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# HORIZON KINETICS RESEARCH

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November 2012

## The Credit Crisis of 2012 & Sector Implications: REITs, MLPs and Financial Sector Preferreds

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*These selections represent sample research reports as of the listed publication dates. There have been no edits made to these research reports since they were published.*



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## *Murray's Musings*

### THE CREDIT CRISIS OF 2012

*Fixed Income Contrarian Compendium, August 2012*

The subject of the *Musings* is the credit crisis of 2012. Everyone is familiar with the credit crisis of 2008 which, defined from the perspective of the borrower, meant that they generally could not obtain credit; even very creditworthy borrowers couldn't obtain funding. That situation had obvious implications for the economy, because the credit markets stopped functioning.

In the credit crisis of 2012, the credit markets are functioning remarkably well. Virtually anyone desirous of obtaining credit is able to do so on very good terms, which is positive when viewed from the perspective of the borrower. However, it's negative when viewed from the perspective of the lender, because it's very difficult to obtain an adequate rate of return on the money that is lent. Why shouldn't that qualify as a credit crisis?

Suppose one invested in a portfolio of high-yield bonds yielding 6% with a six-year average maturity, which would not be very different from a high-yield index. Let's say that the process of selecting these bonds is truly excellent and that the investor's analysis is right four times out of five. In the ensuing first year, then, 80% of the bonds prove to be credit-worthy. Let's also assume that 20% of the bonds, while not necessarily problematic credits, nevertheless become credit downgrades to the extent that the market value of the bonds declines by 20%. For the one time in five that the investor is wrong, there would be a 20% loss on 20% of the names, which would be a 400-basis-point loss from a 600-basis-point yield. That portfolio would then be yielding 2% not 6%.

In other words, in order to achieve a reasonably respectable yield of 6% in the world of high yield, the loss ratio has to be relatively insignificant. If the loss ratio were only 10%, meaning that the credit analysis of the investor in question was correct 90% of the time—a truly extraordinary intellectual achievement—it still wouldn't be enough to generate more than a 5% rate of return, and that's for high yield.

That example illustrates the problem with bond investing. It simply doesn't offer a high rate of return, even in high-yield, and all the investment-grade securities are far beneath that. Of course, money market funds and short-term securities offer nothing, in general. The real rate of return achievable after taxes is less than inflation. Over time, money is literally going to be transferred, in real terms, from bond portfolios to borrowers. Unless something radically changes, there's very little that bond investors can do about it other than decline to invest in bonds, which they clearly choose not to do.

Another way to understand the financial crisis of 2012 is to look at the basic characteristics of the iShares Barclays Aggregate Bond Index (AGG). The reason the AGG metrics are very useful is that this index purports to represent the entire investment grade U.S. bond

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market. Even though individual bond investors might have characteristics very different from AGG, collectively, all the bond investors in the country look essentially like this index.

Table 1: iShares Barclays Aggregate Bond Fund (AGG)

Average Yield to Maturity	1.41%
Distribution Yield	2.44%
Weighted Average Coupon	4.23%
Average Maturity	6.23 years

Imagine if one deposited \$10,000 in a bank account and left it there for six years, receiving an annual rate of return of 1.41%. That would be equivalent to the stated yield to maturity for the AGG, which is the best estimate of its future rate of return. However, the Form 1099 received for an investment in AGG would state that the fund paid 2.44% annual interest and one would be taxed on that amount.

From the point of view of the depositor, the concern is the after-tax rate of return. Assuming New York City tax rates, that after-tax rate of return would be around 19 basis points per year. That is the dilemma of the bond investor. An investor in this index is taxed on a distribution yield of 2.44%, so what's essentially happening is that one is converting principal into taxable income. If the bonds trade above par, ultimately they will gravitate to par, because they will mature, be called, or be tendered.

It's a little bit worse than earning 19 basis points a year, because it's not really a bank account. AGG is a bond fund and, because the bonds gradually but inexorably gravitate towards par, the end value will certainly fall. Let's imagine that the current premium to par 6 years hence were to erode merely to par; a \$10,000 investment would have a principal value of \$8,500. That's the dilemma of the bond investor and that's really the best measure of the financial crisis of 2012.

Another problem is that as the higher coupon bonds either mature or are called, the coupons inexorably gravitate lower, and the convexity increases. Convexity, the inherent risk of this portfolio, is inversely proportionate to the coupon: the lower the coupon, the higher the convexity. Therefore, the risk of this fund is increasing.

A given individual investor might be sufficiently sensible to avoid this fate but, as a whole, what will happen to the nearly \$37 trillion of bond capital that exists in this country?<sup>1</sup> The situation that was just described regarding AGG is ultimately going to happen to that \$37 trillion.

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<sup>1</sup> Securities Industry & Financial Markets Association *Outstanding U.S. Bond Market Debt*  
<http://www.sifma.org/research/statistics.aspx>

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As unpleasant as that trend might be, one might think a greater danger would result if rates increase. It's only a different danger. Even though the market value of those bonds would decline if rates increase, at least the coupons would be higher and there would be some compensation. At the end of the day, there are actions one can take in such a circumstance if one is sufficiently prescient to anticipate the problem.

Some examples of actions one could take include shortening the average maturity, selling short zero coupon bonds, buying options, or buying interest rate swaps. There are ways of hedging oneself against that circumstance, were it to occur, but there's nothing to be done if the coupons keep gravitating lower, because the opportunity set is based on what exists. One can't create higher coupons from an opportunity set of low coupons. That is the issue of reinvestment rate risk.

Almost all of the academic literature on bonds deals with the question of how to control the volatility of the bond portfolio in the event that interest rates rise. There's really nothing to speak of that deals with the issue of reinvestment rate risk. The world of bond investors and the academic world are completely unprepared for the circumstance in which the low coupons remain low for a very long period of time.

To make matters still worse, neither the individual investor nor the institutional investor can compete effectively with the banks in bond investing. For example, if an individual buys a 10-year Treasury at 1.49%, assuming rates don't rise, that rate of return is obviously unsatisfactory. The bank, however, might buy the 10-year Treasury at 1.49% and leverage that investment 10x with zero cost funding from its deposit base. A bank could buy the 10-year Treasury at 1.49% and actually earn nearly 15% a year, but it's not possible for an institution to engage in that strategy.

Even if it were possible for an individual or an institution to treat a 10-year Treasury with a 1.49% return in the manner that a bank could, if rates were to rise, unquestionably the individual institution would pay some margin call. The banks can legally carry the bonds at par. That differential is the reason why the current credit crisis is so serious and has such far reaching implications.

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## *Murray's Musings*

### FURTHER COMMENTS ON THE CREDIT CRISIS OF 2012

*Fixed Income Contrarian Compendium, November 2012*

The subject of the *Musings* is an update of the bond market crisis. In this reference, the bond market crisis reflects the absence of income that can be collected; it's a crisis viewed from the point of view of those who buy bonds. Generally speaking, bond market crises are viewed from the perspective of borrowers of capital, who find it impossible to obtain credit. In this bond market crisis, capital is available, but investors are unable to earn a suitable rate of return. That's the risk they assume.

On September 20, 2012, the iShares Barclays Aggregate Bond Fund (AGG) provided an average yield to maturity of 1.31%. The iBoxx High Yield Corporate Bond Fund (HYG) provided an average yield to maturity of 5.58%. It's extraordinary that bonds, some of which are obviously not very credit-worthy, collectively in this index produce a yield to maturity of 5.58%, and it has certain mathematical consequences. Within that index there will be defaults, so it's an actuarial absurdity for pension funds to have any exposure to it. Given the obvious fact that some bonds will default, the return cannot possibly be as high as the average yield to maturity. The bonds can only depreciate to par. The weighted average coupon in that index is 7.73% and the higher coupon bonds are gradually disappearing from it for obvious reasons. Consequently, it is likely that the yield to maturity of HYG will decline further.

That circumstance in the bond indexes has a parallel in income-oriented equity indices. For example, one finds a similar phenomenon, albeit more dangerous, in the real estate investment trust (REIT) indexes. The following table examines the five largest positions in the Vanguard REIT Index ETF (VNQ), which are Simon Properties; Public Storage; Equity Residential; Ventas and HCP.

Table 1: Five Largest Positions in Vanguard REIT Index ETF (VNQ)

	<u>Weight in Index</u>	<u>Qtr. Div. Rate</u>	<u>Most Recent Qtr. Earnings</u>	<u>Yields</u>
Simon Properties	11.0%	\$1.05	\$0.71	2.69%
Public Storage	5.0%	\$1.10	\$0.77	3.11%
Equity Residential	4.4%	\$0.34*	\$0.10	2.35%
Ventas	4.3%	\$0.62	\$0.14	3.69%
HCP	4.3%	\$0.50	\$0.48	4.45%

\*Gain from discontinued operations in current quarter made earnings \$0.3375.

Source: Vanguard, Company Reports

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As Table 1 shows, these five companies represent a very substantial proportion of the index. Considering the most recent quarterly dividend rate and the most recent earnings as reported by each company, you can see that they are paying out depreciation in addition to earnings, which REITs can do for some period of time. The market values the payout of that depreciation in earnings through the following yields: Simon Properties, 2.69%; Public Storage, 3.11%; Equity Residential, 2.35%; Ventas, 3.69% and HCP, 4.45%.

Table 2 lists the shares outstanding in the last five quarters for these REITs.

Table 2: Shares Outstanding of Top 5 Holdings in VNQ (in millions)

	<u>Simon Properties</u>	<u>Public Storage</u>	<u>Equity Residential</u>	<u>Ventas</u>	<u>HCP</u>
2Q 2011	293.6	169.5	296.3	188.1	407.1
3Q 2011	293.8	170.0	296.6	287.9	407.8
4Q 2011	293.9	170.2	297.5	288.8	408.6
1Q 2012	303.1	170.5	300.5	289.0	419.4
2Q 2012	303.3	170.5	301.0	295.4	429.4

Source: Company Reports

In all cases, the shares outstanding increased, albeit relatively modestly in the case of Public Storage. In all the other circumstances, the companies themselves were issuers of shares. Since the market values that business at a much lower capitalization rate than real estate entrepreneurs value the buildings contained in that business, it's possible for an REIT to issue shares at a certain capitalization rate and buy real estate at a much higher capitalization rate to engage in an antidilutive transaction. From an index point of view, the index trades on demand for the shares, which is a major factor in leading to high valuations, and the companies take advantage of those valuations. Companies are not the only ones to do so; recently the Simon family sold \$1 billion worth of stock.

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Table 3 provides the depreciation expense and the capital expenditures as recorded by the same five REITs.

Table 3: Depreciation Expenses vs. Capital Expenditures  
First 6 months 2012 FY

	<u>Depreciation Expense</u> <i>(\$ in millions)</i>	<u>Capital Expenditures</u> <i>(\$ in millions)</i>
Simon Properties	\$620.0	\$343.8
Public Storage	\$175.5	\$40.3
Equity Residential	\$348.1	\$68.3
Ventas	\$366.4	\$23.8
HCP	\$176.2	\$27.1

Source: Vanguard

It would appear that the companies are altering their normal policies with regard to maintenance of the property with a view to maximizing dividends. That, of course, will have an impact on the stock price and on earnings. A virtuous circle is being created and, as a consequence of the intense demand for income on the part of many investors, the index is not fulfilling its customary function of simply being a measurement benchmark of reality. Rather, the index itself is becoming the reality.

It should be self-evident that this trend is entirely unsustainable. Although it could continue for some period of time, ultimately the properties will require capital expenditures. Either the companies will have to issue shares from that standpoint and thereby dilute investors, or they will have to change their dividend policies. This distortion is but one example of those being created by the bond market crisis and the practice of modern indexation.

## *Industry Thoughts*

### THE MOST DANGEROUS FIXED INCOME SECTOR: FINANCIAL PREFERREDS

*Fixed Income Contrarian Compendium, August 2012*

Among the panoply of industries, from the point of view of fixed income, there are only the dangerous and the more dangerous. One of the more dangerous is that subset of the fixed income sector known as the financial preferreds. These are preferred stocks issued by banks at various points in time—most of them in the last 4 or 5 years—with the objective of enhancing their capital base and permitting them to continue leveraging their capital tenfold.

For some banks that have improved their creditworthiness and are in a position to improve their asset portfolio, the preferred itself isn't problematic except for the fixed income investor, because ultimately that preferred will be retired. From the point of view of the banks whose balance sheets *are* problematic, the preferreds won't be retired, but then their value is questionable.

To illustrate, let us consider the Banco Santander Credit Finance 10.5% preferreds. Given the condition of Banco Santander and the financial climate of Spain, it's fairly obvious why Banco Santander had to issue 10.5% preferreds at some point. Banco Santander's balance sheet is more or less sensibly arranged and it is not an immediate credit risk, so the preferred in question trades at approximately 40% above par and, consequently, yields 6%. There are really only two possibilities. The first is that at some point Banco Santander is going to find the opportunity to refinance that preferred, in which case the investor will receive something like par value plus a tiny call premium. In that case, therefore, there'll be a fairly substantial principle loss. Alternatively, Banco Santander will find itself in problematic circumstances, in which case, if the preferred merely trades at par value or slightly below, it would likewise cause a big capital loss.

From the point of view of the investor, there are very few winning scenarios. There are only different degrees of losing scenarios. From the point of view of Banco Santander, in order for that preferred to trade near par, only a very minor cloud needs to surround the corporation. Of course, if a bigger cloud surrounds it, circumstances would be worse.

There are many examples of such preferreds and they all have the same trading characteristics, so I will list only four, all of which trade above par:

1. Goldman Sachs Series GSC3, the 6% preferreds
2. Fifth Third Capital Trust V, the 7.25% preferreds
3. Citigroup Capital Trust XI, the 6% preferreds
4. Barclays PLC, 8.125% preferreds (despite all the problems that surround Barclays, given the LIBOR rate fixing scandal)

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There are a number of preferred indices that are dominated by financial preferreds for obvious reasons. They are dangerous and should be avoided, because very little good can come of them.

## *Industry Thoughts*

### MASTER LIMITED PARTNERSHIPS

*Fixed Income Contrarian Compendium, November 2012*

Master Limited Partnerships (MLPs) are mostly, but not entirely, in the pipeline area. An example is Enterprise Products Partners (EPD). The capital expenditure, dividend, and capital allocation policies of pipelines are very different from those of REITs. Nevertheless, the MLPs, like the REITs, are affected by the indexation movement.

As can be seen in Table 4, in the first six months of 2012, Enterprise Products reported net income of \$1.22 billion and distributed \$1.068 billion to its partners, a distribution that was less than the company's income.

Table 4: Enterprise Products (EPD)  
First six months of 2012

	<i>(\$ in billions)</i>
Net Income	\$1.220
Distribution to Partners	\$1.068
Depreciation Expense	\$0.537
Capital Expenditures	\$1.813

*Source: Company reports*

Here is a company that is not allowed to accumulate retained earnings. For very logical reasons, it engages in expansion policies that require vast capital expenditures in amounts far in excess of depreciation expenses. In Table 5, one can see that the company has been able to increase its debt without materially increasing its leverage ratio.

Table 5: EPD Long Term Debt vs Shareholders' Equity

	<i>(\$ in billions)</i>	<i>(Shares in millions)</i>	
	<u>Debt</u>	<u>Shareholders' Equity</u>	<u>Shares Out</u>
2011	\$14.0	\$12.1	890.0
2010	\$13.3	\$11.4	851.8
2009	\$12.4	\$1.9	613.1
2008	\$11.6	\$6.1	441.4
2007	\$6.0	\$6.1	435.3

*Source: Company Reports*

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Enterprise Products had \$6 billion in debt and \$6.1 billion of book value in 2007. At the end of 2011 it had \$14.0 billion in debt, but its shareholders' equity had risen to \$12.1 billion at year-end 2011. All that was made possible by share issuance, which is a function of the index demand. The company had 435.3 million shares outstanding at year-end 2007 and 890 million shares outstanding at the end of 2011.

Table 6 displays the share issuance of various leading MLP companies over a slightly longer period of time. I've included just a few of these entities as illustrative examples.

Table 6: MLP Share Issuance: Shares Outstanding at Year-End (*in millions*)

	<u>Kinder Morgan (KMP)</u>	<u>Magellan Midstream (MMP)</u>	<u>Enbridge Energy (EEP)</u>	<u>Energy Transfer (ETP)</u>
2011	336.5	112.7	284.4	225.5
2010	316.1	112.5	230.6	193.2
2009	296.9	106.6	215.2	179.2
2008	266.3	106.6	190.5	151.1
2007	247.9	66.5	146.0	142.1
2006	230.4	66.4	127.5	137.0
2005	220.2	66.4	115.5	110.7
2004	207.0	66.4	103.4	107.9
2003	189.0	49.1	94.3	90.1
2002	180.9	40.9	75.8	14.2

*Source: Company reports*

All had significant increases in the number of shares outstanding from 2002 through the end of 2011. The market absorption of this incredible number of shares made possible the dividend growth of these five companies and the growth in earnings, debt and shareholders' equity. The companies were able to make antidilutive acquisitions in the sense that they could issue shares at a cost of capital that was lower than the reinvestment of that capital in acquiring other MLP businesses.

Table 7 shows how the market values the dividend streams of these five MLPs.

Table 7: Yields of 5 Representative MLPs

Enterprise Products	4.70%
Kinder Morgan	5.96%
Magellan Midstream	4.47%
Energy Transfer	8.35%
Enbridge Energy	7.38%

*Source: Company reports*

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To understand why the dividend yields are so much higher for MLPs than for REITs, let's consider some Enbridge Energy data for the first six months of 2012.

Table 8: Enbridge Energy Data, First six months 2012

	<i>(\$ in millions)</i>
Net Income	\$251.7
Depreciation	\$169.7
Additions to Property	\$651.7
Distribution to Partners	\$318.8

*Source: Company reports*

For that period, Enbridge Energy reported \$251.7 million of net profit and had depreciation expense of \$169.7 million. It made distributions to its partners of \$318.8 million and additions to property—in other words capital expenditures—of \$651.7 million. In the case of the MLPs, the dividend increases can only be sustained by investing ever-increasing sums of capital, which can only be obtained from the capital markets.

The fundamentals for pipelines are quite good, since the U.S. is dramatically increasing its energy production and will clearly require more pipeline and storage capacity. However, the growth thus far has been made possible by the debt and equity markets allowing these firms to access capital at unusually favorable rates, but that will not continue forever. The high yields are simply a reflection of the market sentiment and such a circumstance cannot possibly endure. It's not quite as absurd as the REIT situation, but it does have an element of absurdity.