THE GLOBAL SPIN-OFF REPORT COMPENDIUM

September 2014

Note: The below selections represent sample research reports as of the listed publication dates. There have been no edits made to these research reports since they were published.

Featured Companies

Reckitt Benckiser Group Plc. (RB/ LN)
Crompton Greaves Ltd. (CRG IN)
Reliance Communications Ltd. (RCOM IN)
BHP Billiton (BHP AU, BLT LN)

Exclusive Marketers of
The Global Spin-Off Report

PCS Research Services
125 Maiden Lane, 6th Floor
New York, NY 10038
(212) 233-0100
www.pcsresearchservices.com

Research Team

Murray Stahl **Steven Bregman**

Thérèse Byars, Ryan Casey, James Davolos, Derek Devens
Peter Doyle, Michael Gallant, Matthew Houk, Utako Kojima
Eric Sites, Salvator Tiano, Fredrik Tjernstrom, Steven Tuen

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Murray's Musings

INDEXATION AT A CROSSROADS

The recent announcement that Kinder Morgan will combine its various entities into a C corporation has enormous implications for the various MLP indexes and exchange-traded funds ("ETFs") that hold Kinder Morgan. There are 23 MLP ETFs. The top 10 in that group have roughly $22.4 billion of assets under management. Of these 10, the bulk of the money is in two ETFs: the Alerian MLP ETF (AMLP) and the JPMorgan Alerian MLP Index (AMJ). Together, these two funds have approximately $16.2 billion of assets under management.

It should come as no surprise that Kinder Morgan is the largest position in both ETFs, since it is usually the biggest position in any MLP ETF. Kinder Morgan has a 9.82% weight in AMLP. At AMJ, that weight is 9.64%. In some number of months, Kinder Morgan will no longer be an MLP, so one may wonder what will happen to these indexes. One possibility is that they will eliminate Kinder Morgan. If this occurs, the remaining MLPs necessarily must rise in weight.

Table 1 is designed to illustrate what would happen to the weights of the next six holdings in AMLP if Kinder Morgan were eliminated.

Table 1: Change in Weight of AMLP Holdings 2-7 if Kinder Morgan Were Eliminated

Ticker	Company	Current Weight	Future Weight
EPD	Enterprise Products	9.45%	10.47%
PAA	Plains All American Pipeline	7.04%	7.81%
ETP	Energy Transfer	6.89%	7.64%
MMP	Magellan Midstream	6.70%	7.42%
MWK	Markwest Energy	6.09%	6.75%
RGP	Regency Energy	4.95%	5.49%
	TOTAL	*41.12%*	*45.58%*

Source: Alerian

The current weight of the next-largest holding, Enterprise Products (EPD), is 9.45%.Assuming all else stays the same and only Kinder Morgan is eliminated, that weight would rise to 10.47%. As one can see, those six holdings would increase from their current aggregate weight of 41.12% to a total weight of 45.58%.

The next two holdings are Buckeye Partners (BPL), currently at 4.85%, and ONEOK (OKS), at 4.80%. They were not included in the above table because they are currently less

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than 5% yet, without Kinder Morgan those weights would become 5.39% and 5.32%, respectively. Consequently, the total weight of the positions greater than 5%, assuming Kinder Morgan were eliminated from the index, would be a total of 56.29%. Ordinarily, a diversified mutual fund is not permitted to have 5% positions that exceed 50% of the fund.

Leaving this question aside, the purpose of an index is to have a diversified investment in a particular segment. Most observers probably would agree that a fund in which eight positions comprise over 56% of the fund is not genuinely diversified. As the fund currently stands, with Kinder Morgan included, the top 10 positions currently comprise 64.95% of the fund so it is not diversified anyway. The irony of the situation is that, currently, there are six positions greater than 5% in weight, but the top 10 have a 64.95% weight. If Kinder Morgan is excluded, the top 10 positions would still have a weight of around 64%, but then there would be eight positions that exceed a 5% weight. One consequence of the change is that the fund will be more concentrated.

The other obvious possibility, apart from eliminating Kinder Morgan, is that Kinder Morgan might remain in the index. This could be accomplished in a number of ways. One would be to change the rules for inclusion. In other words, instead of an MLP index, the fund, or the funds, could be reconstituted as pipeline indexes. Clearly, Kinder Morgan, in its new C corporation incarnation, would qualify for inclusion under that standard.

Under that definition, however, a company such as Williams Companies (WMB) would be eligible for inclusion. The new Kinder Morgan Inc. should yield more or less 5%, as opposed to the 5.91% yield generated by Kinder Morgan Energy Partners (KMP), which is the Kinder Morgan entity in the index. Williams Companies currently yields roughly 3.79%. Therefore, since this is lower than the ordinary yield of an MLP, an MLP fund such as AMLP, were it reconstituted to include Kinder Morgan in its new incarnation, would actually produce a lower distribution than is currently the case.

This is particularly intriguing since AMLP is the largest MLP fund and it has gone to great lengths to preserve the tax-advantaged status of the MLP dividends received. The fund has elected to be taxed as a federal C corporation, which means it pays federal income taxes. (Normally, an ETF is treated as a regulated investment company and does not pay taxes.) The logic of this action on the part of AMLP was to preserve the return of capital component of an MLP dividend when the aggregate dividend collected is passed through to the fund participants. Being a C corp was the only way for this fund to preserve that. This is an important tax advantage and is one reason this is the most popular MLP ETF.

If Kinder Morgan Inc. (KMI) were to be a member of the index as a C corporation, and Williams Companies would therefore be included as well, almost 15% of the fund would then be a C corp, and hence have no tax advantage to pass through the fund. Nevertheless, the fund would pay corporate income taxes on these dividends.

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In any case, the index would change from what it was into something else. It is conceivable that the new index will be less intriguing to participants, who might therefore gravitate to some other type of income-producing investment. In such an event, perhaps the yields required by investors for funds of this type would be higher, to compensate for a new type of event like the elimination of some portion of MLP status. Consequently, the prices would be lower.

That is not the salient point, though. The salient point is that, in principle, an index should be structured in such a manner that the inevitable changes in valuation are the consequences of changes in the dynamics of an industry, and not a reflection of decisions by the management of only one firm. If the fortunes of one firm can alter the character of the index, the index begins to have the attribute of an actively managed fund, with the distinction that the holdings of an index are not selected by conscious thought but by a predetermined formula.

An investor must reflect upon the holdings, however, because these holdings may influence the character of the return of the index in a way very different from the actual industry dynamics. In other words, the MLP pipeline business might prosper, but Kinder Morgan could cause the index to trade at a different valuation simply because of a decision made by Kinder Morgan Inc. management. Consequently, one might well ask: Is this what was intended when the indexes were originally created? Note that this is not really a negative about MLPs, but about the manner or method by which indexes are assembled for investors.

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Industry Thoughts

THE SUPERMARKET INDUSTRY

The salient characteristic of the supermarket industry is very low profit margins. Consider Table 2, which shows the net profit margins of various supermarket companies.

Table 2: Net Profit Margins of Supermarket Companies

WFM	Whole Foods	4.30%
FWM	Fairway	(16.0)%
KR	Kroger	1.50%
SWY	Safeway	1.70%
SFM	Sprouts Farmers Market	2.10%
TFM	The Fresh Market	3.40%
SVU	SuperValu	1.10%
WMK	Weis Markets	2.70%

Source: Bloomberg

Whole Foods has the highest margin at 4.3%. Clearly, this is a very low-margin business. It has the highest profit margin because it is the most active among the supermarket chains in stocking store brands. Companies can earn a wider profit margin on a store brand than on a so-called name brand, because the space available in any store, however large, is finite. That space can be very valuable if the goal is to extract a handful of basis points of margin from it, and Whole Foods has been the leader in introducing store brands more intensively.

Name-brand products historically took up a great deal of shelf space in supermarkets, and the bulk of the margin belonged to the branded companies rather than to the supermarkets. It was impossible to charge consumers sufficient markup to make a name-brand product a good-margin product for the store.

Whole Foods presents itself as a leader in the field of natural, unprocessed foods. Its products branded under its 365 name brand, for example, include Everyday Value Organic Cereal, Organic Waffles, and Organic Pancakes. The company also sells Engine 2 store brand called Engine 2 Almondmilk. Other of its own branded products are Allegro Tea, Whole Foods Soap, Pacifica Candles, Vitamin Code Lotion, and others.

Because Whole Foods has been so successful in creating and stocking its shelves with its own brands, the other supermarkets gradually have begun to emulate Whole Foods. That

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strategy is important because, as Table 3 shows, total revenue annually of all the supermarkets mentioned is $176 billion.

Table 3: Supermarket Chain Revenue

	($ in billions)
Whole Foods	$13.9
Fairway	0.8
Kroger	101.3
Safeway	36.3
Sprouts Farmers Market	2.7
The Fresh Market	1.6
SuperValu	17.1
Weis	$2.7
Total	*$176.4*

Source: Company reports

Supermarkets are not the only retailers offering branded products more intensively. The drug store chain, Walgreen, is introducing more store brands of its own. Rite Aid, a drug store chain, is beginning to do the same. Target has a brand called Archer Foods. Walmart is also doing this, as is Loblaw in Canada.

Adding up the annual revenue of Walgreen, Rite Aid, Target, Walmart and Loblaw comes to $686 billion.

Table 4: Drugstore and Other Chain Revenue

	($ in billions)
Walgreen	$75.3
Rite Aid	5.7
Target	73.2
Walmart	477.2
Loblaw	35.2
Total	*$686.6*

Source: Company reports

Add to that the $176 billion of the supermarket chains mentioned, and you start pushing $1 trillion of annual sales. Obviously, there are other supermarket chains as well.

The issue here is not so much what will happen to the margins of supermarket companies. If they go up, they might be good investments, but it is much more interesting to think

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about the big branded consumer products companies because, at the margin, they are losing shelf space. That is a danger.

Procter & Gamble, as an example of such a company, might find it difficult to grow in that type of environment and more difficult to maintain its already record profit margins. Therefore, it is at least theoretically possible that the margin expansion of the last two decades for companies of its type could gradually begin to reverse itself.

Facts & Figures

PROCTER & GAMBLE

Looking at Procter & Gamble, let us begin by breaking out its revenues domestically and internationally for the last three years. (Note that the company's fiscal year ends in June.) As seen in Table 5, the company had $28.4 billion of domestic revenue in 2012; in 2014, the figure was $29.4 billion. It did increase over 24 months, but not a lot.

Table 5: Procter & Gamble Revenue

($ in billions for FY ending June)

	U.S.	International
2014	$29.4	$53.7
2013	29.2	53.4
2012	28.4	53.6

Source: Company reports

In 2012, its international revenue was $53.6 billion; in 2014, 53.7 billion. In other words, it had essentially no revenue growth, which is surprising because just from inflation alone you might have expected some. It is getting harder to secure shelf space.

Another interesting feature, which does not really apply to margin pressure but is interesting nevertheless, is that only about 35% of Procter & Gamble's revenue is from the U.S., with the rest coming from outside the international sources. Could one, therefore, assert that Procter & Gamble, by that definition, is not even an American company?

It is also worth noting that the foreign retailers, including Netherlands-based Ahold and Germany's Aldi Group, which are pan-European in scale, have the same problem with Procter & Gamble as U.S. retailers: Procter & Gamble makes the money, not the retailers. Consider Aldi, a discount supermarket chain. It is present in 18 countries and owns over 9,000 stores; in the United States, it owns Trader Joe's. Many shoppers do not realize that in Trader Joe's, there are only store brands. You cannot find branded products there. This is a company that has gone to the extreme of eliminating the branded products. Since Aldi

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is a private company, we do not know what its margins are, but the management is only carrying its own brands for a reason.

Table 6 shows another way of looking at Procter & Gamble.

Table 6: Historical Dividends

	(per share split adjusted)
1956	$0.01
1966	0.03
1976	0.06
1986	0.16
1996	0.40
2006	1.15
2014	2.45

Source: Company reports

Procter & Gamble's dividend from 1956 through 2014, adjusted for splits, increased at an annualized rate of 9.9%. The S&P 500 is replete with companies that have benefited from the same trends, and they have produced more or less the same kinds of dividend growth rates and, more or less, the same kinds of earnings growth rates.

The historical return of the S&P 500, to a not-small extent, is merely the story of the creation of market dominance by companies like Procter & Gamble. Some companies become dominant in their industry. Once they become dominant, however, what is the next step? It might not be a continuation of the trend; it might be a reversal of it. That possibility has implications for the S&P 500 because these companies are such important components of it.

How is Procter & Gamble responding to the challenge, if there really is a challenge? Let us look at the Procter & Gamble advertising expenditures, shown in Table 7.

Table 7: Advertising Expense

	($ in billions for FY ending June)
2014	$9.236
2013	9.612
2012	9.222

Source: Company reports

In 2012, Procter & Gamble spent $9.2 billion on advertising; in 2014, it spent $9.2 billion. It has frozen its advertising budget. The idea is very simple: Freeze the advertising budget,

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achieve even very modest revenue increases, and expand the net profit margin creating a rise in earnings per share.

Table 8 shows spending on research and development, which is investment in new products.

Table 8: Research and Development Expense: New Products

	($ in billions for FY ending June)
2014	$2.023
2013	1.980
2012	1.987

Source: Company reports

Assume that the large branded products companies, which already have market acceptance, are mature. To continue to expand at the historical rate, they will need to develop new products. The research and development budget at Procter & Gamble in 2012 was $1.99 billion; in 2014, it was $2.02 billion—basically, unchanged.

Consider that the advertising budget and the research and development budget are unchanged. The company is a people-intensive business and, due to inflation, the workforce is probably being paid more. If the budget is static, the chances are that fewer employees are doing the work.

Capital expenditures are another way that companies invest for future growth. As Table 9 shows, in 2012, Procter & Gamble spent $3.96 billion on capital expenditures; in 2014, $3.85 billion. It has actually gone down slightly.

Table 9: Capital Expenditures

	($ in billions for FY ending June)
2014	$3.848
2013	4.008
2012	3.964

Source: Company reports

Here are some miscellaneous facts about Procter & Gamble, to illustrate the degree of its dominance. In the razorblade and razor market, Procter & Gamble's worldwide market share is 70%; in other words, 70% of all the razorblades and razors sold worldwide are Procter & Gamble products. In the realm of toothpaste and toothbrushes, that share is 20%. For shampoo and hair color, the number is 20% globally. It is 25% for detergents and cleansers, and 30% for diapers and wipes.

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To demonstrate how certain brands can be dominant, the American market for Bounty paper towels—and this is just the American market—comes to 45%. In other words, almost half of all the paper towels sold in America are Bounty.

With all that said, consider net profit margin, as shown in Table 10:

Table 10: Net Profit Margin

	($ in billions for FY ending June)
2014	14.09%
2013	13.68%
2012	11.15%

Source: Company reports

If one translates the profit margin expansion into earnings, in the last 24 months the earnings have grown by 27.9%. That is being accomplished merely by cost control and, in some cases, actual cost reduction. The number of employees at Procter & Gamble has been declining for years, a process that just cannot continue.

DOMESTIC EQUITY FUND OUTFLOW AND INDEXATION

A completely different kind of statistic is the cumulative amount of domestic equity mutual funds outflow from January 1, 2007 to the end of August 2014. In that period of time, the cumulative outflow was $614.1 billion, according to the Investment Company Institute. The proper number, however, might be closer to $1 trillion, because the category includes index funds. For example, the Vanguard Equity Index Mutual Funds are in that category. To the extent that an investor pulls money out of an actively managed fund and puts it in an index fund, it stays in the equity mutual fund category. Therefore, the withdrawals from actively managed equities might approach $1 trillion.

Vanguard has total assets under management of $2.86 trillion. For all reasonable purposes, this is all indexed. Vanguard has $358 billion just in ETFs. State Street has $2.48 trillion indexed. The AUM for just those two companies easily comes to $5 trillion.

BlackRock has $4.59 trillion of assets under management, but it is not all indexed. BlackRock is the largest ETF provider and its ETFs total $993 billion, or nearly $1 trillion. Add its institutional index business of $1.795 trillion, and the total is $2.789 trillion.

In other words, adding up the index components of those three companies alone—and there are other indexation firms, of course—indexation assets already amount to $8.129 trillion. That is a lot of money, and more flows in every day. The significance of all of these statistics will be discussed later on in this report.

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Featured Companies

RECKITT BENCKISER GROUP PLC. (RB/ LN)

Reckitt Benckiser has a $38 billion stock market value, and it is spinning off its pharmaceutical business. The main thrust of the company is branded consumer products. Its brands are fabulous. Its dominant brands include Woolite, Lysol, Vanish, Clearasil, and Dettol. The latter is a disinfectant that one does not see much in America but would in Europe.

Reckitt Benckiser is huge and very much like Procter & Gamble, with one distinction: Reckitt Benckiser, has a pharmaceuticals group, which represents something of a strategic problem for a couple of reasons. The first is that the pharmaceuticals business represents 7.3% of revenue, which is relatively insignificant, but it also generates 16.9% of operating profit. The operating margin of the consumer business, excluding the pharmaceuticals, is 20.7%. The operating margin of the pharmaceuticals business, as a standalone entity, is 53.1%. For an idea of how high that is, the operating margin of Merck, which is a much larger company than the pharmaceutical division of Reckitt Benckiser, is 17.2%. The operating margin of Pfizer, which is actually a larger company than Merck, is 31.3%. The operating margin of Bristol-Myers is 18.6%.

Looking at the tax rates of these three companies it is amazing how low they were. Merck has paid minimal taxes in 2014. From 2009-2013, the highest tax rate was 27.9% in 2012. Pfizer pays a 25% tax rate. Year to date in 2014, Bristol-Myers has a rate of 11.3%.

Many companies have been increasing their earnings simply by reducing their taxes. When I came into the business, if a company did that, it did not get a valuation multiple increase. Furthermore, tax benefits were considered to be an unstable source of earnings because taxes can go up and down, so they were considered to be another type of cyclicality: cyclicality comes from the economy and from your ability (or inability) to manage your tax rate. That point of view, however, dates from when investors made decisions. (Now, in the era of indexation, we have made a decision not to make a decision. The computer reads the earnings. If the earnings rise by a certain level, there are algorithms that select companies with rising earnings; there are algorithms that select companies with rising dividends; there is what is called smart beta. There are all sorts of combinations of such indexation selection criteria. No doubt the companies are aware of it.)

At Reckitt Benckiser, how is it that the pharmaceuticals business can maintain such extraordinary profitability? The vast majority of the pharmaceutical revenue, and the vast majority of the pharmaceutical profits, is earned by one drug, Suboxone. Suboxone is a prescription drug used to treat people addicted to opiates. Generic competition emerged in the last year or so— before that it was a monopoly—but the company still has a 61%

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market share and that 61% market share is sufficient to get a 53.1% operating margin. Given the level of competition, however, that margin is obviously vulnerable and that is the primary reason for the spin-off. As such, it is not an interesting spin-off.

The parent, however, has been modestly repurchasing its shares. Once the pharmaceutical business is spun off, this is a branded consumer products company that has a lot of room to buy back stock, and perhaps it will become, going forward, more like Procter & Gamble in raising its margins. In fact, it might be able to accomplish that which Procter & Gamble has accomplished over the last several years, and so the parent company is the entity that is sort of interesting.

For a huge company, it has minimal debt. It has £2.3 billion in short-term debt, not a lot for a company of this size, and £583 million in long-term debt. It is not unlikely that much of that, if possible, will be placed with the spin-off. If so, Reckitt Beckinser would have a balance sheet enabling it to make use of a lot more leverage than it currently uses, and it could buy back a lot of shares. That is quite possible.

CROMPTON GREAVES LTD. (CRG IN)

Crompton Greaves has a market capitalization of 121 billion Indian rupees (INR). That sounds like a lot of money, but it is only USD 2 billion, so in American terms, this would be considered a small-capitalization company. In Indian terms, however, it is actually a large company. It proposes to spin off its consumer business.

The company has three divisions. The first, the Power Systems Business, is not going to be spun off. It makes transformers and switching equipment for utilities, primarily. It produces 64.5% of the revenue and has a 3% operating margin, so it is barely profitable.

The second division, Industrial Systems, is also electrical equipment, in a sense. It makes AC/DC motors, alternators, and railway signaling equipment. This provides another 13.8% of revenue but it is a little more profitable than the Power Systems Business. It operates at a higher, though still slender, 7% operating margin.

The third division, the Consumer Products Business, makes fans, lighting products, appliances, pumps, basically all devices that the consumer could conceivably buy. This is the most profitable unit. It provides 21.7% of revenue and has a 12% operating margin, which accounts for more than 50% of the profits of the whole company. This division is the proposed spin-off.

The basic problem of Crompton Greaves is twofold: It is very cyclical, as will be seen momentarily, and has a very low return on capital. In 2005, Crompton Greaves made a profit before tax of INR 128 crore. In India, crore is a unit of account that means 10 million. So, that would be 128 times 10 million, which is INR 1.28 billion. In U.S. dollar

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terms, divided by the exchange rate of 61.35 rupees to the dollar, that would be USD 20.86 million of pre-tax earnings. As displayed in Table 11, its earnings were rising until 2011; this was a growth company. By 2013, however, earnings had declined almost down to the level of 2005.

Table 11: Profit Before Tax

	USD in millions
2005	20.86
2006	45.15
2007	71.07
2008	100.24
2009	141.32
2010	193.81
2011	200.33
2012	89.65
2013	30.15

Source: Company reports

Table 12 lists net assets employed, and one can see how low the return on capital employed really is.

Table 12: Net Assets Employed

	USD in millions
2005	$119.64
2006	191.85
2007	303.18
2008	341.81
2009	409.94
2010	491.28
2011	631.62
2012	727.47
2013	843.68

Source: Company reports

In 2013, net assets employed came to USD 843.68 million. Simply take USD 30.15 million (the 2013 profit before tax) and divide by USD 843.68 million net assets employed to get a 3.57% return on assets. This is very low. It is a cyclical business with very low returns on capital; it is not going to get a good valuation. The aggregate valuation might be improved with a spin-off of the most profitable business, which is what is being done.

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The chances are that the spin-off is going to get between 60% to 70% of the market cap value of the current Crompton Greaves. Most of the revenue is going to stay with the parent, though. More important, most of the capital is going to stay with the parent as well. In other words, the parent is going to have a very low market-cap-to-sales ratio and a tremendous amount of capital in a business that earns a very low rate of return. As a matter of fact, it will look even lower than it currently does once the most profitable component is removed.

A gentleman by the name of Gautam Thapar owns 41% of Crompton Greaves through his holding company, Avantha. It seems reasonable that this transaction is a preparation for him to make a bid for the parent company and take it private and bring it into his holding company. It is unlikely that the parent company is going to be included in any index, so this is going to become an orphan security, as happens to many spin-off transactions. The spin-off will be a company of reasonable profitability, but it seems like the real value is going to be with the parent.

RELIANCE COMMUNICATIONS LTD. (RCOM IN)

Reliance Communications is the 15th largest mobile phone operator in the world, with 150 million subscribers. This is a huge company. It has only a USD 5.4 billion market capitalization. That alone is incredible. It is also incredible to observe that, even given that it is the 15th largest mobile phone company in the world and has 150 million subscribers, it is not the largest mobile phone company in India; it is the second largest. The is largest, Airtel, which has 275 million subscribers.

Immediately that tells us that the business does not generate a lot of profit. In fact, the net profit margin of Reliance Communications is 3.08%, which is extremely low. This is also a very competitive business. As a result, Reliance Communications proposes to spin off its real estate assets.

The real estate assets are dormant assets, not income-producing assets, more of which shortly. The operating business is not only very competitive but also has limited growth prospects, mainly because of the high degree of cellular telephone penetration in India already and the inability to increase dramatically the penetration due to the poverty of India's poorest citizens. In other words, there is a certain market that can be served, beyond which you begin to encounter people who are genuinely impoverished, without resources, and even without income by our standards. They just cannot afford a cellular telephone. That means it is going to be very difficult for the company to grow itself.

In addition to that, the technology is changing, and it might be necessary to employ more capital in the business. Reliance, which has issued shares to fund capital expenditures in the past, is seeking permission from the Indian government to sell more shares to qualified

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institutional buyers in the future. When Reliance did that in the past, given that the real estate is in Reliance Communications, the company was effectively selling interests in its real estate, too. The company obviously does not wish to sell any more of its real estate.

This is another company with an owner/operator who owns a lot of it. Anil Ambani owns 68% of the company, and he clearly does not wish to sell his real estate assets and intends to spin them off. What are they? They are 135 acres in Knowledge City, Mumbai. Knowledge City is like Silicon Valley, or like Menlo Park in California. It is some of the most valuable real estate in India. There are also four acres on Connaught Place in New Delhi, also very valuable.

The company values the real estate at USD 2 billion. Let us make some observations. The first is that this will be a dormant asset, meaning it generates no profitability whatsoever. The real estate is also clearly reflected in the Reliance stock price already, because Reliance trades at more than 50x current earnings. Reliance is not growing, so clearly the market is assigning a value to these properties.

Furthermore, the real estate is unlikely to be in any index. As a consequence, like any dormant asset influenced by the so-called equity yield curve, the real estate is likely to trade at a discount to NAV after the spin-off, especially as there are no plans, or at least announced plans, to develop the properties. Assuming an appropriate discount to NAV, it could be very interesting as an investment. Attention, therefore, is called to it, and once it is spun off we shall see at how much of a discount to NAV it trades.

BHP BILLITON (BHP AU, BLT LN)

BHP Billiton has a market capitalization of USD 172 billion. It is an enormous company. It is the largest mining company in the world and it proposes to spin off what it terms its nonstrategic mining assets. That is interesting because the company has spent the last decade making huge acquisitions to collect all these nonstrategic assets that, at the time, it considered to be strategic. The company also tried to make many larger acquisitions, which could not be consummated.

Had those acquisitions occurred, the company would have had a yet greater market capitalization. For example, in the 2007 to 2008 time period, BHP tried to buy Rio Tinto, which is a huge company. In 2010, it tried to buy Potash Company of Saskatchewan, Canada, which is also a very large company; it did not get that, either. The Canadian government did not approve it. In 2011, however, BHP did buy the shale assets of Chesapeake Energy for $4.8 billion. It also bought Petrohawk Energy for $12 billion. (It should also be noted that in May 2008, a fairly decent-sized Chinese firm, known as Chinalco, China Aluminum, tried to buy a stake in BHP. Various obvious parties objected to that.)

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Clearly, this spin-off is a complete reversal of the historical strategy of buying competitors with a view, ultimately, to dominating the mining industry. The idea was that BHP would become to the mining industry what Procter & Gamble was to the consumer products industry. By dominating various products and being such a big portion of the supply, it would eliminate some of the cyclicality of the mining business. Unfortunately, that did not happen. Therefore, it proposes to spin off the nonstrategic assets which, interestingly enough, happen to be assets with cyclically depressed ROEs and margins.
The fact that the company has assets whose operating margins are depressed and whose ROEs are depressed from cyclical peaks does not mean that the operating margin of BHP is low. In 2013, its operating margin was already 29.14%. That is a fairly high level in any business, and is actually higher than some drug companies. The company achieved some of what it wanted to but it could not achieve all. Therefore, it will achieve higher margins simply by spinning off companies or businesses with currently depressed margins.

Table 13 shows the seven assets included in the spin-off.

Table 13: BHP Billiton Assets Included in Spin-Off

	Current EBITDA	10-Year Avg EBITDA
	(USD in millions)	
Illawarra Met. Coal	$131	$426
Energy Coal South Africa	315	325
Worsley Aluma Aluminum Refinery	217	304
Hillside & Mozal Alum. Smelters	178	584
Cannington Silver Mine	459	672
Cerro Matoso Nickel Mine	104	513
Manganese Assets	383	439
TOTAL	1,787	3,263

Source: Company reports

One is Illawarra Metallurgical Coal (Illawarra is an area of Australia). There is Energy Coal South Africa. There is also Worsley Alumina Refinery and Hillside Aluminum Smelters. Those are the aluminum businesses and aluminum at the moment is depressed. There is also Cannington Silver Mines and silver is arguably depressed; Cerro Matoso Nickel Mine, and that is depressed; and the manganese assets. Manganese is depressed because it is a component of steel.

Table 13 lists the current EBITDA of that business and the 10-year average EBITDA in U.S. dollars. The total current EBITDA earnings of the seven companies come to $1.787 billion. If all those businesses were merely performing at their 10-year average, not at their peaks, that aggregate figure would be $3.263 billion. In other words, the current EBITDA is a little more than half of what the average is, not even of peak profitability.

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There is a reasonable chance that the parent company, BHP, will offload debt onto the spin-off. Therefore, it would trade at a low market capitalization to EBITDA and low market capitalization to revenue.

In any case, index funds will not own it, and some amount of time will be required before the assets recover their normal EBITDA. Therefore, the spinco will most probably use the cash flow to engage in debt repayment rather than expansion. The spin-off is going to have cyclical characteristics but, if the cyclical characteristics eventually normalize, it could have a lot of profit potential. That is a very interesting spin-off.

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Post-Musings

THE BASIC ASSUMPTION OF EFFICIENT MARKETS

One could argue convincingly that markets are efficient if the marketplace is made up of a multiplicity of active managers gathering information and, by their trading, expressing that information in the prices of securities. However, as we saw in the *Facts and Figures* section, if the majority of the dominant investors, who are also the marginal buyers and sellers, are now passive, and if this dominance is growing, how can one be sure that the efficient market model remains a valid assumption?

This question is rooted in the fact that the index is price-indifferent: It is just a machine, there is no subjective attribute to it, and it will automatically buy to the extent that new money is placed in the index funds. Furthermore, those purchases will be done in proportion to the market-capitalization-weighted floats of the constituent companies.

What does it mean when one—that is, the investment ecosphere—creates multi-trillion-dollar managers that are valuation-indifferent? The active managers were not value-indifferent. If they periodically created egregiously over- or undervalued securities, they had merely exercised poor judgment. But the balance of price-making activity, on the margin, is going to the value-indifferent indexes while the active managers are gradually eliminated. We are going to replace poor judgment with no judgment whatsoever. If a judgment is not being made and, by design of the system, we remove all judgment from it, what mechanism can exist to ensure that the market remains efficient?

The standard test is the presence or absence of serial correlation of individual securities. What does that even mean in an index fund calculation? The index funds receive the money in random order; therefore their purchasing is random; securities enter and exit the index in random, unpredictable ways; companies change their shares outstanding, and therefore their float, in random, unpredictable ways.

All that proves is there is not necessarily an exploitable pattern to stock trading. But what does that matter if index funds will purchase whatever trades, as long as it is sufficiently liquid to be included in the index? That is the key question, to which no one knows the answer. One day we will find out.

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From the Readers

BRANDED COMPANIES

Q: *Do non-food-related retailers like Ralph Lauren have the same problem relative to brands as the supermarket companies discussed earlier in this report?*

A: They do. Over the years, brands have developed even in clothing. You can see it in Target, for example. Target has its own clothing brand, which is called Massimo. Target is a sufficiently large company that it can go to the Far East for manufacturing, as Ralph Lauren does. Ralph Lauren designs the clothing but goes to the Far East to engage some manufacturing company to produce the clothing. Target can do exactly the same thing, and it does. To a degree, Target has an advantage, because it can engage in in-store advertising as well by giving its own brand prominent shelf space. That is a factor, and it is starting to happen in various retailers.

When I started in the business in 1978, what we today call branded companies were considered low-margin, low-growth companies. You would buy them for the dividend yield. The world has since become enamored with them, but back then they were considered to have real problems expanding their businesses. They were more or less market saturated. During the decade of the 1970s, as investments, they did not fare very well.

Then, in the 1980s and in the early 1990s, they fared well, not because their revenues grew but because interest rates declined. They were trading as fixed-income substitutes. In fact, they had high dividend yields and their valuations rose enormously. Then, in the early 1990s, the process of margin expansion began. The question arises: When does that reach its culmination, as it has to do so at some point?

If a company were to eliminate all expenses, meaning it had no cost of goods sold, no administrative expenses, and no expenses for employees, and it eliminated all taxes, the highest margin it could achieve would be 100%. That is preposterous, of course, because there will be expenses of various types and there will be taxes, though one can debate how much. The question therefore becomes: What will the maximum margin be?

No company has really been able to maintain a net profit margin much above 25% for an extended period. You might think that has something to do with the government, that the government would object if companies paid too little in taxes, but that is not the case. What really happens is that when the profit margin rises above a certain level, a company begins to attract new competitors and that is what forces the margin lower. Businesses can make a very good profit simply by underselling you. They can make a better product and

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cheaper. It is actually dangerous, in a business sense, to have too high a margin, because you run the risk of attracting competitors and changing the nature of your whole business.

My own belief is that this will happen ultimately to the leading companies in the index, and because those companies determine the performance of the index, ultimately that will happen to the index itself. It could be wrong but that is my working assumption.

One way of testing that proposition is to look at the leading companies in the Dow Jones Industrial Average, every five or 10 years, from the end of the 19th century to today. Which were the leading companies? They were the highest-margin companies. In their day, those were General Motors, U.S. Steel, and their ilk. There was a time when they had enormously high profit margins. In each and every case, they attracted competition and ended with low profit margins.

It is hard to find an example of a company that maintained high profit margins for a very long period of time. It is possible to find those that maintained dominance in an industry because they would not let the profit margin exceed a certain level. For example, Standard Oil of New Jersey eventually became Exxon, and Exxon ultimately merged with Mobil. What was Mobil? Mobil was Standard Oil of New York. Roughly 100 years ago, the United States government broke it up. Then, 100 years later, it let them put it back together again.

Exxon, however, was never really a high-margin business in the sense of the branded businesses we have today. The management, it seemed to me, was always sensitive to the danger of high margins. Perhaps for that reason, it has always remained the leading company. Exxon is an exception. There are other exceptions but, generally speaking, I cannot think of a company that maintained dominance longer than a generation. Even IBM was a dominant company for a generation. Now its revenue is in decline.

FUTURE GLOBAL SPIN-OFFS?

Q: *Do you see any particular industries on the global side, in which you think there will be a wave of spin-offs similar to what we have seen on the domestic front?*

A: I always believed that the German chemical companies should spin off their pharmaceutical businesses. It seems like a logical transaction, but they have never done it, nor have even talked about it.

If you want a general rule, sooner or later any company that contains both a high-margin business and a low-margin business will spin off the low-margin business. This is one of the reasons for the decline in volatility in recent years. Some of the volatility was due to fluctuation in interest rates, some to leveraged balance sheets. Those problems have

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disappeared. The next problem is due to the cyclicality of earnings. That is what makes securities volatile, for some reason.

Therefore, the big companies around the world gradually have been spinning off or selling the low-margin businesses and the ones that are more cyclical. I think it is fair to say that, on balance, most companies in the world have businesses that have inherently less cyclical earnings than they used to have. If you want to look for the next group of spin-offs, I would say a good rule of thumb is to find a business with a stable earnings division and a low-margin cyclical earnings division, and that will probably be a pretty good candidate for spin-off.

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Index Constituent Changes: 1. Nuveen Investments Inc (JNC US) was delisted from the US Security Exchange effective 11/14/2007 and has been removed from the index. 2. Alliance Financial Corp (ALNC US) was delisted from US Security Exchange effective 03/11/2013 and has been removed from the index. The divisor has been adjusted accordingly for each of these changes.

Money Manager Index

From Aug 1983 to Aug 2014

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	1.79	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	123.18	127.91	131.76	135.00	2012	135.00	29.8%	18.1%
2013	151.20	155.13	165.52	166.55	174.89	164.20	179.01	168.47	176.12	192.14	197.16	208.44	2013	208.44	54.4%	19.2%
2014	194.17	196.87	203.88	196.24	195.40	206.41	194.00	207.06					2014	207.06	(0.7)%	18.7%

S.No.	Ticker	Name	Amount Invested	Shares Purchased	Date of Investment	Current Index Value
1	AMG US Equity	Affiliated Manager	$22,947	1,377	11/30/1997	$290,713
2	BLK US Equity	BlackRock	$23,205	1,658	9/30/1999	$551,057
3	WDR US Equity	Waddell & Reed	$27,513	1,587	3/31/1998	$86,507
4	EV US Equity	Eaton Vance	$2,641	3,998	1/31/1986	$156,577
5	TROW US Equity	T. Rowe Price	$2,423	2,014	4/30/1986	$163,112
6	BEN US Equity	Franklin resources	$908	1,263	4/30/1985	$214,177
7	LM US Equity	Legg Mason	$1,000	462	8/31/1983	$22,795
8	FII US Equity	Federated Inv	$26,381	2,206	5/31/1998	$68,256
9	FIG US Equity	Fortress Investment Group	$102,249	3,389	2/28/2007	$26,164
10	PZN US Equity	Pzena Investment Management	$122,426	6,317	10/31/2007	$64,056

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Index Constituent Changes: 1.New Star Asset Management (NSAM LN) was delisted from the London Security Exchange effective 03/10/2009 and has been removed from the index. 2. Australia Wealth Management (AUW AU) was delisted from Australian Security Exchange effective 05/18/2009 and has been removed from the index. 3. Bluebay Asset Management/UNI (BBAY LN) was delisted from the London Security Exchange effective 12/20/2010 and has been removed from the index. 4.Everest Financial Group Limited (EFG AU) was delisted from the Australian Security Exchange effective 7/19/2011 and has been removed from the index. 5. RAB Capital Plc (RAB LN) was delisted from the London Security Exchange effective 9/2/2011 and has been removed from the index. 6. Invista Real Estate (INRE LN) was delisted effective 8/13/2012 and has been removed from the index. 7. F&C Asset Management Plc (FCAM LN) was delisted effective 5/8/2014 and has been removed from the index.The divisor has been adjusted accordingly for each of these changes.

International Money Manager Index

From Nov 1986 to Aug 2014

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly return	Annualized 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	14.43	33.8%	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	(2.2)%	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)%	14.56%
2012	32.12	34.36	35.67	35.08	31.03	32.92	32.66	34.17	36.33	37.28	38.11	40.73	2012	40.73	33.1%	15.22%
2013	43.61	42.58	44.42	49.29	50.40	47.75	50.58	49.32	52.49	55.65	55.41	58.88	2013	58.88	44.6%	16.19%
2014	55.35	58.98	61.86	59.92	59.05	59.89	57.84	58.64					2014	58.64	(0.4)%	15.75%

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	$3,507
2	IVZ US Equity	Invesco Plc (Previously Amvescap)	$1,357	1,153	1/31/1991	$23,678
3	SDR LN Equity	Schroders Plc	$1,208	505	3/31/1991	$20,625
4	RAT LN Equity	Rathbone Brothers Plc	$1,208	736	3/31/1991	$24,741
5	ADN LN Equity	Aberdeen Asset Mgmt Plc	$1,208	1,827	3/31/1991	$13,165
6	CIX CN Equity	CI Financial Corp.	$2,585	3,224	6/30/1994	$106,167
7	EMG LN Equity	Man Group Plc	$2,862	6,344	10/31/1994	$9,670
8	AGF/B CN Equity	AGF Management Ltd-Cl B	$3,343	1,346	1/31/1996	$15,410
9	8739 JP Equity	Sparx Group Co Ltd	$11,762	108	12/31/2001	$22,908
10	HGG LN Equity	Henderson Group Plc	$14,447	8,666	12/31/2003	$26,963
11	AZM IM Equity	Azimut Holding Spa	$21,908	4,977	7/31/2004	$129,608
12	CCAP LN Equity	Charlemagne Capital Ltd	$36,848	22,300	3/31/2006	$5,732
13	PGHN SW Equity	Partners Group-Reg	$36,848	578	3/31/2006	$152,645
14	ASHM LN Equity	Ashmore Group Plc.	$36,688	9,873	10/31/2006	$57,632

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