3rd Quarter Commentary

© 2012 Horizon Kinetics LLC ®

Questions About the Portfolio

Perhaps because some of our long equity strategies have done so well this year, we've been asked whether our process has changed or whether there is any room left for continued outperformance. As to the first question, there have been no substantive changes to our process or approach in these particular strategies during the past year, and few have remarked upon any noticeable increase in intelligence. As to whether, as it is asked, we should 'take some chips off the table,' this is very much the same question as is sometimes directed toward an individual holding that has risen substantially. One response is common to both questions: if a security we hold was sufficiently undervalued to begin with, a rise of, say 50%, does not mean that it has become overvalued or even yet fairly valued. To understand that, though, one must have some qualitative familiarity with the company itself and, quantitatively, with what the share price represents relative to earnings and assets—familiarity with the behavior of the share price alone is insufficient, much as we'd like it to be sufficient. For instance, Henderson Land has appreciated by 40% this year.

Time to back off, sell into strength, know when to fold 'em? At the beginning of the year, Henderson Land Development Co. ("Henderson Land") traded at a 50% discount to book value (over 75% if adjusted to exclude the value of the shares it holds of publicly-traded Hong Kong China & Gas); it presently trades at a 35% discount to book value. This company has a stock market value of $17 billion, an underleveraged balance sheet, it is profitable and is expanding its operations, and Chairman/Managing Director/Founder Lee Shau Kee and his family own over 60% of the shares.

As to the entire portfolio, there is an additional response. Taking our Core Value strategy as an example, here are five holdings that account for about 12% of the strategy. On a simple-average basis these were down about 2% as of September 28, 2012, whereas the S&P 500 Index ("S&P 500") was up about 15% during the same period. We believe they are all undervalued. They have been, one might say, dormant assets within the portfolio and have yet to add to the portfolio return. The following briefest of reviews of a few of these will suggest why we choose to continue to hold such securities. For capital properly allocated to equities, there is a heavy opportunity cost for avoiding equities indiscriminately on the basis of price patterns.

	% of Portfolio	YTD Price Change as of Sep 28 2012
Air Lease Corp	1.1%	(12.6)%
Dish Network	1.9	7.5%
DreamWorks Animation	3.6	12.0
Leucadia National	3.7	0.0
WPX Energy	1.3	(8.7)
	11.6%	(1.8)%
S&P 500 Index (total return)		14.6%

Source: Horizon Kinetics, Bloomberg

Dish Network ("Dish"), the satellite TV company, with a stock market value of over $14 billion, is more than 50%-owned by founder Charles Ergen and his family. It trades at 13x so-called consensus earnings estimates for 2013. The company has been engaged in some activities other than satellite TV as well, but these do not as yet contribute to earnings. One of these activities has been the acquisition of broadband radio spectrum. Since 2008, Dish has made at least three significant spectrum-related acquisitions totaling $3.5 billion or more. We are immeasurably less qualified than Charles Ergen to determine the wisdom of this allocation of capital, but do presume that with $7 billion of his own capital

at risk in this company, he is making the best decisions he can. One may infer that he believes that wireless spectrum is valuable.

For obvious reasons, Cisco Systems ("Cisco"), the dominant provider of networking and communications equipment, conducts ongoing studies of expected changes in demand for internet usage, wireless data usage and so forth, and actually maintains indices of such usage. Cisco expects mobile data traffic for the five years between now and the end of 2016 to increase 17-fold. That is an astounding figure. It is certainly related to the global adoption, still in the early phases, of smart phones and tablet computers. There are technological efficiencies that will accommodate some of that demand. For instance, broadband transmission speed is expected to increase by 3.5x. But those who are concerned with logistical preparation for such matters believe that more spectrum must be had. The value of spectrum could rise greatly. At the moment, we do not believe that potential is reflected in the price of Dish Network shares, so Dish might be said to incorporate at least two predictive attributes: an owner-operator and a dormant or unrecognized asset.

Leucadia National, under the management of Ian Cumming and Joseph Steinberg, who collectively own 19% of the shares, has one of the best records of value creation among publicly traded U.S. companies. Over the course of the 32 years from 1979 through 2011, the Leucadia book value per share, inclusive of a special dividend paid out some years ago, has expanded by 18.5% per year, and the share price by 19.8% per year. As a basis for comparison, the total return on the S&P 500 during the period was 7.6% per year. That is the difference between $1,000 becoming $299,000 or $10,400. This is an almost unmatched record. We believe Leucadia is a well diversified, well capitalized, profitable company with the same management in place that created this history. The shares, should you want them, trade below book value, which is to say below accounting liquidation value, which as of the most recent financial statement was $24.92. A low valuation is one of the better predictive attributes and is particularly compelling when combined, as in the case of Leucadia National, with proven owner-operators.

WPX Energy ("WPX") was a December 2011 spin-off from The Williams Companies ("Williams"). Williams was (and remains, at $22 billion) a large capitalization stock. Williams is a natural gas pipeline company, which is a highly stable, high free cash flow generating business that currently pays a 3.5% dividend yield. WPX is a natural gas exploration company, considered a mid-cap stock (at $3.5 billion), and pays no dividend. What one might term the natural Williams shareholder, interested in a blue-chip, large cap, pipeline-type, income oriented equity is not the natural holder of WPX. This is exactly the type of spin-off that is sold from or excluded from mutual funds or ETFs that hold a Williams-type company, and these are some of the classic reasons that spin-off companies trade at low, often deeply discounted valuations. In the case of WPX, by a variety of measures, such as its price relative to its reserves, the shares might be fairly valued at twice the current price. Time will tell.

Questions About the Market

As to the yet broader questions about the valuation of the stock market, following the 15%-odd gain this year, I will segregate the question as to the stock market in general and the market of our stocks in particular. While it would have been naïve or professional vanity to presume the ability to make such a distinction historically, it is now possible to do so because of the "ETF Divide" that we have been discussing for the past year. Using mutual fund flows as a proxy for the direction of capital flows in the

© 2012 Horizon Kinetics LLC ®

overall market, it is now 5 years that investment capital has been exiting equities, with equity mutual fund outflows of over $365 billion during this period[1], compared to fixed income fund inflows of $1.09 **trillion.** As a single predictor, this fund flow data does not suggest a stock market bubble in the way that the question is being asked. More to the point, though, it is the 5th year that within those flows, capital has exited equity mutual funds[2] ($59 billion of net outflows year to date through August 2012[3]), which figure does not include other forms of actively managed equities, and moved into passive equity ETFs ($35 billion net inflows as of June 2012[4]). On a marginal flow of funds basis, companies not represented or poorly represented in ETFs and other index-based investment vehicles are, practically speaking, invisible to the broad investing public. Active management has been and remains out, passive is in. That makes possible below-liquidation or single-digit P/E clearing prices for the likes of Leucadia National and other truly exceptional businesses we hold, such as Dundee Corp., Howard Hughes and Liberty Interactive.

Some of the Expiring Historical Supports for U.S. Corporate Profit Growth:

- 17%-point reduction in corporate tax rates the 60 years since 1952[5];
- 10-point decline in interest rates (and beneficial impact on cost of capital) in the 30 years since 1982[6];
- Near impossibility of a continuation of the incremental demand for corporate products and services represented by Federal and local government spending in excess of GDP growth (1%/year since 1950).

But as to the broader stock market, we'll add another impediment to the continuation of the rate of profit growth experienced over the last 60 years and longer. That 6-odd percent figure is the foundation for our expectations of what normal investment returns and P/E ratios should be and what asset allocation models should look like. First, and in addition to previously cited expirations of important systemic supports for the historical 6% corporate profit growth rate (as summarized in the accompanying table), one can add the challenge of the underfunded pension plan.

Many companies in the S&P 500 have underfunded pension plans. A few examples are provided below. The $14 billion of underfunded obligations at Lockheed Martin are almost 50% of its $30 billion market capitalization and 6x its book value of $2.2 billion. A Towers Watson study of the 100 U.S. public companies with the largest defined benefit pension plans, in which one would find the likes of Exxon Mobil, General Electric, Pepsi, Verizon, and UPS, suggests that American companies recorded perhaps the largest underfunded status ever, certainly within the past dozen years. And this follows a helpful three years of double-digit annualized returns on their plan assets. The study estimates the deficit for 2011 at $(260) billion, versus an $85 billion surplus in 2007. These figures do not include other post retirement obligations, such as for health care, which are of significant size. Ultimately, this deficit must

	Stock Market Capitalization	Book Value	Unfunded Retirement Liabilities	Plan Assets
Lockheed Martin (bill).	$29.9	$2.2	$14.0	$29.0
Ford (bill.)	38.7	17.1	20.2	39.4
Huntington Ingalls (mill.)	2,110	994	1,155	64

Source: Company reports, Bloomberg

1 http://ici.org
2 http://ici.org/pdf/2012_factbook.pdf
3 http://ici.org/research/stats/trends/trends_08_12
4 http://etf-ia.com/sites/all/themes/etfia/downloads/June-2012-ETF-Data-Net-Flows.pdf
5 http://www.taxpolicycenter.org/taxfacts/Content/PDF/corporate_historical_rates.pdf
6 Based on the 10-year Treasury bond. Source: http://www.federalreserve.gov/releases/h15/data.htm

be made up, but it will likely come from earnings. Recent pension fund contributions by some larger S&P 500 companies have been on the order of $1 billion per year.

It's important to understand why this underfunding exists, because the reasons speak to why the problem is unlikely to recede and might well worsen. First, while the S&P 500 is still lower than it was in 2000, the pension liability for companies with defined benefit plans climbs each year, so a failure to earn a sufficient offsetting return on the plan assets in a given year (much less for a dozen years) further increases the net liability. Second, the typical pension fund has over 40% of its assets allocated to bonds. This is a serious problem. It is the problem posed by the Credit Crisis of 2012. The Credit Crisis of 2009 was the inability to get credit. The Credit Crisis of 2012 is the inability to get yield.

The average pension plan presumes that it will earn about 8% on its plan assets. Yet, the average yield to maturity of the U.S. investment grade bond market is now merely 1.25%[7]. If 40% of these pension plan assets will earn only 1.25%, then those bond portfolios, all else equal, can contribute only 0.5% to the return of the entire plan assets. This leaves the remaining 60%, most of which is invested in equities, to produce the balance of the 8% expected return, which means that the balance must produce about 13% each year.

One is hard pressed to suggest that this will come to pass. In addition, the actual pension liabilities—the aggregate of what is due now and in all the many years into the future—are far higher than what is presented on the balance sheet. The balance sheet figure is an estimate of the present value of all these future payments, and is arrived at by applying a discount rate. This rate now averages about 4.8%. It means that the balance sheet liability, all else equal, will be 4.8% larger in each successive year. That rate was about 6.3% in 2007; it is lower now, because it is supposed to have a relationship to the real-world interest rate structure, and interest rates have, obviously, been declining. The discount rate should continue to decline over time and, as it does so, the present value of the pension obligation recorded on the balance sheet will rise.[8]

Accordingly, one should expect larger funding deficits in the coming years and, it follows, larger contributions to those pension plans, which in turn must detract from shareholder earnings and earnings growth. That pending reality, though, is less interesting—more important, perhaps, but less interesting—than this one: that these companies, by dint of their investment philosophy and practice, place the major portion of their equity assets in the S&P 500 (and other indices representing essentially the same, largest companies in the U.S.), in order to attempt to earn the highest risk-adjusted returns. Yet, the S&P 500 to a significant degree is composed of the set of companies with the largest pension plans, which are problematic as described above—these companies are investing in themselves for future returns to restore their pension plans, even as they themselves are problematic because of their

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

[8] In July, legislation was passed that permits companies to base their discount rates on the average interest rate of the past 25 years, as opposed to the previous practice of using an average from the past 2 years. This will permit companies to delay or minimize the use of a lower discount rate, which will allow them to minimize the increase in the present value of the post-retirement liabilities on the balance sheet. It will only affect the present value that is recorded on the balance sheet, though–that is, the appearance of the liability–not the actual liability.

© 2012 Horizon Kinetics LLC ®

pension plans. But this is their formulaic process, and the tools by which this process is measured and implemented are these self-same indices.

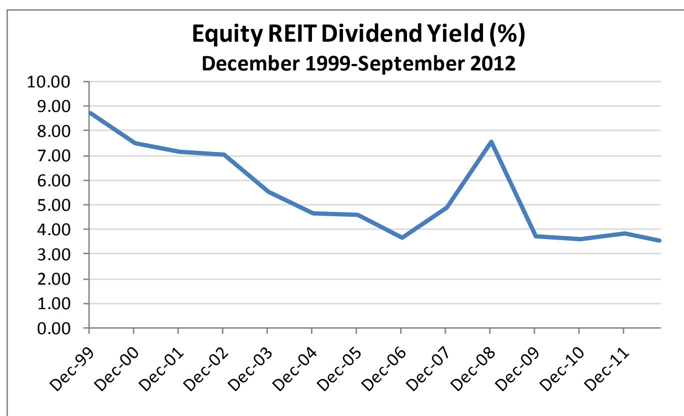
The essential challenge of these pension funds is to invest differently than their current practice—on at least two fronts. One, the S&P 500 and Russell 2000 types of companies in which they invest, for more reasons than will be covered in this letter, are dysfunctional for them and, in fact, not even what they think they are. And they must find ways to produce more cash flow from the balance of their investments. This is no different than the dilemma that faces individuals.

Please Don't Repeat These Mistakes

The low interest rate environment has yet to be fully felt. Various bond funds that have reasonably high distribution yields have these only because they hold higher-coupon bonds that haven't matured or been called yet. As they do mature, reinvestment will be at lower rates and distributions will decline, as will the net asset value, because the prices of the premium-priced older bonds will decline toward 100 as they approach maturity. Unfortunately, in that old rhythm, individual investors will seek out or be shepherded toward higher-yielding alternatives that will ultimately become overpriced and form their own bubbles, with further injury done to the already injured.

For instance, utility stocks are now trading at their lowest yields, at approximately 4%, since late September/early October 2008, because they have been pursued as lower-risk, higher-yield equities. Yet, exclusive of any other difficulties, utility companies face the same path as bond funds. Over time, as their own bonds mature, the utilities will replace them with new, lower-coupon borrowing, which means that their total cost of capital will decline. Paradoxically, that's not as good as it sounds, because the regulators will in turn reduce the companies' allowed return on capital. Instead of returns exceeding 10% in some jurisdictions the allowed rate of return will be adjusted downward. Dividend growth will slow or be disrupted and so, too, might valuations.

Another favored area toward which investors are shepherded in such times as these are the REITs, yield-oriented and with rising book values and dividends. In a prior letter, we identified the near-100% valuation premium of popular REITs that are large constituents of large ETFs, on the order of 3% yields and 2x book value pricing versus 6% and 1x book value for REITs on the wrong side of the ETF Divide. Vanguard's REIT ETF (ticker VNQ), inclusive of its open-end share classes, had almost $28 billion in AUM as of August 31st. That figure is for but one product at one fund company. What about Fidelity, BlackRock, Putnam, and Cohen & Steers, among others? Here are some other elements of a localized bubble in the making.



Source: www.reit.com

© 2012 Horizon Kinetics LLC ®

As a matter of course, a REIT issues more shares and more debt over time in order to fund the acquisition of additional properties and thereby expand earnings, because the REIT dividend payout policy does not leave much earnings available to reinvest. Typically, the cheapest source of equity capital is the investing public, and due to the hunger for yield, a REIT like Simon Properties, which is by far the largest component of most REIT ETFs and indexes, can raise equity capital at a cost of only 2.7% (its current dividend yield). This can be quite accretive to earnings, because the cash raised can be reinvested in new properties at a higher up-front earnings yield, let's assume 9%. That serves to increase earnings and the dividend and invite more demand for the shares. It can be a virtuous circle for a time. Eventually, though, that funding window closes, for any number of reasons; when it does, the impact upon earnings, the dividend and the valuation multiple can be great indeed. One might ponder the Simon family's sale, three weeks ago, of $945 million worth of shares. Surely, amongst one's choice of experts, they must be among the most qualified to assess the merits of those shares.

If You Can't Buy Yield…

If, next month, or next year, interest rates were to begin to rise, then aside from the damage that will be done to those investors holding long-maturity Treasuries or corporate bonds, the reinvestment risk problem would dissipate. But what if they remain low? The prospect of a decade or more of low interest rates has historical precedent. How can one secure sufficient cash flow if one can't purchase yield? As strange as this may sound, one might have to manufacture it. That might require very different approaches than those to which we are accustomed. Let's combine, as an exercise, the challenge of the bond market and the challenge of the new limitations on government spending and consider one alternative way of producing income.

According to the United States Defense Budget, defense spending in 2010 was $729.8 billion. The Department of Defense projects it to be $655.9 billion in 2012, and $613.9 billion in 2013. The mere fact of planned declines is important, since defense spending has increased monotonically since 1998, and on the order of about 8.5% per year; it expanded from about 3.6% of GDP in 1998 to 5.8% of GDP in 2010. While there will be reductions in some programs and reductions overall, there will be increases in others. Large-platform, high-cost weapons systems are more likely to suffer reductions. The cost of certain planes or ships can run from the hundreds of millions to over $1 billion each and, for an aircraft carrier, $10 billion. Spending will likely tilt away from that sort of product and toward what is now C5I (it used to be C2) – Command, Control, Communications, Computers, Combat systems and Intelligence. Cyber security and warfare might add a 6th C soon enough.

U.S. Defense Spending ($ bill)	
2010	$729.8
2011	$711.1
2012	$655.9
2013	$613.9

Source: http://comptroller.defense.gov/defbudget

Accordingly, the large defense contractors will be less likely to experience overall increases in revenues. On the other hand, a company such as CACI International (ticker CACI), which provides these types of electronics and intelligence services, is better positioned to acquire revenues. CACI, founded in 1962, has a stock market capitalization of about $1.5 billion and, due in large part to its particular specialties, has increased revenues and earnings by about 18% per year over the past decade. Interestingly, though, its P/E ratio on estimated 2013 earnings is only about 8x, actually lower than the roughly 9x P/Es of General Dynamics, Lockheed Martin, Raytheon, and Northrop Grumman, which would seem to face greater growth challenges. Boeing, which has its commercial aviation business as well as defense, trades

© 2012 Horizon Kinetics LLC ®

at 12.7x expected earnings. Perhaps the relative undervaluation of CACI reflects the impact upon clearing prices of the ETF Divide and that the aforementioned five companies are included in many ETFs whereas CACI is not.

If one wished to invest in equities for yield, one might consider the following transaction, for which some qualitative context has just been provided. On October 10th, one could have purchased a share of CACI at a cost of $49.10. One could have then written a call option against that share, with a $50 strike price that expires in March 2013, and received a premium of $3.35. The result is that although the stock would be called away if it rises above $50, one would keep the $3.35 premium. If one could repeat the exercise on much the same terms come March, the annualized premium would be $7.78, which would be 15.8% per year. With a buy/write transaction such as this, one has no more or less a guarantee that the shares will appreciate or not than by simply holding the stock. However, in at least 2 of the 3 basic scenarios that can unfold—a lower stock price, a flat stock price, or a higher stock price—one will be better off by selling to someone else the option to buy the CACI share from you. Even if the possibility or expectation of future appreciation embodied in the option premium doesn't materialize for the common shares, one gets to capitalize that expectation in the here and now by keeping that premium. Certainly there are no guarantees, but let us compare this instance of a 15% yield generated in this fashion by a creditworthy company with a reasonable growth path and trading at 8x earnings, with a 3% yield of a REIT at, effectively a P/E of 33x, or for that matter, with other conventional yield-oriented equities.

For many individuals seeking to replace income that had been provided by bonds, the example above is far too exposed to the risk of a share price decline—share prices are volatile. Here, then, is a related exercise that greatly diminishes the volatility risk. One could, instead, have sold a put option on Boeing with a $50 strike price that expires in January 2014, meaning you would have to buy the shares if they drop below $50, and received a premium of $2.15. Now since Boeing shares were $70.83, on October 9th, the stock would have to drop to below $50 (really, to $50 minus the $2.15 premium, or below $47.85), before a loss would be experienced—that would require a price drop of between 29.4% and 32.4%. If the shares of Boeing were to decline by any amount, 5%, 10%, 20% or even by 29.4% to $50, the writer of this put would be completely unaffected and still earn the $2.15 premium. If the Boeing shares were to drop to $47.85, the writer would have to buy the shares at $50 and, offset by the premium of $2.15, would break even. Relative to the $50 potential purchase price, the $2.15, on an annualized basis, represents a yield of 3.3%. In summary, one can potentially earn a 3.3% yield on a blue-chip stock and be indifferent to any price decline less than about 30%.

This risk/return profile can be compared to a 10-year Treasury Note, which now yields 1.7%. If, also in January 2014, the yield on that Treasury note were to rise to 4%, the price decline would be 17%, which is to say that the price loss would be 10x the expected yield—I might rather have the Boeing trade.

If the goal is to create yield or cash flow in a no-yield environment, there are many approaches that can serve the purpose, but they will require some adjustment in perspective.

© 2012 Horizon Kinetics LLC ®

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. There are risks associated with purchasing and selling securities and options thereon, including the risk that you lose money.

Horizon Kinetics LLC is parent company to several US registered investment advisors including Horizon Asset Management LLC ("Horizon") and Kinetics Asset Management LLC ("Kinetics"). Horizon and Kinetics manage separate accounts and pooled products that may hold certain of the securities mentioned herein. For more information on Horizon Kinetics, you may visit our website at www.horizonkinetics.com.

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.

© 2012 Horizon Kinetics LLC ®