1st Quarter Commentary

April 2015

So, we'll talk about the portfolios. And we might talk about performance, but it won't be about short-term performance, because—forgive a perhaps incendiary statement—it's meaningless. We'll review some portfolio holdings, using some objective valuation facts and predictive attributes as they relate to security selection, but only in a long-term context. We won't reference much in the way of the macroeconomic factors that are considered a de rigueur element of the portfolio management process and security valuation models, such as the outlook for interest rates, GDP growth, future oil prices, and so forth. In actuality, they are more a source of bad decision making and return erosion than they are of assistance. Sound extreme? A couple of examples, then, to set the stage. These examples will, for contrast, include substantial data of the sort that are considered important or even critical in investment decision making by non-long-term investors, yet in reality are not able to reliably inform decisions that assure or improve returns.

What is Long Term, Anyway, and Would You Fire this Manager?

First, here are some actual 5-year performance figures for a certain investment partnership, to be identified later. These are net of management fees and expenses. Your task is to determine whether an investment consultant would have retained or dismissed this manager on behalf of clients in the fund. Without exaggeration, the underperformance is massive, a difference of roughly 28 points.

	Fund	S&P 500
1970	(0.1)%	2.4%
1971	20.6%	14.9%
1972	7.3%	19.8%
1973	(31.9)%	(14.8)%
1974	(31.5)%	(26.6)%
Cumulative	(39.7)%	(11.8)%

For illustrative purposes only.

Source: Warren Buffett, "The Superinvestors of Graham-and-Doddsville," *Hermes, the Columbia Business School Magazine* (Fall 1984), 4-15, http://www8.gsb.columbia.edu/rtfiles/cbs/hermes/Buffett1984.pdf

Is 5 years sufficient time to permit a reasoned judgment? Bear in mind that the manager underperformed during 4 of these 5 years. Worse yet, a standard statistical analysis of the fund's return patterns, such as its beta or Sharpe ratio or alpha, would have revealed that it was far more volatile relative to its returns and the returns of Treasuries than the market, such that the manager would appear to have been taking excessive risk. It probably does not require much discussion to agree that late in year 5 or early in year 6, this manager—had he managed to last that long—would have received a letter of dismissal.

But what if we add a few more data points? The preceding 8 years look very different than the 5 above. This same manager outperformed the market in each year but one, and by a yet more massive 94% points. And in the original year 6, which was the final year of this 14-year record and which would have been the year of this manager's dismissal, the fund returned a rather startling 73.2%.

	Fund	S&P 500
1962	20.1%	(10.6)%
1963	47.8%	23.3%
1964	33.1%	16.5%
1965	6.0%	13.1%
1966	8.3%	(10.4)%
1967	37.5%	26.8%
1968	27.0%	10.6%
1969	21.3%	(7.5)%
1970	(0.1)%	2.4%
1971	20.6%	14.9%
1972	7.3%	19.8%
1973	(31.9)%	(14.8)%
1974	(31.5)%	(26.6)%
1975	73.2%	36.9%
Cumulative	5.96x	2.03x
Annualized	13.6%	5.2%

Source: Ibid. For illustrative purposes only.

Over the full 14 years, the fund returned 13.6% annually versus the S&P's 5.2%, or 6.0x a client's original investment, versus 2.0x for the S&P 500. The true time period, as shown in the second table, was 1962 through 1975. The fund was Munger Partners, and the fund manager was Charles Munger, perhaps best known as the Vice Chairman of Berkshire Hathaway and longtime business partner and confidant of Warren Buffett.

No doubt, modern portfolio analytical techniques can reveal some interesting aspects of a fund manager's style, but such analysis would also have dictated the firing of Charlie Munger. Such data is no substitute for understanding the thought process behind the construction of a portfolio. They don't describe the degree of undervaluation or return expectations for the securities within it—

would the decision to dismiss have been any different if the consultant understood the nature and valuations of the holdings? Perhaps not—one might, in order to know this, have to evaluate the *consultant's* decision making and risk control processes in the conduct of that business.

One might pause, for just a moment, to again consider just how extraordinary the Munger Partners returns were for his investors, and just how extraordinary the opportunity cost was for the hypothetical dismissal of his services. Even so, the Munger Partner returns pale beside his later investment record.

Just as Warren Buffett ultimately closed Buffett Partnership and continued investing through the corporate vehicle of Berkshire Hathaway, so too did Charlie Munger eventually operate through his control of publicly traded Wesco Financial. During the 10-year period 1989 to 1999, the book value of Wesco Financial compounded at a 21.0% annual rate, from $39.54 per share to $266.21.

Volatility in Core Value

The failure of Munger Partners to control the downside volatility—or perhaps worse, the absence of any process to control such price risk—is more anathema in the world of modern portfolio management than is mere underperformance. How, exactly, does one control against such interim price risk? There is a bedrock presumption that one can anticipate events that will cause individual stocks or industry sectors to decline, that this can be done in an actionable way, that if it can be done it will not detract meaningfully from returns and, most importantly, there is a bedrock presumption that to not do so is a failing, if not an act of irresponsibility. Whether it is possible to prevent short-term downside volatility without damaging long-term returns (it isn't, really) is a longer discussion, for another letter; so, we'll stay here with the uncontroversial notion that investors appear very much to wish to avoid downside volatility.

That requirement is observable in the flow of funds: from the 2008 Financial Crisis year through the end of last year, if one adds together both the amount of capital that was withdrawn from equity mutual funds (which is a proxy for active security selection) and that was added to ETFs (which are, simply, indexed baskets of securities), the total is over $1 trillion – and that is a conservative estimate of the exodus from active to passive management. In February, over $30 billion of net new ETF units were issued, or about $1 ½ billion per trading day.

Active management, by the way, is not synonymous with long-term investing—the historical average turnover rate, or trading activity, in equity mutual funds is about 60% per year, and it is not unusual to see turnover of 100% or more. This level of activity presumably reflects an effort to anticipate and avoid a decline in the price of a holding. Why hold an energy stock that will do well over five years if, this year, it might decline due to lower oil prices? Nevertheless, investors are leaving this form of investment and risk control for index-based investing. One would think that indexing is an inherently low-transaction-volume form of investing—one simply buys and holds an index that, representing the market or a portion of the market, should be less volatile and have less security specific risk.

Rather than own a single energy stock in an uncertain oil price environment, one can simply hold a basket of energy stocks, such as the Energy Select Sector SPDR ETF. It is, with $12 billion in assets, clearly popular, and the largest holdings are ExxonMobil, Chevron and Schlumberger, all blue chips. Why, then is the average daily turnover 14.5%? That's about 3,600% per year, incredibly more than the most aggressive mutual fund managers. In fact, the annual turnover of ExxonMobil itself is only 0.3% per day. By that measure, the trading or liquidity demand for the Energy ETF exceeds by 40x the daily liquidity of its largest constituent, ExxonMobil. Why buy a passive basket of stocks to avoid one sort of perceived risk in order to incur additional risk by trading, unless the trading is supposed to reduce risk? But on what basis are investors determining exactly when to sell the Energy ETF, and just where to put that money almost once every week (14.5% per day X 5 trading days equals 72.5% turnover), and then to buy it again almost once every week? Even a broad index, like the iShares Russell 2000 ETF, with $30 billion in assets, has average daily turnover of 11.6%, which is about 2,900% per year.

The flow of funds into, and the buying and selling of these ETFs, which represents the marginal dollar of supply and demand, has caused the stocks that comprise these indexes to behave more and more alike—a correlation convergence bubble has developed. Yet, it is a presumed benefit and a desired characteristic of modern portfolio theory to hold different types of assets because their prices will tend to exhibit different patterns, thereby lending more stability to a portfolio. Securities or sectors that display very different price behavior are highly sought after and considered quite valuable in a portfolio context.

Here, then, is the pattern of price behavior of the Core Value model portfolio during the last 503 trading days, the 2 years through April 10th of this year:

- The portfolio return varied inversely with the S&P 500—that is, up during a down market day, or down on a day when the market was up—18% of the time.
- The differential on those days averaged over one-half percent, or over 50 basis points.

	Years Held[1]	Price / Cost	Avg. Position Size, %	Annl'zd Apprec.[2]
Brookfield Asset Management	7.0	2.0	6.7	10.5%
Jarden Corp	4.4	3.8	10.7	34.9%
Henderson Land	4.2	1.5	3.3	10.7%
Liberty Media Corp Cl C	4.2	2.5	3.7	24.6%
AutoNation	4.2	2.1	5.8	20.0%
L Brands	3.6	2.5	4.0	28.8%
Howard Hughes Corp	3.5	3.1	8.7	38.0%
Continental Resources	3.3	1.6	0.8	15.2%
Dish Network	3.2	2.7	2.8	36.4%
Sears Holdings	3.0	**1.0**	**5.8**	-0.4%
Simple avg. or cumul. weight:	4.1	2.3	52%	
DreamWorks Animation	2.7	**1.1**	**5.3**	5.0%
Liberty Interactive	2.6	2.0	2.0	30.6%
Colfax	2.6	1.3	1.2	11.3%
Starz	2.6	2.6	5.0	44.5%
Viacom	2.3	**1.0**	**2.3**	1.6%
Simple avg. or cumul. weight:	2.6	1.6	16%	
Tourmaline Oil	1.8	1.2	**1.2**	8.9%
Wendy's	1.7	1.9	5.5	47.1%
Platform Specialty Products	0.9	1.5	4.4	*52.2%*
Silver Wheaton	0.5	0.9	**1.2**	*-12.5%*
Tri Pointe Homes	0.5	1.0	**2.1**	*1.3%*
Royal Gold	0.3	1.0	**1.6**	*-3.3%*
LSB Industries	0.1	1.1	**1.4**	*11.0%*
Simple avg. or cumul. weight:	0.8	1.2	17%	
		Aggregate weight:	86%	
		Positions yet to work:	**21%**	

[1] Mid-point between first and last purchase dates
[2] Not annualized for periods less than 1 year
Data as of March 31, 2015

The portfolio isn't managed with the goal of producing these figures. But were that set of figures described as a distinctive type of security or contract that behaved in that manner, it would be highly sought after by certain fund managers. They would want to buy it. As a frame of reference, the iShares MSCI EAFE ETF, which is a benchmark for large- and mid-cap non-US companies in developed markets (i.e., for Europe, Asia and the Far East), and which has $57 billion of assets, varied inversely with the S&P 500 18% of the time during the same period, and the differential on those days was also about 50 bps.

That is not a conventional measure – consultants and 'manager analysts' do not look at portfolios this way. However, they are currently interested in a statistic called "active share". In reaction to the convergence of price movements among different types of equities and assets, some are beginning to seek out managers that have a high active share. Active share indicates what proportion of a portfolio is NOT in the S&P 500 – the higher the number, the less the portfolio looks like the market. The Core Value figure would be north of 95%, which we are informed is about as high as it gets.

Consequently, to return both to long-term investing and active management, or individual security selection, the accompanying schedule describes the Core Value portfolio in a manner that is probably not used by many analysts: by the length of time most of the securities have been held. It has been arranged in three tranches: stocks held for three years or longer, for 2 to 3 years, and for less than 2 years.

Of the 10 stocks held for 3 years or longer, the record holder is 7 years; that stock, Brookfield Asset Management, has doubled, for a 10.5% annualized rate of appreciation, separate from the dividend. The two largest holdings, Jarden Corp, at 10.7%, and Howard Hughes Corp., at 8.7%, are largest by virtue of having appreciated the most, by 3.8x and 3.1x. On a simple average basis, the typical holding period has been over 4 years, and the average appreciation has been 2.3x. Importantly, gains taxes have not been paid on that appreciation. In this tranche, which accounts for over 50% of the portfolio, the only stock that hasn't appreciated is Sears Holdings—we'll consider that a 'yet to work' position.

The second tranche, 5 positions, has an average holding period of 2.6 years and has appreciated by 1.6x so far, and contains two have-yet-to-work positions, DreamWorks Animation and Viacom. It accounts for 16% of the portfolio.

The third tranche, of 7 names, has an average holding period of less than a year, has so far appreciated by a factor of 1.2x and contains, as might be expected, 5 have-yet-to-work positions.

One will notice that the magnitude of performance and the consistency of the annualized returns are highest in the longest-dated holdings, less so in the 2-3 year tranche, and even less so, to the point of near randomness, in the 0-2 year tranche.

These return statistics are much different than the volatility statistics typically used to review portfolios. Another important statistic for this portfolio is that 21% of the positions, by weight, are in the 'yet to work' category. Let's just suppose that those shares were to appreciate by 50% in a particular year, even as the rest of the portfolio were completely unchanged. On the basis of that contingent alone, the entire portfolio would appreciate by 10%.

Fun and Games with Predictive, Objective Attributes

Now here is a friendly two-part quiz. The first set of companies set forth below are almost universally known, and known as among the greatest growth companies, blue chips all, of the past 30 years: Procter & Gamble, Microsoft, Johnson & Johnson, and Wal-Mart. They are near the top of the S&P 500, and they got there by tremendous appreciation. Over the last 30 years, they've appreciated between about 10% and 20%+ per year, versus about 8% for the S&P 500, and created significant wealth for anyone who actually held the shares all that time (know anyone who did?). Also provided is some descriptive information: the revenue they generate on a per-employee basis, and their net profit margins. Microsoft, with its monopolistic Windows PC operating system and Johnson & Johnson with its drug patent protection, generate after-tax profit margins well above 20%, which is rare to sustain for the many years they have.

There's also Company X. It produced the same level of appreciation as these justly lionized companies. Company X does stand out for one measure: relative even to Microsoft, it generates 10x the level of revenue per employee, and it has twice the net profit margin.

Company X stands out for one additional measure. Despite the 30-year record, these blue chips are no longer the companies they once were (see the following table). They have matured and can no longer sell increasing volumes of product to the same population, or are facing competitive or obsolescence threats that they once did not.

Great Long-Term Growth Companies

(At Least They Were)

The Last 30 1/4 Years Were Great, 12/31/85 - 3/31/15

	Company X	Procter & Gamble	Microsoft*	Johnson & Johnson	Wal-Mart	S&P 500
Position in the S&P 500 Index	**??**	#8	#3	#4	#30	
# Analyst Earnings Estimates	**??**	26	34	19	27	
# ETFs where signif. holding (1)	**??**	60	74	70	24	
Cumulative Appreciation	**23.6x**	18.8x	425.7x	30.6x	41.3x	9.8x
Annualized	**11.4%**	10.5%	23.2%	12.4%	13.5%	8.1%
Revenues/employee	**$6,900,000**	$704,000	$ 678,000	$ 588,000	$221,000	
Number of employees	**7**	118,000	128,000	126,500	2,200,000	
Net profit margin	**63.0%**	14.0%	25.9%	22.0%	2.4%	

* Microsoft period begins on IPO date: 3/14/86, if one could get 'circled' for shares. If from 3/31/87, the annualized appreciation rate is 18.7%.
(1) Significant holdings are the top 10 exposures in a given ETF.
Time period chosen for illustrative purposes only.
Source Horizon Kinetics Research, Company reports, Bloomberg, www.etfdb.com

Accordingly, the 10-year record does not look much like the 30-year record. It doesn't even look as good as the S&P 500. The average annualized appreciation was, uniformly, roughly 4%. Except for Company X, which generated an 18% annualized rate of return.

What is Company X? Texas Pacific Land Trust[1].

The Last 10 1/4 Years, Not So Much, 12/31/04 - 3/31/15

	Company X	Procter & Gamble	Microsoft*	Johnson & Johnson	Wal-Mart	S&P 500
Cumulative Appreciation	**5.4x**	1.48x	1.52x	1.58x	1.56x	1.70x
Annualized	**17.8%**	3.9%	4.2%	4.6%	4.4%	5.4%

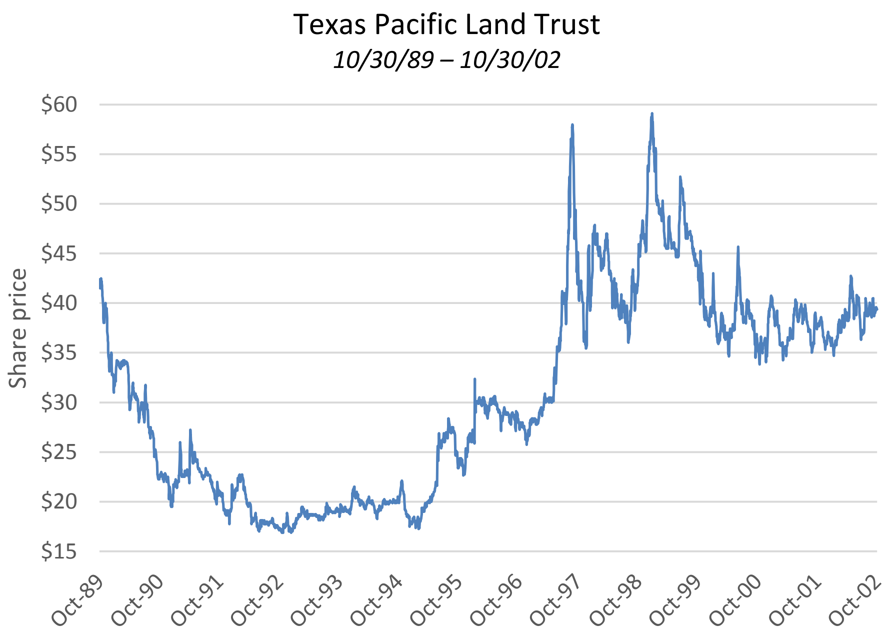
Time period chosen for illustrative purposes only.
Source Horizon Kinetics Research, Company reports, Bloomberg, www.etfdb.com

Created in 1888, in the bankruptcy reorganization of the Texas & Pacific Railroad, bondholders received interests in the Trust, which held millions of acres of land liened against the bonds. The governing Trust document charges the trustees with repurchasing shares over time with whatever income the Trust receives from grazing fees, periodic land sales, and mineral royalties generated by mining and energy companies active on the Trust's acreage. The Trust mandate serves as a form of mandatory capital allocation program that prevents trustees from engaging in other perhaps enticing activities, of which, over the past century there must have been many. Hence, for over a century, the Trust has been repurchasing shares and selling land, but the repurchases exceed the sales, so that the amount of acreage represented by each share has constantly increased. At present, there remains 900,000 acres (of the original 3 million-plus) in west Texas in an area that includes the Delaware Basin shale, which has lately become an area of intense drilling activity. The shares likely trade near their liquidation value, based on evidence from land sales, which can vary widely depending on its best use.

[1] Texas Pacific Land Trust is not owned within the Core Value Strategy. However, it is owned in other strategies managed by Horizon Kinetics.

With that description, which can't be searched for on a database, Texas Pacific Land Trust can be understood to be a business model that is unusually free of manager risk, technological obsolescence risk, domestic competition, foreign competition, capital requirements, currency risk, regulatory risk, and most other important threats that beset other businesses. Its basic business asset has an extremely long lifespan, certainly longer than that of Microsoft Windows. There is very little to interfere with the steady, internally generated compounding of acreage/share. The assurance of a certain degree of return from share repurchases and an allowance for the inflation of oil prices and land prices over time is readily calculable. The theoretical benefit of compounding over extended periods is enormous. It has been demonstrated in fact, as well:

> A Certificate worth approximately $350 in 1907, lost and not recovered until 1979, was restored to an heir of the original owner and liquidated in 1986 for an amount in excess of $5,700,000. That's the product of a 14.4% annual return over a lifetime. However, there were extended periods—that is, of a decade's duration—when the shares did not appreciate at all. Should one not have held them; should they have been timed?



Source: Bloomberg. Time period selected for illustrative purposes only.

It perhaps goes without saying that Texas Pacific Land Trust is not in the S&P 500 Index, and has no Wall Street analyst earnings estimates. It trades about 12,000 shares per day. You could not get exposure to this stock in any ETF, even if you wanted to.

Now for Company Y

This next schedule selects the leader in each of several industries: Barrick Gold, among the gold miners; Apple Inc. in the realm of technology; Coca-Cola; and General Electric, among industrial companies. As the leaders in their industries, they are represented in a dizzying array of ETFs, and are intensively covered by Wall Street analysts: Apple is covered by 46 analysts and is included as a significant position in 94 different ETFs. They are highly regarded businesses. How did they fare in the aftermath of the Financial Crisis? Their returns from year-end 2007 onward are, with the exception of Apple, which is in its ascendance, unsatisfactory.

Industry Sector Leaders
Financial Crisis to Present: 12/31/07 - 3/31/15

	Company Y	Barrick Gold	Apple Inc.	Coca-Cola	General Electric (1)	S&P 500
Position in the S&P 500 Index	**??**	n/a	#1	#14	#5	
# Analyst Estimates	**??**	25	46	24	18	
# ETFs where signif. Holding (2)	**4**	5	94	18	64	
Cumulative Appreciation	2.06x	0.29x	4.66x	1.64x	0.88x	1.41x
On a per-year basis	**10.5%**	-15.8%	23.6%	7.1%	-1.70%	4.8%
Revenues/employee	**$11,858,000**	$ 593,000	$1,884,000	$356,000	$487,000	
Net profit margin	**24.1%**	11.2%	21.6%	15.4%	13.2%	
Free Cash Flow Margin	**66.9%**	3.5%	20.7%	14.5%	11.9%	
Price/Free Cash Flow	25.9x	39.9x	19.5x	26.8x	18.8x	

(1) Excludes Financial Services segment
(2) Significant holdings are the top 10 exposures in a given ETF
Source: Company reports, Bloomberg, www.etfdb.com

Two are negative, Coca-Cola still did better than the S&P 500, but only in the single digits. Company Y's price rose by 10.5% per year, and while that's about half of Apple's share price return, its free cash flow margin is triple that of Apple's.

Apple, which has been remarkably successful, generates almost $2 million of sales per employee. It's an extremely high figure. Microsoft and Procter & Gamble, which are models of scale and profitability relative to the average company, reach only about $700,000 per employee. Company Y's employees: $15 million each. Also, Company Y, while priced somewhat comparably to these market leaders relative to last year's free cash flow, also has an unusually high degree of visibility into future earnings. Based on the production levels the company anticipates in the next three years, it trades at a price/free cash flow multiple of roughly 15x. The shares can be found as a significant position in only 4 ETFs, and there are 8 Wall Street earnings estimates.

Company Y is Royal Gold. It is owned in part because it possesses a very predictable profit model. It does not mine for gold—it owns no shovels or trucks. It has 20 employees and, as far as we know, they all work in suits, and one works in Zug, Switzerland. It collects royalties from mining companies for which it helps to fund mine development. In exchange for that funding, Royal Gold gets to buy a given proportion of a mine's output for an extended time frame, say 30 years or for the life of the mine, but at a discount. When gold was trading for $1,200 an ounce last year, Royal Gold wrote contracts granting it the right to purchase future production at $400 an ounce—that's a two-thirds discount.

That discount provides Royal Gold with three basic scenarios:

1) All else equal, Royal Gold earns the discount, which on an annualized basis might be on the order of 15% per year.
2) If gold prices fall, Royal Gold earns less, but it has no meaningful operating costs or capital expenditures that need to be covered. How would a gold mining company fare if the price of gold were to decline by 5% each year for the next 20 years? On the contract just described, Royal Gold would earn 10%.
3) If gold prices rise, Royal Gold benefits from a rising profit margin on the expected volume of gold production and, as well, from the likelihood that the miners will begin to extract greater volumes by mining more expensive or less economic ores.

The Royal Gold business model permits a more reliable and objective assessment of what its profitability will be than does the typical company, without reference to a host of unpredictable exogenous variables. One buys the discounts that Royal Gold owns, and one can pay, periodically, a higher or a lower price for that discount. When the shares were purchased in Core Value, they were about 35% lower than the near $100 price they reached in September 2012, and in the intervening 2 ½ years, the company continued to build its portfolio of discounted future purchase contracts. Purchase of the shares was not contingent on our outlook for gold prices or the next series of Federal Reserve actions which we, sadly, are not equipped to discern.

We hope, next time, to address some of the controversial comments made at the beginning of this discussion.