2nd Quarter Commentary

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Would the Real S&P 500 Index Please Stand Up (or, Wouldn't It Be Nice to Know How it Really *Did All These Years?)*

While much of the recent market commentary offered by the major media outlets is focused on the now more than four-year-old stock market rally, whether it can continue and whether the uninspiring prospects for the fixed income market may result in a "great rotation" into equities, it is interesting to note that the largest corporations in the S&P 500 Index ("S&P 500" or the "Index") do not actually appear to be growing much, if at all. Of the 20 largest non-financial corporations in the S&P 500, only one-half experienced any revenue growth in the first three months of this year relative to the same period last year. The aggregate sales growth of these largest U.S. companies (the first being Apple, the 20th Disney) was only 2%; excluding Google, growth was not even one-half of 1%. Perhaps these largest companies are now too large to grow at a meaningful rate, which has implications for investors in the largest companies; or perhaps it was just a bad quarter.

Company	Revenue Growth Q1 '13 vs Q1 '12
Apple	11.20%
Exxon	-10.10%
Microsoft	17.80%
Chevron	-6.40%
Johnson & Johnson	8.70%
General Electric[1]	-9.30%
Google	31.10%
Procter & Gamble	2.00%
IBM	-5.30%
Pfizer	-9.40%
AT&T	-1.30%
Coca Cola	-0.90%
Philip Morris Int'l	2.80%
Verizon	4.30%
Merck	-8.60%
Wal-Mart[2]	3.90%
Pepsi	1.60%
Oracle	-0.90%
Intel	-2.30%
Disney	10.40%

[1]Excludes GE Credit.
[2]Quarter ended 1/31/13.
Source: Company reports

There is another question, though, more subtle yet with deep implications for any investor who selects equities, makes asset allocation decisions, or conducts retirement planning or pension plan funding projections. What if the historical returns of the S&P 500, which form the basis for projecting future stock market returns, and which therefore powerfully influence the proportion of a pension plan or 401k that will be allocated to stocks or bonds, are not actually representative of what investors are purchasing if they invest in the index today? The nature of the S&P 500 today is different than it was before 2005. The difference came about this way: in order to accommodate greater quantities of assets for management in investment products linked to the S&P 500—that is, provide greater liquidity—Standard & Poor's shifted to a float-adjusted weighting system for the index constituents. The problem for users of the Index was that if 40%, say, of the shares of a company like Microsoft were owned by insiders, there might be an insufficiency of publicly available shares, or float, to accommodate the volume of assets destined to buy those shares without inflating the share price and valuation. In practical terms, float-adjustment means that a large company like Oracle or Microsoft would have its weighting in the index reduced by the amount of inside ownership. The higher the inside ownership, the smaller the weighting would be set, so that there would be a proportionately lower index-based demand for the shares.

The entrepreneurial companies of today, those with substantial inside ownership (think Tesla or Google) are accorded lower weights in the S&P 500 than would have been the case prior to

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2005. Likewise, their impact upon the Index's returns will be lower than they would have been prior to 2005, when they were given full weight based upon their stock market capitalization. Therefore, the historical returns of the S&P 500 are no longer continuous with or representative of what the S&P 500 is today. How big would the impact have been on the S&P 500 had the entrepreneurial companies of the past been float-adjusted, as they are today? Let's review two examples known to all: Wal-Mart and Microsoft, which span two generations of innovative service and technology business development in the U.S.

Wal-Mart was added to the S&P 500 in August 1982. Its initial weighting was a mere 0.25% Sam Walton died in the first week of April 1992. During that decade, the Wal-Mart stock price appreciated by 28.0x, which translates to over 40% per year, and its Index weighting expanded to 2.0%. Inside ownership in 1982 was 38%, as it was after Sam Walton died. Had the S&P 500 applied its current float-adjusted rules back then, 38% of that spectacular return would not have been part of the historical S&P 500 return.

Just a couple of years later, in 1994, Microsoft was added to the S&P 500, at a 0.85% weighting. Insiders owned about 40% of the shares. When Bill Gates announced his departure a dozen years later in 2006, the shares had risen in value 8.3-fold, or by over 19% per year (and the S&P 500 by 9.1% per year, inclusive of dividends). Microsoft's weighting in the Index had expanded to 2.0% (and was as high as 2.6% in 2004). A large part of this return would also have been lost from the S&P 500 had it been float-adjusted at the time. The liquidity-motivated float-adjustment mechanism, even if applied only to these two companies, would have had a measureable negative impact upon the Index's returns. What of the others: the Apples, the Intels, the Hewlett-Packards, the Nikes, the Starbucks, the Schwabs? The S&P 500 today cannot provide what it did in the past, to the degree that any great future entrepreneurial ventures will find their way into the Index.

As an aside, there is something interesting about the pattern of the Microsoft share ownership. When added to the S&P 500, the share price was about $2.41. At January 1999, when the stock was $44.75, insiders still owned 31% of the shares. By September 1999, near the peak of the Great Technology Bubble, when the shares were $47.50 (and when Microsoft's weight in the S&P 500 exceeded 4%), inside ownership had been reduced to 26%, and by early September 2000, the very threshold of the collapse of that bubble, when the stock was $35, inside ownership had dropped to 19%. Today, 13 years later, the shares are lower than that. Whether by fortune or perception, insiders were dramatically reducing their holdings going into a decade-plus period of decline and stagnation. What did outsiders do? Had the float-adjusted index weighting method been in place at the time, as insiders sold, such that the float increased, the Index rules would have increased the Microsoft weighting, and mutual funds and other index investors would have been buying more—more of what the insiders were selling. It's not your grandfather's S&P 500.

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Valuations and Company Commentary

We've been asked about valuations—what type of future returns to expect after the recent price appreciation in many of the stocks in our portfolios. To begin the answer narrowly, we do intend, as a matter of logic and philosophy, to sell shares that in our estimation are priced at levels that are either unsustainable or no longer suggestive of alluring future returns in the context of their business model or business risks. For instance, in the first few trading days of January, the position in the Core Value holding Lennar Corp, the homebuilder, was reduced by 50%. The shares had appreciated to the degree that the price anticipated a full recovery in the homebuilding sector, such as existed in 2006. What else can go right? A small weighting is still retained since the company might spin off an interesting division named Rialto that was created to opportunistically purchase distressed real estate loans and properties in the wake of the 2008/2009 financial crisis.

On the other hand, we have added significantly to five Core Value positions this year: Colfax Corp, DreamWorks Animation SKG, Starz, Viacom, and Wendy's. To give a sense of the long-term earnings and valuation possibilities for one of these, DreamWorks Animation SKG, which we increased by 33%, one might start with the "SKG" suffix, which is an acronym for founders Steven Spielberg, Jeffrey Katzenberg, and David Geffen. They collectively own 22% of the shares. The company has a film library that until recently consisted exclusively of DreamWorks-produced animated movies such as the Shrek and Madagascar series. That asset base continues to expand, as the company's film production schedule is for three films per year.

Last year the company made some significant strategic choices. First, it acquired Classic Media, so the DreamWorks library now also includes a portfolio of older movies and TV series featuring such characters as Lassie, Casper the Friendly Ghost, and The Lone Ranger, among many others. It intends to re-commercialize some of these as television series. The company also announced two significant initiatives in China. One is a joint venture with China Media Capital to produce original Chinese animated and live action films. DreamWorks owns 45% of the new company, called Oriental DreamWorks, which has been capitalized initially with $330 million. Relative to the approximately $2.0 billion market capitalization of DreamWorks, that is no small sum. The joint venture's first project is based on a wildly popular Chinese series of adventure books called Tibet Code. The other effort in China, with local partners, is called The Dream Center, a giant riverfront development in Shanghai that is expected to cover six large city blocks and include theaters, restaurants, shopping, and even an entertainment zone with a "Kung Fu Panda" theme. That project is underway and is expected to be completed in 2016.

Finally, in the past quarter, DreamWorks signed two unprecedented television distribution contracts, including over 300 hours of original content, first-run programming with Netflix. This will provide an entirely new revenue steam and will largely leverage well-recognized and established characters from the DreamWorks content library. Furthermore, the success of the television distribution may very well lead the company towards developing its own children's television network in the coming years.

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Now, there's a problem with the DreamWorks stock, which is that the investment community doesn't seem to appreciate it much. The share price today is more than one-third lower than its initial trading price in late 2004. The shares tend to fluctuate with the box office success of the company's latest theatrical release and whether investment analysts are excited or disappointed. However, there is an entirely different and far more important dimension to the long-term value of its proprietary content. Once a film has been produced, it is an asset that exists in the film library—practically speaking, forever. Additional revenues may then be generated from the library as, for instance, from DVD and streaming sales, or television broadcasts, at very little incremental cost. A successful film may form the basis of a franchise, including subsequent theatrical releases and television series—for example, there are now three Madagascar movies, as well as a television series based on a subset of the characters. The characters may be licensed for merchandising or for use in other entertainment venues.

If there is a key statistic for valuing DreamWorks, it is not the success of its most recent film, but the growing size and value of its film library, which can continue to generate earnings for generations and which provides DreamWorks' bargaining power to strike deals such as the theme park and distribution agreements noted above. By our calculations, the market value of DreamWorks is roughly equivalent to the value of the library, separate from the earnings from new releases that form most of the basis for near-term price targets. While any investor can readily find the company's most recent revenue or earnings figures on a financial market website, one can't screen for the number of titles in the DreamWorks library.

As to true optionality, the Chinese market is so enormous that even a very modest success for DreamWorks' efforts there could materially benefit earnings. It speaks to the value of intellectual capital, which is the epitome of a scalable asset.

To respond to the valuation question more broadly, investing at Horizon Kinetics has never been easier. Really. Value investors in our style, who prefer companies possessed of strong business attributes, traditionally had few opportunities to acquire such companies at advantageous prices. They generally traded at high valuations befitting their high quality. Appropriate entry prices would usually appear only upon the occurrence of some misfortune—a misfortune that would be resolvable over time, or which was the cause of an overreaction on the part of sellers. By its nature, this approach involved controversial or challenged companies. And then, too, we had to compete with like-minded value investors.

But all that has changed. The primacy of indexation—of investing through baskets of securities—has given rise to the ETF divide. This segregates the investable world into those securities on the 'right' side of the divide, those that receive their ongoing share of buying demand every day, and those on the 'wrong' side, which are more and more ignored or invisible to those who see the investment world through the lens of indexation. The companies we tend to prefer also tend to be on the wrong side of the ETF divide. The rest of the world, as it invests via exchange-traded funds, or ETFs, makes individual security selection ever easier. Whereas we used to require a negative event to create a buying opportunity, quite superb

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companies with no blemishes or controversy are now on sale, much like retailers' every-day sale pricing. And the ranks of value investors have thinned as well; some have gone over to the other side (the ETF side); others have retired or otherwise closed their doors.

The table below is illustrative of the ETF divide at work in our portfolios. For the five companies mentioned above, in which we increased positions substantially this year, it displays the number of ETFs in which they rank among the top 10 holdings (according to the website www.ETFdb.com). We'll call that being popular. One will note that they show up in one or two or no ETFs, usually as small holdings and, generally speaking, those ETFs have little in the way of assets under management, on the order of some tens or some hundreds of millions of dollars. As a basis of comparison, we've also shown some rather more popular companies in some of the same industries: Disney, McDonalds, and United Technologies. Those are each among the top 10 holdings in about a dozen ETFs, generally as rather large weightings, and individual ETFs in which they figure contain assets measured in the billions of dollars, even the $10 billion-plus range.

Company	# ETFs in which Top 10 holding	Weight in ETFs	Size of ETF
Colfax Corp.	1	1.74% of Industrials/Producer Durables AlphaDEX Fund (FXR)	$242 million
DreamWorks Animation SKG	1	0.22% of FTSE RAFI US 1500 Small-Mid Portfolio (PRFZ)	$663 million
Starz	2	4.56% of Guggenheim Spin-Off ETF (CSD)	$235 million
		2.65% of Dorsey Wright Technical Leaders Index (PDP)	$931 million
Viacom, Inc.	1	2.61% of Dynamic consumer Discretionary Profile (PEZ)	$23 million
Wendy's Co.	0		

Source: www.etfdb.com as of 7/18/2013

For comparison:

Company	# ETFs in which Top 10 holding	Weight in ETFs	Size of ETF
The Walt Disney Company	12	*5% or greater weight in 3 ETFs:*	
		6.49% of Consumer Discretionary Select Sector SPDR (XLY)	$7 billion
		5.02% of Dynamic Leisure & Entertainment Portfolio (PEJ)	$120 million
		5.00% of iShares U.S. Consumer Services ETF (IYC)	$433 million
McDonald's Corporation	13	*5% or greater weight in 2 ETFs:*	
		5.66% of Consumer Discretionary Select Sector SPDR (XLY)	$7 billion
		5.09% of Dow Jones Industrial Average ETF (DIA)	$13 billion
United Technologies Corp.	9	*5% or greater weight in 2 ETFs:*	
		9.09% of iShares U.S. Aerospace & Defense ETF (ITA)	$108 million
		6.27% of Aerospace & Defense (PPA)	$54 million

Source: www.etfdb.com as of 7/18/2013

Let's call it a new common wisdom. The difference in popularity between the stocks on one side of the ETF or the other mediates major differences in valuation: the 'popular' stocks are pretty expensive; the unpopular stocks are pretty inexpensive. Perhaps there should be a Popularity Index, a sort of aggregation of Top 10 lists, so that investors can know the popularity choice they're making when buying certain stocks or ETFs.

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