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Structural Constraints As Opportunities

In today's efficient marketplace, finding an undervalued company ahead of the crowd is a difficult task. Instead, Murray Stahl, Chairman, CEO and Chief Investment Officer of Horizon Kinetics, and co-portfolio manager of the Kinetics Market Opportunities Fund, concentrates on companies with no fundamental issues but with structural impediments that drive away other investors. Employing the scientific method in research, the fund has the discipline to look for opportunities and the patience to wait for the market to catch up.

Murray Stahl
Chairman, Chief Executive Officer, Chief Investment Officer, Co-Founder

Murray Stahl is Chief Executive Officer, Chief Investment Officer, Chairman of the Board of Horizon Kinetics and is a co-founder of the Firm. He has over thirty years of investing experience and is responsible for overseeing the Firm's proprietary research. As the Firm's Chief Investment Officer, Murray chairs the Firm's Investment Committee, which is responsible for portfolio management decisions across the entire Firm. He is also the Co-Portfolio Manager for a number of registered investment companies, private funds, and institutional separate accounts. Additionally, Murray is the Chairman and Chief Executive Officer of FRMO Corp. He is also a member of the Board of Directors of the Bermuda Stock Exchange, the Minneapolis Grain Exchange, Winland Electronics, Inc., and IL&FS Securities Services Limited.

Prior to co-founding the Firm, Murray spent 16 years at Bankers Trust Company (1978-1994) as a senior portfolio manager and research analyst. As a senior fund manager, he was responsible for investing the Utility Mutual Fund, along with three of the bank's Common Trust Funds: The Special Opportunity Fund, The Utility Fund, and The Tangible Assets Fund. He was also a member of the Equity Strategy Group and the Investment Strategy Group, which established asset allocation guidelines for the Private Bank. Murray received a Bachelor of Arts in 1976, a Masters of Arts in 1980 from Brooklyn College, and an MBA from Pace University in 1985.

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Would you give us an overview of the company and the fund?

Our firm was established in 1994 by five founding partners, who are still with the company. The firm grew over the years, and now we have more research analysts and we manage more money, but otherwise, nothing has changed. We still have the same investment philosophy.

The fund invests in companies engaged in capital market related activities and services. In the last two hundred years of American history, it has been the money managers and the custodians who have facilitated all these transactions, from mortgage-backed securities to oil wells to gold mines. The facilitators seem to be in a much better position than the entrepreneurs, because the facilitators just take a fee and rarely risk their own capital.

The great financial firms also have a longer lifespan than conventional businesses. J.P. Morgan founded J.P. Morgan trust in the 19th century and now, in the 21st century, there is still J.P. Morgan Chase. It has been through good times and bad times, but still exists. How many companies founded in the 19th century still exist? Not that many. Sotheby's was founded in the 18th century as a bookseller, because books were expensive at the time, and still facilitates art and rare book deals.

Overall, the facilitators manage activities on behalf of others without taking existential risks. Of course, they have capital invested in computers and buildings, as they need a place to operate. Sometimes their businesses don't do that well, but they are not challenged in the way that a manufacturer would be if someone makes a better product.

What are the key elements of your investment philosophy?

Generally speaking, our philosophy is to do things that other people are not doing. We believe that the efficient market hypothesis is usually valid. If you want to find a good investment, meaning a good business or company, you are unlikely to uncover information or devise an analysis that other people do not have.

The only time you get a "deal" is when you invest in a company that people do not know well or avoid because of a structural anomaly or a structural constraint.

For example, today there is a rise in quantitative investing. Based on statistical characteristics, investors are long in a group of stocks and short in a group of stocks. Prime brokers will not accept many companies for margin purposes, even if there is nothing wrong with them. As a consequence, we believe those companies tend to be undervalued at the moment.

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What is your investment strategy and process?

Our analytical team is divided by structural anomalies or constraints. For example, we have analysts who cover spin-offs. When one company spins off another, the new company is not in an index and has no analytical coverage and can be thrown out of portfolios. That is a structural reason for not buying a stock that has nothing to do with fundamentals. So, we have analysts covering every conceivable spin-off.

Another area of interest is pre-packaged bankruptcy. Right now, there aren't many such companies that apply to the Kinetics Market Opportunities Fund, but we follow them. When a pre-packaged bankruptcy happens, everybody knows that the company is going bankrupt in a month or two. Typically, prior to the filing, the company gets together with the bondholders and tries to reach agreement on a reorganization plan. If the parties agree, the court stamps it. The company then may come out of bankruptcy and move forward in only a few months.

That represents an anomaly for several reasons. First, the parties negotiate prior to the filing and, second, everyone knows the filing is coming. Nobody wants to hold a security that will go bankrupt, so everyone sells it. At the same time, the bankruptcy workout funds avoid the stock, because a deal is likely to happen. Usually, their job is to negotiate on behalf of the bondholders, but if there is already a deal, there is nothing for them to do. So, nobody really gets involved in these stocks.

In addition, when coming out of bankruptcy, it may take weeks to actually obtain the new security and investors hate that. They simply hate waiting with a security that is difficult to value and would rather avoid the whole process. So they just sell the security.

In a nutshell, we find things that nobody wants to buy for a reason that is not related to fundamentals of valuation.

How do you narrow down the opportunity set?

Our opportunities have to fall into one of the categories of structural anomaly or structural constraint. So, first we narrow down the opportunity set. Over the course of a year, there would be typically about 100 stocks in all the different structural constraint categories, and we may already own some of them.

Then we narrow them down to businesses that are within our circle of competence. That screen would probably decrease the list to 72 companies, or six per month. With a team of 12 analysts, that's a manageable universe.

Once we have defined the structural impediment, we have to know if there is a fundamental difficulty in the business, not a temporary problem or a cyclical feature, but something permanent that would really damage the company on a long-term basis.

We exclude businesses that carry too much debt, have too much competition, or are existentially challenged. Some businesses may have a product life cycle that is too short. Intel is the most obvious example in that area.

If a company doesn't have such a problem and is undervalued, then we spend time to analyze and get to know it really well. But there aren't many new ideas to seriously consider through the course of the year. Out of the universe of 100 companies a year, we would be lucky if we find 12 or 15 that are really good.

What is your research process?

Normally, a research team is organized by industries or geographies. We are different and our team is organized by structural constraints. I ultimately make the final decision on an investment.

We write reports on our findings to be able to have a meaningful discussion on the investment. Writing takes time, but there is no other way of bringing people to your level of knowledge, so that they can read and critique your ideas.

Some time ago I considered the devil's advocate approach, but after reading Jeremy Bentham's Handbook of Political Fallacies, I decided not to do it, because someone mastering the techniques of logical argumentation, paradoxes, and phrases that unnerve your opponent, could actually win a debate, without necessarily arguing for the right decision.

Instead, I chose the non-adversarial, collegial approach and the scientific method. In science, the way to confirm or reject a discovery is through objectively reproducing the experiment. If someone says he can initiate a nuclear chain reaction, he puts it on paper and someone else follows the same process to see if he gets the same answer.

I think the scientific method is much better because it is a cooperative, not an adversarial process. It leads to a better working environment, better idea sharing and, ultimately, to a better conclusion.

How would you reproduce and validate the analysis of a colleague?

When somebody presents a paper with data and logical conclusions, someone else has to examine and validate the presumptions. For example, if there is a claim that the CBOE Volatility Index (VIX) is going to get more business because people are starting to use it, then the primary research will involve meeting money managers and asking them if they know about the VIX index, what they think about it, if they are they interested in using it, what are the problems using it, etc.

A problem may be that custodians are not able to account for it yet. Then the next step would be to call custodians and ask them about that problem and if it is going to be solved. Is it insurmountable? They may

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say they are working on it, or have solved it already, or are planning a new system. Basically, you gather the information in a way to supplement the analysis, to look at the problem in a different way and gather information from different sources to see if the conclusion is valid.

Could you give us some examples of specific holdings to illustrate your thought process?

We have a position in Icahn Enterprises, Carl Icahn's company. Everybody knows who he is and what he does. He is an activist with a very good long-term record and we have been involved with the company for a long time. At the moment, he thinks the stock market is filled with peril and is very worried about it. So, he has an enormous short position, something unprecedented in his career.

At the same time, we generally do not make bets against the market; we may have big cash positions when we don't find that many opportunities. In addition, Icahn Enterprises pays a dividend, although not in the conventional sense, and these are intriguing characteristics.

I respect Icahn as an investor and I would like to participate in what he does. He is navigating an area of undervalued companies and some of them might be outside of my expertise, but they are within the realm of his. Through this investment, we have obtained exposure to areas I ordinarily would avoid.

Another example would be the Chicago Board Options Exchange, or CBOE, which we still own. The option exchange area is a very competitive, yet also unique business. The CBOE has the rights until 2035 for the VIX index, so it has a monopoly. VIX is a measure of volatility and an increasingly popular way to control risk. The more popular it is, the more it trades, and the more money CBOE makes. At the same time, the growth in trading doesn't really entail more costs.

So, CBOE has a lot of operational leverage on the way up. Normally, exchanges have operational leverage on the way down too, when trading volume declines. In this particular case, there wasn't a lot of trading volume on the VIX at the time we invested, so there was not a lot of downside. It was either not going to work, without a meaningful impact on the company, or it would be successful and make a lot of money for CBOE, which is exactly what happened.

In addition, CBOE used the income to buy back stock and that further increased return on equity. That has been a very good investment for us.

What are the major risks in exploiting structural anomalies and constraints?

We are not diversified, especially in this portfolio, for several reasons. First, we look for companies with specific characteristics. Second, there are industries and sectors outside of my circle of competence, so I am not going to buy them.

Diversification is a risk control measure, but do you really reduce risk by investing in areas you know nothing about? For example, a biotechnology company, which works on a cure for a disease, may or may not succeed. I do not have the expertise to determine the outcome.

I believe it is much better to concentrate the investments where my critical understanding would play a role and where I can find something with investment merit, not just conjecture. In the world of biotechnology, I have no way of using the scientific method to determine which company is the best.

What is your portfolio construction process?

At different times, some of the structural constraints work better than others. At the moment, buying securities out of favor, in the classical contrarian sense of the word, is a much better strategy than it would have been nine years ago, when many more investors were practicing it. How well a constraint works is a function of how many people practice it. Obviously, if everybody believes that buying out of favor companies is the right thing, you would never find any companies out of favor worth buying.

Kinetics Market Opportunities Fund

Company	Kinetics Mutual Funds (Horizon Kinetics LLC)
Symbol	KMKAX (Adv. A) KMKCX (Adv. C) KMKYX (Inst.) KMKNX (No Load)
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Source: Company Documents

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In modern investing, indexation has become a dominant strategy. Indexes are sold with backtesting for performance over the last 10 years and over different environments. However, out of favor companies do not backtest well, because they have either declined or have underperformed, even if they went up. Therefore, when indexation is the dominant strategy, the out of favor companies have intriguing valuation characteristics.

Nine years ago, at the end of 2007, the environment was radically different. Value investing, which to a large extent means investing in out of favor companies, was in ascendancy. People thought it was a great way to invest, but today no one talks about value investing.

So, when you find the structural constraint, there is also the question of whether others are trying to exploit it. If they are, the investment will not do you a lot of good and the odds are not in your favor.

Is there a way to improve the odds?

The less others are involved in the investment, the better the odds. Basically, once something becomes relatively well known and documented, it will be reflected in the price, because the efficient market hypothesis is largely correct. You could argue whether it is completely reflected or not, but there isn't a large opportunity.

Also, once you find an opportunity, you need to be patient, because investors generally will not like a company when there is an impediment. You need the patience to wait until they start buying it. Sometimes it happens quickly and sometimes it requires a number of years.

The best spin-off we ever found was a company called East West Communications, which had a market capitalization of less than $2 million at the time. When we wrote a report on it years ago, investors were wondering why we would even waste time with such a small company. Nobody could buy it and it wasn't trading well. The low market capitalization meant low valuation and great upside potential, because nobody was valuing the company.

Today, in the industrial-scale investment world, investors get upset when you present something that is not that liquid. It may be a very good investment, but most people wouldn't buy it. They need to see a reliable quote every day with a lot of liquidity, so they can validate its worth every second of the day. If its last trade was at $10 yesterday, but it did not trade today, they wouldn't know what to do.

So, a company could be earning money and building shareholder equity, but if you have no way to validate it, you wouldn't buy it. The money manager business is really not the investment business. It is the asset gathering business. Money managers raise money by validating their investments, by demonstrating a higher price. Unfortunately, that's the way the business works. On the positive side, it opens up possibilities for people who have the patience to wait. T

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