Chief Executive Officer
69	KSS	Kohl's Corp	William S. Kellogg	Director
70	KRO	Kronos Worldwide Inc	Harold C. Simmons	Chairman
71	LVS	Las Vegas Sands Corp	Sheldon Gary Adelson	Chairman/Chief Executive Officer/Treasurer
72	LEN	Lennar Corp	Stuart A. Miller	Chief Executive Officer
73	LUK	Leucadia National Corp	Joseph S. Steinberg	President
74	LVLT	Level 3 Communications Inc	Walter Scott Jr.	Chairman
75	LBTYA	Liberty Global Inc	John C. Malone	Chairman
76	LINTA	Liberty Interactive Corp	John C. Malone	Chairman
77	LMCA	Liberty Media Corp - Liberty Capital	John C. Malone	Chairman
78	L	Loews Corp	Andrew H. Tisch	Co-Chairman
79	LTD	Ltd Brands Inc	Leslie Herbert Wexner	Chairman/Chief Executive Officer
80	MSG	Madison Square Garden Co/The	James L. Dolan	Chairman
81	MAR	Marriott International Inc/DE	John W. Marriott Jr.	Chairman/Chief Executive Officer
82	MCY	Mercury General Corp	George Joseph	Chairman/Founder
83	MGM	MGM Resorts International	Krik Kerkorian	Director Emeritus
84	MSFT	Microsoft Corp	William Henry Gates III	Chairman
85	MOLX	Molex Inc	Frederick A. Krehbiel	Co-Chairman
86	MORN	Morningstar Inc	Joseph D. Mansueto	Chairman/Chief Executive Officer/Founder
87	NWSA	News Corp	Keith Rupert Murdoch	Chairman/Chief Executive Officer
88	NKE	NIKE Inc	Phillip H. Knight	Chairman
89	NCQ	NovaCopper Inc	Thomas S. Kaplan	Chairman
90	NG	Novagold Resources Inc	Thomas S. Kaplan	Chairman
91	OXY	Occidental Petroleum Corp	Ray R. Irani	Chairman
92	OZM	Och-Ziff Capital Management Group LLC	Daniel S. Och	Chairman/Chief Executive Officer/Founder
93	OPK	Opko Health Inc	Phillip Frost	Chairman/Chief Executive Officer
94	ORCL	Oracle Corp	Lawrence Joseph Ellison	Chief Executive Officer
95	PCBC	Pacific Capital Bancorp	Gerald J. Ford	Chairman
96	PAYX	Paychex Inc	Blasé Thomas Golisano	Chairman/Founder
97	PCO	Pendrell Corp	Craig O. McCaw	Chairman
98	PENN	Penn National Gaming Inc	Peter M. Carlino	Chairman/Chief Executive Officer
99	PAG	Penske Automotive Group Inc	Roger S. Penske	Chairman/Chief Executive Officer
100	PGR	Progressive Corp/The	Peter Benjamin Lewis	Chairman
101	QCOM	QUALCOMM Inc	Paul Eric Jacobs	Chairman/Chief Executive Officer
102	RL	Ralph Lauren Corp	Ralph Lauren	Chairman/Chief Executive Officer/Founder
103	RJF	Raymond James Financial Inc	Thomas A. James	Chairman
104	RYAAY	Ryanair Holdings PLC	David Bonderman	Chairman
105	CRM	Salesforce.com Inc	Marc R. Benioff	Chairman/Chief Executive Officer/Co-Founder
106	BFS	Saul Centers Inc	B. Francis Saul II	Chairman/Chief Executive Officer
107	SHLD	Sears Holdings Corp	Edward S. Lampert	Chairman
108	SPG	Simon Property Group Inc	Herbert Simon	Chairman Emeritus
109	SBUX	Starbucks Corp	Howard D. Schultz	Chairman/President/Chief Executive Officer/Founder
110	SYK	Stryker Corp	Ronda E. Stryker	Director
111	SYNT	Syntel Inc	Bhrat Desai	Chairman/Co-Founder
112	TCO	Taubman Centers Inc	Robert S. Taubman	Chairman/President/Chief Executive Officer
113	TSLA	Tesla Motors Inc	Elon R. Musk	Chairman/Chief Executive Officer
114	TEVA	Teva Pharmaceutical Industries Ltd	Phillip Frost	Chairman
115	TIE	Titanium Metals Corp	Harold C. Simmons	Chairman
116	TRIP	TripAdvisor Inc	Barry Diller	Chairman
117	UA	Under Armour Inc	Kevin A. Plank	Chairman/President/Chief Executive Officer/Founder
118	URBN	Urban Outfitters Inc	Richard A. Hayne	Chairman/President/Chief Executive Officer
119	VIAB	Viacom Inc	Sumner M. Redstone	Chairman/Founder
120	VNO	Vornado Realty Trust	Steven Roth	Chairman
121	WMT	Wal-Mart Stores Inc	Samuel Robson Walton	Chairman
122	WEN	Wendy's Co/The	Nelson Peltz	Chairman
123	WRB	WR Berkley Corp	William R. Berkley	Chairman/Chief Executive Officer/Founder
124	WYNN	Wynn Resorts Ltd	Stephen A. Wynn	Chairman/Chief Executive Officer/Founder
125	YHOO	Yahoo! Inc	David Filo	Chief Yahoo/Co-Founder

Source: Horizon Kinetics LLC, International Securities Exchange, Bloomberg

See important disclosures for additional information.

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## WEALTH INDEX (Ticker: RCH Index)

As of June 30, 2012

<u>Annualized Total Return</u>	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>7 Years</u>	<u>10 Years</u>	<u>15 Years</u>	<u>20 Years</u>
Wealth Index	-1.99%	24.98%	5.85%	9.45%	11.58%	9.00%	11.48%
S&P 500	5.45%	16.40%	0.22%	4.09%	5.33%	4.77%	8.34%
S&P 500 Eq. Wgt.	-0.12%	19.43%	1.60%	5.63%	8.03%	7.65%	10.39%
Russell 3000	3.84%	16.73%	0.39%	4.29%	5.81%	5.15%	8.50%
Russell 2000	-2.08%	17.80%	0.54%	4.60%	7.00%	6.14%	8.96%

Excess Return vs. S&P 500	-7.44%	8.58%	5.63%	5.35%	6.25%	4.22%	3.14%
Excess Return vs. S&P 500 Eq. Wgt.	-1.88%	5.55%	4.25%	3.82%	3.55%	1.35%	1.09%
Excess Return vs. Russell 3000	-5.83%	8.25%	5.45%	5.16%	5.77%	3.84%	2.98%
Excess Return vs. Russell 2000	0.09%	7.18%	5.31%	4.84%	4.58%	2.86%	2.52%

\*Note: Calculated Using Total Returns

<u>Risk Adjusted Return</u>	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>7 Years</u>	<u>10 Years</u>	<u>15 Years</u>	<u>20 Years</u>
Wealth Index	(0.09)	1.21	0.22	0.41	0.53	0.37	0.53
S&P 500	0.30	1.02	0.01	0.25	0.34	0.29	0.55
S&P 500 Eq. Wgt.	(0.01)	1.05	0.07	0.28	0.42	0.41	0.62
Russell 3000	0.20	0.99	0.02	0.25	0.36	0.31	0.55
Russell 2000	(0.08)	0.81	0.02	0.21	0.33	0.29	0.46

\*Note: Calculated As Annualized Total Return Divided By Annualized Total Return Volatility (Uses Monthly Total Returns)

<u>Information Ratio</u>	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>7 Years</u>	<u>10 Years</u>	<u>15 Years</u>	<u>20 Years</u>
Wealth Index vs. S&P 500	(1.19)	1.13	0.52	0.54	0.66	0.37	0.29
Wealth Index vs. S&P 500 Eq. Wgt.	(0.40)	1.04	0.67	0.62	0.58	0.12	0.11
Wealth Index vs. Russell 3000	(1.08)	1.21	0.56	0.58	0.67	0.36	0.30
Wealth Index vs. Russell 2000	0.01	0.96	0.59	0.60	0.55	0.23	0.22

\*Note: Calculated As Annualized Excess Total Return Divided By Annualized Excess Total Return Volatility (Uses Monthly Excess Total Returns)

<u>Wealth Index Batting Average</u>	<u>Roll 1 Year</u>	<u>Roll 3 Year</u>	<u>Roll 5 Year</u>
vs. S&P 500	61.94%	66.37%	67.34%
vs. S&P 500 Eq. Wgt.	59.92%	60.54%	54.77%
vs. Russell 3000	64.78%	66.82%	73.87%
vs. Russell 2000	62.75%	63.23%	70.85%

\*Note: Calculated Using Total Returns

<u>Annualized Volatility</u>	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>7 Years</u>	<u>10 Years</u>	<u>15 Years</u>	<u>20 Years</u>
Wealth Index	22.47%	20.62%	26.32%	23.00%	21.77%	24.22%	21.86%
S&P 500	18.18%	16.11%	19.21%	16.66%	15.84%	16.52%	15.14%
S&P 500 Eq. Wgt.	21.46%	18.50%	23.21%	20.06%	19.22%	18.67%	16.87%
Russell 3000	19.23%	16.82%	19.95%	17.31%	16.34%	16.89%	15.42%
Russell 2000	25.10%	21.87%	24.90%	21.93%	21.08%	21.55%	19.66%

\*Note: Calculated Using Total Returns

<u>Annualized Tracking Error</u>	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>7 Years</u>	<u>10 Years</u>	<u>15 Years</u>	<u>20 Years</u>
vs. S&P 500	6.28%	7.62%	10.74%	9.86%	9.43%	11.46%	10.66%
vs. S&P 500 Eq. Wgt.	4.63%	5.33%	6.38%	6.17%	6.17%	10.89%	9.96%
vs. Russell 3000	5.39%	6.80%	9.80%	8.96%	8.65%	10.65%	9.86%
vs. Russell 2000	6.44%	7.46%	9.01%	8.08%	8.38%	12.34%	11.24%

\*Note: Calculated Using Total Returns

<u>Wealth Index Beta</u>	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>7 Years</u>	<u>10 Years</u>	<u>15 Years</u>	<u>20 Years</u>
vs. S&P 500	1.21	1.21	1.28	1.28	1.27	1.33	1.29
vs. S&P 500 Eq. Wgt.	1.03	1.08	1.10	1.11	1.09	1.17	1.16
vs. Russell 3000	1.15	1.17	1.25	1.25	1.25	1.33	1.30
vs. Russell 2000	0.87	0.89	0.99	0.98	0.95	0.97	0.95

\*Note: Calculated Using Total Returns

<u>Calendar Year Total Returns</u>	<u>Wealth Index</u>	<u>S&amp;P 500</u>	<u>S&amp;P 500 Eq. Wgt.</u>	<u>Russell 3000</u>	<u>Russell 2000</u>	<u>ER v. SP500</u>	<u>ER v. SP500 EW</u>	<u>ER v. R3000</u>	<u>ER v. R2000</u>
1991	44.25%	30.47%	35.51%	33.68%	46.04%	13.78%	8.73%	10.57%	-1.80%
1992	20.20%	7.62%	15.63%	9.59%	18.41%	12.58%	4.56%	10.61%	1.79%
1993	3.38%	10.08%	15.12%	10.88%	18.88%	-6.70%	-11.75%	-7.50%	-15.50%
1994	0.33%	1.32%	0.95%	0.19%	-1.82%	-0.99%	-0.62%	0.14%	2.15%
1995	31.31%	37.58%	32.03%	36.80%	28.45%	-6.27%	-0.72%	-5.49%	2.86%
1996	23.09%	22.96%	19.02%	21.82%	16.49%	0.13%	4.06%	1.27%	6.59%
1997	27.31%	33.36%	29.05%	31.78%	22.36%	-6.06%	-1.74%	-4.48%	4.94%
1998	24.95%	28.58%	12.19%	24.14%	-2.55%	-3.63%	12.76%	0.81%	27.49%
1999	44.68%	21.04%	12.03%	20.90%	21.26%	23.64%	32.66%	23.78%	23.43%
2000	-19.16%	-9.10%	9.64%	-7.46%	-3.02%	-10.06%	-28.80%	-11.70%	-16.14%
2001	-10.80%	-11.89%	-0.39%	-11.46%	2.49%	1.08%	-10.41%	0.65%	-13.29%
2002	-15.49%	-22.10%	-18.18%	-21.54%	-20.48%	6.61%	2.69%	6.05%	4.99%
2003	45.41%	28.68%	40.97%	31.06%	47.25%	16.72%	4.44%	14.35%	-1.85%
2004	17.97%	10.88%	16.95%	11.95%	18.33%	7.09%	1.02%	6.02%	-0.36%
2005	3.30%	4.91%	8.06%	6.12%	4.55%	-1.61%	-4.76%	-2.82%	-1.25%
2006	22.61%	15.79%	15.80%	15.71%	18.37%	6.81%	6.81%	6.89%	4.24%
2007	1.73%	5.49%	1.53%	5.14%	-1.57%	-3.76%	0.20%	-3.41%	3.30%
2008	-43.67%	-37.00%	-39.72%	-37.31%	-33.79%	-6.68%	-3.95%	-6.37%	-9.89%
2009	72.80%	26.46%	46.31%	28.34%	27.17%	46.33%	26.49%	44.46%	45.62%
2010	31.51%	15.06%	21.91%	16.93%	26.85%	16.45%	9.60%	14.58%	4.65%
2011	5.11%	2.11%	-0.11%	1.03%	-4.18%	3.00%	5.22%	4.09%	9.29%
YTD 2012	3.86%	9.49%	8.08%	9.32%	8.53%	-5.63%	-4.22%	-5.45%	-4.67%

\*Note: Calculated Using Total Returns

Source: Horizon Kinetics LLC, International Securities Exchange, Bloomberg

See important disclosures for additional information.

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## **Important Disclosures**

Horizon Kinetics ISE Wealth Index (the "Index") was created in conjunction with the International Securities Exchange, LLC ("ISE"), which operates a leading U.S. options exchange and offers option trading on over 2,000 underlying equity, EFT, index, and FX products.

Any returns or performance provided in this presentation is provided for illustrative purposes only and does not demonstrate actual performance. Past performance is not a guarantee of future investment results. It is not possible to invest directly in the Index. Exposure to the Index is only available through investable instruments. Horizon Kinetics, its subsidiaries and ISE may receive compensation in connection with licensing the Index to third parties. Horizon Kinetics or its subsidiaries may sponsor, endorse, sell, promote or manage investment funds or other vehicles that seeks to provide an investment return based on the returns of the Index. There is no assurance that investment products based on the Index will accurately track Index performance or provide positive investment returns. Inclusion of a security within the Index is not a recommendation by Horizon Kinetics or its subsidiaries to buy, sell, or hold such security, nor is it considered to be investment advice.

This presentation may show the performance of the Index for a period of time prior to when the Index was officially launched. Such information may reflect hypothetical historical performance and as such may be back-tested. Horizon Kinetics generally employs the same methodology in its back-test calculations as it does when the actual index was officially launched. Anyone interested in better understanding the methodology for the Index, including details on the manner in which the Index is rebalanced, the timing of such rebalancing, the criteria used in determining additions and deletions to the Index as well as other Index calculations may contact Horizon Kinetics at [info@horizonkinetics.com](mailto:info@horizonkinetics.com) or (646) 495-7333.

In situations where back-tested performance of data has been employed, prospective application of the methodology used to construct the information of such index may not result in performance commensurate with the back-test returns shown. The back-test period does not necessarily correspond to the entire available history of the Index.

A limitation associated with the hypothetical information of the Index is that generally the Index calculations are being prepared with the benefit of hindsight. Back-tested data reflects the application of the Index methodology and selection of Index constituents in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities markets in general which cannot be, and have not been accounted for in the preparation of the Index information, all of which can affect actual performance. Historical calculations may change from month to month based on revisions to the underlying economic data that was used in the calculation of the Index.

Furthermore, the Index returns shown do not represent the results of actual trading of investor assets. Index returns do not reflect payment of any sales charges or fees an investor would pay to purchase the securities they represent. The imposition of these fees and charges would cause actual and back-tested performance to be lower than the performance shown.

# THE DEVIL'S ADVOCATE REPORT COMPENDIUM

## Money Manager Index

From Jan 1 1983 to Aug 2012

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly return	Annualized return (since inception)
1983								1.00	0.81	0.76	0.87	0.75	1983	0.75	(60.5)%	(50.2)%
1984	0.75	0.71	0.70	0.66	0.67	0.67	0.61	0.83	0.79	0.76	0.67	0.65	1984	0.65	(13.5)%	(26.5)%
1985	0.92	0.93	0.99	0.95	1.20	1.30	1.32	1.38	1.28	1.50	1.86	2.02	1985	2.02	211.8%	33.7%
1986	2.46	2.78	2.47	2.31	2.36	2.33	2.03	2.23	1.98	2.37	2.34	2.34	1986	2.34	15.9%	28.2%
1987	3.21	3.27	3.16	2.55	2.37	2.30	2.39	2.47	2.22	1.56	1.44	1.52	1987	1.52	(35.0)%	9.9%
1988	1.80	1.87	1.78	1.78	1.69	1.94	1.92	1.96	2.01	1.97	1.95	2.07	1988	2.07	36.0%	14.3%
1989	2.42	2.37	2.54	2.63	2.64	2.64	2.93	3.12	3.07	3.05	3.23	3.26	1989	3.26	57.8%	20.2%
1990	3.12	3.15	3.53	3.06	3.47	3.45	3.30	2.70	2.68	2.40	2.52	3.02	1990	3.02	(7.3)%	16.1%
1991	3.08	3.49	3.70	3.68	3.71	3.61	3.86	4.05	4.07	4.69	4.47	5.72	1991	5.72	89.4%	23.0%
1992	5.76	5.61	5.30	5.12	4.98	4.99	5.93	6.06	6.19	6.56	7.25	7.36	1992	7.36	28.6%	23.6%
1993	8.06	8.04	8.20	7.94	8.15	8.57	9.05	10.00	9.99	9.31	8.97	8.90	1993	8.90	21.0%	23.4%
1994	9.52	8.73	8.05	7.85	7.81	7.53	7.66	8.31	8.15	8.52	7.88	7.95	1994	7.95	(10.6)%	19.9%
1995	7.74	8.38	8.72	8.77	9.20	9.35	9.93	10.78	11.22	10.53	10.89	10.40	1995	10.40	30.8%	20.8%
1996	11.12	11.50	11.33	11.62	11.86	12.53	11.91	12.36	13.32	14.03	14.42	15.02	1996	15.02	44.4%	22.4%
1997	16.04	16.81	15.32	17.27	18.42	20.29	22.28	21.39	25.31	24.95	24.95	25.50	1997	25.50	69.8%	25.2%
1998	25.67	29.00	29.89	30.60	28.90	30.44	27.67	21.33	21.74	25.16	27.27	25.41	1998	25.41	(0.4)%	23.3%
1999	26.00	23.71	23.92	26.77	28.94	29.74	28.78	26.74	25.89	27.73	28.54	30.55	1999	30.55	20.2%	23.2%
2000	31.07	31.19	36.01	35.60	35.20	40.32	43.58	45.75	45.62	48.69	44.05	49.84	2000	49.84	63.1%	25.2%
2001	50.23	46.41	44.27	46.96	48.90	49.98	50.67	49.70	46.47	44.81	48.04	51.91	2001	51.91	4.2%	23.9%
2002	53.62	53.74	55.11	52.52	52.83	50.48	42.58	44.92	41.54	42.66	45.78	43.17	2002	43.17	(16.8)%	21.4%
2003	42.72	41.18	42.36	45.98	49.02	50.71	53.47	53.97	53.46	56.12	55.83	58.49	2003	58.49	35.5%	22.1%
2004	64.38	65.08	64.63	61.68	60.86	62.30	58.71	64.08	65.73	68.86	73.53	78.16	2004	78.16	33.6%	22.6%
2005	76.46	77.94	74.06	72.83	77.02	80.25	83.59	83.07	86.03	89.19	96.58	97.35	2005	97.35	24.6%	22.7%
2006	107.62	111.44	110.75	111.88	101.89	100.61	100.62	104.98	114.61	116.64	113.78	118.05	2006	118.05	21.3%	22.6%
2007	125.73	123.77	122.62	127.58	133.57	134.68	126.61	124.07	133.57	148.09	135.13	135.56	2007	135.56	14.8%	22.3%
2008	127.53	115.76	115.94	121.58	130.51	115.68	119.94	120.55	109.69	72.70	62.95	67.91	2008	67.91	(49.9)%	18.1%
2009	57.51	51.76	65.63	79.49	85.67	90.79	99.97	101.69	107.32	107.36	110.94	115.01	2009	115.01	69.4%	19.7%
2010	106.84	110.32	118.13	114.91	100.18	88.17	97.65	89.64	103.59	108.29	108.64	119.58	2010	119.58	4.0%	19.1%
2011	122.80	128.28	127.94	127.97	126.06	121.03	115.49	104.25	91.32	102.44	103.79	103.98	2011	103.98	(13.1)%	17.8%
2012	109.46	120.12	125.37	121.64	108.44	114.12	113.56	118.33					2012	118.33	13.8%	17.8%

S.No.	Ticker	Name	Initial Amount Invested	Shares Purchased	Date of Investment	Current Index Value
1	AMG us equity	Affiliated Manager	\$22,947	1377	11/30/1997	161,940
2	ALNC us equity	Alliance	\$7,633	491	4/30/1994	17,993
3	BLK us equity	BlackRock	\$23,205	1658	9/30/1999	294,822
4	WDR us equity	Waddell & Reed	\$27,513	1587	3/31/1998	46,984
5	EV us equity	Eaton Vance	\$2,641	3998	1/31/1986	108,316
6	TROW us equity	T. Rowe Price	\$2,423	2014	4/30/1986	123,731
7	BEN us equity	Franklin Resources	\$908	1263	4/30/1985	148,292
8	LM us equity	Legg Mason	\$1,000	462	8/31/1983	11,361
9	FII us equity	Federated Inv	\$26,381	2206	5/31/1998	47,342
10	FIG us equity	Fortress Investment Group	\$102,249	3389	2/28/2007	13,489
11	PZN us equity	Pzena Investment Management	\$122,426	6317	10/31/2007	31,965

# THE DEVIL'S ADVOCATE REPORT COMPENDIUM

Index Constituent Changes: 1. Everest Financial Group Limited (EFG AU) was delisted from the Australian Security Exchange effective 7/19/2011 and has been removed from the index. 2. RAB Capital Plc (RAB LN) was delisted from the London Security Exchange effective 9/2/2011 and has been removed from the index. 3. Invista Real Estate (INRE LN) was delisted effective 8/10/2012. The divisor has been adjusted accordingly for each of these changes.

## International Money Manager Index

From Jan 1983 to Jul 2012

Year													Annualized return			
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly return	(since inception)
1986											1.00	1.02	1986	1.02	10.0%	10.0%
1987	1.25	1.37	1.48	1.48	1.37	1.33	1.39	1.40	1.33	0.81	0.76	0.73	1987	0.73	(27.7)%	(23.3)%
1988	0.75	0.92	1.02	0.95	0.80	0.89	0.88	0.82	0.86	0.88	0.89	0.93	1988	0.93	26.4%	(3.4)%
1989	1.03	1.02	1.06	1.17	1.19	1.18	1.25	1.16	1.17	1.20	1.21	1.28	1989	1.28	37.8%	8.1%
1990	1.24	1.24	1.18	1.19	1.22	1.24	1.26	1.26	1.23	1.24	1.25	1.33	1990	1.33	3.7%	7.0%
1991	1.34	1.52	1.56	1.58	1.57	1.47	1.52	1.64	1.81	1.89	1.94	1.92	1991	1.92	44.8%	13.5%
1992	2.01	1.93	1.88	2.14	2.19	2.13	2.08	1.99	1.95	1.77	1.76	1.96	1992	1.96	1.9%	11.5%
1993	1.98	2.03	2.20	2.39	2.42	2.45	2.54	3.05	3.01	3.07	3.01	3.30	1993	3.30	68.7%	18.1%
1994	3.72	3.39	3.17	3.04	2.99	2.89	3.01	3.14	3.13	3.19	3.15	3.15	1994	3.15	(4.7)%	15.1%
1995	3.07	3.12	3.28	3.41	3.56	3.59	3.87	3.76	3.76	3.77	3.70	3.73	1995	3.73	18.6%	15.4%
1996	3.76	3.85	3.70	3.79	3.96	3.90	3.75	3.96	4.16	4.47	4.90	4.86	1996	4.86	30.3%	16.8%
1997	5.11	5.37	4.99	4.96	5.43	5.94	6.57	6.32	7.45	7.24	6.80	7.19	1997	7.19	47.9%	19.3%
1998	7.12	8.05	8.78	9.25	8.95	8.74	8.91	6.67	6.08	7.01	7.51	7.71	1998	7.71	7.3%	18.3%
1999	7.99	8.21	8.68	9.07	8.71	8.61	8.63	8.43	8.47	8.79	9.80	10.79	1999	10.79	39.9%	19.8%
2000	11.23	12.27	13.95	13.50	13.73	15.39	15.85	16.82	17.07	16.31	14.43	16.76	2000	16.76	55.4%	20.7%
2001	17.42	15.88	13.46	15.14	15.84	15.15	14.21	13.61	10.77	11.43	13.90	14.12	2001	14.12	(15.8)%	19.1%
2002	14.74	13.78	15.09	15.11	16.38	14.14	12.92	12.10	11.23	11.06	11.33	10.50	2002	10.50	(25.6)%	15.7%
2003	10.18	9.52	9.69	10.62	12.17	13.04	13.98	15.38	16.67	17.88	18.16	18.07	2003	18.07	72.1%	18.4%
2004	20.00	22.41	29.98	35.46	26.68	30.80	25.37	25.20	23.67	23.34	27.56	31.48	2004	31.48	74.2%	20.9%
2005	32.19	32.57	31.88	27.79	27.36	29.05	30.38	31.49	33.39	32.24	32.95	37.18	2005	37.18	18.1%	20.8%
2006	41.01	40.97	43.69	46.45	42.39	41.58	40.60	43.32	43.55	43.70	44.58	49.38	2006	49.38	32.8%	21.3%
2007	50.95	51.18	53.59	56.09	58.16	56.37	53.90	48.65	50.96	57.03	48.21	45.75	2007	45.75	(7.3)%	19.8%
2008	38.71	39.71	38.59	40.18	39.25	35.10	34.59	33.33	26.09	18.72	14.50	15.79	2008	15.79	(65.5)%	13.3%
2009	14.62	13.24	14.96	19.63	22.82	23.73	26.14	27.05	28.41	28.53	28.69	29.83	2009	29.83	89.0%	15.8%
2010	28.50	27.58	29.90	29.58	25.53	24.72	27.82	26.74	30.36	33.68	31.85	34.52	2010	34.52	15.7%	15.8%
2011	34.91	36.17	36.51	39.63	37.86	35.31	35.83	32.76	29.28	32.04	31.23	30.59	2011	30.59	(11.4)%	14.7%
2012	32.12	34.36	35.67	35.08	31.03	32.92	32.66	34.17					2012	32.66	6.7%	14.5%

S.No.	Ticker	Name	Initial Amount Invested	Shares Purchased	Date of Investment	Current Index Value
1	IGM CN Equity	IGM Financial Inc	\$1,000	73	31/11/1986	2,823
2	FCAM LN Equity	F&C Asset Management Plc	\$1,203	485	5/31/1989	692
3	IVZ US Equity	Invesco Plc (Previously Amvescap)	\$1,357	1,153	1/31/1991	13,745
4	SDR LN Equity	Schroders Plc	\$1,208	505	3/31/1991	11,496
5	RAT LN Equity	Rathbone Brothers Plc	\$1,208	736	3/31/1991	14,926
6	ADN LN Equity	Aberdeen Asset Mgmt Plc	\$1,208	1,827	3/31/1991	8,080
7	CIX CN Equity	CI Financial Corp.	\$2,585	3,224	6/30/1994	72,760
8	EMG LN Equity	Man Group Plc	\$2,862	6,344	10/31/1994	5,969
9	AGF/B CN Equity	AGF Management Ltd-CI B	\$3,343	1,346	1/31/1996	15,528
10	8739 JP Equity	Sparx Group Co Ltd	\$11,762	108	12/31/2001	7,068
11	HGG LN Equity	Henderson Group Plc	\$14,447	8,666	12/31/2003	11,925
13	AZM IM Equity	Azimut Holding Spa	\$21,908	4,977	7/31/2004	52,807
15	CCAP LN Equity	Charlemagne Capital Ltd	\$36,848	22,300	3/31/2006	3,272
16	PGHN SW Equity	Partners Group-Reg	\$36,848	578	3/31/2006	111,267
18	ASHM LN Equity	Ashmore Group Plc.	\$36,688	9,873	10/31/2006	51,528