3rd Quarter Commentary

October 2013

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A Review… Fewer Words, More Pictures

No one can accuse us, in these pages, of not being diligent in using our words, though we have been accused at times of using too many. So this review switches modalities somewhat, with more exhibits and fewer words. What won't switch are the themes, which are as relevant as ever: 1) the important and dysfunctional ways in which indexation is affecting security valuations, risk, and returns; and 2) the antithesis of indexation—active management and individual security selection, of which we, certainly, are practitioners.

The rise of indexation in the modern (post 2008/2009 Credit Crisis) era:

Assets in rules based investing via ETFs have risen roughly 10-fold in the past decade—this is a major phenomenon.

	2002	2012	Change
No. of ETFs in U.S.	113	1194	957%
Number of U.S. Listed Stocks	5,685	4,102	(28%)
AUM in ETFs	$102 bill	$1.2 trillion	1,182%

Sources: ICI Fact Book, http://data.worldbank.org/indicator/CM.MKT.LDOM.NO?page=2

($ bill.)	2008	2009	2010	2011	2012
Equity mutual fund net outflows/inflows	-229.1	-1.8	-23.4	-128.3	-153.1
ETF equity net inflows	143.6	42.1	80.0	68.6	123.9

Source: ICI

These assets have flowed into ETFs even as funds flowed out of equities over all, year after year.

Even within equity mutual funds, which are traditionally actively managed, the proportion of assets indexed has increased by almost 50% since the Credit Crisis.

	2007	2012	Change
% of domestic equity mutual fund assets invested in index funds	11.5	17.4%	47%

Source: ICI

Prices in the marketplace are made by the marginal, or last, buyers or sellers—it's not the 99%+ of Apple's shareholders who determine its price, but the net buying or selling pressure of the fractional percent who are transacting on a given day. It's certainly not us: we've been accused of harboring *really* long-term holding periods—years and even decades. Granted, we inhabit one end of the spectrum. So, here are some recognizable benchmarks: the annual turnover rate for IBM (the proportion of its outstanding shares traded each year) is about 83%; the figure for ExxonMobil is 68%. The average mutual fund has 68% annual turnover.

Now, for two of the most popular exchange-traded funds (ETFs), the large-company SPDR S&P 500 Index ETF and the iShares Russell 2000 Index ETF, which is supposed to provide exposure to small company stocks, their annualized turnover, respectively, is 3,309% and 3,340%! Yes, I said 3,340%! The average holding period is measured in days.

Annual Share Turnover	
ExxonMobil	68%
IBM Corp	83%
Average domestic equity mutual fund*	68%
Horizon Kinetics equity strategies**	
Core Value	15%
Strategic Value	12%
Research Select	30%
Small Cap	14%
Large Cap	10%
Spin-Off	9%
SPDR S&P 500 ETF (ticker SPY)	3,309%
iShares Russell 2000 Index (IWM)	3,340%

**Source: Morningstar, based on last annual report for each fund.*

***For the 12 months ended September 2013*

Every Which Way but Right

Classification Confusion

In relying on an index or ETF description, investors no longer bother (or believe they need) to evaluate the stocks they own, if they happen to be owned through that index. This both creates, and is blind to, some remarkable, suitable-for-cocktail-party-story imbalances. Let's just say one wished to have some exposure to Spain. Perhaps the intent is to profit from excessive fears of its economic demise. One chooses to participate via an ETF like the iShares MSCI Spain Index Fund (EWP). Unfortunately, all that's really been accomplished is to invest *outside* of Spain, not inside: roughly three-quarters of the revenues of the companies in this ETF come from outside Spain. If you examine these companies individually, you'll find that EWP might be fine if you want to invest a bit in Venezuela, Mexico, Ireland, the UK, and Slovakia, but it is not a very good way to invest in Spain. A more representative classification, which could prevent such mistakes, might be "Spain-Incorporated Large Company Index".

Top 10 Holdings in iShares MSCI Spain Index Fund (EWP)

Company	% Rev not in Spain
Banco Santander SA	85%
Telefonica SA	76%
Banco Bilbao Vizcaya Argentaria	70%
Inditex	78%
Iberdrola SA	52%
Repsol YPF SA	49%
Amadeus IT Holding SA	94%
Abertis Infraestructuras SA	55%
Banco Popular Espanol	8%
Ferrovial SA	62%

Source: Company reports, Bloomberg for FY 2012

An Irony: the failed search for security diversification in ETFs

Another type of problem inherent in ETFs is that the combination of price appreciation of the successful companies and the poorer stock performance of the less-successful constituents can rapidly lead to very high concentrations among the top several holdings. Although one of the bedrock reasons for ETF investing is to avoid security-specific risk, the aforementioned EWP is an example of the opposite: merely the top 5 holdings account for almost 55% of this ETF. So, this Spain index fund might be a good way to invest outside of Spain via a handful of investments, but it certainly does not diversify company-specific risk. One can imagine the consternation of the investing public if the Top 10 positions of an actively managed mutual fund were as high as 72%.

Top Heaviness in iShares MSCI Spain Index Fund (EWP)

Company	Position Weight	Cumulative Weight
Banco Santander SA	19.69%	19.69%
Telefonica SA	13.13%	32.82%
Banco Bilbao Vizcaya Argentaria	12.63%	45.45%
Inditex	4.81%	50.26%
Iberdrola SA	4.49%	54.75%
Repsol YPF SA	4.46%	59.21%
Amadeus IT Holding SA	4.24%	63.45%
Abertis Infraestructuras SA	3.09%	66.54%
Banco Popular Espanol	3.06%	69.60%
Ferrovial SA	3.04%	72.64%

Source: http://us.ishares.com/product_info/fund/overview/EWP.htm as of 9/23/2013

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Another Classification Problem: Are Emerging Markets ETFs Investing in the Emerging Markets?

It would probably not be controversial to say that the aim of investing in emerging markets is to participate in the high unit sales growth that can be witnessed in an economy shifting from subsistence level to one in which the populace begins to generate discretionary income. Demand for consumer and capital goods can skyrocket for many years. Add the possibility of first-mover advantage and market share acquisition on a scale that is rare in a developed economy, and the returns for the successful emerging market company can be enormous. The essential notion is to participate in the expansion of local demand somewhere near the ground floor, so to speak.

Vanguard Emerging Markets ETF (ticker: VWO; AUM: $51 billion)	% of Sales outside of home market
Taiwan Semiconductor Mfg. Co.	86.2
China Mobile	0.0
Petroleo Brasileiro	28.0*
China Construction Bank	1.4
Industrial & Comm'l Bank of China	0.0
Vale SA	80.9
Gazprom OAO	59.8
Tencent Holdings	4.9
Banco Bradesco	1.6
Lukoil OAO	81.8

**Percentage of unit sales. Source: Bloomberg, Company reports. Sales data for FY 2012.*

So how do the most popular emerging markets ETFs provide this participation? Let's look at some critical characteristics: the origin of these companies' sales growth, and how large they are (relative to what they might become). With the Vanguard Emerging Markets ETF (VWO) as an example, the largest 10 holdings include Taiwan Semiconductor, the giant computer chip manufacturer; Vale SA, the Brazilian mining giant; Petroleo Brasileiro, the Brazilian oil giant also known as PetroBras; Gazprom OAO, the Russian oil giant; and Lukoil, another Russian oil giant.

Over 75% of these companies' sales come from *outside* their home markets. Really, by the nature of their customer base, these are developed market enterprises that happen to be classified as emerging simply because that is where they are incorporated.

Vanguard Emerging Markets ETF (ticker: VWO; AUM: $51 billion)	Stock Mkt Value (USD bill)	Some Roughly Comparable S&P 500 Companies	Stock Mkt Value (USD bill)
Taiwan Semiconductor Mfg. Co.	93	Intel	112
China Mobile	219	Verizon	135
Petroleo Brasileiro	106	Chevron	225
China Construction Bank	195	JP Morgan	191
Industrial & Comm'l Bk of China	228	Wells Fargo	214
Vale SA	80	Rio Tinto*	87
Gazprom OAO	110	Conoco Phillips	85
Tencent Holdings	102	Yahoo	33
Banco Bradesco	63	Bank of NY Mellon	34
Lukoil OAO	55	Apache Corp	33

** There are no sizable US diversified mining companies; as a stand-in, Rio Tinto, a U.K. based company with a NYSE listing as well.*

Source: Bloomberg, Company reports. Market cap as of 10/8/2013

As to how large they might grow, they currently compare, in size, quite favorably with the largest U.S. companies. Are they really going to triple or quintuple in size, as might a local emerging market company? This ETF cannot possibly provide participation in the growth of emerging markets in the manner that one naturally presumes.

And Another: Why Are Big-Cap Companies in My Small-Cap ETF?

A curiosity: among the bottom 10 companies in the Russell 1000 Index of the largest 1,000 U.S. companies are 3 with market values below $1 billion, and only 3 above $3 billion. Yet, the top 10

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companies in the Russell 2000 Index, which is supposed to contain the next 2,000 smaller companies, are all between $3.5 and $5 billion.

Why are the smaller companies in the large-company index? In the business of ETF asset management, those smaller companies have insufficient share trading volume to accommodate the demand. In particular, the inside ownership of many of these is quite high, so there are yet fewer shares to go around. But how does this solve the problem? See the "Weight in Index" Column: these companies are given exceedingly small weights, well less than 1/100th of 1%, so that there will be very little buying volume assigned to them; that solves that problem, because now the buying volume for new assets can comfortably go to the largest holdings, such as Apple and ExxonMobil. The index weights of both of those are over 2%, which is 1,000x larger than the smallest in that index. What, though, if these small, insider-influenced companies do exceedingly well, and fulfill the great hope of small company investing? What if they are the next Wal-Marts and Starbucks? It won't make any difference at all, since they are discarded, effectively invisible in the bottom of the Russell 1000 Index. They will never have an impact.

The Bottom 10 companies in the Russell 1000 Index (Largest 1,000 Cos.)

	P/E Ratio	Weight in Index	Stock Mkt. Value ($ bill)	Inside Ownership
Kronos Worldwide Inc	N/A	0.0018%	1.76	82%
Clear Channel Outdoor	N/A	0.0019%	3.30	3%
Intelsat SA	N/M	0.0030%	2.40	5%
PBF Energy Corp	12.32x	0.0031%	0.90	5%
US Cellular Corp	N/A	0.0032%	3.81	85%
AVX Corp	19.47x	0.0036%	2.24	1%
Artisan Partners Asset Mgmt.	21.14x	0.0036%	0.76	93%
Booz Allen Hamilton	11.86x	0.0037%	2.65	4%
Taylor Morrison Home Corp.	17.94x	0.0039%	0.72	1%
CVR Energy Inc	8.58x	0.0040%	3.33	82%

Source: Company filings, iShares data as of Sept 2013, P/E data from Bloomberg

Now, to the so-called small-cap index, the Russell 2000 Index. These companies, with more shares available for trading, have been placed at the top of the Russell 2000 Index and been accorded weights of about 0.25%, or roughly 100x greater than those at the bottom of the Russell 1000 Index. They are the prime recipients of demand when new assets come into ETFs linked to this index. Notice their P/E ratios: one-half range from 38x to over 100x. Accordingly, even if these companies can also be the next Wal-Marts or Starbucks, do their valuations permit full participation? And what happens next year, if their rising market values finally force them into the bottom of the Russell 1000 Index, where

The Top 10 companies in the Russell 2000 Index (Smallest 2,000 Cos)

	P/E (next FY Est.)	Weight in Index	Market Values ($bill)
Costar Group Inc	71.15x	0.29%	$4.93
Commvault Systems Inc	49.84x	0.27%	4.15
Ultimate Software Group Inc	102.31x	0.27%	4.11
AthenaHealth Inc	105.14x	0.27%	4.12
Acuity Brands Inc	27.48x	0.25%	4.07
Prosperity Bancshares Inc	16.83x	0.25%	3.81
First Merit Corp	15.34x	0.24%	3.67
Middleby Corp	27.08x	0.24%	4.04
Chart Industries Inc	38.06x	0.24%	3.85
Questcor Pharmaceuticals	12.08x	0.24%	3.48

Source: iShares data as of August 2013, P/E data from Bloomberg

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their weights could well fall by 90% and the index investors and ETFs must become net sellers? The small cap index no longer provides the dynamics one presumes to acquire with small-cap stocks.

Summary

What we've seen in these exhibits is that the marginal net buying (and *not* buying) of stocks is occurring via the modality of ETFs, passive investing—this is where the money is flowing. One can observe, at the very least, that the mechanical, procedural manner in which their operating rules are executed occurs without any need for reassessment or reality checks. ETFs are simply described as providing exposure to factors that their issuers assign—such as market cap, industry classification code, etc. The absence of reality checks can lead, in self-fulfilling fashion, to unreality. So, an ETF intended to be diversified can actually be concentrated; a country-specific ETF can actually be a global non-local ETF; an emerging markets ETF can actually be better described as a developed-nation/large cap fund; and the valuations of the companies on the right side of the ETF Divide are bid to excessive valuations while those on the wrong side can be forced into undervaluation.

The preceding observations might fall under the category of the unintended consequences of a rigid rule set within a fluid marketplace. They do not address the topic of an ETF rule-set deliberately constructed to alter the character of the portfolio to be other than what one might naturally expect, such as the true small-cap stocks in a small-company index being hijacked into the far Siberian regions of a large-cap index where they are unlikely to be heard from again.

The liquidity needs of ETF manufacturers, that is, their need to gather very large quantities of these low-fee assets, requires that they reject some of the most potentially rewarding types of investments, such as the true small-capitalization growth company or the true developing emerging market company. They must reject, for the most part, true owner-operator companies, which have demonstrated a distinct statistical tendency to outperform other market sectors.

Herewith are two final exhibits, each largely self-explanatory. They speak to one qualitative, predictive variable, versus purely descriptive, quantitative ones such as industry sector or market cap: is a company an owner-operator; is the control party's own capital is at risk when making capital allocation decisions and assessing risk? We, above all else, invest in individual companies, one at a time, based upon our own fundamental analysis and, in particular, are willing to hold an undervalued position as long as necessary in order to permit other investors to observe the same.

Average Inside Ownership Comparisons	
S&P 500 Index, excluding owner-operators (estimated; does not exclude holdings by U.S. govt.)	4%
Horizon Kinetics ISE Wealth Index[1]	24%
Horizon Kinetics top ten holdings[2]	38%

Sources: Factset, Bloomberg, Company reports

[1] The Horizon Kinetics ISE Wealth Index was created in conjunction with the International Securities Exchange, LLC ("ISE") beginning in August 2011. It is designed to provide a benchmark for investors interested in tracking the performance of publicly listed companies managed by wealthy individuals who have significant equity stakes in their business

[2] Top 10 holdings firmwide by market capitalization as of September 30, 2013

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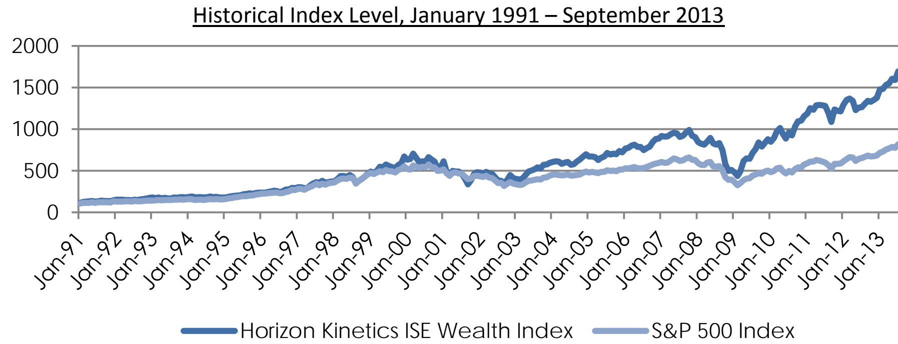

Source: Bloomberg

__Post Script__: In sympathy with the quantitative heart of rules-based investing, we now present a metric to measure these quarterly reviews. The Pictures:Words Ratio (or PW ratio) in this review was 0.52 [defined as the number of exhibits divided by the number of words, the words being re-scaled on a 1:100 basis] and included roughly 2,300 words. According to this scale, a higher ratio, such as 0.7, would indicate relatively more exhibits in relation to words. For comparison purposes, the June Quarter Review included about 2,670 words, with a PW ratio of 0.11, and the March Quarter Review ran to 5,000 words with a PW ratio of only 0.08. With this tool, one can precisely measure and presumably adjust these two quantitative aspects of the Quarterly Review. If the direction of the PW ratio has been pleasing thus far, readers could indicate their interest for a higher ratio. What the qualitative impact might be, we cannot yet know. It might be constructive, or it might lead to unreality—but of course, you will provide reality checks for us in a way that ETF investors have yet to communicate to their advisors.

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