

2nd Quarter Commentary

Little has changed since our last commentary. The owner-operator companies continue to be remarkably discounted high-quality investment vehicles and, as per previous commentaries, we are exceedingly comfortable about their prospective rates of return, especially versus broad market indexes. Although we will close with the customary review of some of our holdings, and despite the fact that these commentaries have traditionally been about equities and our major equity strategies, we'll commence with what I think is a necessary discussion about interest rates.

Interest rates have been likened to the center of gravity of the financial markets—they represent the cost of money for borrowers, and the benchmark for returns on money for lenders and savers. They influence the clearing prices and expected returns for virtually every other financial asset. While they are not often uppermost in our minds, a sufficient alteration in rates forces most people with a meaningful quantity of debt or assets to pay attention. This is one of those times.

First, let's see what is happening, and then we will examine the implications of what might be termed the Great Bond Market Panic.

The Current Bond Market Profile

"Bond market panic" might sound a bit preposterous, given the multi-year bull market in bond prices, but it is appropriate since there is now a manifest absence of yield; in truth, it's another financial crisis, as we'll shortly see. Given that a sizeable majority of individuals have more assets than liabilities, the typical reflexive glee about short-term appreciation of fixed income holdings created by declining interest rates is a naive reaction, since ultimately what should be desired is a high, ongoing return on those assets—a remunerative rate of interest.

If one wants a ready profile of the U.S. investment grade bond market, that is handily provided by the iShares Barclays Aggregate Bond ETF, or exchange-traded fund (ticker "AGG"), which attempts to replicate, through its roughly 1,500 holdings, the 7,900-odd issues in the underlying Barclays U.S. Aggregate Bond Index. It encompasses, in descending proportion, Treasuries, mortgage pass-through securities, industrial bonds, U.S. agency bonds, financial sector bonds, utility bonds, among others. As of July 5th, the salient statistics for this discussion are as follows:

- The weighted average coupon is 4.27%.
- However, the distribution yield is only somewhat more than one-half that figure, 2.44%.
- The 30-day SEC yield is an even lower 1.82%.
- The average yield-to-maturity is only 1.55%.
- The weighted average maturity is 6.4 years.
- And 37% of the bonds in AGG matures within zero to five years.

Anyone with a passing familiarity with bonds will understand from these statistics that the average bond in this index has a coupon that is almost 3x the rate that is available from new bonds, and that the average bond price in this index is well above par value, probably well in excess of \$110. Therefore, as these bonds mature, two things will happen. The first is that their prices must decline toward face value, which means that the net asset value ("NAV") of AGG will drop as well. The second, and more important, is the reinvestment rate problem.

iShares Barclays Aggregate Bond Fund (AGG) Top 10 Holdings

	<u>Coupon</u>	<u>Maturity</u>
1.	4.75%	5/15/2014
2.	7.50%	11/15/2016
3.	3.62%	2/15/2020
4.	3.12%	8/31/2013
5.	8.12%	8/15/2019
6.	3.38%	7/31/2013
7.	4.62%	2/15/2040
8.	7.62%	2/15/2025
9.	2.38%	9/30/2014
10.	1.88%	10/31/2017

Source: iShares as of 7/5/12

http://us.ishares.com/product_info/fund/overview/AGG.htm

Although a somewhat rough approximation, in the interest of convenience and illustration let’s say that AGG mirrors what actually happens in the entirety of the U.S. bond market. (AGG excludes non-investment grade and tax-exempt bonds, but the general profiles of those sectors should not differ dramatically from that of AGG.) The Securities Industry and Financial Markets Association indicates that the size of the total domestic bond market as of the end of the first quarter of 2012 was \$36.9 trillion. Assuming that AGG represents a bona fide replica of bond market reality, 37% of the aforementioned sum, or \$13.65 trillion, will mature within the next 60 months.

If the average coupon on the maturing bonds is 4.27%, and they are replaced by bonds with coupons of 1.55%, then the cash flow of the bond market itself would be reduced by the interest rate difference of 2.72% of \$13.65 trillion, or by \$371 billion every year. That dollar amount is equal to 2.46% of U.S. GDP. Of course, it seems reasonable to suppose that the actual number might be higher, because for the purposes of this calculation the weighted average coupon is being used. What should be used is the average coupon maturing in the next five years, which probably exceeds the average coupon of the overall market. In any case, \$371 billion of income, at a minimum, will be lost to the American bond investor when this process is completed.

In addition to individuals, much of this income is also being lost by tax-exempt entities. Imagine what the reaction would be if the United States government proposed to place a tax of that magnitude upon all the tax-exempt institutions in the nation? For arithmetic purposes, it's actually happening. Ultimately, the reality of that loss will compel bondholders to do rather bizarre things with the money under their care.

What if Interest Rates Remain Low?

If interest rates rise, then the threats posed by the current AGG profile will dissipate—as near-term bonds mature, the capital could be reinvested in successively higher-coupon issues. But what might happen if, unlike that which many expect, interest rates do not rise? Has that situation ever happened before? First, we’ll answer the second question: yes, it has.

The following table shows a century’s worth of U.S. government bond interest rates beginning with the year 1800. In 1800, the average U.S. government bond yield was 6.94%. With some rare exceptions, the

yields kept declining through the entire century. In the 1890-1899 decade, the average interest rate on long-term U.S. government bonds was 2.55%.

Table 1: Historical U.S. Government Bond Yields, 1800-1899

Year	
1800-1809 10-yr average	6.23%
1810-1819 10-yr average	5.90%
1820-1829 10-yr average	4.55%
1830-1839 10-yr average	n/a
1840-1849 10-yr average	5.16%
1850-1859 10-yr average	4.72%
1860-1869 10-yr average	5.34%
1870-1879 10-yr average	3.96%
1880-1889 10-yr average	2.13%
1890-1899 10-yr average	2.55%

Source: Sidney Homer, *A History of Interest Rates: Third Edition, Revised* (Rutgers University Press, 1996), 286-288.

This 100-year record isn't meant to imply that interest rates began to rise in 1900. For the one and a half centuries prior to the 1950s, interest rates were low and relatively stable, which is one of the factors that explains the bond bear market of the 1960s and 1970s. At that time, no one believed a bond bear market was possible but, of course, it happened. In the aftermath, all sorts of interesting concepts were created, including duration and convexity, to manage the potential variability of a bond portfolio in the event that interest rates were to rise. Until the 1960s and 1970s, these concepts weren't really needed.

Few today have thought through the issue of reinvestment rate risk. In the 19th century, there was no concept of convexity, but a great amount of attention was paid to reinvestment rate risk. People wanted long-term bonds with extended call protection, because their experience was that, generally speaking, interest rates declined.

What a 1.55% Yield Really Means

Investors have swung in a vast oscillation since the 2008/2009 financial crisis, from a rampaging flight to safety to an unquestioned quest for yield. In 2009 and 2010, the shift of capital to the perceived safety of short-term U.S. Treasuries created extraordinary clearing-price chaos in long-dated securities of almost every sort, including, as a relatively objective frame of reference, investment grade municipal bonds. For a good two years, as we described from time to time, it was actually possible to acquire high-grade closed-end municipal bond funds at yields exceeding 6% to 7%, at up to double-digit discounts to NAV, with, moreover, the NAV itself reflecting an average discount of 10% or more to the constituent bonds' face value—all in a low-interest rate, low-inflation rate environment. That will likely prove to have been a once-in-a-lifetime opportunity to purchase a far higher long-term income stream than a given portfolio could normally afford. That opportunity has ended, since the fear of financial market and economic catastrophe has now been replaced by the fear of income insufficiency and reinvestment risk. Sadly, municipal bonds in those same funds now trade at meaningful premiums to their face value.

Accordingly, in the unfortunate rhythm of these oft-repeated cycles, that same capital that missed the clearing price opportunity in long-dated bonds, as well as the partial recovery in equity valuations, is now in a quest for an adequate rate of interest, with a professed continued requirement for safety as well.

The fear of reinvestment risk is legitimate. To frame it from the perspective of an individual investor, we might begin with the life expectancy at birth. When the Social Security Act was enacted 77 years ago in August 1935, and funded with—let us pause for emphasis—\$49.75 million for the needy in “old age,” the average American had a life expectancy at birth of 61.7 years. It was actually improbable that a large portion of the population would live long enough to collect social security. Even in 1972, on the eve of massive increases in interest rates, life expectancy in the U.S. was only 71.2 years. Today, life expectancy at birth is 78.7 years, and if you happen to be 60 years old, you can expect to live for slightly more than 20 additional years. Hence, for the first time in American history, there is a need for people to live off the earnings of their own capital, as social security payments provide only poverty levels of income (see below).

Unfortunately, as we already know, AGG has a distribution yield of 2.44%, but an average yield-to-maturity of 1.55%; little-by-little, the higher coupon bonds are maturing, so the distribution yield and yield-to-maturity are in decline. A couple who has accumulated \$1 million in savings over a lifetime and invests it all in that index, which is effectively a mirror of the whole bond market, would earn \$15,500 in income from their portfolio before taxes. Since, according to the U.S. Department of Health and Human Services, the 2012 poverty level for a two-person household in the 50 contiguous states and the District of Columbia is \$15,130, that couple would not, technically speaking, be impoverished. So with \$1 million of wealth, you can earn \$370 more than the poverty level.

Of course, most people won't save a million dollars and, therefore, if that lower sum were invested in the bond market, the earnings on those savings would be below the poverty level—considerably below. There is, of course, Social Security, and the average Social Security monthly payment in the United States is \$1,229, which is \$14,478 annually—also below the poverty level. Our two-person household, though, with \$1 million in savings, could be above the poverty level. But even they are not earning a great deal of income, so the only alternative is to consume one's capital in retirement, as opposed to earning a yield on it. Now, that must be very frightening, if you think it through, because one must balance the heretofore delightful prospect of, perhaps, excellent health in retirement with the fearful prospect of exhausting one's capital.

Incidentally, pension funds and even endowments invested in the bond market have essentially the same problem. If bonds were to yield 2%, what would happen to the pension fund industry that assumes it will earn an 8% rate of return? Clearly it would be problematic. What would happen to foundations and endowments that have 5% legal payout requirements if their bonds were to yield only 2%? If an endowment has a 5% payout requirement, but it does not earn in excess of 5%, eventually the foundation will disappear.

The Dangers of Trying to Replace What Was Lost and the Wrong Way of Avoiding Volatility

The mantra of a few years ago was safety, or suppression of volatility. Today it is yield and safety. But reality does not match the mantra. Whatever people say about wanting yield AND safety, they have now

purchased sufficient quantities of the 10-year Treasury note in the quest for income that it yields only 1.5%. Say what you will about it, but there is nothing safe about a 10-year, 1.5% Treasury. If, one year from now, that Treasury were to yield merely 3.5%, the holder of that note would experience a price decline of 15%, equivalent to a loss that is 10x the magnitude of the expected return. Even equity investors don't dabble in stocks that offer that sort of return profile. In the S&P 500, a 15% drop calls forth newspaper articles presaging a bear market.

Among the places to which capital has now been reflexively fleeing is utility stocks, as well as MLPs, of course, and other yield-oriented securities. We'll examine just one of these as a lesson against unexamined conventional wisdom. Net inflows during the 12 months ending June 30, 2012 to State Street's SPDR Utilities Select Sector ETF (ticker "XLU"), the largest utility sector ETF, with \$6.6 billion of AUM, have increased XLU's size by about 28%; inflows into the 2nd largest such ETF, the Vanguard Utilities ETF ("VPU") have increased its size by about 40%. As a point of reference, two of the largest S&P 500 Index ETFs, the SPDR S&P 500 ("SPY") and the iShares S&P 500 Index Fund ("IVV"), saw net inflows of only about 9% and 4.5% during the past year. The reasons are clear enough: XLU has a 2.9% dividend yield, and VPU has a 3.6% yield.¹

There is the presumption that utility stocks are safer stocks, which in today's parlance means less volatile. However, variables such as volatility are not predictive of what will develop, though the statistics are used as if they are. They simply measure what has already happened, and this data can be further refined by a great variety of sophisticated statistical treatments to buttress the sense of predictive capability. Yet, there is no information in those figures as to what circumstances served to create that price history or, therefore, what might alter that pattern. This is one of the limitations and often misleading effects of time series analysis and volatility statistics without contextual analysis.

Here, then, is some contextual analysis, to take us away from the day-to-day price and volatility reporting to which we are all subjected. We will consider the XLU, in which the ten largest positions as of June represented 55.7% of the portfolio. First of all, that's pretty concentrated, which is what happens to indexes over time, so there is more than a little security-specific risk in this ETF. And it's worthy of note that the tenth security, Progress Energy, has since merged with Duke Energy; consequently, this ETF is now even more concentrated.

Secondly, one may calculate a general case expected return based upon the basic profitability of these companies. This makes use of a traditional formula known as the Dupont Model, which is displayed in the accompanying table. The table has four columns: the dividend yield of these ten companies; their return on equity; their dividend payout ratio; and their resultant estimated total return. The last measure is calculated as: one minus the payout ratio (the earnings retained on the balance sheet after paying dividends) times the return on equity (that which the company is theoretically capable of earning on the retained earnings), plus the dividend yield.

¹ www.bloomberg.com, www.vanguard.com, www.spdrs.com, www.indexuniverse.com, www.etfdb.com

Utilities Select Sector SPDR (XLU) Ten Largest Holdings June 2012

	Yield	ROE	Payout Ratio	Theoretical Total Return
Southern Co. (SO)	4.08%	12.58%	76.0%	7.09%
Exelon (EXC)	5.61	11.34	86.0	7.42
Dominion Resources (D)	3.92	11.93	80.0	6.31
Nextera Energy (NEE)	3.54	14.19	45.0	11.34
Duke Energy (DUK)	4.30	6.53	89.0	5.02
Firstenergy Corp (FE)	4.54	8.76	81.0	6.20
American Electric Power (AEP)	4.71	11.20	56.0	9.63
PG&E Corp (PCG)	4.02	7.32	84.0	5.19
Consolidated Edison (ED)	3.84	8.91	69.0	6.60
Progress Energy (PGN)	4.10	5.32	118.0	n/m

Source: Bloomberg, Company reports, Horizon Kinetics research

You'll observe that Nextera, via the Dupont Model, is the only security to generate a double digit rate of return. Most of the others fall within the 5% to 7% range. Now, that shouldn't be confused with the expected rate of return. That's because the DuPont Model assumes that none of the utilities will actually have a regulatory problem which, unfortunately, many periodically do.

Although all of the ten leading holdings of this fund have experienced earnings volatility in the last ten years; they haven't experienced a major regulatory problem yet. For example:

- Southern Company had flat earnings between 2007 and 2010;
- Dominion Resources had earnings declines in five of the last ten years.
- Duke Energy, which is in the process of acquiring Progress Energy, actually had huge problems in 2003 in the aftermath of Enron with take or pay contracts, and though the company wasn't quite existentially challenged, it experienced severe losses.
- Nextera, formerly Florida Power and Light, had earnings declines three times in the last decade.
- First Energy had two big earnings declines; one in 2003 and one in 2011. And in 2011 it didn't even earn its dividend.
- American Electric Power had two earnings declines in the last ten years in addition to major earnings problems in the wake of the Enron debacle with take or pay power contracts, and actually cut its dividend in 2004.
- PG&E actually filed for bankruptcy in 2002 in the wake of the Enron debacle, and didn't pay a dividend between 2001 and 2006.
- Consolidated Edison had three earnings declines in the last ten years and its annual dividend growth rate has been 87 basis points a year, or less than 1% per year for the last decade.
- Progress Energy had lower earnings in 2011 than in 2002, which is one of the reasons it's merging with Duke Energy.
- Exelon actually had a very substantial earnings decline, in part due to lower wholesale power rates.

As a matter of fact, many of the companies have had problems with lower wholesale power rates, because the utility regulatory environment has been moving away from one of a regulated, predictable

rate of return, to one of a less predictable and not at all assured rate of return; therefore, utilities are being subject for the first time in history to competition.

Today, it is probably safe to say that the Dupont Model return is really the maximum that can be reasonably expected to be earned. In the era when utility yields were higher, the Dupont Model did not represent the maximum because the inevitable utility crises were to a degree masked or at least equilibrated by the lower required dividend yields (higher share prices) attendant to years of declining interest rates. Since that's no longer the case, one is getting, at best case, the Dupont Model return minus a certain error return, whatever that error return is going to be.

But wait, there's more. If interest rates remain low, then as the outstanding bonds of these utilities mature and are replaced by lower-cost borrowings, the public utility commissions will ultimately, most probably, lower the allowed rate of return for the utilities, which would result in lower profitability.

Now, here is a final point about the use of historical volatility figures. On paper, utilities are not volatile, but this is misleading because in practice the volatility tends to occur rarely, in brief quantum bursts, such as when a regulatory problem emerges, whereupon the utility falls in value to a new intrinsic-value price, at which point it ceases being very volatile. So to actually pick securities on the basis of low volatility in share trading price and assume that they therefore won't represent much in the way of risk, is completely fallacious and yet it's being done.

To complete the discussion of the XLU, its annualized rate of return from its December 1998 inception date to the end of 2011 was 5.13%. And it was 5.13% not because there wasn't price appreciation among utilities due to declining interest rates. Rather, it was despite a favorable period of declining interest rates, because there were a sufficient number of regulatory and other problems to offset in relatively significant manner what would otherwise be appreciation realized from the underlying returns of the sound utilities and the lower yields resulting from lower interest rates. Therefore, we can only wonder what might happen not in a period of rising interest rates, but in period of merely stable interest rates.

Consequently, there really isn't any broad swath of the fixed-income markets that can any longer provide a reasonable return on one's money, at least not for a suitably modest level of risk. There are individual, highly selective securities, such as certain corporate bonds, convertible bonds, preferreds, REITs, and the like of sufficient quality and discounted price that can provide a quite reasonable yield. But these will have higher volatility than many would be comfortable assigning to the bulk of their income-generating portfolio. The only other choice is to manufacture sufficient yield, and at a low level of volatility. This can be done, and we have been engaged in such efforts, but that is another discussion.

Portfolio Review

If one were to draw a Venn diagram of the critical, motivating elements in the financial markets today, two of the largest intersecting circles should be labeled Ultra-Low interest Rates/Reinvestment Risk and ETF Proliferation/Equitization of Asset Classes. While our quarterly reviews have traditionally been narrowly about equities and Horizon Kinetics equity strategies, investing does not take place in a vacuum: other people's clearing prices matter, as do capital flows, when they get large enough. The excruciating pressures of declining coupon income, the maturation problem and reinvestment challenge

as bonds come due, and the need (for institutions and individuals alike) to do *something*, will force action.

In the absence of obvious alternatives, some of those actions will be ill considered, irrational, even extreme. They will occur in a financial biosphere in which bizarre pricing behavior and instruments for such action have already been created among the universe of proliferating ETFs, with more on the way. Among the outlets for action, some of which cannot be imagined as yet, will be the search for securities that can produce idiosyncratic returns, which is to say the possibility of reasonable investment results irrespective of broad-based index returns. Another search will be for otherwise ordinary securities that happen to be under-researched or under-owned, such that one can earn a reasonable return on the cost of incremental analysis.

That used to be harder. However, the number of paid analysts on Wall Street has declined over the years, coincident with declining commission rates, the segregation of stock broking from investment banking, and the coming of age of internet-based brokerage—how many analysts can be supported on a couple of pennies per share or an \$8.95 flat trading fee? There will be those who discover or rediscover the sorts of equities we own, and the valuation gap that those securities embody will close or invert, in which case we may one day have to cope with the problem of overvaluation.

It's obvious enough that our selection criteria differ from the typical, so perhaps it's to be accepted that they are occasionally misunderstood. Although we've spoken much about owner-operator companies, for instance, we've been asked if it is wise to make such a large 'bet'—yes, I've heard that term—on a single sector. The reality is the opposite, because we believe that there is more industry sector diversification among these companies than in the universally employed Standard Industrial Classification System ("SIC") coding system. Also, the owner-operator characteristic is a predictive attribute for satisfactory or above-satisfactory returns. But it is only one of many predictive attributes we select for. To illustrate by way of comparison, think of the standard roster of technical-sounding factors by which companies and stocks are ordinarily described, such as industry sector, market capitalization, geographic sector, volatility, P/E, revenue growth, and so forth. These all describe aspects of a company—call them descriptive attributes—but they don't actually offer any predictive value as to how it will perform.

On the other hand, if you were to select a company that has a long product lifecycle (such as Corn Flakes, as opposed to a brand of cell phone), such that it faces less risk of technological obsolescence; or a company with a dormant or hidden asset not reflected in the trading price of the shares, such as a content library or real estate purchased at a very low historical cost, then you would be selecting for factors that have predictive value as to potential business or share price returns. The owner-operator variable is one, albeit an important, predictive attribute. The more predictive attributes that attach to a company, the greater the weight we tend to give it within a portfolio. Among a selection of our largest equity holdings, the following predictive attributes might apply.

Selected Holdings:	Liberty Media Corp.	Jarden Corp.	Brookfield Asset Mgmt	Howard Hughes Corp.	Auto Nation Inc.	Henderson Land Development	Leucadia National Corp.	Dream-works Animation	Sears Holdings Corp.
Ticker:	LMCA	JAH	BAM	HHC	AN	12HK	LUK	DWA	SHLD
Owner-Operators	✓	✓	✓	✓	✓	✓	✓	✓	✓
Bits and Pieces	✓		✓			✓	✓	✓	
Dormant/Hidden Assets	✓		✓	✓		✓	✓	✓	✓
Scalability	✓	✓	✓		✓	✓		✓	
Terms-of-Trade	✓		✓				✓	✓	
Product Lifecycle		✓	✓	✓	✓	✓			✓
Industry History	✓	✓	✓	✓	✓	✓	✓	✓	
Spin-Off	✓		✓	✓			✓		✓
Valuation	✓	✓	✓	✓	✓	✓	✓	✓	✓

Source: Horizon Kinetics research

The largest holding in many of our strategies, and that which probably attaches to the greatest number of predictive attributes, is Liberty Media Corporation (“Liberty”). Although we’ve reviewed this company before, not all of its qualitatively positive characteristics have been detailed. We will review these here, including a strategic asset held by Liberty that is not only a form of hidden asset, but is a form of ‘bits and pieces’ as well, meaning it is a separately traded security, and which also has an enormous scalability advantage—that is, its 46.2% (and growing) interest in Sirius XM Radio (“Sirius”).

Before attending to Sirius, though, Liberty’s primary operating business is the Starz and Encore series of cable channels. Starz has over 54 million subscribers and is one of the largest such properties in the U.S; it is highly profitable and continues to expand, and it is a very scalable business. It is on the right side of the content divide, which gives it terms-of-trade advantage. This was very publicly exhibited when it rejected Netflix’s offer late last year to renew, at 10x the original price, a 3-year contract to redistribute Starz content over the internet.

Liberty also owns shares of a variety of publicly traded companies, such as Live Nation Entertainment, Inc. and Barnes & Noble, Inc., which are not pertinent to its operations and which are periodically hedged. The Sirius position is not hedged, and Liberty has been increasing its shareholdings of late, attempting to gain control of the Board of Directors. Before further explaining the Sirius element, let us first understand that Liberty, net of all debt, has over \$1.5 billion of cash, which is an unusually liquid position for a company with an \$11 billion stock market capitalization. Liquid, or underleveraged, balance sheets are characteristic of owner-operator companies; in this case, the owner-operator is John Malone, who has 40.7% voting control of Liberty.

Another owner-operator characteristic is the aggressive, opportunistic use of a liquid balance sheet during a period of financial stress. Liberty's relationship with Sirius commenced on February 17, 2009—within a few weeks of the stock market lows of the financial crisis of 2008/2009. At this tumultuous moment, Liberty extended a series of lifeline loans to Sirius, in aggregate equal to \$530 million (includes \$100 million in Sirius debt assumed by Liberty), which enabled the company to avoid a bankruptcy; in exchange, Liberty received a \$30 million structuring fee and a 15% coupon payment on \$400 million of the loans in addition to a preferred share class that is convertible into 40% of Sirius equity. At the time, the Sirius shares traded at about \$0.15, having peaked at over \$50 in the year 2000. The Liberty Media loans were fully repaid with interest by May 2011, yet Liberty Media maintained its 40% stake. A liquid balance sheet, in the right hands, can be a beautiful thing.

As to valuation, one may view Liberty from two vantage points. The first is to simply price the company relative to its operating earnings. To do this properly, one should subtract from its \$10.5 billion stock market capitalization, the \$10.35 billion market value of cash and publicly-traded shares held on the balance sheet, since these are not necessary to the business itself. The company could, in principle, pay these out to shareholders as a special dividend and continue to generate the same level of earnings. Priced accordingly, one will find that the company trades at only 0.35x – to be clear, that is less than 1x – analysts' consensus 2012 adjusted net income. Is this not an extraordinarily low valuation for a company of this quality? Comparable media companies such as Disney, AMC Networks, and Discovery Communications will be found to trade in the range of 15.5x to 18.0x analyst consensus 2012 adjusted net income².

The preceding exercise, however, while convenient for establishing that the company is dramatically mispriced, whether in respect of its own earnings capability or by comparison with similar businesses, is a bit artificial. Mr. Malone has not chosen to hedge his Sirius position and, indeed, is seeking to increase his control of the company. So neither should we presume to exclude it. What value does he see in it? Sirius is a business that requires an enormous fixed cost before it can serve even one customer. Before any customer is served, all of the radio spectrum must be acquired, all the satellites must be launched, and all of the radio broadcast infrastructure and on-air talent must be secured. Once that happens, an innumerable number of customers may be served immediately, if they are even available in sufficient quantity.

² In the interest of full disclosure, it bears noting that John Malone formerly served as CEO and Chairman of Discovery Communications, he remains on its Board of Directors, and holds a significant voting stake in the company.

The time span between the initial public offering, which is an early part of the fund raising process, and actually achieving the critical mass of customers required to pay for the ongoing operating expenses as well as the interest expense on the debt incurred, can be very long indeed. Horizon’s first research report on Sirius, focusing on some of its publicly-issued debt, was in February 2001, while the company was not yet operational and was still attempting to induce automobile manufacturers to install satellite radios in new cars. It has only been during the past few years that Sirius has approached this critical mass, as is easily observable in the table below. One will note that Sirius did not achieve an operating profit until 2009, or a net profit until 2010—nearly 20 years after the company’s founding in 1990. Now that Sirius has staved off bankruptcy (in 2009) and is comfortably profitable, John Malone has stated his intention for Liberty Media to either seek control of Sirius and or spin off the Sirius stake to Liberty investors.

(\$ mill.)	FY 2013 E	FY 2012 E	FY 2011	FY 2010	FY 2009	FY 2008
Revenue	\$ 3,759	\$ 3,375	\$ 3,014	\$ 2,817	\$ 2,473	\$ 1,664
Operating Income*	997	740	676	529	261	(260)
Less: Interest Expense			(305)	(296)	(316)	(306)
Net operating income			371	233	(55)	(566)
Add: non-cash deprec. & amortiz. expense			268	274	309	204
Less: capital expenditures			(137)	(312)	(248)	(130)
Operating free cash flow			502	195	(6)	(492)

*Before restructuring costs, impairments, etc.

Source: Bloomberg

That could well be a valuation catalyst by simplifying the capital structure of the two companies and making more prominent the earnings capability of Sirius. As well, Sirius offers yet more value: the radio spectrum owned by Sirius is a form of hidden/dormant asset. There is a finite amount of bandwidth available for those who wish to distribute content or data wirelessly, and the prices for such bandwidth have increased markedly of late with the widespread adoption of wireless devices. A legacy of the 2008 merger of Sirius Satellite Radio and XM Satellite Radio, the sole two such companies licensed in the U.S., is what appears to be excess spectrum that the company does not require for its operations. Although we cannot speculate as to the ability of Sirius to readily monetize the spectrum, it certainly is a form of added optionality. Each company paid somewhat over \$80 million for their FCC licenses in 1997.

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.

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.