1st Quarter Commentary

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Prefatory Remarks:
One could do worse than to begin a new year with a fresh mindset—mindfulness, even—and in this review, the mind's eye is turned toward the most basic considerations in investing today. At the outset, it is important to note that modern investing has become heavily quantitative. A modern portfolio finance paper is virtually unintelligible to someone without an advanced degree in mathematics. There are probably more equations than words, and the words that are used, although written with the Latin alphabet and in English, and pronounceable, are nevertheless impenetrable. Know what a Jensen's alpha is? While it sounds like something that might require a visit to the doctor, it is actually a critical concept and formula in modern finance. It has been used to hire and fire many a portfolio manager.

The reason it is critical to understand just how quantitative modern investing has become, from the academic grounding, through a trustees' strategic plan, to the tactical implementation by the manager, to the annual review and assessment by the self-same trustees or their appointed consultant, is that this is all considered to be quite scientific. But it is not, and it cannot be. The essential misunderstanding is that in science as we generally think of it, physical science, there are certain physical or electromagnetic or chemical properties, constants and relationships that are measurable, repeatable and not subject to change, neither by human effort nor by will. One might believe, or one's entire town, state or even national legislature might believe something about the motions of the planets, the shape of the earth, the speed of light, but those facts cannot be changed, because the reality is independent of those beliefs.

Investing, though, is a human activity, occurs in the marketplace, and is therefore a phenomenon of social, not physical science. In the social sciences, reality *is* affected by belief. Any of you who, alone (or nearly alone), believes that the path to riches lies, for example, in purchasing bank-owned foreclosed homes at a 50% discount to construction cost, or stocks selling below the replacement value of their hard assets, and if that idea has merit, have a very good chance of walking that path. Unfortunately, if that belief comes to be widely accepted, it will no longer have merit—others acting on that belief will inflate the prices until that path to riches either disappears or ends at a cliff.

The reason to pay attention to universally accepted views is not to implement them, but to think about them and implement or make use of the valuation paradoxes they create. Just about any technical, scientific-seeming, rules-based approach to investing, once it becomes the accepted wisdom (and woe to those who don't subscribe to that accepted wisdom), will become inoperative and, taken too far, absurdly so. Here, then, we will examine some of the most basic such propositions about how we invest our money. They can't be discussed all at once, so from the following list, to which we might add or detract as time and circumstance dictate, we will choose one or two at a time during the course of the year.

Proposition 1a: I invest a portion of my capital in an emerging markets stock index because it has provided a higher return than domestic stocks.
Question: That's what they say. Is it true?

Proposition 1b: I'll be satisfied with the historical rate of return of the stock market (or X%/year better than the historical rate of return).

Question: How do we even know what the historical rate of return is? Hint: if you think you do, you're probably wrong.

Proposition 2a: I invest some of my portfolio in venture capital for: a) return enhancement; b) lower volatility; and c) risk diversification.
Question: Are venture capital investment returns actually higher? Is your volatility really lower? Is your price variability really unrelated to the public equity markets?

Proposition 2b: I invest some of my portfolio in private equity for: a) return enhancement; b) lower volatility; and c) risk diversification.
Question: Do you really receive all of those presumed benefits?

Proposition 3: I concur with the collective academic wisdom of the Efficient Markets Hypothesis, and therefore invest in a market index. Absent the security-specific risk, I get a superior risk-adjusted return.
Question 3a: The providers of stock indexes (who must be the ultimate believers in the Efficient Markets Hypothesis) have launched over 8,000 different indexes, with more on the way, and they encourage investors to sell one type of ETF in favor of another. But, doesn't the act of selecting and trading these various indexes amount to active, rather than passive management? Why do they do that?
Question 3b: Are you sure you're not getting a *poorer* risk-adjusted return?

Discussion
This review will confine itself to Question 1a, about the universally accepted proposition that emerging markets investing, as through an index instrument like the MSCI Emerging Markets ETF (ticker "EEM"), provides higher returns than developed markets stocks.

First, for semantic clarity: what is the notion of indexation about? It is simply based on the observation that most equity managers who make discretionary stock selections do not outperform the indexes, since the market is believed to be efficiently priced, or reasonably so; ergo, one should use an index, which costs less and in theory[1] is less subject to security specific risk. That idea has almost universal academic acceptance. Unfortunately, few investors examine the rules by which the index constituents were selected, their individual characteristics, which companies were excluded, and why those various elections were made. Even if one ultimately agrees with all of the choices of the index creator, one should at least understand the qualitative characteristics of the index. But we don't.

Rather, we are provided with certain data, such as annualized return, price volatility, trading liquidity, and historical price correlation with other indexes. These are all the modern portfolio theory statistics employed to construct portfolios targeting some optimal balance, however defined, of historical return and price volatility. It's presumed that these portfolio building blocks—described as a large domestic company index, or a small-company growth index, or an international large cap index, and so forth—will in the future exhibit their past behavior. New car, place key in ignition, drive. But what if the labeling on the car isn't even accurate—it says 40 mpg, but…?

[1] Although not necessarily in practice.

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So, back to Question 1a, we know that this has been a very popular way to invest: just two ETFs, iShares MSCI Emerging Markets ETF (EEM) and Vanguard's FTSE Emerging Markets Index (VWO) have almost $100 billion of assets between them. There are, of course, other ETFs, mutual funds and privately managed funds that are indexed the same way. We know that these markets are volatile, and we believe we know that they outperform to a great degree. Let's address the volatility first. The MSCI Emerging Markets ETF was created in April 2003 (although the index upon which the ETF is based, originally with 10 countries, was created in 1988). In the 10 calendar years since, it has had only one year with a single-digit percentage change in price; that is, its price changed, positive or negative, by double-digit amounts in 90% of those years, and the average price change was, rounding up by a fraction of a point, 30%. Since its inception, its annualized rate of return has been 14.3%, a remarkably high number. But is it true? Well, it is undoubtedly true as far as the accuracy of the figures. But is it valid?

MSCI Emerging Markets Index

Year	Return
2003	51.6%
2004	22.4%
2005	30.3%
2006	29.2%
2007	36.5%
2008	(54.5)%
2009	74.5%
2010	16.4%
2011	(20.4)%
2012	15.1%
2013	(5.0%)

Source: Bloomberg

As far as the emerging markets are concerned, there are technical problems with even devising an index. The first is that although the emerging markets actually had stock exchanges in 1900, they were, variously, wiped out. For instance, there was a Shanghai Stock Exchange until China became a communist nation; it was then wiped out. There was a Russian Stock Exchange until the Bolsheviks took over. There was a Hungarian Stock Exchange, a Romanian Stock Exchange, a Polish Stock Exchange, and so on and so forth. When the Russians took over, they did not leave a lot for investors—even in the German stock market, there was a discontinuity, given that half of Germany was occupied by the Soviet Union. Even those companies that could survive in what was then West Germany and were reconstituted in the aftermath of the war by the Marshall Plan lost at least half of their assets.

Therefore, it is not entirely clear that you can take the stock prices of the early 1900s and construct an index. Even if you could, what would that mean, since there would be decades when the index value would have been zero? You would have to find the point at which each such stock market was reconstituted.

In the case of Russia and China, the data can only go back two decades or so. Those are two major emerging markets. Furthermore, the initial data can be very misleading, because how did any of these companies come into the marketplace? The government owned everything. It basically auctioned off assets, and had no idea at what prices to do so (or perhaps set the prices deliberately low so as to advantage those few buyers with the political and financing access to bid for the shares). The fact that investors earned a very high rate of return in the early years resulted from very unusual circumstances. And because the measurement period is so short, those unusual circumstances still weigh very heavily upon any index results. Vietnam would be an example of the same sort of phenomenon.

Given those circumstances, can the emerging markets' return data be considered valid, at least in the sense that it is used to suggest what the future data will look like? There might be exceptions to the rule,

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but even a nation like Brazil, which did not experience those particular problems, instead had a market that was very narrow. There were very few companies listed there, a handful that survived in publicly traded form. An example of the distortions that can be created in a narrow market can be found in Mexico. There was a period of time when Telefonos de Mexico (Telmex to its friends) was essentially the lion's share of the Mexican stock market. The company had a huge dividend yield, and a P/E of 2x. Why 2x? Because if you were a resident of Mexico in 1982 and wanted a telephone, you had to buy stock in Telmex. It was the only way to get a telephone. The company was controlled by the government, had precarious finances, and no other way of providing for a modern telecommunications infrastructure.

Nobody really wanted to own shares of Telmex, yet everyone was compelled to buy them. Accordingly, once they received their phone, they would sell the shares. When the government ultimately abandoned that policy, the stock rose from 2x earnings to a normal valuation of 12x to 14x. Mexico, with an initial 8% weighting in the MSCI Emerging Markets Index at inception on January 1, 1988, produced a greater than 50% annualized return during its first five years in the index.

As a point of comparison, the three largest companies in the S&P 500 Index, Apple, ExxonMobil, and Google, together account for just over a 7% weighting; imagine if all three appreciated by so much that the entire index rose by over 50% a year for five years. With Telmex representing such an enormous weighting in the Mexican stock market, that very specific phenomenon endowed the entire market with an extraordinary rate of return. Can one draw any reasonable conclusions about future Mexican returns from the fact that the Mexican stock market experienced a decade of extraordinarily returns? Similar sorts of anomalies can be observed in other emerging markets. Emerging markets' historical data should be used with extreme caution before drawing any conclusions about the risk and reward.

Selected MSCI Emerging Markets Index Constituents

Company	*Country of Domicile*	*% Revenues Generated in Country of Domicile*
Samsung Electronics Co. Ltd.	South Korea	10.0%
Taiwan Semiconductor*	Taiwan	14.4%
Hon Hai Precision Industry Co.	Taiwan	2.9%
Infosys Limited	India	2.1%

** Revenues generated in Asia Pacific (excl. China and Japan)*
Source: Company reports as of 2013 for Samsung Electronics and Infosys, and as of 2012 for Taiwan Semiconductor and Hon Hai Precision Industry

As to their present character, there are two additional qualitative problems with the emerging markets' historical data. The first is one of provenance. As the various emerging market nations became more free enterprise-oriented, and as more companies came public, their exchanges have come to be dominated by world-class enterprises that are active in the export or international trade markets. In the case of Brazil, is Vale, the global mining conglomerate, really a Brazilian company in terms of where it derives its revenues and earnings? How about Russia's Gazprom, which supplies about 30% of Europe's natural gas? In the case of South Korea, is Samsung really, economically, a South Korean company? One could ask the same about many of the computer service and software companies in India. In terms of the factors that determine their earnings growth, the largest companies in the emerging markets indexes really provide exposure to the developed nations that purchase goods from developing economies, not to the distinctive demographic and other features of the emerging economies that differentiate them from the developed economies.

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The second problem is one of size or the law of large numbers. Are these major constituents of the emerging markets indexes really superior growth vehicles in any other respect? If you look inside the index, you will find the Industrial and Commercial Bank of China and China Mobile. Are these really growth companies? Is it readily conceivable that the Industrial Bank of China will grow at 15% a year? Or China Mobile, when, really, everybody in China already has a mobile telephone? There are 1.2 billion cellular phones in China, or 89 for every 100 citizens; the ratio in the U.S. is 90. Even the Chinese government does not want China Mobile to dominate the market the way it does now, and has taken steps to prevent the company from gaining market share.

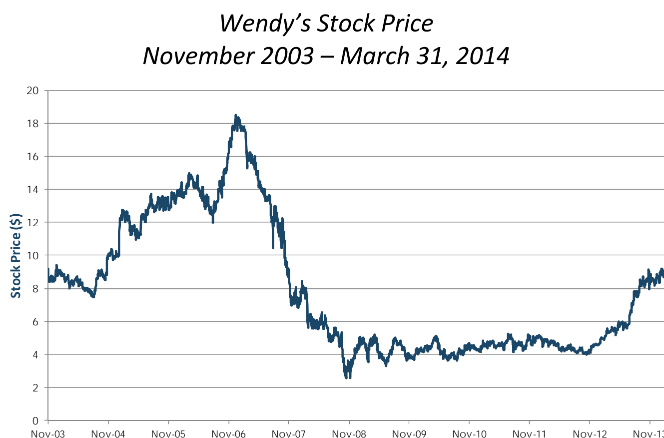
Similarly, are companies like Samsung and Taiwan Semiconductor emerging market investments, or are they really developed market investments? Their products are sold in developed markets. Why, therefore, should their rates of return differ markedly from those of developed markets? For the period beginning in mid-2008, the rate of return of the emerging markets has not differed significantly from that of the developed markets. These are facts that investors have to examine.

Selected Holdings

The investment process at Horizon Kinetics is commonly considered to be a "value" investing strategy, which would imply to some that we adhere to the strict valuation criteria popularized by Benjamin Graham. We would rejoice at the opportunity to allocate capital to high quality companies that are priced by the marketplace below net working capital. Unfortunately, equity market valuations have increased sharply from their crisis lows of 2009; accordingly, such opportunities are not often available (at least not among readily tradable U.S. stocks). This is not to say that we lack for ideas. As the investing world continues to embrace indexation, it assists us in sourcing truly attractive investments in areas that are structurally overlooked (or created) by the mainstream. Wendy's, a relatively recent purchase and significant holding, is one example.

The **Wendy's Company** has long been unloved. It is the world's third largest hamburger-oriented quick service restaurant ("QSR"), behind McDonald's and Burger King. A common criticism is that it has chronically underperformed its larger peers in many key areas, particularly profit margins. Accordingly, the company "screens" poorly by nearly every quantitative measure of business performance and valuation. The stock price was essentially unchanged for 2010, 2011, and 2012. Although it has almost doubled during the past year, it is lower now than it was over 10 years ago, in 2003. However, many of our most successful investments over the past two decades have been in companies that, like Wendy's, underperform their competitors. Operational/financial underperformance is, in fact, an opportunity, if the underlying business is fundamentally viable and an actionable plan exists to improve operating performance.

Wendy's Stock Price
November 2003 – March 31, 2014

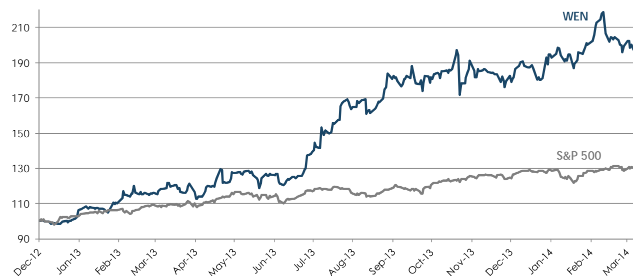


Source: Bloomberg

Wendy's operating results are clearly deficient: the company's cash operating earnings margin (before interest, tax, depreciation, and amortization) ("EBITDA") of 14.1% can be compared with the McDonald's and Burger King Worldwide restaurant-level margins of 35.9% and 56.4%, respectively. Yum! Brands averages a lower margin through its KFC, Pizza Hut, and Taco Bell restaurants, but at 20.9%, it is nevertheless almost 50% more profitable than Wendy's. One of the several reasons for Wendy's deficiency here is the ratio of franchised restaurants to company-owned stores. The franchisee in the QSR industry typically pays 4% of gross store revenue to the parent company, the parent only being responsible for corporate overhead and limited marketing costs. Thus, this 4% revenue is a very high margin business, over 80% for both McDonald's and Burger King Worldwide. Company-owned stores not only require much larger balance sheet commitments, but also have much lower margins that seldom exceed 20%. Only about 82% of Wendy's stores are franchised, compared to nearly 100% at Burger King Worldwide.

The franchise/company-owned mix is not the only factor impairing Wendy's profitability; at 1%, the company also has nearly no locations outside of the United States. McDonald's and Burger King generate 69% and 42% of company revenue outside of North America. The mix is even higher for Yum! Brands, although this figure is inflated due to a concentration of "strategic" company-owned stores in international markets.

Wendy's Stock vs. S&P 500 Index
December 2012 – March 2014



Source: Bloomberg

The untapped potential for Wendy's is readily apparent, and although this is beginning to be recognized (i.e., the shares increased 85.5% in 2013), one can observe that considerable upside remains. Wendy's currently trades at approximately 11.8x 2013 EBITDA, compared to 10.7x for McDonald's, 18.0x for Burger King Worldwide, and 13.3x for Yum! Brands. The modest relative multiple assigned to McDonald's likely reflects recognition of the market saturation that the company has achieved worldwide. Burger King Worldwide, on the other hand, has recently re-emerged as a public company after having been taken private by the esteemed private equity company 3G Capital Partners, in 2010. The current company strategy is "asset light," as evidenced by the minimal proportion of company-owned restaurants, and is focused on international expansion (42% international revenue mix in 2013) and paying down its debt. The inflated cash flow multiple is likely in recognition of the company's strategy and its value-oriented private equity management team. Yum! Brands also has market saturation issues to contend with, yet the high cash flow multiple may reflect the company's early-mover status in entering various emerging markets.

Wendy's, on merely the two sub-par ratios (franchise/company-owned store mix and absence of international presence) has superior margin and revenue expansion possibilities relative to all of these peers, yet trades at a multiple that fails to reflect this fact. Moreover, the methodological approach, popular though it is, of comparing a company's earnings multiple to those of its peers is an error in this

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case. After all, with an EBITDA multiple of 11.8x, does Wendy's seem so very much cheaper than Yum! Brands at 13.3x? The problem here, as mentioned at the beginning of this discussion, which is also the opportunity, is that the current earnings are irrelevant in this instance. One must estimate what the normalized Wendy's earnings will be at the conclusion of its program to rebalance its franchise mix and refurbish its out-of-date stores, which is a third major factor in its valuation. That project, described below, will be a four year process at a minimum, with an important cross-over point in about four years. But Wall Street consensus earnings estimates only go as far as next year.

Accordingly, standard-time-horizon investors are unlikely to be holders of Wendy's shares due to the lack of a tangible short-term catalyst for value realization. While it is true that there is no short-term catalyst, there is undoubtedly a catalyst. Nelson Peltz, and Peter May, along with the investment fund that they control (Trian Fund Management, L.P.) currently hold over 23% of Wendy's shares, and Mr. Peltz acts as non-executive chairman. These two investors have extensive experience in the food and beverage industries, beginning with a 1993 activist investment in Triarc Companies ("Triarc"), which owned Arby's franchises and Royal Crown Cola, amongst a variety of other businesses. Subsequently, through Triarc, they acquired Snapple Beverage Corp. in 1997 for $300 million, only to sell the business for a $480 million profit just three years later, after having fixed some of the management and structural problems that Snapple suffered under its prior corporate owner, Quaker Oats. Ultimately, Triarc merged with Wendy's Corporation in 2008, creating Wendy's Arby's Group; however, the name was changed back to The Wendy's Corporation in 2011, after the sale of the majority of the interest in Arby's. A cursory review of the investment and operating history of Messrs. Peltz and May, even exclusive of the Snapple coup, reveals their capacity for exceptional shareholder value creation.

Beyond the international and franchise model initiatives at Wendy's, management is also focused on repositioning the brand within the QSR market. This primarily involves "reimaging" stores, which essentially refers to a company-wide model to follow for modernizing stores, some of which are over 25 years old. The initial investment costs vary depending on the requisite work, but a successfully completed test period indicates 10-20% sales lift for reimaged stores, and a 25-35% increase for "scrapped" and rebuilt stores. The profit flow-through of each strategy is expected to be 40%.

However, this process is in its early stages, such that the enhanced profitability of the newly reformatted stores will be obscured by the incentives and financing that Wendy's will provide to induce additional franchisees to participate during this phased program. The cost per store can be $0.5 million or higher. Management intends for 85% of the company-owned stores to be updated by 2017, amounting to 35% of the overall Wendy's system. It can be presumed that the full profitability of this transition will not be reflected in the financial statements until 2018. There will come an important cross-over point when more stores will have been reformatted than those that remain, such that the latent profitability of the program will become more apparent in the financial statements.

Concurrently, Wendy's is also engaged in a "system optimization" strategy aimed at selling 425 company-owned stores, completed a few weeks ago, for proceeds of $325 million. The incremental cash facilitated a $275 million share repurchase program, for 7.5% of its shares, completed earlier this year.

In sum, there does not appear to be any natural impediment to Wendy's being able to achieve a profit margin closer to those of its major competitors, in which case profits could be 50% or 100% higher. It is

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now executing a tactical and strategic set of plans, under the direction of two activist owner-operators, to correct its deficiencies. There are several levers and sources of earnings expansion, which jointly can be very powerful in success mode, and one of the sources of return is simply the operation of the equity yield curve: that however successful the financial outcome might be, it will be too far in the future to be relevant to most investors and, thus, that as-yet-unrealized success is excessively discounted in the present.

A recent purchase in certain strategies is **Platform Specialty Products** (ticker PAH). Like Wendy's, this stock does not trade at a presently low price-to-earnings, or P/E ratio; in fact, it's somewhat high. However, the company incorporates many predictive attributes that are suggestive that its revenues and earnings several years from now will be far higher than they are today. As a U.S. company, PAH is new, having been listed on the NYSE only since this past January. Its operating business, though, has been around for over 90 years, and PAH was trading on the London Stock Exchange when it was acquired this past October for $1.8 billion by what is known as a blank-check company. The current stock market value is $2.4 billion. A blank check company raises equity capital in order to acquire a target, often within a specified window of time, and this particular one was organized by three well-known parties: Nicolas Beggruen, through his investment company Beggruen Holdings; Bill Ackman, through his hedge fund Pershing Square; and Martin Franklin. At year-end they each controlled, respectively, 6.5 million, 33.3 million, and 7.3 million shares. Martin Franklin is also the founder and Executive Chairman of Jarden Corp, which is a significant holding in the Core Value and Strategic Value strategies, among others. The same three, also through a blank check company, brought Burger King public again in mid-2012.

PAH produces specialty chemicals for a wide range of industries. It manufactures over 1,000 compounds, and its largest customer represents only 3% of sales. It exhibits very little cyclicality. Energy costs are only 2% of sales. It's important to qualitatively differentiate the nature of the PAH chemicals business from that of the typical chemicals company. These particular chemicals are often proprietary both as to makeup (the company has over 750 patents) and process. Their employees spend considerable time with customers guiding them as to how to use these chemicals, often in multi-step processes, such as might be used to enhance the performance of a circuit board. PAH refers to these as dynamic chemistries and seeks out markets requiring highly technical post-sale customer service. What PAH sells tend to represent a very small portion of the cost of a customer's product, yet are important to the product's function or appearance. According to the company, customer retention is very high because the cost savings from switching to another provider are modest, while the switching costs are high due to process complexities and quality control requirements.

All of these attributes differentiate PAH from commodity chemical providers. Perhaps the most obvious way to observe this is via the balance sheet: whereas total assets are $2.2 billion, property, plant and equipment are only $140 million. Now, the balance sheet is distorted because of $1.7 billion of goodwill and intangible assets; nevertheless, $140 million of production assets is inordinately small relative to $750 million of annual revenue and $383 million of current assets. Accordingly, PAH has more of the character of a branded products business than of a commodity business. If so, it should have greater than average pricing power and modest capital expenditure requirements, which should also be reflected in the financial statements, which they are: capital expenditures are only about $10 million per year, such that free cash flow is about equal to net income, and the 2013 free cash flow margin was

about 11.8%. As a point of comparison, to pick a branded consumer products company, General Mills had a 9.4% net profit margin last year.

The reason the proprietary-product character of PAH is intriguing is because it bears certain commonalities with Jarden Corp., which *is* a branded products company. Jarden, which we've reviewed in the past, has been a very skilled acquirer and integrator of branded products, its portfolio comprised exclusively of either the leading market share products in their categories or the second largest market share. These range from Bee and Bicycle playing cards to Bionaire, Mr. Coffee, Oster and Sunbeam home and kitchen appliances, to Aerobed mattresses, Coleman camping gear, and on and on. Mr. Franklin's curricula vitae at Jarden include these two statistics: book value per share, from 2001, when he assumed control, through 2013, expanded at a 26.4% annual rate; earnings per share have increased at a 20.2% rate.

The relevance of the relationship of Jarden and Mr. Franklin to the PAH investment thesis is this: it was a stated goal of the blank check company to identify a suitable target not merely to acquire it but also to use it as a platform for additional acquisitions in its industry. PAH, as a company that has relatively proprietary products and which generates relatively high free cash flow, can afford to fund additional acquisitions. Many large companies in recent years, in order to demonstrate a single-minded focus on their core business lines and maximize their returns on capital, have been spinning off or otherwise divesting lesser or ancillary divisions. The chemicals industries are no exception. The buyers have been entrepreneurs and private equity firms. A sterling example of just such a strategy well executed, aside from Jarden, is Colfax Corp., established by the Rales brothers, and which came public in 2008. It is also a holding in Core Value and Strategic Value. Not a quarter goes by without one or more acquisitions, in their case, of generally modest-size industrial companies that manufacture gas- and fluid-handling products and services. If you simply look at the 5- or 6-year price chart, you get the picture.

In this instance, the qualitative assessment is of particular importance. The thesis is that Mr. Franklin will oversee a series of acquisitions, priced well, integrated effectively, eventually with the further benefit of scale economies, and that there will be a suitably large supply of acquisition candidates. If this thesis bears fruit, one can readily see that in success mode PAH can be far, far larger in the foreseeable, though not near, future. The rewards for the patient would be suitable.

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