HORIZON RESEARCH GROUP

March 2014

Owner-Operators

HORIZON KINETICS

1994 ~ INVESTING FOR 20 YEARS ~ 2014

Horizon Kinetics LLC
470 Park Avenue South, 4th Floor
New York, NY 10016

Research Team

Murray Stahl **Steven Bregman**

Thérèse Byars Ryan Casey James Davolos Derek Devens

Peter Doyle Michael Gallant Matthew Houk Utako Kojima

Eric Sites Fredrik Tjernstrom Steven Tuen Salvator Tiano

Horizon Kinetics LLC ("Horizon Kinetics") is the parent holding company to several SEC-registered investment advisors including Horizon Asset Management LLC and Kinetics Asset Management LLC. This report is based on information available to the public; no representation is made with regard to its accuracy or completeness. This document is neither an offer nor a solicitation to buy or sell securities. All expressions of opinion reflect judgment as of the date set forth above and are subject to change. Horizon Kinetics and its respective employees and affiliates may have positions in securities of companies mentioned herein. All views expressed in this research report accurately reflect the research analysts' personal views about any and all of the subject matter, securities or issuers. No part of the research analysts' compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analysts in the research report. Reproduction of this report is strictly prohibited. ©Horizon Kinetics LLC® 2014.

Prelude

Following the financial crisis of 2008, markets have periodically experienced high levels of volatility driven by a variety of macroeconomic factors. Understandably, these volatile episodes have been disconcerting to many investors. In keeping with our long-term investment philosophy, we do not attempt to predict or react to such short-term market movements, but rather we endeavor to identify securities that we believe will perform well over the long term, irrespective of episodic volatility in the broader markets.

As investment management has become more of a risk management business and less of a long-term wealth creation business, the market's affinity for company management teams that place quarterly earnings and short-term financial metrics at the top of their priority lists has increased. Predictability, stability and linear thinking tend to be rewarded with premium market valuations. Consequently, investors appear to be as wary as ever of public companies run by what we refer to as "owner-operators". In bygone eras captains of industry, tycoons, magnates, or multi-generational families may have been considered owner-operators. In brief, owner-operator companies are businesses that are managed and run by their founders and/or largest shareholders, whose decisions are squarely focused on securing remunerative long-term returns on capital rather than on short-term results. Historically, such companies have tended to trade at valuations commensurate with their financial successes and the established track records of their distinguished, and sometimes controversial, leaders, a reflection of the fact that many owner-operator companies have achieved the highest shareholder returns over time.

Recently, the market has appeared to favor complacent management teams that have reactively rather than proactively accumulated excessive cash through 'these troubled' times over those that have taken advantage of distressed prices, pushed into new markets, or repurchased shares or subsidiaries at attractive valuations. Owner-operators tend to seize opportunities and shun complacency during periods of uncertainty. We believe such shrewd actions should contribute to long-term returns on capital and are indicative of competent, unencumbered decision making. Coincident with these actions is the potential for increased earnings variability, a decidedly unappealing characteristic for investors who have seen the market value of their investments fluctuate widely of late. This is not by accident and is consistent with owner-operators who are, in essence, managing their own capital and are not overly concerned with short-term earnings and near-term shareholder sentiment. Accordingly, many owner-operator companies are available at steep discounts to their intrinsic value, more than a few trading close to, or even below, their liquidation value. It is a rare, if not unique, occurrence.

Additionally, profit margins for many of the S&P 500 companies are at or near their historic peaks. The majority of this margin expansion has been achieved on the back of expenditure cuts following the financial crisis, material decreases in tax rates over the last several decades, as well as more than half a century of government spending increases well in excess of the nominal GDP expansion rate. Hence, we believe current margins reflect potentially insufficient levels of investment in both core businesses and new ventures.

HORIZON KINETICS
1994 · INVESTING FOR 20 YEARS · 2014
© Horizon Kinetics LLC ® 2014

Ultimately, we believe it is likely that the overall market will earn an unsatisfactory rate of return over the near- to medium-term.

In contrast, owner-operator companies have not exhibited the same complacency. They have continued to produce strong operating results while making opportunistic investments and strategic decisions that will serve to sustain or improve upon their historical returns-on-capital. These are characteristics that would appeal to us in any market environment, but are even more attractive given the valuations at which some of these companies currently trade.

HORIZON KINETICS
1994 · INVESTING FOR 20 YEARS · 2014
© Horizon Kinetics LLC ® 2014

Introduction

> *The directors of such [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own…Negligence and profusion, therefore, must always prevail, more or less in the management of the affairs of such a company.*[1]
>
> — Adam Smith, 1776.

Adam Smith's unambiguous suspicions of joint stock companies—the public corporations of his time—and his broader contemplations on conflicts of interests and incentives in *The Wealth of Nations,* foreshadow the importance of corporate governance in the study of management of public corporations.

> *It is upon this account that joint stock companies for foreign trade have seldom been able to maintain the competition against private adventurers.* [1]
>
> — Adam Smith, 1776.

We believe Smith's observations are as relevant today as they have been at any point in history. Hence, this paper puts forth our thoughts on company ownership, and, ultimately, substantiates what we believe is an attractive wealth opportunity.

Ownership: Then vs. Now

Prior to the industrial revolution, most enterprise owners worked directly in that trade. The industrial revolution introduced large managed work forces, removing owners from the toils of day-to-day operations, beginning the separation of wealth and operational control. This split has continued to widen such that the modern corporate system is one in which those who control the wealth don't own it and those who own the wealth don't control it.[2]

Corporate structures were originally employed as simple legal entities to facilitate the transactions of enterprise owners. The wealth, control, and property of the enterprise belonged to the proprietors and their families. However, corporations have indefinite duration, which necessitates retention of the interests in and control of the enterprise over time.

How removed is today's public shareholder from ownership? Today's owners are generally passive participants holding entitlements with respect to an enterprise, but with little if any control over the enterprise itself. Becoming a shareholder of a public company

---

[1] Adam Smith. *The Wealth of Nations*. Everyman's Library, Vol. II, p 229. Michael C. Jensen and William H. Meckling reference the same passage from Adam Smith's *The Wealth of Nations* in similar form in their 1976 paper, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure."

[2] Adolf A. Berle and Gardiner C. Means. *The Modern Corporation and Private Property*. New York: Macmillan, 1932.

© Horizon Kinetics LLC ® 2014

requires no blood, sweat, or tears. One can purchase interests in a variety of enterprises, and often one does so through investment funds or other delegates, guaranteeing complete disassociation from the enterprise. In exchange for liquidity, the majority of today's owners have reduced their wealth to stock certificates—electronic accounting entries in today's reality—and subjected their wealth to constant appraisals and the erratic behavior of market participants.

The Principal-Agent Problem[3]

If ownership does not entail management, and management does not require ownership, then something must be done to align the interests of managers and owners.

Academia's treatment of the principal-agent, incentives and self-interest problems has produced a rich social science littered with models that attempt to quantify highly subjective situations with sweeping assumptions. Let's survey some of the key topics as we develop our own perspective. We will touch on three specific areas: management interests, compensation as a control, and shareholder control to conclude with a more general theory on the evolution of corporate decision making.

Management Interests

Directors and managements of public corporations wield enormous influence. While generalizations abound regarding their motivations, individual managers have unique sets of influences. Money, pride, politics, reputation, risk aversion and even religion are all relevant to varying degrees. Shareholders, although subject to similar influences, generally care about two things with respect to the companies in which they invest: profits and risk. Aligning the interests of these two constituencies is a complicated affair.

Risk aversion is widely cited as the most significant influence on management decisions. When corporate decision-making puts at risk anything a manager values, the potential for the manager's motivations to conflict with the interests of shareholders arises. However, a company that avoids all risk cannot survive in a competitive market—while risk management is important, it cannot preclude taking calculated risks, lest it impede growth.

Academic theory suggests that the decision to continue or abandon a failing project is highly influenced by a manager's expectations with respect to his cost of capital after failure.[4] If a manager believes that investors will hold him responsible and view the failure as a sign of a lack of talent, he may stick with the failing project, hoping to get lucky, rather than make the rational decision to abandon it. If the manager believes that he will maintain investor confidence and that his cost of capital for the next venture will remain low, then he will likely cut his losses and move on to the next project.

---

[3] Eugene F. Fama and Michael C. Jensen. "Separation of Ownership and Control," *Journal of Law and Economics* Vol. XXVI, June 1983.
[4] Augustin Landier. "Entrepreneurship and the Stigma of Failure," New York University Department of Finance, December 2004.

HORIZON KINETICS
1994 · INVESTING FOR 20 YEARS · 2014
© Horizon Kinetics LLC ® 2014

Another contributor to the divergence of risk preferences between management and shareholders is the time horizon differential between a manager's career and a corporate entity's operations. Shareholders benefit if the present value of all future cash flows increases, regardless of the duration of investment projects. Managers, however, may benefit from short-term gains even if they come at the expense of beneficial long-term projects.

We have only scratched the surface of the academic discussions regarding management interests. The important point is that managers may become conflicted by any number of internal or external interests when making decisions on behalf of shareholders. So, let's consider the primary arbiter of management and shareholder conflicts: compensation.

Compensation

Compensation is without question the most widely prescribed solution to the principal-agent problem. Cash, pensions, stock and options are the main ingredients of most management compensation arrangements. In particular, let's consider the categories proposed by Smith and Watts,[5] which were expanded upon by Jensen and Smith:[6] (i) compensation that does not depend on firm results (salary, pensions, and insurance), (ii) compensation related to market performance (stock, options), and (iii) compensation tied to accounting performance (bonuses, participation shares).

Compensation that is independent of firm performance and, therefore, is a fixed claim on the firm's assets and cash flows encourages three undesirable behaviors. First, managers will seek to reduce the variability in cash flows to reduce the probability of default. Second, managers have incentives to retain firm funds to increase coverage of fixed claims. Lastly, managers are less likely to employ leverage within the capital structure.[7]

Compensation that is dependent on firm performance is well-suited to solve the time horizon problem mentioned previously. Tying management compensation to the performance of company stock better aligns management fortunes with those of shareholders. In the case of stock grants, managers are generally given relatively small holdings in the company to signal an alignment of interest with shareholders. However, the shares are simply given to management and are either issued, diluting the existing shareholders, or are purchased with firm capital. We draw a distinction between open market stock purchases by operators and simply holding on to stock grants, with the former making a much stronger statement about the degree to which a manager is vested in the firm, in our view. While stock holdings are a step in the right direction, much depends

[5] Smith, Clifford and Ross Watts. "The Structure of Executive Compensation Contracts and the Control of Management." Unpublished manuscript, University of Rochester, 1983.
[6] Michael C. Jensen and Clifford W. Smith Jr. "Stockholder, Manager, and Creditor Interests: Applications of Agency Theory," *Recent Advances in Corporate Finance*, edited by E. Altman and M. Subrahmanyam, Dow-Jones Irwin, 1985.
[7] Ibid.

HORIZON KINETICS
1994 · INVESTING FOR 20 YEARS · 2014
© Horizon Kinetics LLC ® 2014

upon what portion of the manager's wealth is held in company stock and whether he has been a net accumulator over time. Does he own a larger, the same or a smaller percentage of the company as his tenure grows? The preference is obvious, keeping in mind that issues can arise when managements become dominant shareholders.

Stock options or rights have a few unique characteristics that have led to their wide adoption as compensation. Since option values increase with stock price variance, options should create incentives for managers to consider projects that may increase the variability of the firm's cash flows. The use of leverage has similar effects, which should induce management to consider employing it.[8] Many argue for the use of options in compensation by citing the fact that options do not expose managers to downside risk in stock price and, therefore, reduce the tendency for managements to be risk averse. While the argument is practical, it simply trades one problem for another. Managements receiving large option grants have nothing to lose and everything to gain relative to the shareholders. Let's not forget the option scandals in which prominent public corporation CEOs backdated option grants at lower prices to guarantee windfall gains.

Accounting-based performance is usually most effective in middle management positions where efforts are project-specific and time horizons are consistent with project and/or career durations—a manager nearing retirement does not have the same horizon as a mid-career manager and will likely not perform for longer-term compensation. In instances where management receives significant cash payouts based on accounting measures of performance that are inconsistent with stock price performance, management is likely absconding with a disproportionate amount of shareholder wealth.

We should also mention the infamous 'golden parachutes' that senior managements enjoy in the event of mergers or acquisitions. These are intended to compensate management for their loss of control benefits, making them indifferent when considering takeovers that may increase shareholder wealth. It is reasonable to compensate managers for considering deals that may ultimately put them out of work. However, managements and boards who pack the golden parachutes tend to be overly generous with shareholder funds and do not sufficiently tie manager compensation to post-merger results. Were exiting managers tied to post-merger performance, as shareholders often are, they might approach deals with a longer-term perspective.[9]

Structuring management compensation is an unavoidably complicated matter with an ever-present moral hazard due to the fact that boards and managements oversee compensation decisions. Not surprisingly, research suggests that the optimal compensation schemes utilize a mix of the elements mentioned above.[10]

---

[8] Ibid.
[9] Haresh Sapra, Ajay Subramanian and Krishnamurthy Subramanian. "Corporate Governance and Innovation: Theory and Evidence." University of Chicago, 2008.
[10] Ibid.

HORIZON KINETICS
1994 · INVESTING FOR 20 YEARS · 2014
© Horizon Kinetics LLC ® 2014

Shareholder Control

The right to vote is a common shareholder's main instrument of power.[11] Unfortunately, this instrument has dulled over time. Originally, shareholders did not vote by proxy. They had the right to remove company directors at will and unanimous shareholder consent was required to implement certain corporate policies. Today, shareholders are generally less aware of the issues on the ballot and are encouraged to vote by proxy in line with management recommendations. Company directors almost always serve out their full terms and are granted near complete discretion over management. Corporate charters have been made increasingly complex with bylaws to allow management significant latitude in implementing corporate policies. When shareholder approval is required, generally only two-thirds or a simple majority is needed for consent. The role of the shareholder has become increasingly passive, furthering the principal-agent problem.

Fama and Jensen[12] identified several market related mechanisms that help mitigate the diminished influence of shareholders. First, the stock market functions as a constant external monitor of public corporations and evaluates public information to assess internal dealings. Second, a public takeover in the form of a tender offer or a proxy fight is an external means of circumventing a company's board and management, and acts as a natural governor of company affairs. Third, outside board members are motivated to develop and preserve their reputations as experts in decision control. These external influences should assist the shareholder in aligning company actions with shareholder interests.

Two situations warrant specific consideration. The first is the ability of shareholders to ally themselves and launch a proxy fight against management. On the surface this should be a reasonable approach if enough shareholders desire common changes. Yet, the advantage is tilted toward the incumbent managements. Staggered board member elections ensure that only a few seats on the board can change hands each year, preventing sudden shifts in control. Management is at liberty to spend company funds, i.e., shareholder money, to fight the proxy—in essence the shareholders of the firm pay for both sides.

The second situation is an external shareholder or group of shareholders that controls a significant portion of company's common stock. Burkhart, Gromb & Panunzi[13] argue that while a concentrated shareholder base may seem to reduce principal-agent costs associated with control, an expropriation threat diminishes both a manager's initiative and his likelihood of pursuing investments whose returns will be difficult to attribute to his actions. The manager's concern is that the large shareholder will extract a disproportionate share of project profit, leaving the manager unfairly compensated.

[11] We ignore common stocks that lack voting rights or have diminished voting rights.
[12] Fama and Jensen, 1983.
[13] Mike Burkhart, Denis Gromb, and Fausto Panunzi. "Large Shareholders, Monitoring, and the Value of the Firm," *The Quarterly Journal of Economics,* August 1997.

HORIZON KINETICS
1994 · INVESTING FOR 20 YEARS · 2014
© Horizon Kinetics LLC ® 2014

Evolution of Corporate Decision Making

Fama and Jensen[14] proposed that the modern corporate structure evolved in a competitive environment. "Since most goods and services can be produced by any form of organization, different organizational forms compete for survival in any activity just as different species compete for survival in nature."[15] They assert that competition on many levels including marketing, compensation, project decisions, and financing produces an efficient corporate structure. The assumption that the most widely adopted or observable corporate structure represents the most highly evolved corporate entity is susceptible to availability error. One might easily propose that the modern corporate structure has not evolved out of need for survival but, rather, out of the maximization of self-enrichment by agent managements.

What do they identify as the key trait of the most highly evolved corporations? Checks and balances in decision making, as reflected by a separation of decision management from decision control.[16] The natural motivation for the separation arises from the influence of shareholders who bear the residual risk of the corporation. If ownership of residual claims remains concentrated with management, i.e. owner-operator, this separation may not occur, leaving non-controlling shareholders exposed to the opportunistic decisions of the controlling agents. Fama and Jensen assert that this may diminish the value of the residual claims. We find this assertion troubling in that it fails to acknowledge that 'opportunistic decisions' and flexibility to act can *create* value just as easily as they can detract value.

Fama and Jensen go on to write "Separation and diffusion of decision management and decision control—in effect, the absence of a classical entrepreneurial decision maker—limit the power of individual decision agents to expropriate the interests of residual claimants. The checks and balances of such decision systems have costs, but they also have important benefits." We have underlined a portion of this statement for emphasis, because such a sacrifice strikes us as quite an expense to a company.

Fama and Jensen were speaking of *complex* corporations—those characterized by multiple levels of specialized management across many disciplines. They cite proprietorships, small partnerships and closed corporations as examples in which concentrated decision processes are functional because residual claims are largely held by the decision agents. However, this suggests to us that *complex* organizations must forfeit entrepreneurial leadership to control potential opportunistic decisions by management agents. In doing so, we believe they may pay an ultimate price: diminished returns-on-capital. So we ask, "Does a corporate structure exist that mitigates the principal-agent problem, but potentially preserves a successful enterprise's profitability over the long term?"

---

[14] Fama and Jensen, 1983.
[15] Jensen and Smith, 1985.
[16] Fama and Jensen, 1983.

© Horizon Kinetics LLC® 2014

As an aside and evidence of investors' focus on standardizing their evaluation of corporate governance, Institutional Shareholder Services ("ISS"), a part of MSCI Inc., publishes Governance Risk Indicators™ which assess various aspects of a company's management structure including its board structure, executive compensation, shareholders rights and audit practices. It does not surprise us when prominent owner-operator companies receive poor marks in several of these categories given their concentrated ownership and leadership structures which often differ from accepted 'best practices'.

The Owner-Operator

In this section we define the concept of the owner-operator and discuss how it relates to some of the issues raised in the previous section. The subsequent section will explore some empirical data and discuss investment merits.

Defining the Owner-Operator

An owner-operator is a principal or an owner—often a founder—who is directly involved in the management of a corporation in which he or she maintains a significant portion—ideally the majority—of his or her wealth.

An owner-operator is not to be confused with a notable board member or a hired manager owning a few percentage points of company common equity. An owner-operator is simultaneously the decision maker and a large shareholder. In practice, owner-operators exist in a spectrum that balances ownership and significant control over management decisions. Both are required. A company held by a family that has hired outside agents to oversee business operations is not an owner-operator company. Nor is a company whose founding managers remain engaged in business operations, but maintain minimum equity holdings in the company. A company that is owned by a family and is operated by a second generation would be considered an owner-operator provided the second generation has managed the company autonomously for a reasonable period, has materially grown the company under their stewardship and is financially vested in the company.

An owner-operator, rather than an agent or a hired manager, makes long-term return on capital decisions. The latter must manage their careers in relation to the short-term reactive expectations of shareholders and analysts, and must abide by arbitrarily set benchmarks such as market share and quarterly revenue growth. They may be reluctant to invest in their businesses during times of great economic uncertainty. Conversely, owner-operators are vested in the company and can base their actions on long-term return-on-capital considerations.

Owner-operators often enjoy strategic flexibility to choose capital structures that enhance returns and manage risk. They are willing to take on risks to invest in their businesses, including employing leverage as appropriate. Because of their established history of shrewd decision-making and good returns-on-capital, they benefit from access to capital that some less proven managers might not. They have developed a reputation and a

© Horizon Kinetics LLC ® 2014

network over their career that provides them with an information advantage—their record of success makes them desirable partners, and companies looking for an investor, a strategic partner, or a buyer may bring an idea to them before shopping it to other companies. Owner-operators can choose to remain in a given business or to allocate capital elsewhere in a timely manner. They are not afraid to take a contrarian view, and typically maintain liquid balance sheets to take advantage of economically uncertain times and pursue investment opportunities when others are unwilling to do so. Often they are able to do so at fire-sale prices.

Our comments are not categorical. There are many first-class company managements that operate in an incentive-based compensation structure and are stakeholders in the companies they direct. However, there are subtleties to consider when evaluating a management's circumstances. One cannot simply look at ownership percentages or transactions of company insiders in isolation. Consistent with our Firm's investment philosophy, we consider the data to be of limited value when consumed in the absence of a qualitative context.

Interests, Compensation, Control

In the previous section we discussed various aspects of the principal-agent problems and moral hazards present in management activities. Owner-operators are subject to the same influences. However, owner-operators are the most vested shareholders across all levels. They typically have the most emotional, reputational, and monetary capital invested in their company. A decision regarding their enterprise simultaneously impacts all three. In a way, their company is an extension of themselves and their family. As such, they must take a balanced approach to decision making that ultimately places the long-term welfare of the firm above all else. Without the firm, they have little; without them, the value of the firm is diminished.

A typical company can expend enormous amounts of financial and human capital on controlling conflicts, maintaining its corporate culture, setting strategic direction, and managing day-to-day operations. Owner-operators minimize the expenses and frictions that typically arise from these efforts, and can detract from shareholder value. Peter Drucker, widely considered one of the founding fathers of modern management theory, wrote:

> *Management is doing things right; leadership is doing the right things.*

As managers and significant shareholders, owner-operators are focused on 'doing the right things.' Wall Street, the media and short-term investors applaud managers who 'do things right.' Unfortunately, those things may be managing quarterly earnings, focusing on revenue growth, making expensive acquisitions, or raising cash during recessions. We applaud owner-operators who do the right things: focus on balance sheet strength, return-on-capital, grow book value, acquire cheap assets, and protect margins.

As investors, we face a similar quandary. We are routinely asked if we invest firm and employee capital in our strategies (Answer: Yes!), a sound means of assessing an

© Horizon Kinetics LLC ® 2014

investment manager's alignment of incentives. Yet, when the investment environment appears to favor short-term decision making, investors' expectations shift and some expect us to invest more tactically despite our preference to manage our capital as we have done for decades. Changing our investment approach in response to the market environment might be viewed as 'doing things right' but it would not be the 'right thing to do' as we see it.

The immediate concern that likely jumps to mind is the potential for a large shareholder to expropriate rent from the company at the expense of minority shareholders. Many cite this as particularly material in situations where owner-operators preserve their control through the use of multiple share classes of common stock with different voting rights or controlling trusts. The risk does not disappear with owner-operators, but it can be mitigated by investors. First, an investor usually has the benefit of an observable history of an owner-operator's actions. Seldom does a proprietor build an empire in just a few years. A longer tenure affords the investor a potentially more accurate assessment of an owner-operator's observable and unobservable actions. The latter is an important point, given most company management decisions are conducted outside of the view of public investors. Second, an investor has the luxury of diversification. He or she can diversify across various owner-operators—implicitly diversifying across sectors, countries, and industries—to reduce single-company event risk to an acceptable level.

A final point to consider regarding owner-operators is knowledge transfer. Intellectual property, information networks, industry experience, culture, and strategic relationships (political, business, or social) are often the life blood of a corporation. In industries with low or reasonable rates of innovation, efficient knowledge transfer can be a significant, sustainable and essential competitive advantage. The exceptions tend to be industries like technology where obsolescence occurs at a rapid rate. In such industries, patents tend to be the more reliable source of competitive advantage. The owner-operator is concerned with preserving the continuity of and commitment to long-term corporate strategy in the face of an unpredictable financial market and maximizing the return on his or her capital. These concerns typically mirror those of their fellow shareholders.

The Owner-Operator Premium

It is our belief that the owner-operator structure is a solution to the complicated matters of corporate governance and long-term return-on-capital maximization. Hence, companies structured as such deserve to trade at a premium to, or at parity with, comparable public companies rather than at the discounts at which they frequently trade. Wall Street analysts and many investors generally view owner-operator companies as unpredictable and unclassifiable from a traditional industry or sector perspective. Rightfully so, they are generally not managed with short-term earnings as a priority and may be opportunistic in the businesses they operate. From our perspective, as an investment manager, we find it ironic that companies with high earnings variability or opportunistic managements are assigned a discount when, in our industry, investment managers that offer higher tracking error strategies, i.e. take more risk relative to a benchmark, or pursue unconstrained

© Horizon Kinetics LLC ® 2014

strategies are frequently viewed as premium strategies that command higher fees. This discrepancy strikes us as an opportunity to acquire attractive owner-operator companies that are too frequently penalized despite their ability to sustain high returns-on-capital.

The Data

Below are some empirical analyses that illuminate our views.

Initial Public Offerings: Owners Who Choose to Sell

First, we offer Jeremy Siegel's study on initial public offerings ("IPOs"). In his book *The Future for Investors*, Mr. Siegel undertook a study of the IPO market from 1968 to 2000.[17] During that time period, 8,606 companies completed IPOs.

According to Siegel's study, approximately half of these companies underperformed a representative small-cap index by 10% per annum. More than one-third underperformed by more than 20% per annum. Approximately 17%, or 1,417 companies, underperformed the small-cap index by 30% per annum. Only about one-fifth outperformed at all, and less than 5% outperformed by more than 10% per annum. Out of 8,606 companies, 49, or slightly more than one half of one percent, outperformed by 30% per annum.

The returns are not normally distributed. The majority of the companies failed to produce a return equal to the representative small-capitalization index. Phrased alternatively, over the course of 32 years, more than two-thirds of the 8,606 companies that completed IPOs had inferior annual rates of return relative to the benchmark.

Included in Siegel's book is an interesting table titled "IPOs with Highest Cumulative Returns per Dollar Invested, 1968-2000," which lists the year of each IPO and its compound annual rate of return from the end of its first trading month to the year 2000.[18] All of the ten IPOs with the highest return per annum are owner-operated companies; there were no exceptions. We have added the names of the owner-operators to Siegel's data in the table below.

IPOs With Highest Cumulative Returns per Dollar Invested, 1968-2000

IPO Year	Company[1]	Owner-Operator[2]	Compound Annual ROR (%)[1]
1971	Intel (INTC)	Andy Grove, Gordon Moore	27.55%
1970	Wal-Mart (WMT)	Sam Walton	26.58
1981	Home Depot (HD)	Bernie Marcus, Arthur Blank	36.80
1977	St. Jude Medical (STJ)	Manuel Villefana	28.68
1973	Mylan, Inc. (MYL)	Milan Puskar, Don Panoz	24.29
1970	Sysco (SYY)	John Baugh, John Woodhouse	22.04

Jeremy J. Siegel, *The Future for Investors: Why the Tried and the True Triumph Over the Bold and the New* (New York: Crown Business, 2005), 85-86.
[18] Ibid., 87.

HORIZON KINETICS
1994 · INVESTING FOR 20 YEARS · 2014
© Horizon Kinetics LLC ® 2014

1973	Affiliated Publications[3]	Taylor Family	23.95
1971	Southwest Airlines (LUV)	Rollin King, Herb Kelleher	23.10
1979	Stryker (SYK)	Homer Stryker	29.51
1971	Limited Stores (LTD)	Leslie Wexner	22.80
		Average	26.53%

1. Adapted from Jeremy J. Siegel, *The Future for Investors: Why the Tried and the True Triumph Over the Bold and the New* (New York: Crown Publishing, 2005), 87.
2. Identification of owner-operators: Horizon Research data.
3. Affiliated Publications was acquired in 1993 by The New York Times Co. and is no longer public.

We studied every company in the table to determine the characteristics of their leadership and to see if the people who ran the company also owned the bulk of the stock. If yes, they were classified as owner-operators. In all cases, they did.

In a sense, the average rate of return for this group of companies is not meaningful, because each has a different date of commencement but, to the extent that one can compute an average, it is 26.5% per annum.

The companies listed above represent a relatively diverse set of industry exposures. The table below provides a quick summary.

Company[1]	Industry[2]
Intel (INTC)	Semiconductors
Wal-Mart (WMT)	Retail
Home Depot (HD)	Retail
St. Jude Medical (STJ)	Health Care Products
Mylan, Inc. (MYL)	Pharmaceuticals
Sysco (SYY)	Food
Affiliated Publications[3]	Media
Southwest Airlines (LUV)	Airlines
Stryker (SYK)	Medical Devices
Limited Stores (LTD)	Retail

1. Jeremy J. Siegel, *The Future for Investors: Why the Tried and the True Triumph Over the Bold and the New* (New York: Crown Publishing, 2005), 87.
2. Source: Bloomberg Industry Classifications.

If we examine the S&P 500 since 1957 with the goal of identifying the best stocks, we find Wal-Mart (WMT), Apple (AAPL) under the tenure of Steve Jobs, Hewlett-Packard (HPQ), Microsoft (MSFT), Intel (INTC) in their glory days—each and every one an owner-operator. We have not performed the exercise of calculating the S&P as if those companies never existed but we are confident that the return would be dramatically lower than what it has been, and would not have been an attractive investment.

The Wealth Index

A broader illustration of the performance for companies owned and/or managed by successful business leaders with substantial wealth is the Horizon Kinetics ISE Wealth

HORIZON KINETICS
1994 · Investing For 20 Years · 2014
© Horizon Kinetics LLC ® 2014

Index ("RCH") [19]. Admittedly, the index represents a population of companies that extends beyond our definition of owner-operator companies, but the results provide an adequate illustration of our contention. The reader should note that while ownership data is readily available, one cannot just screen a universe of stocks for insider ownership as many owners retain control through varying share classes and investment vehicles rather than simply their personal name.

RCH provides a benchmark for investors interested in tracking the performance of U.S.-listed, publicly-held companies that are managed by some of the wealthiest individuals in the United States. These individuals generally have a high degree of management skill and specific industry knowledge, which is manifested through the superior historical share price performance of their companies. In many cases, these individuals have used their respective companies as the primary means of accumulating substantial personal wealth. By virtue of this vested interest factor, they tend to give priority to creating shareholder value rather than to the shorter-term considerations typical of corporate managements. The use of wealth as a predictive index variable, rather than traditional index classifications, has been demonstrated to provide meaningful excess returns over time versus the S&P 500.

The table below provides historical returns for RCH and the subsequent table provides the constituents as of September 30, 2013, which the reader will find representative of many industries and sectors.

Horizon Kinetics ISE Wealth Index (RCH)
Annualized Total Returns as of December 31, 2013[20]

	1 Year	**3 Years**	**5 Years**	**10 Years**	**15 Years**	**20 Years**
Wealth Index (RCH)	41.1%	19.0%	30.8%	12.6%	10.0%	12.7%
S&P 500	32.4%	16.2%	17.9%	7.4%	4.7%	9.2%
Excess Return	**8.7%**	**2.8%**	**12.8%**	**5.2%**	**5.4%**	**3.4%**

[19] International Stock Exchange (ISE) Methodology Guide.
[20] Please refer to the International Stock Exchange (ISE) Methodology Guide for the RCH, available at http://www.ise.com/WebForm/options_product_indexDetails.aspx?categoryID=96&symbol=RCH for further information on the computation of returns for the RCH.

HORIZON KINETICS
1994 · INVESTING FOR 20 YEARS · 2014
© Horizon Kinetics LLC ® 2014

Horizon Kinetics ISE Wealth Index (RCH)
Constituents as of November 30, 2013

Symbol	Name	Symbol	Name
AEO	American Eagle Outfitters	KRO	Kronos Worldwide
AFSI	Amtrust Financial Services Inc	L	Loews Corp
AL	Air Lease Corp	LBTYA	Liberty Global plc
AMCX	AMC Networks Inc.-A	LEN	Lennar Corp
AMKR	Amkor Technology Inc	LINTA	Liberty Interactive Corporation Interactive A
AMZN	Amazon.com Inc	LMCA	Liberty Media Corp
AN	AutoNation Inc	LB	L Brands Inc
APOL	Apollo Education Group Inc	LUK	Leucadia National Corp (NY)
ARG	Airgas Inc	LVNTA	Liberty Ventures A
ARII	American Railcar Industries	LVS	Las Vegas Sands
ASPS	Altisource Portfolio Solutions S.A.	LYB	LyondellBasell Industries N.V.
AXE	Anixter Intl Inc	MAR	Marriott Intl A
BEN	Franklin Resources Inc	MCY	Mercury General Corp
BF/B	Brown-Forman Corp B	MENT	Mentor Graphics Corp
BKE	Buckle Inc	MGM	MGM Resorts International
BOKF	Bok Financial Corp (OK)	MHK	Mohawk Industries Inc
BRCM	Broadcom Corp A	MNKD	MannKind Corp
BRK/B	Berkshire Hathaway B	MNST	Monster Beverage Corp
BRKR	Bruker BioSciences Corp	MOLX	Molex Inc
BRO	Brown & Brown Inc	MORN	Morningstar
BXP	Boston Properties Inc	MRVL	Marvell Technology Group Ltd
CAB	Cabelas Inc Class A	MSG	Madison Square Garden
CACC	Credit Acceptance Corp	MSM	MSC Industrial Direct A
CBS	CBS Corp B	NATI	National Instruments Corp
CCL	Carnival Corp	NAV	Navistar Intl Corp
CERN	Cerner Corp	NEU	NewMarket Corp
CETV	Central European Media Enterprises Ltd	NG	Novagold Resources Inc
CFX	Colfax Corp	NKE	NIKE Inc B
CHH	Choice Hotels Intl	NWSA	News Corporation
CHK	Chesapeake Energy Corp	OCN	Ocwen Financial Corp
CLR	Continental Resources Inc/OK	OPK	Opko Health Inc
CMCSA	Comcast Corp	ORCL	Oracle Corp
COLM	Columbia Sportswear Co	PAG	Penske Auto Group
CRM	Salesforce.com	PAYX	Paychex Inc
CTAS	Cintas Corp	PCYC	Pharmacyclics Inc
CVA	Covanta Holding Corp	PEGA	Pegasystems Inc
CVC	Cablevision Systems Co A	PENN	Penn National Gaming Inc
CVI	CVR Energy Inc	PGR	Progressive Corp
DHI	Horton D.R. Inc	PSMT	PriceSmart Inc
DHR	Danaher Corp	QCOM	QUALCOMM Inc
DISCA	Discovery Communications Inc	RAX	Rackspace Hosting Inc
DISH	DISH Network Corp	RES	RPC Inc
DKS	Dicks Sporting Goods Inc	RIG	Transocean Inc
DST	DST Systems Inc	RJF	Raymond James Financial Inc
DSW	DSW Inc	RL	Ralph Lauren Corp
EBAY	eBay Inc.	ROL	Rollins Inc
EL	Estee Lauder Cos.	RP	REALPAGE INC
ELS	Equity Lifestyle Properties Inc	SAM	Boston Beer Inc A
EQR	Equity Residential	SATS	EchoStar Holding Corp
EXPE	Expedia	SBUX	Starbucks Corp
FAST	Fastenal Co	SCHW	Schwab Charles Corp
FCNCA	First Citizens BancShrs A(NC)	SHLD	Sears Holdings Corp
FDML	Federal-Mogul Corporation	SHOS	Sears Hometown and Outlet Stores Inc
FDO	Family Dollar Stores Inc	SMG	Scotts Co A
FDX	FedEx Corp	SPG	Simon Property Group
FOSL	Fossil Group Inc	STRZA	Starz
FOXA	Twenty-First Century Fox, Inc	SYNT	Syntel Inc
FRX	Forest Laboratories	TCO	Taubman Centers Inc
GLPI	Gaming & Leisure Properties Inc.	TEVA	Teva Pharmaceutical Industries ADR
GLRE	Greenlight Capital Re Ltd	TR	Tootsie Roll Industries Inc
GOOG	Google Inc	TSLA	Tesla Motors Inc
GPS	Gap Inc	TTEC	TELETECH HOLDINGS INC
GRMN	Garmin Ltd	TTWO	Take-Two Interactive Software
GWW	Grainger W.W. Inc	UA	Under Armour Inc A
H	Hyatt Hotels Corp	URBN	Urban Outfitters
HALO	Halozyme Therapeutics	VAC	Marriott Vacations Worldwide Corporation
HES	Hess Corp	VIAB	Viacom Inc B
HHC	Howard Hughes Corp	VNO	Vornado Realty Trust
HRG	Harbinger Group Inc	WEN	The Wendys Company
HST	Host Hotels & Resorts Inc	WERN	Werner Enterprises Inc
HTH	Hilltop Holdings Inc	WLK	Westlake Chemical Corp
HUN	Huntsman Corp	WNR	Western Refining
IACI	IAC InterActiveCorp	WRB	WR Berkley Corp
INTU	Intuit Inc	WTI	W&T Offshore
ITW	Illinois Tool Works Inc	WYNN	Wynn Resorts Ltd
JWN	Nordstrom Inc	YHOO	Yahoo Inc

HORIZON KINETICS
1994 · INVESTING FOR 20 YEARS · 2014
© Horizon Kinetics LLC ® 2014

Conclusion

In the absence of founding leaders, principals or special considerations aimed at having a similar effect, we believe that companies will tend to drift inexorably towards agent management operations. In the process, we believe the corporation's likelihood of maintaining high profit margins and returns-on-capital declines.

Under the short-term pressure of Wall Street analysts and trading oriented shareholders, agent managements focus on 'doing things right' rather than 'doing the right things.' Following the financial crisis of 2008, the average company management was rewarded for raising balance sheet cash and taking less risk. Managements that buck this trend by acquiring competitors or expanding operations at attractive terms risk being viewed as irresponsible. If it were easy for managements to take long-term views or make radical strategic changes, one might expect there to be fewer private equity funds, hedge funds and activist investors earning attractive rates of return by agitating managements.

Wall Street analysts have been particularly critical or dismissive of the opportunistic actions and long-term focus of companies run by owner-operators. These criticisms and conflicting views will, from time to time, produce discounted valuations for fundamentally strong businesses run by exceptional owner-operators. Investors have the opportunity to acquire businesses which offer potentially higher returns-on-capital without paying the premium frequently associated with such investments. We believe that there are currently a disproportionate number of such opportunities.

DISCLAIMERS

This information is for information purposes only. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable or that future investment decisions will be profitable or will equal or exceed the past investment performance of the securities listed.

This information should not be used as a general guide to investing or as a source of any specific investment recommendations, and makes no implied or expressed recommendations concerning the manner in which an account or strategy should or would be handled, as appropriate investment strategies depend upon specific investment guidelines and objectives. This is not an offer or solicitation to any person in any jurisdiction in which such action is not authorized or to any person to whom it would be unlawful to make such an offer or solicitation.

The information contained herein has been obtained from sources believed to be reliable; however, no representation is made regarding its accuracy or completeness.

No part of this material may be: a) copied, photocopied, or duplicated in any form, by any means; or b) redistributed without Horizon's prior written consent.

© Horizon Kinetics LLC ® 2014

References

Berle, A. A. and Gardiner C. Means. *The Modern Corporation & Private Property*, New York: Macmillan, 1932.

Burkhart, Mike, Denis Gromb, and Fausto Panunzi. "Large Shareholders, Monitoring, and the Value of the Firm." *The Quarterly Journal of Economics,* August 1997.

Fama, Eugene F. and Michael C. Jensen. "Separation of Ownership and Control," *Journal of Law and Economics,* Vol. XXVI, June 1983.

Holmstrom, Bengt. (MIT) "Managerial Incentive Problems: A Dynamic Perspective," *The Review of Economic Studies*, 1999.

Jensen, Michael C. (Harvard) "Self-Interest, Altruism, Incentives, & Agency Theory," *Journal of Applied Corporate Finance,* Vol. VII, no. 2 (Summer 1994).

Jensen, Michael C. (Harvard) and Clifford W. Smith Jr. (Rochester) "Stockholder, Manager, and Creditor Interests: Applications of Agency Theory," *Recent Advances in Corporate Finance*, edited by E. Altman and M. Subrahmanyam (Dow-Jones Irwin, 1985).

Lambert, Richard A. (PENN) "Executive Effort and Selection of Risky Projects," *Rand Journal of Economics,* Vol. 17, no. 1, Spring 1986.

Landier, Augustin. (NYU) "Entrepreneurship and the Stigma of Failure," December 2004.

Prendergast, Canice. (University of Chicago) "The Tenuous Trade-off between Risk and Incentives." *Journal of Political Economy,* 2002, Vol. 110, no. 5.

Sapra, Haresh, Ajay Subramanian and Krishnamurthy Subramanian. "Corporate Governance and Innovation: Theory and Evidence," University of Chicago, 2008.

Siegel, Jeremy J., *The Future for Investors: Why the Tried and the True Triumph Over the Bold and the New* (New York: Crown Business, 2005).

Smith, Clifford and Ross Watts. "The Structure of Executive Compensation Contracts and the Control of Management." Unpublished manuscript, University of Rochester, 1983.

Stein, Jeremy C., "Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior". *The Quarterly Journal of Economics,* November 1989.

HORIZON KINETICS
1994 · INVESTING FOR 20 YEARS · 2014
© Horizon Kinetics LLC ® 2014