HORIZON RESEARCH GROUP

Representation in ETFs, the ETF Paradox, and Orphan Stocks

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HORIZON KINETICS

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REPRESENTATION IN ETFS

The topic of this section is the representation of various companies in a range of ETFs. Let's start with Exxon (XOM), the largest company in the S&P 500. It may interest some readers to know that XOM is represented in the top ten individual holdings of 86 different ETFs and, of course, in their underlying indices. Some are quite obvious, like the S&P 500, the Large Cap ETF, the Russell 1000, the Russell 3000, the S&P 100, the Dow Jones Industrial Average, the Low P/E Fund and the S&P 500 Value Fund. However, it may also interest readers to know that Exxon is represented in the following ETFs: Large Cap Growth, the Russell Top 200 Growth, the Consistent Growth, the Aggressive Growth, the Russell 1000 Growth, the Growth at a Reasonable Price, the Russell 1000 Value, the Russell 3000 Growth, the Russell 3000 Value—in itself it is quite an accomplishment to be in both the Growth and Value ETFs—the S&P 500 Growth Index, the Russell 1000 High Beta Index, the Russell 1000 High Momentum Index and others. Certain companies appear in various indices whose structural orientation, in principle, should be mutually exclusive to one another.

Selected ETFs that Include Exxon in Top 10 Holdings

	Ticker
S&P 500	VOO, IVV
Large Cap ETF	VV
Russell 1000	VONE
Russell 3000	VTHR
S&P 100	OEF
Dow Jones Industrial	DIA
Dow Jones Energy	IYE
Low P/E Fund	EZY
S&P 500 Value	IVE
Large Cap Growth	ROI
Russell Top 200 Growth	IWY
Consistent Growth	CONG
Aggressive Growth	AGRG
Russell 1000 Growth	VONG, IWF
Growth at a Reasonable Price	GRPC
Russell 1000 Value	IWD
Russell 3000 Growth	IWZ
Russell 3000 Value	IWW
S&P 500 Growth Index	IVW
Russell 1000 High Beta	HBTA
Russell 1000 High Momentum	HMTM

Source: www.etfdb.com, as of 11/11/2011

Apple (AAPL) is another example of such a company. It is represented in the top ten holdings of 82 ETFs. Some are quite obvious like the QQQ Trust, the S&P 500, the Technology Select SPDR, the Russell 1000 High Beta, the Russell 1000 Low Volatility, the Russell 1000 High Momentum and the Russell 1000 High Volatility. It's quite an accomplishment to simultaneously be in both the low volatility and the high volatility ETF. Nevertheless, it's a fact. Apple also happens to be in the S&P 500 Pure Growth, the S&P 500 Growth Index and the Russell 1000 Growth Index.

Selected ETFs that Include Apple in Top 10 Holdings

	Ticker
QQQ Trust	QQQ
Technology Select SPDR	XLK
Russell 1000 High Beta	HBTA
Russell 1000 Low Volatility	LVOL
Russell 1000 High Momentum	HMTM
Russell 1000 High Volatility	HVOL
S&P 500 Pure Growth	RPG
S&P 500 Growth Index	IVW
Russell 1000 Growth	IWF
S&P 500 Index	IVV

Source: [*www.etfdb.com*](http://www.etfdb.com), as of 11/11/2011

There are ETFs with a very narrow focus as their objective and it's amazing how the decision criteria repeatedly lead one to large cap liquid companies. For example, there exists an ETF known as the Ocean TOMO Patent ETF (OTP) and its purpose is to find companies in which to invest that hold patents. The S&P 500, in contradistinction, is merely a selection of stocks meant to be representative of what's available for investment in the entire stock market. The top ten companies in the S&P 500 Index are: Exxon, Apple, IBM, Chevron, Microsoft, GE, Johnson & Johnson, Procter & Gamble, AT&T and Coca-Cola. The top ten investments in the Ocean TOMO Patent ETF are Microsoft, Royal Dutch Petroleum, IBM, GE, AT&T, Oracle, Pfizer, Intel, Toyota, and Glaxo. The Ocean Tomo Patent Index is not radically different from the S&P 500, nor is its performance.

Top 10 Holdings of OTP	Weight *(as of 11/11/11)*	Top 10 Holdings of IVV	Weight *(as of 11/11/11)*
Microsoft	4.95%	Exxon	3.32%
Royal Dutch	4.94%	Apple	3.28%
IBM	4.86%	IBM	1.93%
GE	3.91%	Chevron	1.84%
AT&T	3.83%	Microsoft	1.74%
Oracle	3.66%	GE	1.55%
Pfizer	3.35%	Johnson & Johnson	1.54%
Intel	2.87%	Procter & Gamble	1.54%
Toyota	2.53%	AT&T	1.52%
Glaxo	2.52%	Coca Cola	1.37%

Source: [*www.etfdb.com*](http://www.etfdb.com), as of 11/11/2011

According to my own count, in the energy space there are 59 ETFs, in the commodity space there are 157 ETFs, in the large cap space there are 249 ETFs. Since for all intents and purposes the S&P 500 represents the benchmark for large cap investing, one might wonder why we would need more than one index, but apparently we do. There are 110 Small Cap ETFs, 127 Large Cap Blend ETFs, 238 Blend ETFs in general, 52 Emerging Market ETFs, 616 American Stock Only ETFs, 49 Treasury ETFs, and 396 Sector ETFs, which in itself is interesting inasmuch as there are only 10 sectors in the S&P 500.

There are at least a trillion dollars in ETFs and there are clearly many trillion dollars more that are indexed in general without entering the ETF space. Indexation represents the most prevalent equity investment strategy and, therefore, it is the biggest business in investing. To orchestrate those investments requires exceedingly liquid large capitalization stocks. The problem is that there is a limited supply both in number and in capitalization of such stocks.

59	Energy ETFs
157	Commodity ETFs
249	Large Cap ETFs
110	Small Cap ETFs
127	Large Cap Blend ETFs
238	Blend ETFs
52	Emerging Market ETFs
616	American Stock Only ETFs
49	Treasury ETFs
396	Sector ETFs

Source: www.etfdb.com, as of 11/11/2011

THE ETF PARADOX

In the modern day, companies trade in relation to their identifiable characteristics. If a company is in financial services and it's in a Financial Services ETF, it will trade like the other companies, irrespective of whether or not it has those characteristics. In philosophy there is a situation known as the Idler's paradox, which deals with an imaginary university student who has been studied and whose grades have been predicted by the academic staff. He has been admitted to a very good university and the admissions department has decided that throughout his university career, this student will have certain grades. The admissions staff is known to be very good at predicting the grades. If that is the case, then why should the student attend classes or study? He already knows what his grades are going to be. That's known as the Idler's paradox.

In philosophy there's a much bigger paradox known as Newcomb's paradox. It's almost the reverse of the Idler's paradox. In Newcomb's paradox, there is a Predictor who thoroughly understands human nature and is exceptionally skilled at predicting a person's actions. The Predictor creates a game in which there are two boxes, and one box is transparent and holds $1,000. The other box is opaque and can have either nothing or $1 million in it. The idea is that you, as the object being studied, have the opportunity to pick either one box or both boxes. The Predictor is very cynical, however, so if it predicts that you will pick both boxes, it will put zero in the opaque box. What should you do? Should you always pick both boxes and be guaranteed at least $1,000, or should you take a chance and pick the opaque box? The paradox is that you're only being asked to choose after the Predictor has already made a choice. Is your action dependent upon the Predictor or not?

I think the ETF world is very similar to these paradoxes in that an ETF is essentially a box that contains a variety of prizes, but instead of a series of boxes, it's only one box. The idea is that each of the various elements in that box should have the same characteristics as all the other elements in the box. The paradox arises in the fact that it's not possible for them all to have the same characteristics.

Let's say that there were 100 companies in a given box and that all are in the same industry. Let's also say that the consensus view is that this industry will be a very bad industry, and two-thirds of the companies will fail, meaning that they become insolvent. If two-thirds of the companies will be insolvent, then the one-third that remains will probably be very prosperous, because they will pick up business from the two-thirds that fail. At some point, if the forecast is sufficiently dire and it comes to fruition, the surviving companies within that box will do very well. That's the paradox. The various constituent elements cannot be separated in the context of the box, but they can be purchased separately outside the box.

Ultimately, the very logic of ETF investing, and the vast sums of money invested in those instruments, is going to create an enormous opportunity for individual stock selection, if it hasn't done so already. I think one such opportunity is companies that are not included in ETFs. I think another opportunity is to study the ETFs in depth, especially the ones that are under stress, and try to identify which companies might not be individually stressed in a fundamental sense, even though their stock prices are stressed.

ORPHAN STOCKS: COMPANIES NOT INCLUDED IN ETFS

I have decided once again to create an industry: Orphan Stocks, which I define as those companies that are poorly represented, if at all, in the top ten holdings of ETFs. The table below lists 10 companies, their price-to-book ratios and the number of ETFs that I could find in which each company is a member of the top ten individual holdings. Republic Bank of Kentucky, zero; Icahn Enterprises, zero; Winthrop Realty, one; Howard Hughes Corporation, zero; Jefferies, two; Sears Holdings, three (even though it happens to be a large capitalization company); Brookfield Residential, zero; Air Castle, one; Willis Lease Finance, zero, Marriott Vacations, which is a recent spinoff from Marriott Corporation, at the moment is not a member of any ETFs.

Ticker	Company	Price/Book Ratio	Membership in ETF Top 10 Holdings
RBCAA	Republic Bank of Kentucky	0.93x	0
IEP	Icahn Enterprises	0.91x	0
FUR	Winthrop Realty	0.84x	1
HHC	Howard Hughes Corp	0.80x	0
JEF	Jefferies Group	0.71x	2
SHLD	Sears Holdings	0.98x	3
BRP	Brookfield Residential	0.86x	0
AYR	Aircastle	0.64x	1
WLFC	Willis Lease Finance	0.64x	0
VAC	Marriott Vacations	0.45x	0

Source: www.etfdb.com, as of 11/11/2011

These companies all trade below book value, while the S&P 500 trades at over 3x book. Are these companies truly so demonstrably inferior to those in the S&P that they deserve to trade at less than one-third the valuation of the S&P 500 companies? It seems that there is a process at work here to drive down the valuations of those companies that are not included in ETFs, and it's been happening for years. The reverse process is at work for the companies that are included in ETFs.

One could design a very nice investment management business by confining oneself only to those companies that are only slightly represented, or are not included at all, in the S&P 500 or other major indices. However, even as these words are written, I find myself under pressure not to recommend companies like those represented in the Orphan Stock list, because even the active managers want companies with copious liquidity. They would like to operate their investment management businesses on a very large scale. Since investing is a social science, the stocks of companies meeting those liquidity requirements have a great many owners, and are unlikely to be inefficiently priced. Conversely, companies that have very few people observing them are much more likely to be inefficiently priced. It appears that one can either have interesting valuations, but not be able to operate on a large scale, or one can operate on a large scale, but have only non-interesting valuations.