1st Quarter Commentary

April 2013

© 2013 Horizon Kinetics LLC ®

<u>Tax Avoidance, the Right Way (For Those Interested)</u>

This review is being published on April 16th, which, naturally, follows April 15th. Even for quarterly tax filers this date still bears some significance, and perhaps certain less-than-uplifting associations. Not everyone shares the same depth of feeling about it, and for those who do care, not everyone's feelings translate into action—then again, some do. Take the case of the owner-operators, those captains of industry and finance who have a major—if not the major—portion of their own capital at risk in a publicly traded company they control. Though a subjective and purely anecdotal conclusion, it seems that among this group can be found some of the more determined and creative efforts to reduce those quarterly and mid-April corporate tithes. Any success on this front accrues directly to their personal capital and, by extension, to that of their public shareholders. Our portfolios contain a number of illustrative examples.

A better-known practitioner of corporate tax reduction, **Warren Buffett**, writes regularly about one of his techniques. The Berkshire Hathaway book value at year-end 2012 was $191.6 billion. That figure is net of a $16.1 billion income deferred income <u>tax liability</u>. This balance sheet item represents taxes that *would* be payable on the unrealized appreciation of various investments *had* those investments been sold this past December 31st. But they haven't been sold. In fact, some of them, like the Washington Post Company and Wells Fargo, have been held for decades.

Not only is the actual year-end Berkshire Hathaway Inc. ("Berkshire") book value $16.1 billion higher than stated, but Mr. Buffett likens the difference to an interest-free loan by the government, since until such time that he sells those investments and realizes the gains, he still retains use of that capital and can deploy it toward other investments to earn a further return.

Some might say that the $16 billion, at a modest 8% of the total $191 billion of total shareholders' equity, is not truly significant. Yet, shareholders' equity increased by $22.6 billion in 2012, and $4.7 billion, or 20% of that, was an increase in deferred tax liability on unrealized gains. That is not so insignificant. More important, the historical, smaller Berkshire was more greatly aided by this mechanism than is apparent within the enormous size of its balance sheet today. Fifteen years ago, for instance, the December 1997 balance sheet recorded $31.4 billion of book value, net of $9.9 billion of deferred tax liability related to unrealized appreciation—which means that the company's effective book value, upon which it could earn returns, was actually 32% greater that the reported amount.

An underappreciated fact is that by keeping their capital in the form of publicly-traded shares, owner-operators reduce taxes and enhance their return on capital to a perhaps astonishing degree. If the primary method of increasing their wealth is through appreciation of their stock, this isn't taxed until they sell it, which could be decades in the future. Moreover, that future gain will be dunned at the lower long-term capital gains rates. For those who haven't worked out the math, this must be one of the most efficient tax schemes available to an American who doesn't wish to forfeit citizenship or move to Puerto Rico. For example, the effective tax rate on

$100,000 that appreciates 12% per year for 20 years and is then sold at a capital gains tax rate of 20% is, strange as it might sound, only 1.1%. (The future value of that $100,000 would be about $965,000. The tax, at 20%, would be $173,000, leaving $792,000, which would represent a 10.9% annualized return on the original $100,000. Comparing that 10.9% after-tax figure with the pre-tax rate of return of 12%, the effective tax rate is 9.2% (1.1% tax drag / 12% pre-tax return.) If a long-term 20% capital gains tax rate were incurred annually during those 20 years, the final capital would be about $625,000. If the gains were incurred annually (it is not unusual for the turnover rate in equity mutual funds to approach or exceed 100%), and the short-term gains taxed at only 36%, the final capital would be only $439,000.) Is it naïve of Mr. Buffett to share this valuable secret? Perhaps. But how many investors actually have the fortitude to exploit it by holding their investments for a decade or longer?

A renowned practitioner of April 15th warfare is **John Malone**, who is well represented in our portfolios. Expanding his original investment vehicle, Telecommunications Inc., through an aggressive acquisition strategy, he orchestrated over 480 transactions with smaller cable television system operators between 1973 and 1990; that is an average of more than 2 per month for almost two decades. Ultimately, he built the nation's largest cable system. Because that business produces very stable cash flows, like a utility in its collection of millions of monthly customer service charges, he willingly assumed larger amounts of debt than the typical company could tolerate. This did not merely finance the expansion; the interest expense also greatly reduced Telecommunication Inc.'s taxable income.

As well, in order to encourage the national buildout of expensive cable infrastructure, government regulations permitted cable companies to deduct from taxable income the non-cash goodwill amortization charges that arise from acquisitions; ordinarily, companies are not permitted to use goodwill amortization to reduce income taxes. Mr. Malone used this mechanism as well, modulating both types of expenses—interest and goodwill amortization—in order to produce no reportable or taxable income, even as he built an exceedingly valuable enterprise. In fact, it was due to this particular tax reduction strategy that a new method of valuing companies was developed by a young, theretofore unreknowned media analyst named Mario Gabelli. It eventually became, and remains, a de-rigeur valuation tool. Frustrated in trying to value Telecommunications Inc. using the standard P/E ratio—the "E" standing for earnings—since the company had no "E", Mr. Gabelli employed an alternative formula. This was the enterprise value/EBITDA ratio, which recast the "E" as operating earnings before deducting interest expense, non-cash depreciation and amortization charges, and taxes. He was able to posit, on that basis, that Telecommunications Inc. was dramatically undervalued, whereas it had previously been shunned by investors who had assessed the company as, simply, a highly indebted and unprofitable enterprise.

Another tax reduction tool that has been used to good effect is the deferred tax asset. It is not unusual for an owner-operator to acquire another company with a failed or struggling business

© 2013 Horizon Kinetics LLC ®

in order to capture the target's tax loss carryforward or deferred tax asset. Properly structured, it can be used to offset a significant amount of the acquirer's future earnings. This is a convenient segue to the next section of this quarterly review, through **Eddie Lampert** and Sears Holdings. In this review we will continue last quarter's trip down the alphabet of some of our portfolio holdings—we had stopped at L—to highlight the capital allocation decisions that many of these companies have been making of late. For businesses run by properly incentivized managers with sufficiently long records to suggest their repeatable skill at generating rewarding returns on capital, one might assert that an active investment program in the current period should produce expanding earnings in subsequent periods—a predictive variable as to future performance, and a very different type of security selection metric than purely descriptive variables like size or industry sector.

Before addressing recent capital allocation activities at Sears, an analysis of the company should include the company's tax asset. In 2011, Sears recorded a $1.8 billion non-cash charge to write down its deferred tax assets. This was necessitated by an accounting rule test requiring that a valuation reserve be established when income has not been generated over a three-year cumulative period to support the deferred tax asset. However, the company stated in its just-released 2012 annual report that it believes that no economic loss has occurred. If the company is correct, then those net operating losses and tax benefits remain available to reduce future taxes on future income. So, as of 2012, Sears still had $679 million of deferred tax assets on its balance sheet and what it believes should be an additional $1.8 billion. Future after-tax income, then, could be far higher than would otherwise be anticipated. The company's book value, now $3.2 billion, as against a stock market capitalization of $5.3 billion, would actually be $5 billion if the write-down of the tax asset were reversed. The Sears book value discussion has some additional interesting complexities, so we'll call this adjusted $5 billion book value an "all else equal" figure.

<u>A Different Metric, Continued</u>

As to recent capital allocation activity amongst some of our holdings below the letter L:

- **Sears Holdings** has lately been disinvesting, though in a selective and telling way. This past October, it conducted a spin-off and rights offering of its Sears Hometown and Outlet business, which generated gross proceeds of $447 million for Sears.

  In 2012, the company sold 11 Sears store locations to a real estate investment trust ("REIT") for $270 million, and a gain of $223 million. Five of these stores were leased by Sears. It also recorded a gain of $163 million for the surrender and early termination of the leases on three properties operated by Sears Canada; proceeds were $170 million. In comparing the amount of gain with the total proceeds, which were only marginally greater, one might reflect on what the stated book value of Sears really means. One might also reflect on the value of some of the Sears stores that it doesn't own, but merely leases, if those are long-

term leases. Finally, one might reflect on the aggregate gains figure of $468 million on these 14 properties in the context of the 2,109 full-line stores that the company operates.

On the other hand, Eddie Lampert, the Sears Chairman, has personally acquired nearly $200 million of Sears shares since the end of 2011. That includes, most recently, $13.6 million on January 9th and 10th of this year; and $27.9 million of stock from his hedge fund ESL Investors on March 4, 2013. As well, in February of this year, he also assumed the role of CEO.

- **Tourmaline Oil Corp.**, which commenced operations in 2008, was established by Mike Rose, who is Chairman, President and CEO. He has done this twice before and, thus far, seems to be a very successful allocator of capital. Berkley Petroleum Corp., which he co-founded in 1993, was sold to Anadarko Petroleum Corp. in 2001 for $1.6 billion. Thereafter, he established and built Duvernay Oil Corp., which was sold to Shell for $5.9 billion in 2008. Consistent with Mr. Rose's strategy of focusing upon long-term growth through aggressive exploration, development and acquisition, Tourmaline's proved and probable reserves were increased by 78% in 2012, to 270 million barrels of oil equivalent. That included the $258 million acquisition of Huron Energy Corp., which held 46 million barrels. Tourmaline, only four years old, already has a $6.6 billion stock market value.

- **Texas Pacific Land Trust** is an exception to the owner-operator theme in this review. Nor is it in the Core Value strategy, since it is a quite small entity, although it is held in other strategies. It is introduced here because it exemplifies an equity yield curve investment as perhaps no other company can and, referencing the opening discussion, a fine example of a tax-deferral vehicle, which is really a tax reduction vehicle. As well, although Texas Pacific is not an owner-operated company, neither is it a standard agent-operated company. The three trustees, Texas Pacific's equivalent of a Board of Directors, in aggregate earn only $8,000 per year, and the total payroll, including bonuses, is $444,000. Compensation is subject to judicial review and there have been periods, quite extended periods, when the court would not grant any increases.

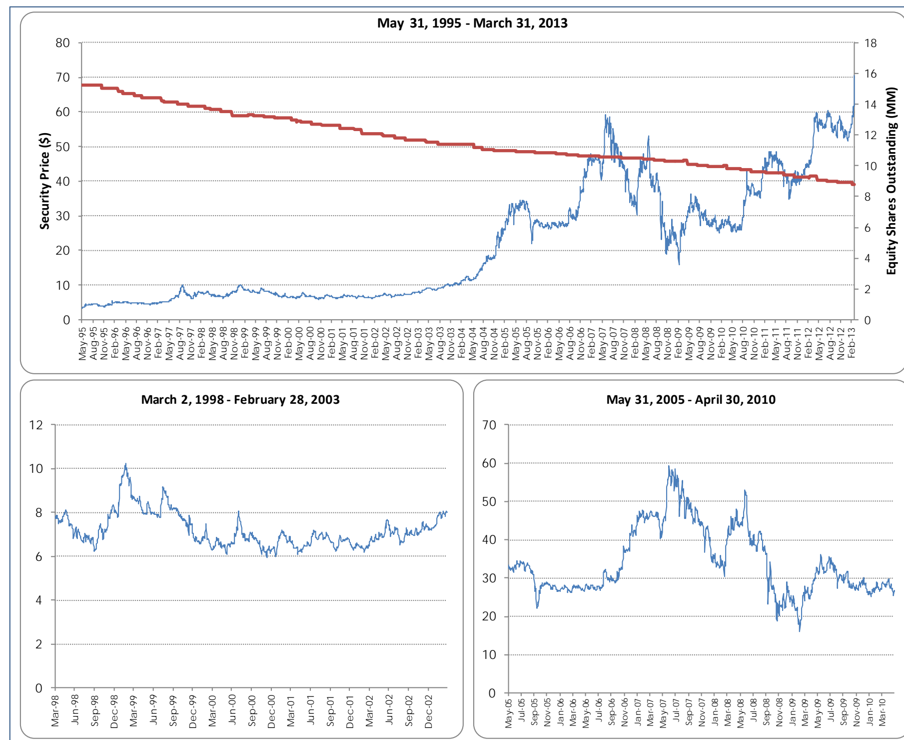
  And Texas Pacific is not exactly a company, either. The shares represent Certificates of Proprietary Interest in a Declaration of Trust, dated February 1, 1888, which established this unique entity. The Trust owns the surface estate in 921,616 acres of land in 21 counties in western Texas, as well as perpetual oil and gas royalty interests under about one-half of that land. It was originally endowed with over 3 million acres as a settlement for bonds backing a failed railroad. It has been following a consistent investment policy for well over a century, applying its income from grazing and easement rights, energy royalties and periodic sales of modest amounts of acreage toward the repurchase of its shares. It is very slowly liquidating itself. Shares have been repurchased in all but four of the Trust's 124 years. This has been occurring at a rate of about 3% per year for decades. Importantly,

© 2013 Horizon Kinetics LLC ®

acreage has been sold at a much more modest pace than that of the share repurchases, such that the number of acres per share has been increasing throughout this period. This produces certain compounding effects.

Texas Pacific was the subject of a 1995 research recommendation; it was, in fact, Horizon's first research recommendation. It is held in certain strategies to this day, and will probably still be there in another decade. What has occurred during the interim is that the share count has been reduced by 43%, or by 3.1% per annum, while the acreage has contracted by only 19%. Meanwhile, inflation has beneficially increased the average prices of the land sales, although these vary widely, and of the oil and gas from which the Trust derives royalties. And the valuation of the shares fluctuates as well. Currently, the stock trades at $701 per acre, whereas in 1995 it traded at $55 per acre. The share price today is $73.50; in 1995 it was $4 (adjusted for a 5:1 split in 2007).

From year to year, or even over stretches of five years or longer, holding this stock can be even less exciting than watching steel rust:



Source: Bloomberg

But, ultimately, the internal compounding power of this strategy is impressive indeed. 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 16,000%+ increase worked out to over 14% per year over those 72 years. Was that not a fine inheritance? It is not inconceivable that a patient buyer of 1,000 shares today could come to own nearly a million acres of fine grazing land within his or her lifetime.

- **The Wendy's Co.** was brought under the control of Nelson Peltz and Peter May in late 2008, when it was merged with their Triarc Companies Inc. Mssrs. Peltz and May have substantial experience in the fast food and beverage businesses. One of their more storied investments was the acquisition, though Triarc, of Snapple in 1997. Only three years earlier, Snapple, credited with creating a mainstream market for fruit and tea drinks as an alternative to carbonated beverages, had been sold by its founders to Quaker Oats. Quaker paid $1.7 billion and thereafter invested a great deal in marketing the brand. Through some strategic missteps, though, particularly mistreating the important Snapple distributors, Quaker created severe difficulties that impacted the entire Quaker Oats income statement. Triarc relieved Quaker Oats of this problem for a price of $300 million, then took a variety of steps, including strategic acquisitions, to return Snapple to profitability and increase its scale. Only three years later it sold the company to Cadbury Schweppes for over $1.2 billion, a gain of over $480 million.

  Mssrs. Peltz and May, directly and through Triarc, own 27.4% of Wendy's outstanding shares and continue to purchase additional shares incrementally every quarter. The most recent purchases were made on April 1st.

  Although Wendy's bought back a trivial amount of shares this past November and December (a total of $1.4 million), the Board recently approved a $100 million share repurchase program.

- **Viacom Inc.'s** Sumner Redstone has almost 80% of the media content company's voting power and owns over 8% of its shares, worth well more than $2 billion. Since November 2011, the company has repurchased almost 13% of its shares, at a cost of $3.5 billion. Of this, $700 million was completed in the quarter ended this past December. Almost $4 billion remains in its $10 billion repurchase authorization.

Looking for Yield in All the Wrong Places

Continuing our informal series on what not to do during the Yield Crisis, having previously touched upon REIT exchange-traded funds ("ETFs") and utility stocks, some insight into Master Limited Partnerships ("MLPs") is in order. The universe of MLPs has historically been dominated by natural gas pipeline operators. These are generally very reliable businesses. Essentially, they rent the use of their pipelines to oil and natural gas producers that wish to transport their product from one region of the country to another. As well, the interstate pipelines are regulated by the Federal Energy Regulatory Commission ("FERC"). Accordingly,

© 2013 Horizon Kinetics LLC ®

the cash flow from this business is rather high and predictable, and since the MLPs must pay out almost all of their cash flow as dividends, legally, they have attracted ever greater interest from investors seeking yield. Also, their business fundamentals are quite good, since the U.S. is dramatically increasing its energy production and will require more pipeline and storage capacity. In this regard, the attractiveness of such shares to investors has been both important and fortuitous for the MLPs, since pipeline construction is extremely expensive. Popularity, translated into well-priced shares, has allowed the MLPs to sell prodigious quantities of new shares at a low cost of capital, along with additional debt, to fund expansion. This, in turn, has permitted them to raise their dividends at an above-average rate, which draws yet more share demand, and finance more expansion—a virtuous circle, it seems.

Let's look for a moment at the instruments that are used by many, perhaps most, investors to purchase MLPs. These include mutual funds, closed-end funds, and ETFs, typically based on some variety of MLP index. The largest MLP index is the JPMorgan Alerian MLP Index (the Index). The table to the right shows its ten largest holdings.

10 Largest Holdings in JPMorgan Alerian MLP Index

		Weight
EPD	Enterprise Products Partners L.P.	15.46%
KMP	Kinder Morgan Energy Partners L.P.	9.59%
PAA	Plains All American Pipeline L.P.	6.68%
ETP	Energy Transfer Partners L.P.	4.83%
MMP	Magellan Midstream Partners L.P.	4.44%
ETE	Energy Transfer Equity L.P.	4.44%
LINE	Linn Energy LLC	4.10%
OKS	ONEOK Partners L.P.	3.84%
KMR	Kinder Morgan Management LLC	3.73%
EEP	Enbridge Energy Partners LP	3.20%

Source:www.jpmorganetns.com/etn/1/index.html#Underlying_Index, as of 4/10/2013.

The largest position is Enterprise Products Partners (EPD), which has a 15.5% weight in the Index. Kinder Morgan Energy Partners (KMP) has a weight of 9.6%, and Kinder Morgan Management (KMR) has a weight of 3.7%. KMR is the ninth largest holding, but actually has as its sole asset units of KMP, so it's not really correct to say that KMR is a 3.7% position and KMP is a 9.6% position. Combined, they are 13.3%. Similarly, Energy Transfer Equity (ETE) and Energy Transfer Partners (ETP), which owns shares in ETE, together are over 9%. Looking at the Index in the sense of combining various like entities, the two largest holdings in the index are really 28.8%, and the three largest are, really, 38.1%. A couple of observations:

The problems in constructing an MLP index are considerable. One of them is the self-reference paradoxical nature of such an index. For example, by definition, MLPs cannot finance much growth from internal cash flows, since they are legally required to pay out most of their cash flow in the form of dividends. Ergo, in order to grow meaningfully, they must issue shares. The companies that issue the most shares at the lowest cost of capital—i.e., the most expensive stocks—clearly have a growth advantage over competitors. Those companies that have issued the most stock at the highest prices will have the highest market capitalizations and, therefore, the highest weights in the index. By definition, the highest weights in the index must draw the most buyers. This creates a virtuous circle, which is a key element of any bubble.

© 2013 Horizon Kinetics LLC ®

There's a further complexity (among many more that we won't be able to cover in this review). The basic idea of an index is to invest in an industry and avoid stock-specific risks, but market capitalization-based, float-adjusted indexes are designed for scalability for the orchestrator, not to lower risk for the investor. The ETF manager cannot afford to be self-limited in terms of asset-gathering ability by smaller, less liquid index constituents and, so, must exclude them. In this instance, since the three largest MLP operators together equal roughly 38% of the Index, is it improper to assert that there might be a bit of stock-specific risk in this Index? Although there are dozens of MLP funds available, which proliferation might give the appearance of diversification and choice, almost every fund must purchase shares of the largest MLPs. The following is a selection of one-and-a-half dozen closed-end funds that specialize in MLPs, and it lists merely their largest three holdings—you'll get the picture.

Ticker	Closed End Fund	Largest Holding	2nd Largest Holding	3rd Largest Holding
CEM	ClearBridge Energy MLP Fund Inc.	Enterprise Prods Partners	Plains All American	Magellan Midstream
EMO	ClearBridge Energy MLP Oppty	Enterprise Prods Partners	Plains All American	Kinder Morgan Mgmt
CTR	ClearBridge Energy MLP Tot Return Fd	Kinder Morgan Mgmt	Plains All American	MarkWest Energy Part
SRV	Cushing MLP Total Return Fund	Enterprise Prods Partners	Tanga Resources Partners	Kinder Morgan Mgmt
SRF	Cushing Royalty & Income Fund	BrietBurn Energy Partners	Vanguard Natural Resources	QR Energy
FMO	Fiduciary/Claymore MLP Oppty Fd	Energy Transfer Equity	Plains All American	Enterprise Prods Partners
FEN	First Trust Energy Income & Growth Fd	Magellan Midstream	Enterprise Prods Partners	Plains All American
KED*	Kayne Anderson Energy Develop Co.	Direct Fuels Partners	Energy Transfer Equity	Vanta Core Partners
KYE	Kayne Anderson Energy Tot Return Fd	Kinder Morgan Mgmt	Enbridge Energy Mgmt	Plains All American
KMF	Kayne Anderson Midstream Energy	Williams Companies	Kinder Morgan Mgmt	ONEOK, Inc.
KYN	Kayne Anderson MLP Investment Co.	Enterprise Prods Partners	Kinder Morgan Mgmt	Plains All American
JMF	Nuveen Energy MLP Total Return	Plains All American	Enterprise Prods Partners	Energy Transfer Equity
SMM	Salient Midstream & MLP Fund	Kinder Morgan Mgmt	Enterprise Prods Partners	Plains All American
SMF	Salient MLP and Energy Infrastructure	Kinder Morgan Mgmt	Enterprise Prods Partners	Plains All American
TYY	Tortoise Energy Capital Corp.	Magellan Midstream Part	Plains All American	Enterprise Prods Partners
TYG	Tortoise Energy Infrastructure Corp.	Magellan Midstream Part	Plains All American	Enterprise Prods Partners
NTG	Tortoise MLP Fund, Inc.	El Paso Pipeline Partners	Williams Partners	Energy Transfer Partners
TYN	Tortoise North America Energy Corp.	Enterprise Prods Partners	El Paso Pipeline Partners	Magellan Midstream Part

**KED invests in non-traded energy companies.*

Source: www.cefconnect.com

© 2013 Horizon Kinetics LLC ®

To illustrate the magnitude of share issuance by the MLPs, this schedule displays the share count for four leading MLP companies over the past decade. The market absorption of this incredible number of shares is what made possible the dividend growth of these four companies and the growth in their earnings, debt, and shareholders' equity. The companies were able to make anti-dilutive acquisitions in the sense that they could issue shares at a cost of capital that was lower than the reinvestment rate on that capital when deployed in to acquire other MLP businesses.

MLP Share Issuance: Shares Outstanding at Year-End *(in millions)*

	Kinder Morgan (KMP)	Magellan Midstream (MMP)	Enbridge Energy (EEP)	Energy Transfer (ETP)
2012	373.2	113.1	300.5	301.5
2011	336.5	112.7	284.4	225.5
2010	316.1	112.5	230.6	193.2
2009	296.9	106.6	215.2	179.2
2008	266.3	106.6	190.5	151.1
2007	247.9	66.5	146.0	142.1
2006	230.4	66.4	127.5	137.0
2005	220.2	66.4	115.5	110.7
2004	207.0	66.4	103.4	107.9
2003	189.0	49.1	94.3	90.1
2002	180.9	40.9	75.8	14.2

Source: Company reports

Why can't the virtuous circle continue forever? In any bubble, there are a handful of factors that are mutually supportive and, in isolation from the broader world or exogenous variables, seem to be internally consistent analytically and self-sustaining. Only one of the factors need be interrupted for the perpetual motion machine to run out of fuel. At a simple level, the law of large numbers will begin to operate. For instance, the largest companies can't stand still– they continue making acquisitions. Kinder Morgan is in the process of acquiring another pipeline company called Copano Energy LLC (CPNO). That's a $5 billion acquisition. Although a large acquisition in dollars, it's not really as significant as one might suppose relative to the $33 billion market capitalization of Kinder Morgan. As long as companies can raise equity at federally-subsidized prices (i.e., the artificially minimized interest rate structure being maintained by the federal government), they'll continue to do so. At a certain size, though, there will be no acquisition sufficiently large to maintain the expected growth rate or, perhaps before that point is reached, acceptable to FERC. That would be a problem.

A less obvious growth challenge, but more important as to the operational and structural health of the MLP industry, is the necessity to continue issuing shares to fund capital expenditures. The MLPs have been paying dividends after deducting a reserve for maintenance-level capital expenditures in order to keep their existing equipment operational. But how is that reserve determined? For instance, the assumed lifespan for EPD's equipment is about 25 years. Therefore, each year the company depreciates 1/25th of its $24.9 billion of property, plant, and equipment. However, EPD applies that rate to its net PP&E, after all accumulated historical depreciation–

Enterprise Products (EPD), 2012 ($ mill.)

Net Income	$2,420
Less: Distribution to Partners	2,192
Retained	228
Add: Depreciation Expense	900
Retained cash flow	$1,128
Versus: Capital Expenditures	$3,622

Source: Company reports

gross PP&E is 25% higher. And what if its equipment's useful life is shorter than 25 years? Meanwhile, the companies continue to add assets as quickly as they can. Observe the accompanying figures; although they are for EPD alone, they are representative of those for other MLPs. In this case, the company made $3.6 billion in capital expenditures, as against reserved cash flow of only $1.1 billion. We could view these figures slightly differently and, I suggest, in the way they should be viewed: EPD's cash flow is $3.320 billion (net income of $2.420 plus non-cash depreciation expense of $0.900 billion), yet it is expending more than that, $3.622 billion, for capital expenditures. So where is the money for distributions coming from? From share issuance. The rejoinder, of course, is that the bulk of the capital expenditures are for expansion, not maintenance, so that the distributions come from operating income. But when the growth stops, and the external funding stops, will there really be enough for the distributions? Even if there are, will the share prices not be affected by the new understanding that the distributions will no longer be increasing?

Even if the final remarks in the preceding paragraph are considered too harsh, MLPs will nevertheless reach a point when their installed base of assets is so large and has been owned for so long, that they will have to issue equity in order to sustain their installed base of capital assets, as opposed to issuing equity to finance expansion or acquisition. Once that occurs, the dilution will be self-evident to all. The conclusion is that an MLP, as a vehicle in itself, is structurally wrong for a growing pipeline investment, because it can't accumulate capital—it needs to rely upon the market for funding. When the market perceives diluted cash flow growth, the valuation becomes damaged, and funding becomes more expensive and/or stops. In the scheme of the normal cyclicality of the market, this won't take all that long. If one thinks that a couple of years is a long time, one should weigh that against the many, many years of dividend payments anticipated as the basis for purchasing such securities in the first place and then consider the valuation risk. Moreover, many MLP holders are reluctant to sell or reduce their holdings due to potential income tax considerations. When the tide turns, look out….

It should also be mentioned that the growth rate of the MLPs will not be shared equally with the public limited partner investors. There is generally silence on this topic, which involves the MLP incentive payments. Using Enbridge Energy Partners (EEP) as an example—and please pay attention to the stock tickers in this discussion—is it reasonable to assume that the investing public is aware that the general partner will receive incentive distributions of 15%, 25%, and 50% of all quarterly cash distributions that exceed 29.5¢, 35¢, and 49.5¢, respectively? Those are the escalating general partner fees, and they make the typical hedge fund look like an eleemosynary institution. Since EEP's quarterly dividend rate is 54.35¢, it has arrived at the 50% stage, meaning that 50% of the dividend increase is shared with the general partner, Enbridge Inc. (ENB), to be distinguished from Enbridge Energy Management LLC (EEQ), which holds limited partner investments in EEP. EEQ and EEP are publicly-traded. EEQ's limited partner interests in EEP are in the form of so-called I Units that do not trade, but they do pay dividends

© 2013 Horizon Kinetics LLC ®

in more shares of stock, so that gradually the EEP shareholders are being diluted. I can't speak for anyone else's family, but I do not believe that they are aware of these arrangements.

Final Remarks

A financial markets analyst last week used the TINA acronym to describe the vast flow of investor funds into higher-yield equities and I believe I recall that he supported that shift. TINA stands for There Is No Alternative. Well, it's not true. For capital that should not be put at risk in equities, there are different choices. They are not conventional choices, but these are not conventional times.

DISCLAIMER

Past performance is not indicative of future returns. This information should not be used as a general guide to investing or as a source of any specific investment recommendations, and makes no implied or expressed recommendations concerning the manner in which an account should or would be handled, as appropriate investment strategies depend upon specific investment guidelines and objectives. This is not an offer to sell or a solicitation to invest.

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

Horizon Kinetics LLC is the parent company to several US registered investment advisers, including Horizon Asset Management LLC ("Horizon") and Kinetics Asset Management LLC ("Kinetics"). Horizon and Kinetics manage separate accounts and pooled products that may hold certain of the securities mentioned herein. For more information on Horizon Kinetics, you may visit our website at www.horizonkinetics.com.

No part of this material may be: a) copied, photocopied, or duplicated in any form, by any means; or b) redistributed without Horizon Kinetics' prior written consent.