4th Quarter Commentary

January 2015

The annual questions: How will the markets do this year? How have we done? Will it be more of the same or different? Every once in a while, those questions are much more important than usual, not merely of seasonal interest. This is one of those times.

In 2013, our equity strategies were up far more than the market. Would it have been reasonable to expect another 35% or 45%? No. This past year, the S&P 500 was up almost 14%, much more than our strategies. Would it be reasonable to expect that again (or, for the next two years)? No. Why not? Because it's not just a roll of the dice or momentum; there are specific and very important activities at work behind these results; to not understand them is to risk being exposed as markets approach a dangerous juncture.

We hope to answer the question as to why, in 2014, the most outstanding mutual fund managers of the past decade or two, collectively and simultaneously, underperformed the S&P 500, and by an enormous margin. They each have different styles and holdings, and well-deserved reputations. Most important, there is no precedent for this common magnitude of underperformance. It is important to understand why. It is also important to understand whether it is because they invested poorly or not. In other words, were they the anomaly for underperforming–and is it reasonable to believe that they all lost their touch at the same time–or was it the S&P 500 that was the anomaly for outperforming? If that latter bit sounds nonsensical, it has happened before (although it can never be proven until after the fact). In 1999, portfolios in our Core Value strategy were up about 4% (net of fees) when the S&P 500 was up 21%: underperformance of 17%.

The Strange Underperformance of Selected Mutual Funds[1] vs. the S&P 500 Index

Ticker	Mutual Fund	*2014* Underperformance, in % Points (net)	*2006 – 2013* Outperformance, in % Points (net)
FAIRX	Fairholme	-16.4%	56.2%
GABVX	Gabelli Value	-12.1%	56.2%
WGRNX	Wintergreen	-15.4%	36.2%
LLPFX	Longleaf Partners	- 8.8%	27.7%

Source: Company Reports, Horizon Kinetics Research

Performance of Selected Horizon Kinetics Strategies On the Cusp of the Technology Bubble vs. the S&P 500

	Core Value	Large Cap
1999	-16.9%	-23.3%
2000	30.3%	29.0%

Performance data are net of fees
Source: Horizon Kinetics Research

Why? It's not that we purchased poor investments. It's simply that we did *not* purchase internet and technology and unregulated utility stocks, which traded at bubble valuations. The following year, we outperformed by 30%. Why? We didn't own internet and technology and unregulated utility stocks.

An important divide has developed between, on the one hand, the S&P 500 and other major stock indexes such as the Russell 2000, and active managers who select individual securities not based on a narrow rule set.

Observe the enormous and continuous flow of assets out of equity mutual funds, which we use as a proxy for actively

Annual Fund Flows and Volatility Phobia ($mill)

Year	Equity Mutual Funds	ETFs
2006	147,548	59,792
2007	73,035	128,116
2008	-229,576	143,644
2009	-2,019	42,086
2010	-24,477	80,031
2011	-129,024	68,585
2012	-152,234	123,942
2013	159,784	196,711
YTD-11/2014	49,172	189,984
Cumulative	**- $107,791**	**$1,033,071**

Source: Investment Company Institute

[1] Neither Horizon Kinetics nor any of its subsidiaries manage or are otherwise involved in the management of these selected funds.

managed strategies, and into exchange-traded funds (ETFs), which of course are indexed. In 2006, before the financial crisis of 2008/2009, more money flowed into mutual funds than into ETFs. In 2008, $229 billion exited equity mutual funds while $143 billion was shifted into ETFs. The financial crisis induced a volatility phobia amongst investors, such that, in every year since, more money flowed into ETFs than actively managed strategies, and as late as 2011 and 2012, $280 billion—more than in the 2008 crisis year—actually left equity mutual funds. In no period, even during the financial crisis, did money leave the ETFs. They are considered safe. In 2014, almost no net investments were made in equity mutual funds, while, once the figures are collected, it is likely that ETFs had the largest annual inflow on record.

One effect of the constant shift of assets into indexes is that stocks, more and more, are purchased as part of a basket. Once upon a time, active managers and analysts would distinguish between and select one consumer service or technology company over another. Today, if one is invested in the stock market via ETFs, one cannot be specifically dissatisfied with Coca-Cola, say, or Procter & Gamble. You can sell your iShares US. Consumer Goods ETF or your iShares S&P 500 Growth ETF, but you will be selling your Coca-Cola together with Procter & Gamble together with Apple, etc. Accordingly, the shares of the larger, more liquid companies that are the prime ingredients of the major indexes, have been rising and falling more and more in tandem. The correlations of these individual companies with the S&P 500 itself is now a lot higher than it was a decade ago.

Correlation with S&P 500 Index*

Security	1994	2014	*Change*
Apple Inc	0.265	0.438	*65.3%*
Chevron	0.436	0.627	*43.8%*
General Electric	0.577	0.749	*29.8%*
Johnson & Johnson	0.382	0.685	*79.3%*
Microsoft	0.444	0.575	*29.5%*
Pfizer	0.379	0.596	*57.3%*
Procter & Gamble	0.608	0.421	*(30.8%)*
AT&T	0.450	0.461	*2.4%*
Verizon	0.403	0.458	*13.6%*
ExxonMobil	0.403	0.668	*65.8%*

A correlation of 1.00 means that a security precisely mirrors the S&P

**Top non-fin'l S&P 500 constituents that have existed for 20 years*

***Using Bloomberg correlation matrix (daily)*

That means that the diversification benefits are being eroded. When, next, the market declines sharply, the traditionally diversified portfolio—some large-cap, some value, growth, *et al*—will not provide the protections that are expected. There has been developing another form of bubble: a correlation bubble among equity classes. Peruse the table at right, and, statistically, the various equity ETF building blocks—mid-cap value, large growth, etc.—are hardly differentiable.

Small Cap vs Large Cap
or Growth vs Value Distinction No Longer Operates

	P/E	Return, 2014
S&P 500 Growth Index	22.3x	14.89%
S&P 500 Value Index	14.7x	12.35%
SPDR S&P Dividend ETF	19.8x	13.80%
S&P 500 Index	17.7x	13.68%
Russell Mid-Cap ETF	21.8x	13.03%
Russell Mid-Cap Growth ETF	26.6x	11.68%
Russell Mid-Cap Value ETF	18.4x	14.49%

Source: Bloomberg, Index and ETF provider reports

Because the marginal dollar of demand is now in the hands of indexes, the active manager of old who might have determined that a certain stock was overvalued and elected to sell it has ever less impact upon share prices. There is no longer a central mechanism for investors to vote with their feet on an individual stock. Taking Coca-Cola, as an example, during the decade of the 1970s, the company generated about 13% annualized earnings growth, some years approaching 20%. For the first 5 years of the '70s, the P/E ratio ranged between about 30x and 40x earnings. Few would argue that it wasn't overvalued. And, as the reversion to the mean principle would dictate, despite a decade of earnings growth that strong, the P/E contracted to 13.6x by 1978 and, over the course of an entire decade, the shares declined by over 45%.

Today, Coca-Cola trades at a P/E of 21x, not 30x or 40x. On the other hand, it is now a mature company: its products are everywhere, there is a limit to how much more Coca-Cola per-capita the world's residents will drink, even if they don't develop a preference to less sugary drinks. In fact, Coca-Cola has lost revenue in the last two years. With that understanding, at 21x earnings, is Coca-Cola any less overvalued than it was in 1973? It might be *more* overvalued. This is the type of unhealthy growth (slowing/declining) and valuation (high/rising) pairing that is more and more representative of the major stock indexes. That they have risen of late is no more a sign that one should be invested that way than that one should have been invested in the notorious Nifty Fifty during the early 1970s or in the favored stocks during the 1999 Internet Bubble.

Which is Worse, Coca-Cola Then or Now

	1970s			**2014**		
	P/E	EPS Growth		P/E	EPS Growth	Rev Growth %
1969	36.0x	--	2013	21.23x	-3.00%	-2.42%
1970	30.5x	16.98%	2014E	20.98x	-1.03%	-1.87%
1971	36.7x	13.71%	2015E	20.94x	6.25%	0.39%
1972	41.1x	13.48%				
1973	36.9x	12.50%				
1974	26.3x	-8.89%				
1975	18.3x	21.95%				
1976	17.7X	19.00%				
1977	14.3X	12.18%				
1978	13.6X	13.48%				

Source: Historical data from Moody's Handbook of Common Stocks; 2014 data from Bloomberg

The traditional valuation divisions in the marketplace are no longer between value and growth companies or between large- and small-capitalization stocks, per se. That has been changed by the ETF mode of investing: a given stock is either included in an index or not. If included, it benefits from continual purchase along with the other index constituents (or, if subject to selling pressure, then all together as a group). Rather, the valuation divide is between those stocks with sufficient liquidity to be suitable members of an ETF, and those that are insufficiently liquid in terms of daily trading volume of shares. This is an important distinction, because some rather large companies can have a significant degree of inside ownership that renders the shares less readily tradable in large, institutional-scale quantities.

Here are some examples. Simon Property Group, the largest REIT, or real estate investment trust, trades 1.3 million shares per day; it is the largest or near largest holding in any number of REIT ETFs—it trades at **11.9x** book value. Howard Hughes Corp, with a $3.8 billion stock market value, is no small com-

New Division is Between Liquid (Index Filler) and Less Liquid

		Real Estate / Land	
	Simon Ppty Group (SPG)	Howard Hughes Corp (HHC)	Dream Unlimited (DRUNF)
Market Cap ($ bill.)	$60.1	$3.8	$0.8
Inside Ownership*	7.0%	13.2%	50.0%
30 Day Avg Vol. (000)	1,369	170	90
Price/Book Value	11.9x	2.2x	1.4x

For Howard Hughes, management warrants would add 6.7% to insider holdings
Source: Company reports, Bloomberg

pany, but it has 13% inside ownership, and trades only 170,000 shares per day–valuation: **2.2x** book value. Dream Unlimited, with only 90,000 shares traded daily, is priced at **1.4x** book value. That's quite a valuation divide.

In the consumer branded products sector, Colgate Palmolive, which experienced less than 2% revenue growth in 2013, and is expected to *lose* 0.5% of its revenue in 2014, trades at 23.3x earnings. It has average daily trading volume of 3 million shares. Jarden Corp., even after almost doubling its share price in the past two years, and with about 11% revenue growth in 2014, trades at 17.8x earnings. In the media sector, Walt Disney trades at 19x earnings, whereas Starz, with 15% inside ownership and one-sixth the trading volume, trades at 12.9x earnings. Discovery, with 26% inside ownership and about one-half the volume, trades at only 8.4x free cash flow.

New Division is Between Liquid (Index Filler) and Less Liquid (cont'd)

	Branded Consumer Prods.		Media/Content		
	Colgate Palmolive (CL)	Jarden Corp (JAH)	Walt Disney Co (DIS)	Starz (STRZA)	Discovery Commun. (DISCA)
Market Cap ($ bill.)	$62.3	$8.8	$155.8	$3.0	$21.9
Inside Ownership*	<1%	6.8%	<1%	14.9%	26.1%
30 Day Avg Vol. (000)	2,992	625	6,516	1,106	3,695
P/E (2014E)**	23.3x	17.8x	19.1x	12.9x	8.4x

For STRZA, voting power is 48.2%. For DISCA, ownership is upon conversion of Preferred shares. For DISCA, valuation multiple is of free cash flow, to correct for distortion caused by very large non-cash amortization charges.
Source: Company reports, Horizon Kinetics Research, Bloomberg

So, this notion that a company—albeit well known, large-cap, and with a long (and perhaps long-past) history of rapid growth—can experience essentially no revenue growth, yet still be accorded a high valuation has not really happened before. Before the dominance of indexation in setting valuations, individual investors and analysts would have sold such shares in pursuit of better alternatives and thereby caused a lower clearing price. Here is what the largest 30 companies in the S&P 500 look like nowadays: the average revenue change this past year was only 4.1%; exclude Facebook and Google, and it was only 1.1%. If you don't find this eye-opening, you should.

Yes, I Understand Your Share Price Is Up, But How Are You Really Doing?
12-Month Change in Revenue, 30 Largest S&P 500 Companies

Apple Inc.	6.72%	Coca-Cola	-2.85
Microsoft	11.69	Merck	-6.89
Exxon Mobil	-8.09	Citigroup	-3.30
Johnson & Johnson	5.92	Facebook, Class A	54.69
Berkshire Hathaway	12.12	Google, Class A	19.56
General Electric	-1.69	Google, Class C	19.56
Wells Fargo	1.31	Gilead Sciences	16.72
Procter & Gamble	0.58	PepsiCo, Inc.	1.41
JPMorgan Chase	7.51	IBM	-4.55
Verizon	4.06	Comcast	3.34
Chevron	-4.88	Walt Disney	8.37
Pfizer Inc.	-12.55	Cisco Systems	-3.01
Intel Corporation	-1.19	Wal-Mart	1.52
AT&T Inc.	1.03	Oracle	2.95
Bank of America	1.96	Philip Morris Int'l	-1.32
		Average change:	**4.1%**
		Excluding Facebook & Google:	**1.1%**

Source: Company reports, Bloomberg

So as far as what one should think about the future returns from the large-company indexes like the S&P 500, there is a different set of concerns than the growth/valuation mismatch illustrated above. U.S. corporate profit growth has benefitted tremendously over the past few decades from changes that have now been exhausted. Since 1980, a span of over 30 years, all of these benefits helped corporate profits grow by all of 6.9% per year. That's it. Add in the benefit of moving from cheap to expensive, and the S&P 500 appreciated by 8.3% per year. So how well should one expect the broad market to fare in the next several years, even assuming that the aforementioned benefits do not reverse and merely stay as is–that is, that interest rates, for instance, remain flat?

Three Decades: Look at All the Help It Got

	Last 33 Years of Support			*Next 10 Years?*
	1980	2013	change	
Interest Rate	11.43%	2.35%	-79.4%	→ or ↑
Corporate Tax Rate	46%	35%	-23.9%	→ or ↑
Fed Govt Spending as % GDP	31.3%	32.3%	3.2%	↓
S&P 500 P/E Ratio (as of 12/14)	9.3x	19.2x	188.2%	↓

And This Was the Result:

U.S. Corporate Profit Growth in the Past 3 Decades: 6.9% / year

S&P 500 Index Appreciation in the Past 3 Decades: 8.3% / year

What Happens When:

Sources:
http://www.taxpolicycenter.org/taxfacts/content/pdf/corporate_historical_bracket.pdf
http://www.whitehouse.gov/omb/budget/Historicals
http://www.federalreserve.gov/releases/h15/data.htm (Market yield on U.S. Treasury securities at 10-year constant maturity)

On the other hand, corrections could develop sector by sector.

The REIT sector, which has been quite popular due to higher yields and rising dividends, now trades at about a 3% yield, 35x to 50x net income, and 20x to 30x cash flow (FFO). Their cash flows, and their valuations, are highly vulnerable to a rise in interest rates.

Moreover, in the years since their valuations soared after the financial crisis (such that they could sell shares anti-dilutively

% Reduction in Operating Income With a 300 BP Rise in Interest Rates

GGP	General Growth Properties	54.3%
SPG	Simon Property Group Inc.	27.6%
SLG	SL Green Realty Corp.	12.9%
PSA	Public Storage	0.0%
VTR	Ventas, Inc.	66.5%
PLD	Prologis, Inc.	69.2%
DLR	Digital Realty Trust Inc.	40.0%
HCN	Health Care REIT, Inc.	87.6%
EQR	Equity Residential	36.7%

Source: Company Reports and Horizon Kinetics Research.

to raise capital), they have sharply reduced their maintenance capital expenditures.

This permits them to raise their dividends more generously and retain shareholder interest. While certain real estate models might require less in the way of capital expenditures, as when a company specializes in renting out its space on a triple-net lease basis (the customer being responsible for elements of such spending), ultimately property must be maintained and those expenditures will have to rise. A cessation in dividend growth, much less a reversal, would drive prices down. Two of the larger REITs, one specializing in retail malls, the other in residential apartments, more or less halved their maintenance capital expenditures relative to their depreciation expense at the time of the financial crisis.

A similar portrait could be drawn for utility stocks, with perhaps more decisive risk triggers.

Ratio of Capital Expenditures / Depreciation

	Simon Ppty Group	Equity Residential
Jan-Sept 2014	0.49	0.23
2013	0.63	0.13
2012	0.62	0.22
2011	0.40	0.22
2010	0.34	0.20
2009	0.97	0.21
2008	1.46	0.28
2007	1.16	0.41
2006	0.94	0.43
2005	0.89	0.44

Source: Company reports

Clearly, there is a divide between the types of stocks that we own and the types of stocks that represent 'the market'. As for our stocks, they are selected because, among other attributes, they are undervalued. We actually expect them to do well. They are not purchased simply to provide exposure to a sector. As for the market, considering the top 15 or 30 stocks in the S&P 500, an expectation for future returns should include what? Well, revenue growth, return on capital prospects, potential valuation changes. We observed, earlier, that there hasn't been much revenue growth, and in the case of $200 billion companies that, as businesses, are mature (Coca Cola) or face regulatory constraints (JP Morgan Chase), there isn't likely to be much. The valuations are sufficiently high, that the probability is greater that they will contract rather than expand.

But what if the market were to do as well as it has in the past and as, apparently, people expect it to? Referencing the earlier statistics, the S&P 500 appreciated by a bit over 8% annually over the past 3 decades, a feat that relied in part upon a P/E ratio that more than doubled to the current level of 19.2x. Let's just say that it continues to appreciate by 8% annually (which together with a dividend yield of 1.9% will provide almost a 10% rate of return). The corporate earnings growth rate over those three decades was 6.9%, but with the aid of lower tax rates, overseas labor cost arbitrage, lower interest rates, and so forth. So let's calculate what the P/E ratio will be in five years if share prices rise at an 8% rate and if earnings rise at varying rates of 5% and 4%. That would be 22x and 23x. Carried to 10 years, and the market P/E would be 25x and 28x. How likely is it that such an elevated valuation could be sustained for another half-decade or more? Certainly, we are not the only interested parties observing this. Accordingly, there will develop investor interest in alternative approaches and strategies that are driven by company fundamentals. Then, things will look different.

Future Valuation of S&P 500?
(appreciation rate 8%; current P/E 19.2x)

Earnings Gr. Rate	P/E in 5 Years	P/E in 10 Years
5%	22.0	25.4
4%	23.1	28.0

Source: Horizon Kinetics Research

On the occasion of the new year, profiles of the larger holdings in a number of our strategies are available on our website. An attempt has been made to standardize the format, although many of these companies do not lend themselves to such uniformity, given the often distinct if not unique aspects of their business models.

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