1st Quarter Commentary

April 2016

Part I: Let's Be Clear About Valuation Risk

Our 4th Quarter commentary established just how much at risk the broad stock market is. Dominated by companies favored by the major indexes and ETFs for their trading liquidity and their low price volatility statistics, they serve the needs of 'industrial scale' investing. For the mature companies representing the largest portions of the S&P 500, margins are at historic highs, growth has slowed or stopped, and the ETF demand for the shares has inflated valuations to excessive levels.

Part I: *Reminder of how dangerous the 'ETF Stock Market' is and of the enormous risk/value tradeoff between index securities and individually selected stocks.*

Part II: *Why Beta, the go-to fund selection statistic, is entirely misleading – and might lead you off a cliff.*

Part III: *The cash balances and what we're doing with them. Also, Core Value's return to 'equity bonds' – not the 2002/2003, but the 2016 vintage.*

The message should not be forgotten just because a few months have passed. So, we'll supplement the discussion with a newly popular type of ETF: the low-volatility ETF. The iShares MSCI USA Minimum Volatility ETF (ticker USMV), for instance, has almost $12 billion of assets[3], more than twice as much as last July. By comparison, the old standard, the iShares S&P 500 ETF (ticker IVV), has only 3% more assets than a year ago. The website ETF.com describes USMV thusly: "The fund typically overweights defensive, dividend-paying sectors ... The ETF takes substantially less risk than the market portfolio as shown by low beta." Really? Language has power, power to distort thinking and decision making. Part I of this review will compare "risk" and opportunity through the prism of formulaic investing, as via USMV, versus individual security analysis and selection, as via Core Value.

The Consumer Brand Group There are 168 companies in USMV, with several major sectors, which are just 'safer' subsets of the S&P 500. A large portion is the well-known brand companies, such as McDonald's, General Mills, Coca-Cola, and Procter & Gamble. Now demonstrably mature, their revenues are either declining or essentially flat. McDonald's, the 3rd largest holding, is an example, and the accompanying table provides some of McDonald's financial data for each of 2008 and 2015. Here are two stories about that data.

McDonald's Financial Data, 2008 vs. 2015

($ in billions)	2008	Change	2015
Revenue	$23.52	7.98%	$25.41
Net Income	$4.31	5.01%	$4.53
Long Term Debt	$10.19	136.81%	$24.12
Net Ppty & Equipment	$20.25	14.14%	$23.12
Equity	$13.38	(47.03)%	$7.09
Weighted Avg. Shares	1.146	(18.06)%	0.939
P/E ratio*	16.94x		24.61x

For 2008, 12/31/08 price/2008 EPS; for 2015, 12/31/15 price/2015 EPS; price now 9% higher.

[3] As of March 31, 2016. https://www.ishares.com/us/literature/fact-sheet/usmv-ishares-msci-usa-minimum-volatility-etf-fund-fact-sheet-en-us.pdf

One Story: Revenue in those 7 years rose by less than 1% per year, 7.98% in all, net income by even less. The balance sheet was more dynamic: property and equipment rose 14%, but long-term debt rose by over 135%. Its shareholders' equity contracted by close to 50%. If you could have been told this story in 2008, would you have purchased the shares? Should we have?

Another Story: The McDonald's share price appreciated by 90% over the 7 years, which is 9.6% annually.

Explanation: One thing that happened is that McDonald's P/E ratio expanded from 16.9x to 24.6x. That shareholders were willing to pay more for the same earnings accounted for about half of the stock return. Another thing that happened was that interest rates dropped; for 10-year Treasuries, from 4.08% at the beginning of 2008 to 2.30% at year-end 2015 (and to 1.77% now). This permitted McDonald's to finance a massive share repurchase program that would have been unaffordable but for these artificially low rates, which is why its interest expense only rose by 22% even as its debt ballooned by over 6x this amount.

Whether or not interest rates increase, though, it must surely be realized that the share price appreciation of the past seven years is hardly likely to be repeated.

And Another Story: An alternative might have been Wendy's. According to etfdb.com, of the well over 1,000 U.S.-traded equity ETFs, none has significant exposure to Wendy's; 29 have significant exposure to McDonald's. Wendy's was purchased in Core Value in 2012[4] not because it was the most profitable restaurant chain (that would be McDonald's), but because it was about the *least* profitable.

In 2012, Wendy's net profit margin was less than 3%. Domino's margin was 6.7%, Panera's 8.1%, and it was 11.8% for Yum Brands (the KFC, Pizza Hut and Taco Bell combo), let alone McDonald's 19.8% margin. Wendy's, though, had a plan to induce franchisees to remodel their stores. Experiments at company-owned stores had already demonstrated higher customer traffic, revenues and profit margins. A related strategy was to sell most of the company-owned stores to franchisees. Restaurant chains' owned stores have a lot of revenue but very low profit margins; revenues from franchisees are akin to royalties: much lower but with extremely high margins.

Like McDonald's, Wendy's increased its debt and repurchased shares. Unlike McDonalds, Wendy's had an observable and practical path to dramatically increase long-run earnings, which, based on our analysis, remains the case. However, one cannot get meaningful exposure to Wendy's through an ETF – it has to be analyzed and selected individually.

By 2015, Wendy's net profit margin more than doubled, to 8%. Between 2012 and today, the share price rose 150%. And the remodeling program is only one-third done. As it approaches half-way, remodeling expenditures are expected to diminish, while the earnings contribution from the growing proportion of reimaged stores will increase. Accordingly, Wendy's expects

[4] Wendy's remains a position in Core Value

free cash flow in 2018 – *after* capital expenditures – to be 33% to 66% higher than 2015's net income. That's about a 10% to 18% growth rate.

<u>The Telecom Group</u> USMV also includes top 10 positions in AT&T and Verizon (numbers 2 and 6), but one can't watch television without seeing competitors advertising for customers to switch carriers based on deeply discounted price plans. Cellphone service is a classically high-fixed-cost, low-marginal-cost business: if the incumbent service providers are forced to lower their prices, there will be a virtually undiluted impact on operating income.

<u>REITs and Electric Utilities</u> Two major USMV sectors are REITs and electric utilities. Marketed as "bond substitutes," they exhibit low price volatility care of declining interest rates and continuous buying by index funds. They are at all-time high valuations. The utilities trade at a remarkably low 3.5% dividend yield. These different sectors do not represent diversification. They simply represent different, very long-dated exposures to interest rates at an historic low—or put differently, additional ways to suffer severe losses if long-term rates rise. Moreover, electric utilities face a rapidly expanding threat from the popularization of rooftop solar panels. Just a couple of percentage points of demand deficit represents tipping point issues relative to utilities' ability to expand earnings at all or to earn sufficient returns on high-cost historical plant and equipment to support dividends.

As to the REITs in USMV, they yield only about 3%, or more than 30x earnings. The largest U.S. REIT is mall operator Simon Property Group (ticker SPG). There are 22 ETFs in which SPG is a significant holding. Real estate companies are not exempt from competition or economic cycle risk. SPG experienced a *1% decline* in occupancy in 2015, while tenants' sales per square foot rose only 0.1%. That is the wrong direction for a high-valuation stock with growth driven by rising base rents, overage rents and leasing spreads. The largest holding in USMV is Public Storage REIT (PSA). The self-storage companies have been expanding so rapidly via new construction and acquisition that the issue of market saturation arises. Their earnings growth has been fueled by 6% rent increases and large quantities of debt. This pattern, for which exaggerated valuations are paid (28x cash flow (FFO) and a 2.5% dividend yield for PSA), is not sustainable; it will probably end badly. Understand that Horizon Kinetics – right or wrong, one can't know, yet – recently issued a short-sale recommendation on Public Storage REIT for our institutional research subscribers. The qualitative point (more about this in the Beta discussion) is that the superficial descriptive characteristics of large market cap, high trading liquidity and low recent volatility are not representative of low business or valuation risk. They're merely a description of a package designed for ETF consumption.

Another Way: It is possible to get exposure to publicly traded real estate that is actually well below fair value and not nearing growth limits. We previously reviewed the deep discounts at which companies like Howard Hughes and Texas Pacific Land Trust[5] trade, and the return possibilities on their underdeveloped properties. Last month Howard Hughes sold some properties it had assembled as part of its South Street Seaport development in lower Manhattan. It sold these buildings for $390 million, a gain of $140 million. Bear in mind, the South Street Seaport

[5] Howard Hughes is held in Core Value, while Texas Pacific Land Trust is not, but is a position in various other Horizon Kinetics strategies

The salient point is that future changes in valuation estimates for Howard Hughes Corp. and Texas Pacific Land Trust appear more likely to be higher, not lower. Future changes in valuation estimates of the largest REITs, like Simon Property Group and Public Storage are more likely to be lower, not higher.

redevelopment is ongoing and remains far larger than when Howard Hughes came public in 2010, when the Seaport was on the books for $3.1 million. With development expenditures, the book value is now about $225 million, and a conservative estimate of its developed value is roughly $1 billion, net of development costs. (This valuation and book value encompass only 362,000 square feet of development, with 700,000 square feet of additional space left to be developed.) When we originally acquired shares of Howard Hughes for Core Value, we assigned zero value to the Seaport.

Part II: Examining Low Betas – They Absolutely Will NOT Protect You From Volatility

We just characterized the iShares Minimum Volatility ETF (USMV) with qualitative and contextual analysis: excessive valuations vulnerable to collapse in the face of slowing or stagnant earnings, rising interest rates and competitive incursions. But the market just uses a statistical assessment, so let's try that: an equity beta of 0.69 and a standard deviation of 9.01% (as of March 31st), as against a 3-year annualized return of 15.4% (to December 31st). That return is only a touch higher return than the S&P 500, but, crucially, with lower volatility (S&P's beta is always 1.00 and its standard deviation was 10.95%). Given that USMV is comprised of brand name companies, and given the statistical evidence of low price volatility, it is almost universally acknowledged to be 'safe' and 'low-risk'.

So, what is beta's value to an investor? It would have to be some predictive information about the risk of a future price decline, right? But all that beta can actually assert is that each of these equities declined by less than other equities during weak markets *during the measurement period*.

So, if the beta is based upon a 3- or 5-year history, does that capture the volatility behavior of REITs between 2007 and 2009, when even the best real estate companies, like Simon Property Group, fell 70%? Is that in the beta? The Simon Property Group beta (5-year) today is 0.59. The beta at the end of March 2007 was an incredibly low 0.3 – only 30% of the volatility of the S&P 500. From that day forward, the two years April 2007 through February 2009, Simon Property Group shares fell almost 70%, while the S&P fell about 45%. So, what does beta mean to you now?

Utilities are almost 9% of USMV. How can historical price statistics capture the future impact of price competition in cellular telephones or from solar power if it never occurred before, though the early stages are quite visible? Many homes and businesses are already leaving the transmission grid, enabled by more efficient solar cells and improved battery storage technology. Another obvious risk to electric utilities is interest rates. As a pure mathematical reality, because the absolute levels of rates and dividend yields are much lower than during the last substantive interest rate increase period, utility shares would experience far more price variability when the next rate increase occurs. That is not captured in the historical price data either. Moreover, electric power generation was historically a rate-of-return regulated business, which also protected them. For many utilities, that's no longer the case. So there seem to be a lot of observable risks that are clearly not captured by the primary risk measure, beta.

Now a few fun examples of beta risk. As ETF fees for conventional indexes like the S&P 500 have been diminishing toward zero (the iShares Core S&P 500 ETF is down to 7 basis points, 7/100ths of 1%, which the providers cannot live on), the ETF organizers have devised more differentiated ETFs that can charge higher fees. However, it is almost impossible to launch a new fund if it does not back-test well. That means that it must have a low beta. So, name a major index, and odds are it will now have a low volatility version.

Here are the top 10 low-volatility ETFs. Interestingly, in the iShares Emerging Markets Minimum Volatility ETF (EEMV), Taiwan has a 17.8% weight, and South Korea has an 11.4% weight. Consider that from a risk point of view. EEMV, by the way, has a beta of 0.85. Is it just me, or is it weird that an emerging markets index has a lower beta than the S&P 500? How do they do that? (We'll provide one answer in just a minute.)

Top 10 Low Volatility ETFs

Ticker	Fund Name	Weight in Financials
USMV	iShares MSCI USA Minimum Volatility ETF	21.0%
SPLV	PowerShares S&P Low Volatility ETF	21.4%
EFAV	iShares MSCI EAFE Minimum Volatility ETF	21.7%
EEMV	iShares MSCI Emerging Markets Min Vol ETF	26.5%
ACWV	iShares MSCI All Country World Min Vol ETF	18.0%
ONEV	SPDR Russell 1000 Low Volatility ETF	20.0%
XMLV	PowerShares S&P MidCap Low Volatility ETF	50.8%
XSLV	PowerShares S&P SmallCap Low Volatility ETF	55.7%
IDLV	PowerShares S&P Int'l. Developed Low Vol ETF	39.3%
EELV	PowerShares S&P Emerging Mkts Low Vol ETF	37.2%

Source: ETF Fact Sheets.

- If there were some incident in which China decides not to acknowledge or respect the autonomy of Taiwan, would this 17.8% weight in Taiwan remain non-volatile? Probably not.
- It is well known that China is building artificial islands in the South China Sea from which to project military power. What if it attempts to assert sovereignty, via military threat, over certain sectors of the South China Sea over which other nations claim sovereignty? Over 72% of the ETFs assets are in East Asia. Is this a low-probability scenario? Would the share prices of this sector remain non-volatile?
- If North Korea were involved in some sort of military altercation with South Korea, would the 11.4% position in South Korea remain non-volatile? Would the other East Asian markets react? Is this a low probability event? Consider that the dictator of North Korea is generally assumed to be quite unpredictable.
- Finally (although we could go further), there is the right-hand column of numbers in the preceding table of the largest low-volatility ETFs. Those are the weightings of each fund in financials. Each and every one has a

large position, including USMV and the just-reviewed EEMV. Both the PowerShares S&P MidCap and SmallCap Low Volatility ETFs have in excess of 50% weightings in financial companies.

A rhetorical question: would an active manager of a low-risk strategy be permitted to take the risk of a 50% weighting in financials? Nevertheless, these portfolios can legitimately be characterized as low volatility, since of late the financial sector has not been volatile. And the high weighting assists the ETF in attaining its advertised low beta. But is low volatility an inherent attribute of companies in the financial sector? Or perhaps it is simply the case that the central banks of the world have maintained a stable, low rate environment for a very long time. Would anyone legitimately assert that these ETFs will remain non-volatile if rates rise?

One can see how the use of historical statistics actually distorts the risk analysis problem. As well, it distorts the ETF creation process.

Part III: Core Value's Cash – Fortune Favors the Well Prepared

I hope we've provided some evidence that standard deviation and beta are merely ex post facto calculations. Rather than ask what the beta of USMV is, perhaps one should ask what it will be. If the goal is to avoid volatility, one must identify risks before they materialize. Investors who buy low-volatility funds are, in our opinion, unfortunately, really buying the next high volatility fund. It is also an unfortunate fact that the traditional Graham & Dodd value metrics, such as low P/E, low price-to-book ratio, companies with net/net balance sheets, or liquidation value investments, do not back-test well. This is because in order to have these desirable attributes a security must first exhibit poor performance and high volatility. Since one cannot market a back-tested index of poor performance, the traditional metrics and investment opportunities are discarded. One can't market a deep value or opportunistic ETF. Really – go ahead and try.

Which brings us to the high cash position in Core Value. It was created as we reduced positions that had become substantially overweighted by virtue of appreciation and for which the return/valuation tradeoff was no longer distinctly in the client's favor. We also reduced or eliminated positions that had become obviously overvalued, or for which the margin of safety had deteriorated. This was done gradually, over many months. Examples would be Jarden, which had a become 10%+ position but also well above its original single-digit P/E multiple, or Liberty Media QVC, which was trading at 22x earnings and, at the end of the day, is merely a retailer. So these were not market timing decisions. Nor, as discussed previously, was the cash intended to protect a portfolio during the market downturn that we anticipate, because it won't really make that much difference. The cash is to provide the flexibility to capitalize on the opportunities that present themselves every handful of years or every cycle. True opportunities. The kind that give multi-year benefits.

But, we've heard some questions, in some cases rumblings, about the cash. First, the market has been up in the last few months, the cash is just sitting there, how long will this go on? Patience is wearing thin. It feels very much like the almost two full years, all of 1999 and most of 2000, during which we stayed far away from the tech bubble stocks. That was also the last time we had this much in cash reserves. For us, and for our clients, it seemed an endlessly long time, interspersed with long, unsatisfying explanations. When it all turned, though, the rewards for remaining sober and having fidelity to our fundamental value oriented approach were well worth the interim purgatory. A related question: if the ETF divide of which we speak incessantly has bifurcated the market into the excessively expensive and the excessively discounted, why aren't we purchasing the plentiful inexpensive stocks?

Two answers to the two questions. First, the valuation contraction hasn't occurred; when it does, no one will have to ask about it. Then, the purchasing power value of the cash will increase enormously. Investments should be made when there is judged to be legitimate return opportunity, not just because.

Second, we actually have begun to deploy some of the cash. One wouldn't see it in the March account statements, because these purchases were only initiated in the past few weeks. They were mostly in a set of related industries that, entirely unrelated to the broad market issues just discussed, have already experienced a true debacle. By certain statistical measures, the level of decline in these sectors is unprecedented. Share prices collapsed, volatility numbers skyrocketed, investors have fled. And we? We've come across real opportunity. In circumstances like this, one can skip the 'interesting', marginal companies – one is given the chance to own the very best, top flight companies, those that will survive, those that during normal periods are the most expensive.

Our purchases include two common stocks and also two non-traditional security types[6]. The latter were employed because they were better tools than the common shares, offering, in one case, a much superior risk/reward profile, and in the other, superior access to characteristics we want in the portfolio.

Of the new stock positions, one is A.P. Moeller Maersk, the world's largest publicly traded container ship company. The other is involved in the energy industry, which has been impacted to an unprecedented degree by the oil price decline. The U.S. rig count, as one barometer, is now the lowest it has been since records began in the 1940s. We're buying it, though, and as we're still buying it and as it lacks the first-order trading liquidity of a major ETF stock, we'll disclose the name another time. We can say it is much smaller than A.P. Moeller Maersk, its balance sheet is even better, and it's materially cheaper based on a number of valuation metrics. And that, I'd say, reflects the irrelevancy, in the ETF-centric world, of fundamental investment facts; this unnamed stock is not in any ETFs, while A.P. Moeller Maersk is actually in four, including the Guggenheim Shipping ETF (SEA), in which its size and quality are reflected in its dominant weighting of 18%. (On the other hand, SEA has all of $35 million of AUM.)

AP Moeller-Maersk The shipping sector has been in decline for more than half a decade: container shipping daily lease rates are down 75% from a year ago, and down almost 85% from 2011. As might be expected, there have been numerous bankruptcies in the shipping industry. The company's shares are 50% lower.

[6] Subject to client/platform permission

Nevertheless, AP Moeller-Maersk is not only substantial in scope – it has $40 billion in annual revenue – but is profitable. It is extraordinary that a business that suffered a pricing contraction of 75% or more could generate free cash flow near $1.5 billion, which the company did in 2015. As to its balance sheet, it has over $4 billion in cash and securities, and shareholders' equity of $35 billion, as against long-term debt of $11 billion.

> A.P. Moeller-Maersk is one example of an equity that exists outside the indexation sphere of activity, and its price behavior will be uncorrelated with the general market.

In an industry that is about as depressed as it can get, Maersk is not financially challenged, and it trades below book liquidation value of a strong balance sheet. It began to repurchase shares ($780 million worth) last year. Since the company is not existentially challenged, it should emerge from this cycle, as it has in the past, in a yet stronger competitive position. When shipping rates increase – whenever that might be – it can happen in a matter of weeks and they can increase by many multiples. Is there much uncertainty in this industry? Yes, that's why investors have fled the shares. That's why the return possibilities are so high.

Distressed Bond[7] Another investment in the offshore energy sector is being made through a bond. Because it is still being purchased, we'll not reveal the name at present. This does not mean that the essentials of its investment appeal can't be described, because it is priced pretty much the same as the bonds of quite a number of other companies in this general sector.

The senior unsecured bonds of many of these companies trade at about 50% of face value. Many have maturity dates of only 3 to 4 years. Many have surprisingly strong balance sheets despite the depression they've been enduring. They might have current assets that exceed current liabilities, along with substantial cash balances. Their debt might amount to only about 50% of the value of their property and equipment, even after substantial write-downs in the past year or two. They might actually have been profitable in 2015.

Let's take that information to first examine the margin of safety. If the total long term debt of a company amounts to 50% of the value of its property and equipment, then those operating assets would have to be written down by another 50% before, in a simplistic liquidation mode, the bonds would be worth less than face value. Now, if one purchased such bonds at 50% of face value, then the operating assets would have to be written down by 75% before the bondholder would suffer a principal loss.

To extend the exercise, what if the bond has a 5% coupon and what if one had a high degree of confidence that at least two years of coupons would be received before the company faces additional serious stress (assuming oil prices remain this low for that long, which perhaps shouldn't be assumed). If so, another 10% points of income will be collected, which lowers the effective cost of the bond from 50% of face value to 40%, and the property and equipment would have worth 80% less than today in order to suffer a loss on the bonds.

[7] Subject to client/platform permission

The actual analysis of any particular situation might well have some additional complexities, but that is a margin of safety that is exceedingly difficult to imagine in a common stock. Moreover, for those unfamiliar with the rights of bondholders, the above exercise unrealistically assumes a complete liquidation of the company. The usual course of action is to negotiate a restructuring, in which case the bondholders would generally do quite a bit better, even to the degree, if they inherit the equity of the company, that they can recoup more than 100% of face value.

> The essential difference between standard high yield bonds and distressed bonds is that high yield bond prices, despite being called a different asset class, are mediated by interest rates and are therefore vulnerable to the same systemic risk that equities and REITs and utility stocks are. Distressed bonds are priced relative to fundamental values like cash flow and asset coverage; they will tend to be idiosyncratic in their return pattern and are true diversifiers.

As to the expected return from a bond like this, there are three elements. First, if the coupon is 5% and the purchase price is 50% of face value, then the upfront yield is 10%. That alone is the accepted long-term return from stocks. Second, if the bond matures in four years, then appreciation to face value is a double, or about 19% per year. Combined, the expected total return, if the company merely survives, is 29% per year. There is better scenario, though. What if, say, 2 years from now, oil demand and supply come into better balance and the energy related companies are no longer considered to be at financial risk? Well, the bonds would rapidly approach face value, in which case they would double in price in two years instead of four, and the annualized total return would be 51%.

Royce Micro-Cap Trust We also purchased a closed-end fund known as the Royce Micro-Cap Trust (RMT). This, too, is an unusual instrument for an active equity manager. Why use someone else's fund? Let's start with a different question. There are over 1,250 U.S.-listed equity ETFs, according to etfdb.com. This impressive variety lately includes (and pay attention to the tickers): BITE, The Restaurant ETF; CNCR, the Loncar Cancer Immunotherapy ETF; and HAKK, the Direxion Daily Cyber Security & IT Bull ETF. What percentage of listed ETFs, would you say, are focused on the micro-cap sector, generally defined, depending on the respondent, as below about $300 million to $1 billion of stock market value?

> What percentage of the over 1,250 U.S. listed equity ETFs are focused on the micro-cap sector?

Bear in mind that the ETF industry is organized as an industry first – to make money for the promotors – and an investment philosophy second. It must be able to make money with very low fees, and to do that they must be able to mobilize very large amounts of capital, and to do *that* they must employ stocks with first-order trading liquidity. In any case, the answer, according to ETF.com, is three-one-hundredths of 1%. They don't put it that way, they simply list the four such ETFs. Between them, they

> Answer:
> Three-one-hundredths of 1%.

have $802 million of AUM, and $709 million of that is in just one ETF, the iShares Micro-Cap. The other three have from $22 million to $48 million each, which means they might break even. For instance, at $22 million of AUM and a 0.5% fee, one of them grosses $110,000 annually, and that's before administration fees, rent and personnel expenses.

This issue of fees goes to the heart of the reason for wanting exposure to small- and micro-cap equities. Viewed from the perspective of an ETF manager, the large-cap universe has become commoditized. A financial advisor cannot earn a living or remain employed recommending an asset allocation mix to clients for which the fees are 5/100ths of 1%. They can't do it. Ergo, the proliferation of more exotic funds that can charge higher fees. These include leveraged ETFs, for which fees can approach or exceed 1%, and specialty sector ETFs like CNCR or HAKK, which charge about 0.80%. It's difficult to believe, though, that such exotica will provide adequate returns or even be palatable to investors on more than a marginal basis. What they do demonstrate is an energetic search by ETF providers for a sector that can simultaneously serve both their own business needs and appeal to their clients.

Energetic, but as yet unsolved. But, small- and micro-cap stocks have traditionally been normal elements of diversified portfolios, until they were marginalized by the industrial scale needs of the ETF industry. At some point, the search will alight on this ignored (but entirely reasonable, not exotic) corner of the stock market. Due to the ETF divide, these companies often trade at ridiculously low valuation multiples. Being small, they really are less liquid – or, shall we say, scarce – in terms of daily trading volume. Interest from the ETF universe will drive up their valuations. And this is a case in which first mover advantage – being in the shares to begin with – should prove very rewarding.

Which brings us to the Royce Micro-Cap Trust. Although this exists as a mutual fund, it also exists as a closed-end fund. The fund, which is still managed by Chuck Royce, is in its 23rd year, and has an excellent long-term record. It is known for a consistent discipline in selecting for stocks that Mr. Royce describes as trading at a discount to his estimate of their business value and with a discernable margin of safety. It has about 350 holdings, with an average market cap of just under $300 million.

If we wished to have direct exposure to micro-cap stocks in Core Value, we would face some obstacles. One is, as mentioned liquidity, because we have over $1 billion to deploy. The next is a question of how many such positions we would, in practical terms, wish to purchase, each in very small quantity, because the goal here is to get broad exposure. It could be problematic. In that sense, if the Royce Micro-Cap Trust didn't exist, we might wish to invent it.

There's another beauty to this. The fund does, of course, charge a fee, and its expense ratio is 1.17%. However, being a closed-end fund and not a mutual fund or ETF, it can sell at either a premium or discount to the actual net asset value, or NAV, of its holdings. There have been periods when the shares sold at a premium to NAV. For some years, though, it has sold at a discount. That discount is now 17%, which is near the deepest discount at which it has historically traded. So one can get exposure to an undervalued, strategically important portion of the market, in a well-managed vehicle, itself at a steep discount to NAV.

There are other important things to say about the micro-cap sector, such as that the earnings are actually growing very rapidly, which presumably is an important exposure to have. We'll review further another time.

So, we've made four investments in the past few weeks, all deeply discounted, all of which are true diversifiers in that they will behave relative to factors idiosyncratic to their own sectoral or financial environments that are very much apart from the systemic issues governing the behavior of the broad stock and bond market. And they were made not because a client's cash is supposed to be invested, but because they are compelling investment opportunities.

A Reminder

If you consume financial news (and who among us can say "not I"?) there's always the issue of separating the noise from information that is actually relevant for decision making (the signal). But there's so much noise, all day long and every day. Tuesday morning, days before this was published, I wanted to know why Silver Wheaton stock was up 8%. Here is what I saw on the Yahoo Finance page for news headlines for Silver Wheaton.

Silver Wheaton Corp. (SLW) - NYSE ★ **Watchlist**

18.35 ↑1.42(8.39%) 1:15PM EDT - Nasdaq Real Time Price

Prev Close:	16.93	Day's Range:	17.77 - 18.47
Open:	17.78	52wk Range:	10.04 - 21.12
Bid:	18.30 x 2400	Volume:	8,292,423
Ask:	18.31 x 2400	Avg Vol (3m):	5,879,750
1y Target Est:	21.16	Market Cap:	7.41B
Beta:	0.500786	P/E (ttm):	119.19
Next Earnings Date:	N/A	EPS (ttm):	0.15
		Div & Yield:	0.20 (1.17%)

Quotes delayed, except where indicated otherwise. Currency in USD.

Headlines

- Silver Wheaton (SLW) Stock Spikes on Rallying Silver Prices at TheStreet (Tue 12:17PM EDT)
- Why Analysts Expect Coeur Mining's 1Q16 Revenues to Fall Market Realist (Tue 12:05PM EDT)
- Canadian Stocks Extend Five-Month High as Silver, Oil Rally at Bloomberg (Tue 10:32AM EDT)
- Panoro Minerals Announces Receipt of First Early Deposit Payment from Silver Wheaton for the Cotabambas Project, Peru GlobeNewswire (Mon, Apr 18)
- Silver Wheaton (SLW) Stock Retreats on Barclays Downgrade, Lower Silver Prices at TheStreet (Mon, Apr 18)
- Royalty and Streaming Stocks: What Are the Wall Street Favorites? Market Realist (Mon, Apr 18)
- Silver Wheaton downgraded by JP Morgan and Barclays Briefing.com (Mon, Apr 18)
- How one bull is mining Silver Wheaton optionMONSTER (Fri, Apr 15)
- Silver Wheaton (SLW) Stock Weighed Down by Declining Silver at TheStreet (Thu, Apr 14)

- According to The Street, the shares are up because silver prices are rallying.
- One must factor in a subtlety, since 12 minutes earlier, Market Realist noted that analysts expect Coeur Mining's 1st quarter revenues to fall, Coeur being a silver and gold miner.
- The day before, on Monday, The Street noted that Silver Wheaton stock was retreating on a Barclay's downgrade and lower silver prices. Earlier tht day, Briefing.com noted that both Barclay's and JP Morgan downgraded the stock.
- And The Street's notation about declining silver prices was a reminder or reaffirmation of its headline of the prior Thursday that the stock was weighed down by declining silver prices.

In real life, we are presented with these sorts of pronouncements not all at once and backward, where the unfounded and clearly useless concatenation of conflicting surface-level data is plain to see, but day by day in the ordinary forward direction. Each day affirms or contradicts the other, warns or exhorts. And to the degree that we become inured to the bizarre nature of this 'financial news' and internalize its messaging and reactivity, to thereupon apply in our own thinking and judgment about our investments, we do ourselves the greatest disservice.

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