3rd Quarter Commentary

October 2017

Excerpts from a Conversation with a Long Time Client

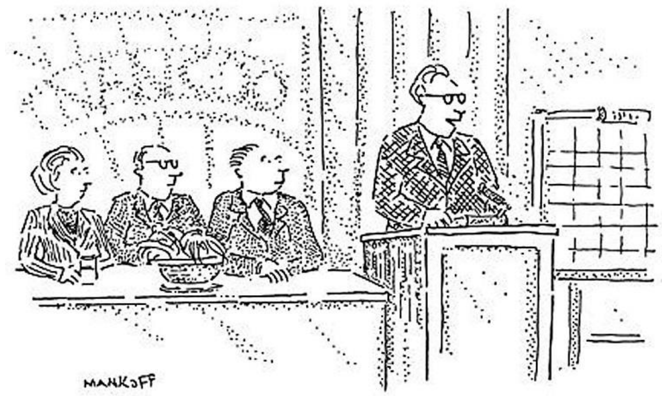
Once or twice a year, for the past two decades, I meet with a particular client during his visit to New York to attend to various interests here. As we did just a couple of weeks ago, the day after I returned from a presentation in Chicago about indexation, ETFs and their impact on the securities markets. "What's the Horizon view of the world today?", or "What do you want to tell me?" is a typical opening. At this particular breakfast, at that moment, what I was most interested in sharing was the unexpected impression I took away from the prior day's event as well from a series of conference presentations I have made this past year. In abridged form, it went something like this:

> Frankly, I've been most struck by the stark contrast between the occasional remark one of our clients might make about our persistent review of the distortions that index-based investing has created, and the responses by these outside audiences. A Horizon client might say, 'Ok, I get it, ETFs bad, overvalued, stay away, but what's next?' Yet, at each of these audiences, filled with sophisticated professional investors and consultants—in one case, an annual assemblage of family office principals and chief investment officers, in another a gathering of investment advisory professionals from firms large and small—I see and hear something quite different. I get raised eyebrows, audible sounds of surprise, chuckles, and smartphones out to take a photo of a chart or slide. They don't even know. They've heard some warnings here and there by industry luminaries such as Howard Marks or Jeff Gundlach; they're more uncomfortable about certain statistical measures of structural excesses than they used to be, but they really don't know.
>
> In yesterday's [the Chicago] presentation, I introduced myself by telling the attendees that before they left the room I will have proven to them that they don't even know what their own portfolio risks really are: what their sector allocations are, whether to international or emerging markets stocks, to high yield bonds, to the financial or value sectors, or even what their P/E ratios are. And I believe that I largely succeeded.

So our breakfast conversation proceeded from there. It was a given that his account has migrated farther and farther from the systemic risks of the major, index-centric stocks and bonds, that there is now hardly any meaningful overlap between his holdings and the S&P 500. So what we really spent our time speaking about were two new asset classes that have arisen from outside the major indexes, from outside the system, so to speak—that this is therefore a development likely to be of historical significance—and about the implications. Which are two-fold. And that they fall into the bad news/good news format.

The bad news was that these asset classes pose extra-systemic risks to the major indexes that hadn't previously existed. All investors should be aware of them, irrespective of whether they are philosophically affiliated with active or passive management.

The good news, as I related it, was that the value destruction threat that these new asset classes pose to the dominant stock market indexes could be recouped in market value creation within these non-indexed assets—a massive wealth transference, really—that we have already begun to incorporate those new asset classes into his account, and that they have already begun to alter the character and return profile of his portfolio. We didn't have time to finish the conversation that morning, but we can try to do so now.



"And so, while the end-of-the-world scenario will be rife with unimaginable horrors, we believe that the pre-end period will be filled with unprecedented opportunities for profit."

Some of What I Said to the Attendees

Anyone who has listened to these quarterly reviews has heard some of what's about to follow. But it won't be laborious, since I'm going to breeze through them. The purpose of this section is simply to let you realize that you know what most experienced investment professionals don't about just how far off the rails the securities markets have veered – at least judging by my experience at these conferences. Here are some of the audience-favored slides, which can be viewed here.

Valuation Sobriety Test

Semantic Mis-Investing #1: Security Diversification

Semantic Mis-Investing #2: Foreign Equity Exposure

Semantic Mis-Investing #3: High Yield (or maybe just Low Quality)

Indexation is NOT Dependent on Individual Securities. Really?

Semantic Mis-Investing #5: Correlation Diversification

The Pursuit and Myth of Low Beta (and accumulation of systemic risk)

Semantic Mis-Investing #6: Indexes as Fact-Based Investing

Are Active Managers the Anomaly, or is the Market?

Central Banks Buying Stocks, and the Destruction of Price Discovery

The Trap: Nowhere to Go

So What's Next?
Let's start with this idea of the externally based risk to indexation that I first mentioned – which one should find alarming. We are almost never exposed to anything but in-system risks, and can hardly imagine the alternative. Consider Amazon, which is clearly a disruptive force. It has already destroyed the profitability of entire industry sectors, and will continue to do so. It wiped out all the bookstore chains but one (although this year Amazon has already opened a half-dozen physical bookstores of its own in New York and other cities), it is destroying profit margins in the retailing industry, and by extension is threatening the real estate that houses those retailers, and by further extension the profitability of the REITs that own the real estate. And by acquiring Whole Foods, Amazon is threatening the grocery store chains.

Yet, the loss of earnings and market value in these industry sectors, which detracts from the value of various indexes, can be counterbalanced by an increase in Amazon's earnings and market value. That resilience within the broad indexes is because they embrace both the ultimate winner as well as the loser.

Here's a similar story, with a slight yet consequential difference. It unfolded beginning in 1913, after Ford Motor Company developed the assembly line technique for producing the Model T in mass market volume, destroying what has been colloquially referred to as the horse and buggy industry. It was many industries, really, along with their vast workforces: wheelwrights, horse farms, harness makers, blacksmiths, stables, I suppose the landlords who housed those businesses, feed growers, and so forth.

The difference versus the Amazon example was that these industries were *not* publicly traded constituents of the Dow Jones Industrial Average. Therefore, Ford's ascendance was not a counterbalance to the loss of their earnings and business value from the index, but purely additive. So all that history knows is that the Dow Jones went up, and that is the result that is included in the historical returns. A freebie for the index.

Now, how about the reverse of that example, whereby a company or technology from *outside* the indexes disrupts industries *inside* the system? The increase in profits and value at the disruptor could not provide a counterbalance to the decline of its index-based victims. This has a very good chance of happening in the foreseeable future due to the emergence of two new, technology-enabled asset classes.

I'm going to start with one of them and describe how, from a risk point of view, this new asset class can disrupt significant industry sectors in all the mainstream stock indexes. After that, a discussion of how it can be used by investors who understand it, either as a source of return or as a hedge against the systemic risk of the indexes. These are equivalent statements, really, just expressed differently.

The asset classes in question are cryptocurrencies, such as bitcoin and, separately, the blockchain technology that enables and supports them. They are related, but different.

A prefatory remark first. Many of our clients have partaken of individual discussions with us about this topic, but we've not spoken broadly about it to date. The purpose here, for those who are not familiar with cryptocurrencies—and why would you be? —is simply to remove the mystery. I'll describe in general terms what they are, and their relevance to you and your investments. It is simply an introduction. If you wish to know more, we recently introduced a dedicated page on our website that includes some further thoughts on the topic (http://horizonkinetics.com/cryptocurrency-research/).

And then I must—there is no question about it—make a brief defense of the suspicion, if not outright accusation, that the research and attention we have spent on this subject means we have strayed from our roots as value oriented, risk averse investors. And after that, of course, an update on a few of the stocks in the portfolios.

Asset Class #1: Cryptocurrencies, General Review

Three Interested Parties, Three Opinions

By now, many more people have heard of cryptocurrencies than even two months ago, if for no other reason than that Jamie Dimon, who as the CEO of JP Morgan Chase is one of the nation's premier bankers, commented briefly upon bitcoin several weeks ago at an investment conference. Bitcoin is the first and by far the most popular cryptocurrency. The most often repeated quotes from that interview were that bitcoin is "a fraud", and that if any JPMorgan trader were to transact in bitcoin, he would "fire them in a second".

Hardly publicized at all were the extensive comments about bitcoin and cryptocurrencies by Abigail Johnson, who as the CEO of Fidelity Investments is one of the nation's premier asset managers. At a conference in May, she revealed that Fidelity had set up its own cryptocurrency mining operation, was planning to make cryptocurrency custody and trading services available to clients on the Fidelity website, and that some Fidelity employees even use bitcoin to pay for lunch at their Boston headquarters cafeteria.

Then there is a third set of interested parties – very interested, actually – who don't exactly care who wins or loses this argument, so long as the trading activity persists. In November 2016, CME Group, the giant among derivatives and futures exchanges, launched two bitcoin price indexes; this is a first step toward enabling a bitcoin futures contract. In August 2017, competitor Chicago Board Options Exchange announced that it intends to establish a bitcoin futures contract within the coming year. If either firm is successful, bitcoin becomes an institutionally tradeable security, not just an esoteric, fringe idea. Indeed, late last month, ProShares, the fifth-largest ETF company, applied to the SEC to offer two bitcoin ETFs, one so-called Bull version and one Bear version, subject to the availability of a bitcoin futures contract.

So, what is cryptocurrency?

In one sense, it is nothing other than an electronic or digital form of money. As far as that goes, it is little different than buying U.S. Treasury Bills at www.treasurydirect.gov. There, you can invest as little as $10 at a time, all, as the website says, "online in a secure environment." You get no physical certificate or statement; your ownership is a digital notation on a digital database on a U.S. Treasury computer.

So, the historical uniqueness and disruptive power of bitcoin is not due strictly to its being digital. It incorporates a few additional factors.

- First, bitcoin is ***not fiat or government issued*** currency. That is not unique either. Before the U.S. national currency and central banking system, banks issued their own currency, and there were hundreds of them. A holder of a banknote from one bank of uncertain creditworthiness might not have been able to get it redeemed by another bank or in another state. It was a pretty horrible system.

- Second, ***the supply of bitcoin is fixed and non-inflatable***. This is defined by its software code, which is its monetary policy: only 21 million units will ever be issued[1]. That *is* unique. That makes it humankind's first non-dilutable currency. This is an enormously valuable attribute, and we will explain why shortly.

  It is worth noting that there is no bitcoin company. There is merely a protocol that is agreed upon by all who use it. All that is necessary for an object to be money is common agreement. For instance, for a number of decades in some of the American colonies in the 1600s, tobacco leaves were the safest and most reliable currency. So much so, that they could be exchanged for gold and used to pay taxes.[2] Ultimately, though, the supply increased – because all you had to do was grow more – which debased the currency, and tobacco leaves had to be abandoned in favor of something superior.

- Third, ***bitcoin can neither be counterfeited nor confiscated***, a universal challenge of physical money. Another reason bank-issued notes of the past were often not accepted was that their authenticity could not be proven. Bitcoin cannot be counterfeited, because each owner possesses a unique cryptographic password, like that of a Swiss bank account. Which is also why it can't be confiscated. This level of security frees the holder from bank safekeeping. It is borderless and can be transferred anywhere, instantaneously and in any amount.

Incidentally, the desire for a form of money not hostage to government dilution or confiscation is hardly new, and has been the subject of previous scholarly work.[3] Bitcoin appears now only because advances in technology have finally made it feasible. In this sense, it is a very old idea, the desire for which is 5,000 years old, whose time has, perhaps, finally come.

"Why Do You Think Cryptocurrency is Valuable?"

Re-framing the Definition of Risk: Volatility or Purchasing Power Protection?

A major reason that academics and the mainstream investment business do not accept cryptocurrency as legitimate is because modern portfolio theory defines risk as price volatility. Cryptocurrency has been far more volatile than even the most volatile equity class. Yet, in a historical, rather than day to day or year to year context, the great investment issue has never been control of volatility. It has been the retention of purchasing power or, stated differently, defense against the erosion of purchasing power—the contest of unending government efforts to debase the value of money versus the struggles of the citizenry to resist debasement.

[1] That number will be reached in the year 2140, versus 16.6 million as of 10/14/2017.

[2] Scharf, J. Thomas. History of Maryland, From the Earliest Period to the Present Day, Volume I. Baltimore: John B. Piet, 1879. p. 273 http://archive.tobacco.org/History/colonialtobacco.html

[3] The Denationalization of Money by F.A. Hayek Nobel Laureate, 1974

To put this in relatable terms, here are just two examples of the mind-numbingly long history of government monetary policy, domestic and foreign, recent and ancient, to debase their currencies. Over any saver's lifetime, this can be devastating.

- The Roman Empire debased its coinage for 2,000 years. As one example, during the 73 years between Marcus Aurelius's reign ended in 180 CE and the beginning of the reign of Emperor Gallienus, the denarius silver coin was debased from 75% silver to only 5%, by which time the silver was just a surface coating that would wear off. That is 93% depreciation, which works out to about 3.6% per year.
- Staying with the 73 year timeframe, from 1943 to 2016, the U.S. dollar likewise lost 93% of its purchasing power, based on an annualized inflation rate of just over 3.6%. For most of that period, though, U.S. citizens could earn a comparable yield on their bank deposits or treasury bills, so that purchasing power could be maintained. That's not been the case over the past ten years, though, since short-term interest rates have been kept near zero; today, money really does earn a negative return.

As importantly, monetary history also reveals repeated examples of how certain items of fixed supply—those that were reliably scarce—have provided a remarkable degree of investment return.

- The Liberty Dime, which has not been minted since 1945, depending on a variety of factors including condition, may be worth about $72 today[4]. That's a 72-year rate of return of 9.7%. That compares quite favorably with any type of fixed income instrument and most forms of equity. And this is despite the fact that the supply of silver is constantly increasing and is now priced at $16.47 an ounce; it traded at almost $50 in 1980.
- Or, there is the 1909-S Indian Head penny. Rare coin website CoinTrackers.com estimates its value, even if only in average condition, at $600. That represents a compound annual rate of return of 11.6%. Compare that with holding a $1 from 1909.

It is astonishing that an average-condition 1909-S Indian Head penny, collecting no interest, could dramatically outperform every bond index or fixed income index within reason, as well as the S&P 500. It only escaped the debasement power of government because it stopped being issued. In an operation of the economic principle known as Gresham's Law—that bad money drives out good—individuals withdrew these coins from circulation and saved them for their scarcity value. One can see that the investment return of the these two coins was not only a matter of appreciation per se, but also of retaining value relative to the depreciating currency in which they were denominated.

In a parallel manner, cryptocurrency also bypasses or renders obsolete the control of the value of money by central banks and governments. As to how valuable something like bitcoin could be, let's presume that it ends up having only one use, as a fixed-supply store of value, like the Liberty Dime, not for transactions or any other purpose. If it were, for the sake of argument, accepted as a store of value, why should it not become equivalent in market capitalization to other presumptive stores of value, like cash, which now earns a negative return? Remember, this is just a thought experiment.

[4] http://cointrackers.com

Last year, for instance, the U.S. dollar was debased by over 3%. That's the degree to which the M2 measure of money supply increased in excess of GDP growth. Sound familiar? If the holders of cash as a wasting asset decided to hold bitcoin instead, how much demand would that represent?

Specifically, the U.S. money supply, a measure known as M2, is $13.7 trillion[5], while as of Saturday, October 14th, the market value of bitcoin was about $94.6 billion[6]. In order to fulfill that much demand, the value of bitcoin would have to rise to $13.7 trillion. That would be a 145-fold increase. If the same sentiment were shared by the citizens of just the Euro Area countries ($9.2 trillion of M2) and Japan ($8.6 trillion of M2), bitcoin would appreciate 333x. This doesn't include demand from any other nations, nor the trillions of dollars of sovereign debt worldwide that trade at zero or negative yields, nor the demand that owners of gold might represent, and so on.

If it seems outlandish to suggest that the people of Japan will suddenly start buying bitcoin, then listen on:

- This April 2017, the Bank of Japan changed its banking laws to recognize bitcoin as legal tender. On July 1st, as encouragement for its use, Japan removed the 8% excise tax on goods and services purchased with bitcoin. There are now retail chain stores and airlines accepting bitcoin in Japan, with ATM-like kiosks to facilitate its purchase via cash or credit card.
- Also on July 1st, 2017, Australia's central bank recognized bitcoin as legal tender and exempted purchases made with bitcoin from the 10% excise tax.
- On July 11th, 2017, Switzerland's Financial Market Supervisory Authority approved the first Swiss private bank for bitcoin asset management. This bank holds $15 billion in client assets. It has offices in Zurich, Abu Dhabi, Dubai, and London.

The actions of these central banks of major developed nations to formally accept bitcoin are not well publicized in the U.S. Nevertheless, their actions make it more difficult to casually dismiss cryptocurrency as a fringe or fanciful notion not worthy of serious discussion.

Moreover, a fixed-supply currency is not only a store of value—or a hedge, if you wish—versus fiat cash or bonds denominated in an inflating currency. It is also a threat to the profitability of the banking system. If and as investors place money into bitcoin, they necessarily withdraw money from banks. This has the possibility of depleting the low-cost funding that banks rely on for their interest-rate-spread earnings, and of demonetizing the banking system. Banks are a major weighting in most broad indexes. They are also one of the major customers of another major sector of the large indexes, information technology. This could have severe repercussions for conventional index-based investing.

If this, too, seems fanciful, you might be interested to know that the Scandinavian countries have been moving toward cashless transactions, such as via phone apps, far more assertively than we are accustomed to here in the U.S. They do it even for purchases as minor as candy bars. Many Swedes don't carry cash at

[5] https://fred.stlouisfed.org
[6] 16.62 million units x a price of $5,691 per coin

all, over one-half of Swedish banks no longer store cash or accept cash deposits, and the circulation of Swedish krona fell over 40% between 2009 and 2016. Most of these transactions still occur via the existing financial system, through the credit card companies and banks. Cryptocurrency, though, is just an extension of this existing trend and doesn't require banks.[7] It can act as both a store of value and a bank account.

Asset Class #2: Blockchain

So, that was a bit about cryptocurrencies—perhaps more than you wanted. There isn't time—and I'm sure no patience—this afternoon to cover the related asset class, which is the blockchain technology that enables and maintains bitcoin and other cryptocurrencies. So, unless there is sufficient active *disinterest*, that will be covered next time. To foreshadow that discussion, note that blockchain poses its own flavor of disruptive force for the financial sector. It is also a much more investable asset class, with very different risk/reward characteristics than the cryptocurrencies it supports. Properly employed, it is actually an asset class that answers another long-sought investment dream: low volatility, coupled with a very high yield. In our opinion, it can be extremely useful in service of a variety of portfolio objectives.

About That Defense

Some questions have been voiced about why we have spent so much time investigating bitcoin, much less writing and speaking about it, much less buying any. A concern implicit in these questions is: "Is it not a very risky investment? You have even written that it could very well go to zero. So how can you justify being involved with it?" A broader and more damning concern is whether we are guilty of abandoning our value-investing roots, or have lost our way. Glad to answer.

Let's start off with the riskiness, and let's use as a benchmark for objective comparison of potential risk, a fund that is universally accepted as a conservative investment. The iShares S&P 500 Value ETF (ticker IVE) should do the trick. It is a $14 billion ETF that is used, obviously, for its lower-risk attributes. The largest sector of this ETF, at 28%, is Financials[8]. It is generally acknowledged as factual that the nation's financial risk measures, such as total debt to GDP, are at historic highs. As well, interest rates are at historic lows, and it is likewise broadly acknowledged that this places finance companies in particular peril if short term interest rates—which represent their cost of funds—rise. It is also true that this 28% position is twice as high as the 14% weight in Financials in the S&P 500, and 25% higher[9] than the *highest* weighting that the Financial sector ever attained in the S&P 500, which was on the eve of the Credit Crisis at year-end 2006.

So, if the financial sector were to experience what is termed a correction, not a collapse, just the defined 10% decline, then the NAV of this Value ETF would decline by 2.8% points. This assumes that during a week or month when the financial sector declines by 10%, the other stocks in the ETF don't decline at all, that nobody cares what that decline implies for the rest of the economy. If the financial sector were to decline

[7] https://cointelegraph.com/news/sweden-poised-to-become-leading-scandinavian-cashless-society-through-bitcoin

[8] Until September 2016, Standard & Poor's included the real estate stocks in the financial sector, since these also share the characteristic of leveraged balance sheets. But, Standard & Poor's wanted to reduce the apparent size of the sector, for whatever good reasons they might have had. So as of September 2016, real estate is shown separately.

9 At the end of 2006, the S&P Financials weight was 22.27%.

by 15% points, that would cause a 4.2% drop in the ETF. That would not even be a crisis-like decline, although it would get people's attention. So that is a risk that people think is just fine.

In comparison, I might think that a 0.5% position in the Bitcoin Investment Trust (ticker GBTC) in an account could be very useful. On the one hand, using a figure discussed earlier, let's say I think it could appreciate by 333x. That 0.5% weighting would cause the entire account to appreciate by 166%. In dollar terms, if a $100,000 account purchased $500 worth of bitcoin, which then increased by 333x, the account would be worth $266,000. If this occurred over a 10-year period, and if nothing else in the account appreciated at all, the account would still experience a 10% annualized return. Or, the account could lose $500. The equivalent of a night out at the theater, with dinner and parking.

Call that high-impact investing, if you like: you don't have to invest a lot to earn a lot. I don't call it that; I call it an emerging, historically and sociologically unique asset class that, if accepted, will change society, and before it does that, will be enormously valuable, and which could also act as a hedge against index-based systemic risks that concern me very much.

Howard Hughes Corp.

The Howard Hughes Corp. (Howard Hughes), as it exists today, was conceived in 2010 as a spinoff from General Growth Properties. The transaction was part of General Growth Properties' bankruptcy reorganization precipitated by the Credit Crisis of 2008. We have owned shares of Howard Hughes since that time, and, though not overly concerned about short-term stock price movements, have watched with interest as its price has fluctuated, often with no obvious relationship to the fundamentals of the business.

Although the company has been publicly traded for seven years, it might still be characterized as misunderstood. This is because, even though it has been very successful in developing and improving the economic value of its portfolio of real estate, it shows very little in terms of net earnings. As is frequently the case for companies that lack visibility in terms of conventional financial results, investors may react to news without placing it in context. Most recently, the shares fell in the period leading up to and following Hurricane Harvey's landfall in the Houston area, while the S&P 500 and the Vanguard REIT ETF rose.

Why? Based on questions we received from clients, it appears that many assumed that the extensive Howard Hughes master planned community operations in the Houston area, namely Woodlands and Bridgeland, would be negatively impacted by the storm. A reasonable concern; after all, the Houston assets are among the firm's most valuable. As it turns out, the company issued a press release several days after the storm reporting only minor damage, that all of their assets were fully operational, and announcing its involvement in disaster recovery efforts in the area. Of course, the long-term value of these assets is inextricably linked to the health of the Houston area economy, which will take some time to recover, but it does not appear that the growth of the area will be halted indefinitely, although it will certainly be more sluggish during the rebuilding effort.

But the broader issue is this: the Houston properties comprise only one of several of the company's major assets. These are geographically diversified across the United States, and even if one removed the Houston assets entirely, one could easily justify the company's current market value. The main asset bases, and our assessment of their fair value, can be found in the accompanying table.

Asset	Fair value estimate
South Street Seaport, Manhattan, NY	$ 2.5-3.0 billion
Houston Assets, Houston, TX	$ 4.25 billion
Summerlin, Las Vegas, NV	$ 2.5 billion
Columbia, MD	$ 570 million
Ward Village, Honolulu, HI	$ 2.5 billion
Other properties	$ 480 million
Recent Market Capitalization for HHC	*$ 5.3 billion*

Source: Company reports, Horizon Kinetics Research

Of course, it is incumbent on investors to monitor news affecting their holdings, but it is crucial that a new bit of information be evaluated within the context of the investment thesis. Will this news have a long-term impact on the value of the company? In the case of Howard Hughes, the share price quickly recovered following the storm, though it remains below highs achieved when oil prices were higher. The latter reaction is, perhaps, another example of what is termed availability bias, making decisions on the basis of information that is more recently recalled (i.e., available) or memorable.

AMC Networks

Cord-Cutting Explodes: 22 Million U.S. Adults Will Have Canceled Cable, Satellite TV by End of 2017
Variety (September 13, 2017)

Cord-Cutters Sap AT&T's TV Business
Wall Street Journal (October 12, 2017)

'The ravages of cord-cutting': AT&T's race against time to save its TV business
Washington Post (October 13, 2017)

The Messy, Confusing Future of TV? It's Here.
New York Times (August 13, 2017)

"Cord-Cutting," "Skinny Bundles" and "OTT Offerings" are disrupting the traditional television landscape, as the NY Times title above expresses succinctly. There are substantial implications for operators in the media sector, but as is often the case, perception often obfuscates reality, which can be very helpful for research-based value investors.

For those not conversant in media industry jargon, *cord cutting* refers to a cable subscriber foregoing a traditional subscription ('cutting' the cable cord, although cable signals are now provided via the same fiber as internet). The consumer is left with a variety of options to access video media (both free and pay models), one of which is a *skinny bundle*. This refers to a cable package, offered either *over the top (OTT)* or via the traditional linear system, in which fewer channels are offered in the bundle compared to traditional packages. *OTT* refers to the ability to bypass the traditional time-linear cable subscription (that is, if you don't get home before the show starts, you've missed it) and instead consume video via a streaming internet feed at a time of your choosing. These offerings now exist directly from content companies, cable companies and third party providers.

Got that? Neither do a lot of other consumers, hence, the NY Times headline. But that is a contributing reason why traditional media companies, which used to trade at material valuation premiums to the broader market, now trade at a median 13x earnings, or about 40% cheaper than the S&P 500. To be sure, some companies are better positioned than others, as exemplified by AMC Networks ("AMC") and Lions Gate Entertainment, both of which are held in Core Value as of quarter end.

AMC's primary business is providing television programming via five national networks, including its flagship AMC channel, IFC and SundanceTV. It earns revenue relatively equally from advertisers and the affiliate fees that cable companies pay to carry the company's networks. These revenues are driven by viewership rates and the number of subscriptions. The headlines above imply that as more consumers forgo traditional cable subscriptions, companies like AMC will lose subscribers, impacting affiliate fees, hence, viewership and advertising fees. Partly as a result, the shares trade at approximately 8.5x earnings, which is about 35% cheaper than other media companies, and 60% cheaper than the S&P 500. More importantly, AMC trades at less than 12x free cash flow. Which is why we purchased AMC in 2016 and added to it this past June.

If someone knew those valuation figures only in isolation, they might wonder what manner of business risk is reflected in such a deep discount, that perhaps that pricing suggests a dire future. Yet, at the company's National Network division, which accounts for over 80% of sales, revenues increased by 5.6% in the June quarter, and operating income rose by 12%. That operating strength, though, is indiscernible to an index buyer or quantitative investor, since the international segment records negative earnings on a GAAP basis, distorting consolidated results, although that division breaks even on a cash flow basis. AMC was able to achieve these overall results despite the "ravages of cord cutting" because of the value of its primary asset: content.

AMC has amongst the highest rated and viewed primetime television shows on cable television, which enables it to negotiate higher distribution fees and advertising revenue. That it only has five channels is a further advantage; carriage of these channels is far less burdensome to cable companies than is carriage of many larger, competing networks that try to include over a dozen channels. AMC's sought-after content is actually resulting in stronger results despite a weaker industry backdrop.

Content is the key variable with all media companies (other than distributors), and if consumers demand specific content it will be valuable. The economics of original content in a world in which more consumers access content via OTT offerings and/or skinny bundles is yet to be determined, but AMC appears well positioned. It has control of long-term contracts covering much of their valuable original content library and production. As a result, the company should be able to continue to monetize these assets for many years to come, across various media platforms.

Back to the valuation, the shares trade at 12x free cash flow despite no contribution from AMC's international division, which accounts for about 17% of revenues. The international cable division was largely acquired recently, with the strategic notion that AMC could extend the commercial reach – mostly into Europe – of content it already produces. That could be very profitable. This requires a certain amount of time to market and to attain a certain degree of scale. If this venture is successful, then AMC's earnings will be that much higher. If ultimately unsuccessful, one presumes that AMC will sell or disband the effort, in which case the earnings drag from this effort will cease.

Lest we forget about behavioral finance, the discounted valuation should not be ascribed to the presumption that rational analysts and investors are making informed decisions about the AMC business prospects.

- First, AMC has a stock market value of only about $3.5 billion, which is well below the size needed for most major index ETFs. In a single week, Disney shares trade $3.5 billion of volume, equivalent to the entire market cap of AMC. Disney has a $150 billion market cap.
- Moreover, the Dolan family, which operates AMC, owns nearly 20% of the company's shares, so the tradeable market capitalization, or float, is that much lower. As well, they have majority voting control, so the company can't be acquired without their say-so.

None of these factors are conducive to inclusion in indexes and ETFs. Accordingly, the current valuation appears to have little to do with practical financial or economic factors; as a result, the company is dedicating a large portion of free cash flow to share repurchases, and has bought back 12% of its shares since year-end 2015.

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