

# 4<sup>th</sup> Quarter Commentary

January 2014

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**Prefatory Remarks:**

This is not merely the time for the obligatory year-end review; it also happens to be the beginning of our 20<sup>th</sup> year. On reflection, one of the most persistently irksome aspects of our business is the often Alice In Wonderland-like inversions between investment reality as we see it and as reported in the news media—and which is the cause of so much investor reactivity and damage. There really ought to be a law. But there can't be a law, so there will be some writing; and, taking liberties in our anniversary year, more than the usual amount.

**Introduction**

As surely as night follows day and less ebullient moods follow elation, so do the inevitable questions follow a 35% or 45% return year in stocks: How can the good performance continue? Aren't prices too high? These are really questions about price patterns, not business values. We'll answer soon enough, but first a review of some of our quarterly commentaries of the past few years. This is much condensed, much excerpted, and very selective<sup>1</sup>. But recalling some of the landmarks along the way can help clarify the present and perhaps a bit of the road ahead. One could skip this section without being rude, though, and move on to "What Does the Press Have to do With My Investments?" (page 7), which is the introduction to the valuation discussion and expected returns. Or one could go straight to page 13.

**Section I: A Review of Reviews**

In the 2010 4<sup>th</sup> Quarter Commentary, we introduced the more focused use of a particular predictive attribute in our equity strategies:

*Beginning in February and March, we began to steadily allocate capital to an extraordinarily discounted sector, one we have been studying closely for over 15 years and believe will produce quite satisfying returns for many years to come. They can exist in any industry, in any geographic jurisdiction, yet share a critical factor – the owner-operator mindset and character. If one were to consider the most successful, iconic constituents of the S&P 500 over the past half-century, which come to mind? Wal-Mart? For 20 years, under the aegis of Sam Walton, who died in 1992, Wal-Mart returned over 20% per year. Afterwards? 9.4% per year. Under the Watson family for the decade ended 1971, IBM returned 6.6% per year more than the stock market. Thereafter? Only 1.7% better. Good, not great. How about Apple without Steve Jobs for over a decade (3.1% per year worse than the market), then with (28% per year better)? There is some faculty of the mind and soul of the owner-operator that seems to produce a different decision making process than the mind and soul of the agent-manager.*

From the 2011 1<sup>st</sup> Quarter Commentary, some early reflections on the gathering swell of assets into rules-based investment products, most noticeably ETFs<sup>2</sup>, and the impact on valuations:

*Since the 2008/2009 financial crisis, there has been a substantial, even accelerating movement towards indexation and passive strategies. The desire is to avoid security specific risk and limit portfolio volatility. As recently as two years ago the ETF industry had \$485 billion of assets under management. That figure now exceeds \$1.0 trillion, a 2.2-fold increase. This movement is impacting the valuations of individual stocks. How so? Indexation favors the more liquid companies, a preference that can be explained by viewing it as a low-fee asset-gathering business rather than an investment management business. Therefore, the rules tend to be set*

<sup>1</sup>With respect to the excerpts quoted within this presentation, no data/information therein have been updated or changed since that time. As such, the data herein should not be relied upon without first reviewing more recent figures.

<sup>2</sup> Exchange-traded funds.

*so that companies with less share liquidity are excluded. Thus, many companies, for reasons entirely apart from investment merit, will not participate in the flow-of-funds buying pressure of the expanding ETF industry. Consider the tremendous value that Warren Buffett amassed for Berkshire Hathaway through the financial crisis. At the end of 2007, the company had a book value of \$78,008 per share and a share price of \$141,600. Berkshire concluded 2010 with a book value of \$95,453 per share, roughly 21% higher, yet a share price of \$120,450, a decline of 15%. Thus, Berkshire's price-to-book ratio contracted from 1.81x to 1.26x.*

From the 2011 2<sup>nd</sup> Quarter Commentary—one of our many required periodic responses to the fear mongering of the news media, which seem to delight in agitating the populace into a panic about their financial safety (more of which later), and an alternative we suggested. (As a side note, the municipal bond fund cited in the 2<sup>nd</sup> paragraph has been providing that very generous yield for the past 2 ½ years. One couldn't for a time, but can again buy similar bond funds of that quality and at that yield.)

*Last year's June (2010) Commentary addressed the anxiety surrounding the Greek debt crisis and its potential global impact, a situation that is again stoking crisis concerns. It is one of many alarms batted about in the financial news media in their breathless style throughout the year; the presumptive commercial real estate crisis, the looming U.S. debt deadline, and a persistently high unemployment rate are others. However, perceived risk and real risk are very different phenomena.*

*Care of this reflexive risk avoidance, closed-end municipal bond funds, even of AA credit quality, yield up to 7%, 165% greater than the after-tax return of a comparable-maturity Treasury. Perceived risk here is viewed through the prism of news about the fiscal strains in various states. Actual risk assessment would incorporate the statutory and legal rights and priorities of municipal bond holders, the adaptive behavior of the parties involved (local budget expense curtailments, tax increases, economic recovery), and the historical record. In reality, the credit risk in investment grade municipals is virtually zero, Fitch, the municipal bond credit rating agency, pointing out in a 2007 study that it was "not aware of any state that permanently defaulted on its general obligations or tax-backed debt in the post-Civil War era."*

*An excerpt from the December 2013 issue of Morgan Stanley's Municipal Bond Monthly:*

Municipal credit quality is likely to continue to improve (yes, continue) along with US housing and the general economy despite select legacy credit challenges for certain high-profile issuers such as Detroit, Puerto Rico and a handful of others. This reality supports our preference for mild extensions on the credit curve to bolster portfolio yield over simply adding or maintaining outsized interest rate risk.

With state tax revenues having risen for 14 consecutive quarters and local revenues beginning to respond favorably to an improving US housing market against a backdrop of continued state and local government fiscal austerity, the presence of inordinately wide credit spreads for A and BBB rated municipal bonds seems out of place versus the longstanding trend of spread tightening in the US corporate bond sector.

*Source:* <https://www2.morganstanley.com/wealth/investmentstrategies/pdfs/munibondmonthly.pdf>

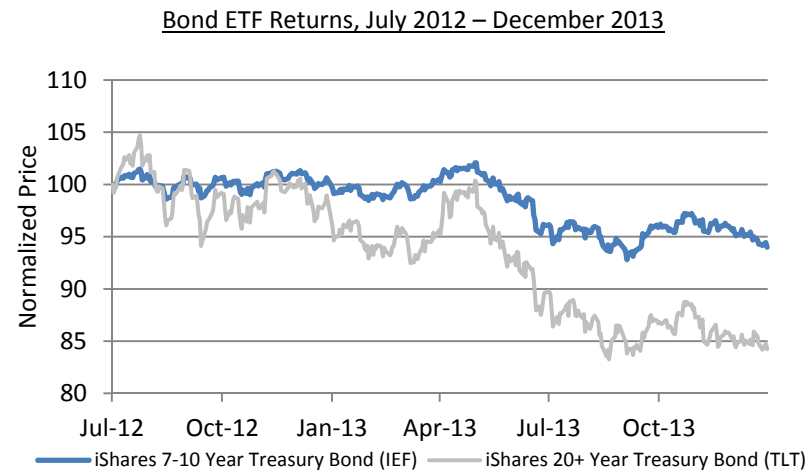
The 2011 3<sup>rd</sup> and 4<sup>th</sup> Quarter Commentaries began to measure the Indexation/ETF phenomenon, which in a true, historical sense has changed investing—the nature of investing is no longer what it was:

We previously wrote about the dramatic increase in assets invested in ETFs. The goal, in part, is to avoid idiosyncratic security risk. Since 1999, the number of ETFs has expanded from fewer than 100 to more than 1,100, even as the number of listed stocks in the U.S. has declined by one-third. This migration away from individual security selection was lent greater urgency by the 2008/2009 financial crisis: in the 3 years following 2007, the percentage of domestic equity mutual fund assets invested in index funds rose by 25% to 14.5%.

This seemingly modest market share greatly understates the shift. The flow of funds into ETFs has been over \$1 trillion. Adding index mutual funds and assets that are indexed but in private accounts, the true figure is in the trillions of dollars. It also greatly understates their influence. ETFs now account for about 50% of the total dollar value of U.S. equity market trading. ETFs alone were responsible over \$20 trillion of trading in 2011, which means that turnover was 20x their \$1 trillion of assets under management, or about 2,000%. This is a wave before which no amount of security selection talent can stand because the funds flow is bifurcated in a very particular way that depresses the shares of some stocks as it inflates those of others.

The 2012 2<sup>nd</sup> Quarter Commentary: The Bond Market Panic

“Bond market panic” might sound a bit preposterous, given the multi-year bull market in bond prices, but it is appropriate since there is now a manifest absence of yield; it’s another financial crisis. The U.S. investment grade bond market is effectively mirrored in the iShares Barclays Aggregate Bond ETF. It has an average maturity of 6.4 years and an average coupon of 4.27%, but the distribution yield is only 2.44% and the yield to maturity only 1.55%. Over one-third of the bonds mature within five



Source: Bloomberg

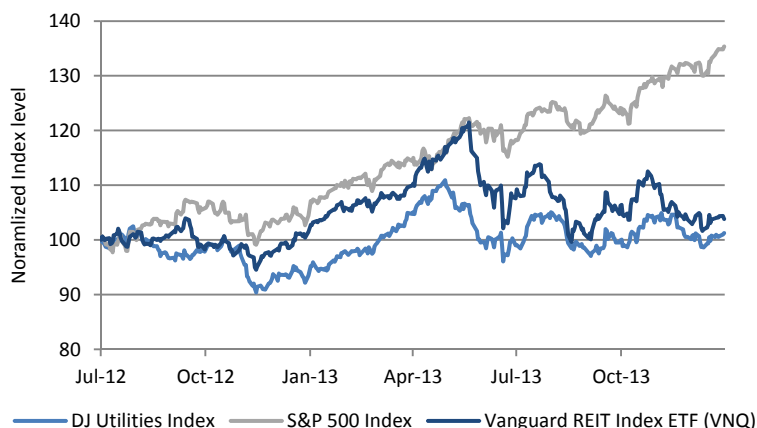
years, and the average bond price is probably well in excess of \$110. Therefore, as these bonds mature, their prices must decline toward face value; more important is that as the coupon income declines it cannot be replaced. What might happen if, unlike that which many expect, interest rates do not rise? Has that situation ever happened before? Yes, it has. In 1800, the average U.S. government bond yield was 6.94%. With rare exceptions, yields kept declining through the entire century. By the 1890-1899 decade, the average interest rate on long-term U.S. government bonds was 2.55%.

The mantra of a few years ago was safety, or suppression of volatility. Today it is yield and safety. But whatever people say about wanting yield AND safety, they have now purchased sufficient quantities of the 10-year Treasury note in the quest for income that it yields only 1.5%. Say what you will about it, but there is nothing safe about a 10-year, 1.5% Treasury. If, one year from now, that Treasury were to yield merely 3.5%, the holder of that note would experience a price decline of 15%, equivalent to a loss that is 10x the magnitude of the expected return. Even equity investors don’t dabble in stocks that offer that sort of risk profile.

From the 2012 1<sup>st</sup> & 3<sup>rd</sup> Quarter Commentaries, reviewing Utility and REIT ETFs: Looking for Yield in All the Wrong Places:

*The low interest rate environment has yet to be fully felt. Unfortunately, in that old rhythm, investors will seek out 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, at about 4%, now trade at their lowest yields since Fall 2008, because they have been pursued as lower-risk, higher-yield equities. Yet, exclusive of any other difficulties, they face the same path as bond funds. As their own bonds mature, they will be replaced with new, lower-coupon borrowing, so that their total cost of capital will decline. The regulators will in turn reduce the companies' allowed return on capital, dividend growth will slow or be disrupted and so, too, might valuations.*

Utility stock and REIT Prices, July 2012 – December 2013



Source: Bloomberg

*Another favored area toward which investors are shepherded 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. One might ponder the Simon family's sale, three weeks ago, of \$945 million worth of Simon Property Group shares. Surely, as experts go, they must be among the most qualified to assess the merits of those shares.*

From the 2012 3rd Quarter Commentary: If You Can't Buy Yield, Manufacture It

*But what if interest rates remain low? The prospect of a decade or more of low 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. Here, then, is an exercise in manufacturing low-volatility income. Using current market prices, one could sell a put option on Boeing that expires in January 2014 and which has a strike price 29% below the current share price, meaning you would have to buy the shares if they drop more than 29%. For this, you would receive an up-front premium equal to 3.3% (annualized) of the current share price. If the Boeing shares were to decline by any amount, 5%, 10%, 20% or even by 29%, the writer of this put would be completely unaffected and still earn the premium. If the Boeing shares were to drop further, by 32%, somewhat below the strike price, the writer would have to buy the shares at the strike price and, offset by the premium, would break even. 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%.*

[Horizon Kinetics, at the time, did in fact establish a strategy to do this very type of trade. The actual returns to date have fulfilled the expectations outlined above, with roughly a 5% annualized return and limited volatility.]

Finally, one year ago, the 2012 4<sup>th</sup> Quarter Commentary returned to the Yield Crisis and yield alternatives:

*Today we are in the Interest Rate Crisis era, because one cannot receive an adequate return on savings or safety capital. The U.S. bond market yields 1.5% for an average 6.4-year maturity (Barclay's U.S. Aggregate Bond Index). That is a largely taxable yield. It is a negative real return. As to the direction of interest rates, we can say one thing with certainty: we don't know in which direction they will go, or when, though we have our ideas. En*

*masse, though, the general investing public seems to have made a prediction—rates are not rising by very much, very soon. This is what people did in 2012 (and for the 4 years prior): they fled, ran, leapt, dove—into bond funds, and out of actively managed funds into indexed funds. Based on the volumes of assets gathered by intermediate-term bond funds versus long-maturity funds, relatively fewer investors are so certain about interest rates over the next 20-30 years; however, a great many seem to have confidence worthy of a 5-10 year wager. It's a fairly big wager. To paraphrase the recent movie title: "There Might Be Blood."*

(\$ billions)	Net New Cash Flows (updated through Nov '13)		
	2013	2012	2011
Mutual Funds			
Stock Mutual Funds	\$158.8	\$(122.5)	\$(98.7)
As % of prior-year assets	2.7%		
Money Market Funds	(28.7)	(76.8)	(162.4)
Taxable Bond Funds	(9.5)	243.6	130.9
Municipal Bond Funds	(48.4)	52.7	(16.4)
Exchange-Traded Funds*	159.9	152.8	99.1
As % of prior-year equity assets	16.4%		

\*For all ETFs; greater than 80% of which, by assets, are equity ETFs.  
Source: [www.ICI.org](http://www.ICI.org)

**Section II: What Does the Press Have to do With My Investments?**

This section does lead to a discussion of the valuations and the appreciation possibilities in our equity strategies, which will also touch upon new positions. But first, I would like to impress upon our clients to please always remember that the news media are almost always wrong about significant investment risks and opportunities. It is perfectly natural to not even question that they are objective and qualified, if not infallible, gatherers and disseminators of reality-reflecting information; no one expects them to be seers or to displace sophisticated analysts. Unfortunately, they are not merely a little bit off the mark; this is not a complaint about literary license or exaggeration—they are entirely and frighteningly wrong or misleading, and over and over again. And this powerfully affects investment decisions.

But I can't make that argument; it is too extreme, too naive. Really?, is the riposte. Are professional news organizations with a century and more of continuous operation and enormous resources wrong, and we just happen to know better?! I understand—it would be foolish to argue the point. So let the newspapers themselves speak to this question. The segue into our portfolio review will be the final news story in this section: of how a recent business article that warned of the imminent demise of a certain publicly-traded company actually demonstrated that the company could not possibly fail and induced us, with a bit of research, to purchase it for our clients shortly thereafter.

We'll start outside the murky realm of finance with an event that can be viewed with the clarity of historical perspective.

Robert Goddard, who died in 1945, inventor, physicist and engineer, was the man who made spaceflight possible. His revolutionary scientific papers and experiments, which included 214 patented inventions, among them, as early as 1914, a multi-stage, liquid-fueled rocket, ushered in the space age. His breakthroughs included everything from steering and stabilizing mechanisms (gyroscopes, steerable thrusts) to the ablative heat shield. His list of accomplishments, not merely in rocketry, is too voluminous to cover here. There is a reason that NASA's first space flight center, near Washington, D.C., was named the Goddard Space Flight Center.

Goddard's seminal and comprehensive work was published by the then venerable Smithsonian Institution journal in December 1919. In January 1920, the equally venerable *New York Times* issued an editorial on his work. It was so scathing, dismissive, and belittling that Goddard thereafter took pains to avoid publicity. As to what *The New York Times* wrote, some of it was reproduced in a most terse apology, shown at right, issued 49 years later in July 1969. Why did the paper apologize 49 years later for crediting the average high-school student with more competence than Dr. Goddard? Why not 50 years later? Maybe it had to do with something else that was happening in July 1969: the Apollo launch, carrying the first humans to land on the moon.

**A Correction**

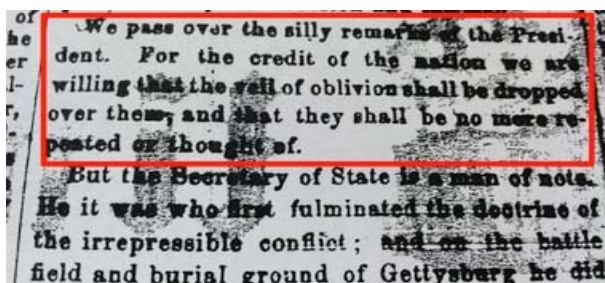
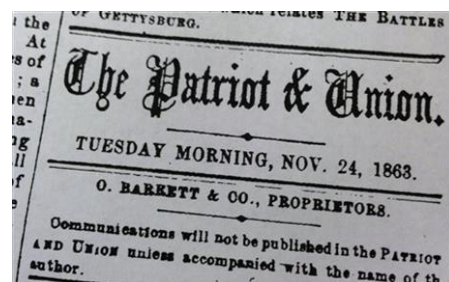
On Jan. 13, 1920, "Topics of The Times," an editorial-page feature of The New York Times, dismissed the notion that a rocket could function in a vacuum and commented on the ideas of Robert H. Goddard, the rocket pioneer, as follows: "That Professor Goddard, with his 'chair' in Clark College and the countenancing of the Smithsonian Institution, does not know the relation of action to reaction, and of the need to have

something better than a vacuum against which to react—to say that would be absurd. Of course he only seems to lack the knowledge ladled out daily in high schools." Further investigation and experimentation have confirmed the findings of Isaac Newton in the 17th Century and it is now definitely established that a rocket can function in a vacuum as well as in an atmosphere. The Times regrets the error.

Abraham Lincoln is considered to have delivered the most famous speech in American history. How many students during the past century have been required to memorize that speech? How many books and papers, in how many disciplines (civics, literature, rhetoric, law, etc.) have been written about that speech? Last November was the 150<sup>th</sup> anniversary of Abraham Lincoln's Gettysburg Address.

On the occasion of that anniversary, a Pennsylvania newspaper—*The Patriot News* of Harrisburg—published an editorial. The purpose of that editorial was to retract another editorial originally issued on November 24, 1863. The newspaper, located only 30 miles from Gettysburg, had made some remarks that they now felt were regrettable. Among other statements, the 1863 edition referred to the "silly remarks of the President" in the Gettysburg Address and hoped that "the veil of oblivion shall be dropped over them and that they shall be no more repeated or thought of."

Lest one think this an isolated reaction, *The New York World*, a major newspaper, printed a highly detailed editorial on the Gettysburg Address in its November 27, 1863 edition in which it accused him of "gross ignorance, or willful misstatement." This complaint, among many about this merely 272-word speech, took exception to the President's use of





the term “equal” in the first sentence, protesting that the Constitution does not say a word about equal rights. More astounding, and we’re still on the first sentence of that speech (“Fourscore and seven years ago, our fathers brought forth in this continent a new nation, conceived in liberty and dedicated to the proposition that all men are created equal.”), the editor branded Lincoln a liar for his comments that the founders had brought forth a new nation, stating that the Declaration of Independence made the colonies free, sovereign, independent states, not a nation. So, *The New York World* disputed the United States was even a nation. That was in 1863, 80-plus years after the Declaration of Independence.

And from the *Chicago Times* (now the *Chicago Record-Herald*): "The cheeks of every American must tingle with shame as he reads the silly, flat, and dishwatery utterances." (And these reactions were from Northern papers!)

Martin Luther King, Jr. delivered, on August 28, 1963, at the Lincoln Memorial, what is also considered one of the most important speeches in U.S. history, likewise studied and written about intensively and almost continuously—the “I Have a Dream” speech. Last August, on the 50<sup>th</sup> anniversary of that speech, *The Washington Post*, the liberal paper and the authority on Washington and national politics, issued an apology, through an op-ed letter, for missing the speech on their own doorstep. *The Post* actually had 60 staffers deployed that day and published a score of articles about the march. But they weren’t particularly listening to the speeches—they were, rather, alert for violence, celebrities, and the exodus to be witnessed at Union Station and the Greyhound station by those fearful of riots.

In the Realm of Economics, a Tale of Two Nations

As is well known, the pent-up demand, new technologies, and enhanced industrial base that developed during World War II, along with the influx of immigrant labor and talent, among other factors, created a well-spring of productivity and economic growth for the next generation. Here is just a smattering of statistics abstracted from several of *Time Magazine’s* annual economic reviews in the post-War period:

Jan. 12, 1948

- In 1947, the U.S. production machine let 'er rip. The unfettered, unguarded U.S. economy turned out an abundance of things such as the country had never known.
- The gross national product was 13% higher than the record peacetime peak of 1946...industrial production was 23% above 1946's surprising total.
- Off the production lines came 17,000,000 radios, 3,000,000 vacuum cleaners and 3,500,000 washing machines, about double prewar production.
- The U.S. alone turned out well over 50% of the known industrial production of the world compared with 30% before the war.

Jan. 8, 1951

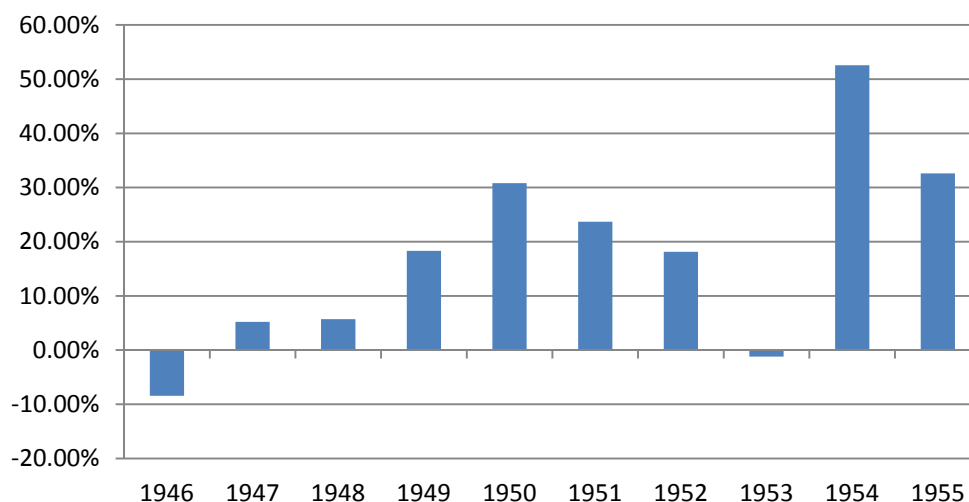
- The automakers, who had scarcely expected to match 1949-8 record-smashing production of 6,500,000 trucks and cars, rolled out about 8,000,000 units, at a rate of 15 a minute—about five times more than the rest of the world combined.
- In the greatest housing boom in history, builders started 2½ new houses a minute. The 1,360,000 starts (v. 1,020,000 in 1949) were enough to house a population as big as Chicago's.
- The [steel] mills ladled out 97 million tons of the metal, almost 10 million more than in the peak year of World War II, and twice as much as all the steel mills in the rest of the world.
- The U.S. productive machine popped out more than 7,000,000 television sets, almost triple 1949; 7,212,000 electric irons, enough nylon stockings to give every woman in the U.S. 11 pairs.

Jan. 10, 1955

- Though total output of goods and services was down by 2½%, it was still a full 38% above 1949. The Federal Reserve Board's index of production was above the corresponding level of 1953.
- Despite the slight dip, Americans were able to make more money after taxes and spend more than ever before.
- The electronics industry was also pushing the U.S. into a new Industrial Revolution. It was being brought about by "automation." The science was too new for the word to be defined in any standard dictionary, but it was already in general use.
- Out from the factories...poured the machines that could solve incredibly complicated technical problems once beyond the scope of even the biggest staffs of engineers. Among 1954's automated strides: G.E., U.S. Steel and Metropolitan Life all started using Remington Rand's \$1,000,000 Univac for totting up payrolls, writing checks and figuring costs (estimated first-year savings to G.E.: \$500,000).

As one might think, the broad-based and ebullient economic activity in the decade after World War II led to expanding corporate profits and quite high stock market returns. During the period covered in the reviews above, 1947 through 1955, the U.S. stock market tripled, for an annualized total return of 19.8%. It had one negative year during that period: -1.2% in 1953.

U.S. Stock Market Total Return 12/46-12/55



Source: Stern School of Business at NYU; data compiled by Professor Damadoran. [http://people.stern.nyu.edu/adamodar/New\\_Home\\_Page/data.html](http://people.stern.nyu.edu/adamodar/New_Home_Page/data.html). Raw data from the Federal Reserve Database in St. Louis.

What do we think the economists and newspapers said? The following comments were also excerpted from the annals of *Time Magazine*.

- July 1, 1946: How long will the postwar boom last? The rosy estimates ... three to five years ... Last week, in a gloomy and significant report, the conservative U.S. Bureau of Agricultural Economics said "Not so." In 1945, those in the top fifth of the salary brackets received almost half the national income, said BAE. The BAE reported that the 50,000,000 people living on the lowest salaries, who had been counted on to do much of the buying, have only 1% of the savings. And they plan to hang on to most of them.

- September 16, 1946: Stockbrokers came back from their Labor Day weekend with nothing to worry about, apparently, but their golf scores. Then it happened. At first, orders to sell were only a trickle. Soon they became a flood. By the time the gong rang at 3 p.m., the toll was terrific. It was the sharpest break in the market in 19 years. In five hours, all the gains of the last year had been wiped out. Next day there was another avalanche of selling. As this week opened, the market cracked wide open again. *The New York Herald Tribune* sounded the knell: "The third oldest bull market of this century has come to a close."
- Monday, Jan. 12, 1948: Economists, with the same instinct that causes flying pigeons to wheel in unison, largely and solemnly agreed on the exact date for the interment of inflation. The recession, they said, would come in the spring. As Barron's financial weekly put it: "The 1947 depression, recession, or shakeout, whichever one calls it, has advanced from a fear to a fad. Not to believe in its imminence stamps one an ignoramus." New York University Economist Marcus Nadler said: "The long expected and long advertised recession is here."
- Monday, Feb. 27, 1950: With the U.S. Government running into the red at the rate of \$10,000 a minute, gaunt, grey Economist Edwin G. Nourse last week issued a stern warning. Said President Truman's former chief economic adviser: the Administration's reckless spending under its "pie in the sky" philosophy would, unless checked by tough-minded slashes, lead to "strain and possible breakdown" of the U.S. economy by 1951.
- Monday, Jan. 08, 1951: The year began inauspiciously. Although industrial production in January was up 14% from 1949's midsummer recession low, there were plenty of signs that it might fall again. Unemployment stood at 4,480,000, the highest since World War II's end; the stock market, which had been climbing steadily for seven months, took a sharp drop. Motorcars were so plentiful that they could be bought readily off any dealer's floor. Was a recession on the way? Croaked Montgomery Ward's Sewell Avery: "The time is not far away." The president of the U.S. Chamber of Commerce saw the same danger. "If we keep on this spending spree at the rate we are going . . . our tax burden will become well-nigh intolerable." The nation, he added, is "very near that point which economists refer to as the 'peril point.'"
- Monday, Jan. 10, 1955: The latest doomsayer: Colin Clark, Australia-born economist, Oxford teacher and author of *The Conditions of Economic Progress* and four other books. Clark as early as 1942 foresaw the great American postwar boom and also won applause for demolishing phony Soviet statistics of vast economic progress in the U.S.S.R. He predicted that the U.S. was in for a major depression, and right up until the November election Democrats cried economic havoc.

From the oceans of facts, statements, and analyses that one might choose, the selections above are but a bit of sea spray. But they paint a picture of two very different worlds over the course of a decade: of an economy in its heyday, yet to be matched again; and of the expert and authoritative keepers and analysts of that economy who required a decade of proof before they abandoned their expectations that the U.S. would sink back into the Depression from whence it came once World War II ended. Reading the daily papers, how might we have allocated our savings during those years?

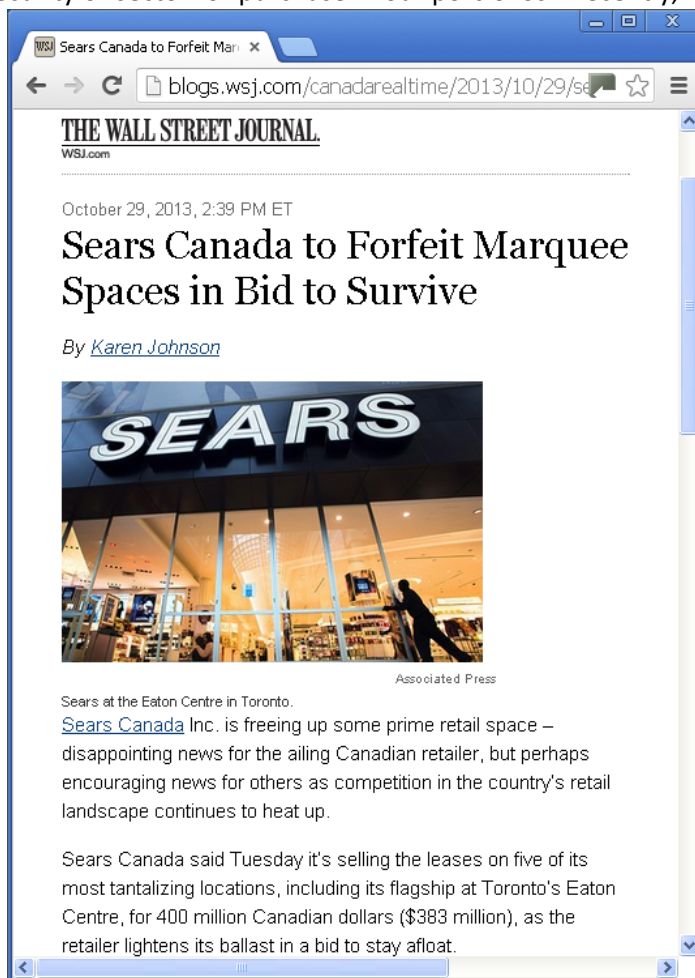
**Section III: How the Press Helped Put a New Stock in Our Portfolios**

It can take weeks or even months to qualify a security or sector for purchase in our portfolios. Recently, it required not so many days, perhaps a Horizon Kinetics record, and it couldn't have been done without the assistance of the press. This is the article that caught my eye some weeks ago. Note the decisive, emotive terminology. From the headline itself: "Sears Canada...In Bid to Survive", and from the 2<sup>nd</sup> sentence in its own standalone paragraph: "...lightens its ballast in a bid to stay afloat."

At the time, I was familiar with Sears Canada mainly in the context of its parent company Sears Holdings, rather than having evaluated it as a standalone investment. I did not have the impression that financial distress was one of the company's failings. Here is the analysis, which required very little in the way of special training—no 'deep dive' here, no databases or Excel spreadsheets. The October 29<sup>th</sup> article reported that the company agreed to surrender the leases at five of its full-line department stores to the landlords, in exchange for which the company received a payment of \$400 million. These are not stores that Sears owned, mind you; they were leased, which is usually shown on the balance sheet as an obligation. But these leases probably had decades before they expired, and apparently the landlords were willing to pay substantially to control those properties again. At the time, the entire stock market value of Sears Canada was only \$1,450 million, so surrendering those five leases provided cash equal to over one-quarter of the company's market value. Moreover, the company still had 111 additional full-line stores remaining as well as over 300 smaller-format stores and other assets.

Well, looking at some older articles, it seems that several months earlier Sears Canada had done the same thing: in June it agreed to vacate two stores, for which the landlords paid the company \$191 million, and the landlords have an option to have the company vacate a third store within five years for an additional \$53 million. And the prior year, the company did the same, receiving \$170 million for vacating three stores. If you try this yourself, you'll see that this part of the analysis doesn't require much effort.

The above article suggested that Sears Canada was in financial trouble, so one must review the balance sheet. Here is what was on that balance sheet as of August 2013: net current assets: \$559 million, of



which cash was more than \$300 million; debt: \$46 million; and retirement liabilities: \$415 million, and heading down. That's a rather liquid balance sheet if a company is not losing money. As to losing money, the company's operations were cash-flow positive in the preceding year. This didn't take too much time either.

So, if the company agreed to vacate six stores for \$644 million, how much might the rest be worth? The annual report provides information that the average size of the full-line department stores is a bit over 128,800 square feet. In that case, the \$644 million, for those 11 stores amounts to about \$450 per square foot. Now some would say, and they're probably right, that these were among the best located, most valuable Sears Canada stores, and that the remaining 111 full-line stores are worth far less.

Ok. Our investigations suggest that merely to construct a mall store costs well above \$100 per square foot. If we assume that the remaining full-line stores are worth only that much, then 111 stores x \$100/sq ft x 128,800 sq ft/store = \$1.43 billion, or \$14 per share. That was equal to the market value of Sears Canada at the time. Nor does that calculation include the 300-plus other properties. Nor does it include the top four full floors of the Toronto Easton Centre, the premier shopping center/office tower/hotel complex in Toronto, which the company did not vacate as part of the October transaction. Nor does it make allowance for development or redevelopment opportunities at certain locations, a major one of which is currently in process. This part of the analysis involved no Excel spreadsheet and no Bloomberg terminal. It did involve the equity yield curve—most investors are not as interested in value 2, 3, or 4 years from now as they are in what can be seen or reported in the here and now, and that disinterest can translate into very significant discounts. That is an intrinsic part of our portfolio construction process.

So, thank you to the press.

*What This Means for Our Portfolios*

Returning to the question about stock valuations and future performance following the 32% return from the S&P 500 Index, that fact contains surprisingly little information. Then what about performance over the past five years, with the stock market returning an annualized 18%, also well above the norm? Neither does that say whether stocks are expensive. These few additional facts, though, do contain a lot of information:

- U.S. corporate profits, during those five years 2009 through 2013, expanded by 11.2% annually; and the per-share operating earnings of the S&P 500 Index companies rose by 17.8% per year. With this information, one would not necessarily think to ask if stocks are too expensive.
- But if one lengthens this time series by another two years, starting with year-end 2006, the picture changes. The S&P 500 Index returned only 6.0% per year during those seven years. U.S. corporate profits expanded by only 3.5% per year, and the S&P 500 earnings by only 2.2% per year.

All that's happened in these examples (and, for that matter, during the past 20 or 40 or 60 years) is that the stock market has mirrored the rate of corporate profit growth. It can't be otherwise. For if it is, and for too long, then stocks will rapidly become bizarrely expensive or cheap. The past five years only seem ebullient because they were a recovery from a trough. The past seven years is undoubtedly more representative of the future. During the 76 years from shortly after World War II, 1946 through 2013,

U.S. corporate profits rose from \$20.3 billion to \$2,126 billion, which is about 7.2% per year. The U.S. stock market happened to appreciate by 7.4% per year. That's the way it works.

As to the future, corporate tax rates, after 50 years, have finished going down; interest costs, after 30 years, have finished going down; the unfettered U.S. corporate global expansion that was hinted at in the *Times Magazine* articles of the 1940s and 50s has run its course, as has Federal spending in excess of GDP growth. With all of these significant contributors to historical growth exhausted, does one realistically expect future corporate profit growth (i.e., stock market returns) to replicate those of the past, irrespective of whether these historical assumptions are baked into asset allocation and retirement planning models?

Back to Sears Canada. Sears Canada has a number of characteristics that tend to exclude it and companies like it from the rule sets of ETFs: it is a spin-off; it is owner-operated; it has a limited share float, since 50% of the shares are held by the owner-operator; it is now being managed as a different type of business (real estate) than the one by which it is categorized in databases (retailer). It is priced, as reviewed earlier, at a startlingly low level. It is an example of the differences to be found between rules-based investing and fundamental analysis, and the types of companies with positive predictive attributes that trade in the shadows on the 'wrong side' of the ETF divide.

As to the question of valuation and future return potential following a period of appreciation, let's first discuss some of the companies we already own.

- The largest holding in our Core Value strategy now happens to be **Jarden Corp.** In terms of sizing, the position hasn't been added to since July 2011, 2 ½ years ago. It then traded at an irrationally low, single-digit earnings multiple. As of this past year-end, the share price had tripled versus our average cost, and is more than 75% higher than at year-end 2012. The P/E ratio, based on Wall Street consensus earnings estimates for this year is 15.4x. The P/E ratio of the S&P 500 Index, based on Standard & Poor's own earnings estimates, is 15.4x. So Jarden is more expensive than it was, but by this measure no more expensive than the overall stock market, and we believe that it is a much superior company than most of those individual companies that make up the market.
- **DreamWorks Animation**, about the 3<sup>rd</sup> largest holding in the Core Value strategy, more than doubled this year, and is about 35% higher than when the position size was increased this past June. Yet, I believe that the shares are cheaper today than they were 12 or 18 months ago. Until then, DreamWorks did one thing: it made animated movies, and it was analyzed and valued as such. We thought it did two things: the movie making and, over time, the building of its movie library, which may be valued separately and had the characteristics of a dormant asset. Here's what has happened in the past 18 months or so, none of which has yet had time to make an appreciable, visible impact upon revenues or earnings:
  - April 2012: acquired Classic Media, which owned characters such as Casper the Friendly Ghost, Waldo, He-Man, Lassie, the Lone Ranger, and Rocky & Bullwinkle, among others. These could be re-commercialized as television series.
  - Late 2012:

- formed Oriental DreamWorks, a joint venture with three Chinese investment firms that will produce Chinese-themed animated and live-action films, The first animated feature film will be released in 2015.
- formed a joint venture with local partners to build The Dream Center, a six-city-block riverfront development in Shanghai that will include theaters, restaurants, shopping and a Kung Fu Panda themed entertainment zone. Completion: 2016.
- February 2013: entered an agreement with a European amusement park operator to create three DreamWorks theme parks in Russia (St. Petersburg, Moscow, and Yekaterinburg). The joint venture partner will design, build, and manage all the properties, with DreamWorks earning licensing revenue.
- April 2013: opened DreamWorks Experience in Macau as a joint venture with the Las Vegas Sands Resort. This is a themed resort that includes performances and shows, a DreamWorks-themed hotel and rooms, a daily parade, and opportunities to meet characters from the films.
- June 2013: entered into an agreement with Netflix to supply 300 hours of original programming based on characters from *Shrek*, *the Croods*, and *How to Train Your Dragon*, among others. The deal also gives Netflix rights to content based on future movie releases, including *Mr. Peabody and Sherman* (acquired with the Classic Media library), to be released this year.
- July 2013: entered an agreement with Hasbro to create toys and games based on *Bureau of Otherworldly Operations* and *Trolls*, two films to be released in 2015 and 2016.

Now, how much in earnings are those worth to a company with a stock market value of still less than \$3 billion?

- **Texas Pacific Land Trust** (the “Trust”) will be the last example of a company that despite being much higher in price than it was a year ago, is actually cheaper. The Trust was actually Horizon Kinetics’ first research report. At that time, in early 1995, it traded at \$4.00 per share. At year-end 2013, the shares closed at \$99.99, which works out to about a 19% annualized return.

The original valuation model was based upon the Trust’s mandate to repurchase shares with available cash flow, which it has been doing since, believe it or not, 1888. In 1995, the Trust owned 1 million acres of land in west Texas and used the proceeds from periodic land sales, along with modest revenues from grazing fees and oil royalties, to repurchase shares. Because the shares were too cheap, this being perhaps the longest-time-horizon security one can identify, more and more acres would come to be embodied in each share as they were repurchased, for a very low-risk form of internal compounding. The report’s original estimation, almost 19 years ago when there were 15.4 million shares outstanding, was that by 2010, which was as far as the projection went, the share count would have shrunk to only 8.3 million. As of last September there were 8.6 million, so the model wasn’t all that far off.

Although the Research Select strategy has held Trust shares since 2007, and even though the shares just about doubled during 2013, the position was added to late last year. The reason was an announcement, this past June, that Chevron and Cimarex, which both own land in Culberson County, Texas that was problematic to drill separately, combined their acreage in a joint venture

so as to establish a major drilling program. This is located in what is known as the Delaware Basin, where, because of horizontal drilling technology, there now appear to be vast reserves of economically extractable oil and gas. Much of this is on former Trust acreage in which it retains a royalty interest in any production. The size of this program suggests that it has the potential to markedly increase the Trust's revenues. Moreover, with this revenue increase, not only will the Trust be able to accelerate its share repurchases, it might also curtail land sales, such that the growth rate of acreage per share can accelerate yet further.

To continue the discussion about future valuation opportunities for companies not yet in our portfolios, one of the outcomes of rules- and ETF-based investing is that a greater variety of undervalued businesses are being made available. A focus of indexation is to provide portfolio exposure to very specific criteria, such as an asset class, an industry sub-sector, a growth metric, a stock market capitalization band, and so forth. Companies that can fulfill those needs can be rewarded by inclusion or a greater weight in a successful index, with the attendant demand for their shares and a higher stock price, which equates to a lower cost of capital. Managements have become sensitive to these constituencies, and they will make capital allocation decisions to accommodate them.

For instance, large corporations have become much more active in spinning off or otherwise divesting subsidiaries that do not closely match the parent's primary business line, or that have a lower return on capital, slower growth profile, are more capital intensive, etc., etc. Our spin-off analysts can hardly keep up lately. An example would be a large chemical company with, say, \$40 billion in sales that divests a division that also makes chemicals, but a different type that doesn't have much production or sales synergy with the parent's main products and which has, in any case, only \$1 billion in sales. Now there's nothing wrong with a company with \$1 billion in sales that are profitable. I wish I owned one. The parent presents this as a streamlining move, which makes the parent more of a 'pure play' and improves its financial metrics. This is attractive from the perspective of index operators. However, unlike the historical norm for corporate spin-offs and divestment, which were typically troubled or underperforming operations, nowadays there is often nothing wrong with the discarded division other than the new fashion for 'purity' among large public companies. Thus, the spin-off realm is providing us with more fundamentally attractive opportunities.

There is another use for us from such streamlining. As the behemoth agent-operators streamline and discard assets, there seem to be, on the other side of the scrimmage line, the more nimble owner-operators ready to pick up these assets at a suitable price. **Jarden**, for instance, acquired Yankee Candle from a private equity firm this past September. The \$1.75 billion price, equal to over one-quarter of Jarden's own market value, was its largest acquisition to date. Yet, Moody's actually wrote that the acquisition was a positive for Jarden's credit standing. There is a new position we hope to establish soon in an owner-operator company that was established with the express purpose of acquiring such divestment candidates from larger firms; but not having purchased it yet, the description will have to wait for another time. Based on our study to date, it has the potential to be a very successful investment, on par with Jarden.

The owner-operators also employ the valuation-enhancing possibilities that indexes offer, but in a different manner. An owner-operator company with a valuable asset or business that is not being suitably valued within the parent company might carve out merely a portion of it so that the public



market can price it more appropriately. This is not divestment. This happened at the end of May, when the Canadian portfolio company **Dundee** spun off one-half of its real estate subsidiary **Dream Unlimited**, which is quite undervalued. It was being purchased in our various funds and strategies as late as last week. **Liberty Media**, under John Malone's direction, makes use of similar techniques constantly.

So, there's no shortage of true, value-oriented companies to buy—the ETF world assures that.

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