ValueInvestor INSIGHT

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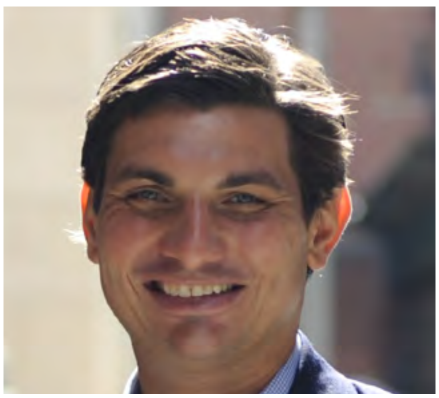
Right Place, Right Time

James Davolos of Horizon Kinetics describes what he thinks investors are missing about inflation, the types of businesses he expects to thrive in an inflationary environment – or even if inflation doesn't turn out to be as big an issue as he expects – and why he sees unrecognized value in Brookfield Asset Management, PrairieSky and Archer Daniels Midland.

INVESTOR INSIGHT



James Davolos
Horizon Kinetics

Frustrated by how expensive most risk assets were, James Davolos and his Horizon Kinetics colleagues five years ago crafted a strategy meant to benefit from what they saw as a serious and likely onset of inflation. The "hard asset, capital light" strategy underpins the firm's Inflation Beneficiaries ETF [INFL] that launched – with opportune timing – at the beginning of 2021.

Arguing that investors still aren't taking longer-term inflation seriously – and that his holdings can prosper regardless of the price-level outlook – Davolos sees opportunity in such areas as financial exchanges, agriculture, energy and alternative-asset management.

You were early in warning against inflationary pressures and in articulating an equity strategy to capitalize on them. Can you provide some background on that?

James Davolos: Five or six years ago we were frustrated with what we thought were excessively valued risk assets. Artificially low interest rates and rapid increases in monetary liquidity were driving high and pernicious asset inflation. Investment capital was moving away from tangible assets to intangible assets held by software and other technology companies. At the same time, after importing disinflation from emerging-market economies for 40 years, for many reasons – trade imbalances, trade wars, rising standards of living in those emerging markets – that dynamic was losing steam, if not poised to reverse.

ON STRATEGY:

We focus on businesses that can benefit from rising price levels but aren't overly exposed to the business cycle.

You could argue whether we were wrong or just early, but we concluded the existing state of affairs would eventually result in much higher overall price inflation and that we needed an approach to equities that would help us endure and benefit from that eventuality. We defined a "hard asset, capital light" strategy, focused on owning companies with exposure to inflationary end markets – often those tied to hard assets – but with business models that don't require a lot of working capital and/or debt financing. The idea is to find businesses that we expect to incrementally benefit from rising price levels, but that aren't overly exposed to the business cycle.

You've categorized the types of businesses you're finding that fit that profile. Let's walk through those categories, starting with royalty and streaming companies.

JD: One big problem with commodity producers is their capital intensity. To start a large-scale greenfield copper mine, for example, would cost at least $1 billion and take probably 15 years. These companies also tend to have debt. When everything is going perfectly, commodity prices are rising and the operating leverage of the business model kicks in, debt is your friend because more value accrues to the equity. Of course, debt is also a great way to permanently impair your capital if you're early or wrong on the cycle.

Royalty/streaming companies aren't capital intensive, have minimal operating costs, have modest to no debt, and generally own properties with long reserve lives. They own royalty rights on properties operated by third parties, earning revenue streams mostly on the sale of resources extracted from their land. They have direct exposure to rising commodity prices – which we want in an inflationary environment – and increases in royalty revenues go almost dollar-for-dollar to the bottom line.

We own some purely cyclical businesses that are just extremely cheap against some notion of normalized earnings – Glencore [London: GLEN] is a prominent example – but the significant majority of the portfolio is in truly capital-light businesses that we don't consider binary bets on inflation. In this category would be Franco-Nevada [FNV], a gold-focused royalty/streaming company. Since 2011, when gold was last around $1,900 an ounce, shareholders in Franco-Nevada have earned a return of around 340% to today, even though gold prices went down to $1,000 before climbing back to $1,900. If you'd instead bought the NYSE Arca Gold Miners Index, you would have lost something like 30% of your money. We think Franco-Nevada and a number of our companies will do just fine without rapidly rising inflation.

What kind of agriculture-related businesses are attracting your interest?

JD: Here we're trying to capitalize on long-term secular demand for agricultural products, driven by rising global GDP per capita – the goal of almost every developing economy – translating over time into higher and more diversified caloric consumption. Our way to play this has primarily been through the large-scale grain and seed processing companies like Archer Daniels Midland [ADM] and Bunge [BG], which have defensible businesses and earn a spread on throughput that tends to widen as prices increase. We like toll-booth businesses and think these businesses are toll takers on global food supply.

Timber, another area of focus, has been a difficult sector for investors until only recently. What are you playing for there?

JD: A number of value investors have been wrong by being early in calling for a timber cycle, driven by an expected normalization in U.S. housing starts after so much underbuilding following the 2008 financial crisis. We think that time is now here, driven by demographics and accelerated by Covid. I'm actually part of the group that left urban apartment dwelling for a house during the pandemic. On the supply side, we've also seen consolidation and rationalization of capacity in the timber industry, which is supportive of higher prices going forward.

We like timber companies like West Fraser Timber [WFG] and Weyerhaeuser [WY] that have extensive timberlands and focus more on selling raw wood as opposed to more specialized downstream products. Basic harvesting and milling is relatively low-cost compared to the price of the finished product, so these companies can generate good free cash flow at modest timber prices, and incremental margins are very high during strong pricing cycles.

ON EXPECTATIONS:

We think we've already reset to a higher level of inflation and investors should assess businesses accordingly.

Your next category, real estate and infrastructure, doesn't seem like a no-brainer if inflation helps drive interest rates higher.

JD: Publicly listed real estate and infrastructure assets are typically cornerstone investments in conventional "real asset" portfolios. The problem is that while these businesses will almost certainly be able to pass along higher rents to their tenants/customers in an inflationary environment, that very well could be negated by the rise in capitalization rates – resulting in lower multiples on cash flows – that would accompany higher interest rates.

Our way around that is to emphasize real-estate services companies like CBRE Group [CBRE] or asset managers with high real estate and infrastructure exposure like Brookfield Asset Management [BAM]. These types of businesses can earn high and scaling margins throughout a full cycle, without nearly the negative impact of rising interest rates you'd see in a real estate investment trust that owns and operates assets in either of these areas.

The last two areas you see as fertile investment ground in inflationary times – what you're calling transaction facilitators and data and research companies – would seem to be a bit further afield than typical real-asset plays. Explain why they qualify.

JD: The best example of an attractive transaction facilitator to us would be a financial-exchange business like Intercontinental Exchange [ICE] or Deutsche Boerse [Frankfurt: DB1]. They operate a number of the largest and most profitable derivatives exchanges for interest rates, currencies, soft commodities, hard commodities, index futures and much more. In a world where inflation is markedly higher than where it's been, we would expect greater price volatility around most of those types of things, which should drive trading volumes from both speculation and hedging. Automation has made variable expenses on higher volume close to zero for exchanges, so the business model is great for inflation – revenues can inflect while costs are static.

We think these companies also provide somewhat of a hedge against a difficult overall market. Typically when the exchanges do well, investors assume they're at peak earnings and everything will revert before long. There is some truth to that, but if we are leaving the 40-year regime of declining interest rates, rising deficits and suppressed volatility, what's normal is likely to look different for these companies going forward. In addition to the secular tailwind from a step-up in volatility, a changing market environment may also better highlight the extent to which companies like ICE and Deutsche Boerse have built out their recurring revenue streams from data and other information services. We think exchange businesses can really decouple from the broader market – it's not a surprise to us, for example, that while the German market is down by 13% year to date, Deutsche Boerse's stock is up 13%.

With respect to data and research companies, we target those that provide critical information and research services with pricing power in serving what could be inflationary end markets. A representative example would be Charles River [CRL], which provides contract research services to pharmaceutical and biotech companies. Another would be Verisk Analytics [VRSK], which provides actuarial and underwriting data and data-analytics services that insurers use to assess risk and detect fraud. These types of companies can accommodate higher volume growth with relatively low variable expense, making them good businesses in any environment, but we think even better ones when inflation is high.

We first spoke about your strategy less than a year and a half ago [*VII*, December 30, 2020], when inflation wasn't nearly the hot topic it is today. Is there a risk the "easy" money has already been made in a number of these ideas?

JD: We're trying to look out three to five years and think about where normalized earnings and valuations are going to be. Our base case in doing that is that liquidity-fueled demand exceeding supply and pushing prices higher isn't a transitory thing and we won't go right back to sub-2% inflation after a couple of interest-rate raises by the Fed and other central banks. Maybe a global recession eases some of the demand, but it doesn't change the long-term secular backdrop in a number of markets. We think we've already reset to a higher level of inflation and investors need to assess businesses accordingly. We still don't see a lot of evidence that that's what most people are thinking.

Explain in greater detail your investment case for Brookfield Asset Management.

JD: This is an alternative-asset manager for institutions and its own account primarily focused on real estate, renewable energy, infrastructure, distressed credit and private equity. It earns fees and carried interest on its clients' investments, plus capital gains on co-invested capital. Assets under management today are close to $700 billion, of which about $70 billion is internal capital.

We like several things here. Brookfield's investment strengths are in a number of end markets that are attracting heavy capital investment, are likely to benefit from inflation, and are generally where institutional investors are going to look for returns beyond stocks and bonds in a yield-starved world. While it has plenty of competitors, it has an operating presence in over 30 countries that not only gives it a unique level of access to deal flow, but because of its roots and expertise in these markets it can also move quickly and effectively to execute on individual deals. If you think about areas like real estate, renewable energy and infrastructure – especially in markets outside the U.S. – that established presence and reputation for getting things done right is a competitive advantage.

ON RISKS:

I believe we assess business quality well and aren't overpaying. One risk: misreading the drivers of the business.

We're also optimistic about two new potential growth drivers, with the recent launches of Brookfield Reinsurance and of a retail-oriented investment advisory business called Brookfield Oaktree Wealth Solutions. Reinsurance is not a unique idea for a company like Brookfield, but we think it should be uniquely positioned to leverage insurance float to create value. While institutions love Brookfield – it raised over $70 billion in fee-bearing capital last year – Wealth Solutions is an effort to expand the client base beyond pensions and endowments to individual, mostly high-net-worth, investors. If institutions see Brookfield's product specialties as increasingly attractive, we imagine individual investors will also.

Brookfield is traditionally closely associated with commercial real estate, including high-profile office properties. Is that a concern in a post-pandemic world?

JD: The market today is rather negative on commercial real estate. Our basic view is that there are at the margin potential headwinds to office and retail properties, but less so for the types of trophy assets that Brookfield tends to own. At the same time, challenges to this space will likely enhance opportunity for Brookfield to do what it does best in real estate, which is buying, updating and repositioning properties to higher use. So while the environment may work somewhat to the disadvantage of the incumbent portfolio, it works to the advantage of allocating new capital.

I don't want to overstate the emphasis on commercial real estate. The secular backdrop for their areas of focus like infrastructure and renewables are highly positive, as decrepit infrastructure in developed markets needs to be updated, new infrastructure in developing markets needs to be built, power grids need to be updated, and energy in general transitions from fossil fuels toward renewables. Management has proven to be very skilled at recycling capital to where it can be best put to use and we expect them to continue to do that.

How attractive do you consider the shares at today's price of just under $50?

JD: This isn't a particularly easy company to value. The base management fees it earns are generally stable, but carried-interest earnings can be fairly episodic. There's also a lot of balance sheet value from all of the co-invested capital, which is largely in the form of direct parent-company investments in the publicly traded Brookfield Infrastructure Partners [BIP], Brookfield Renewable Partners [BEP] and Brookfield Business Partners [BBU], as well as in the now-private Brookfield Property Partners.

On a sum-of-the-parts basis, if we value the three publicly-held stakes at mar-

INVESTMENT SNAPSHOT

Brookfield Asset Management
(NYSE: BAM)

Business: Global alternative asset manager with some $700 billion of assets under management across real estate, infrastructure, renewable power, private equity and credit.

Share Information (@4/29/22):

Price	**49.86**
52-Week Range	44.34 – 62.46
Dividend Yield	1.1%
Market Cap	$80.70 billion

Financials (TTM):

Revenue	$81.28 billion
Operating Profit Margin	21.1%
Net Profit Margin	4.9%

Valuation Metrics
(@4/29/22):

	BAM	S&P 500
P/E (TTM)	20.8	24.1
Forward P/E (Est.)	14.0	18.6

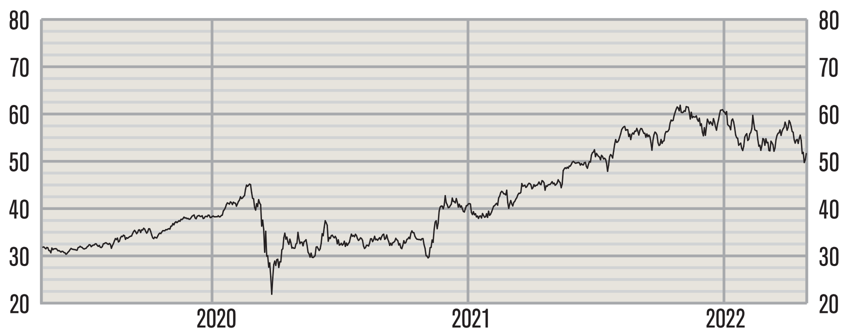
Largest Institutional Owners
(@12/31/2021 or latest filing):

Company	% Owned
Brookfield Asset Mgmt PIC Canada	8.3%
RBC Global Asset Mgmt	3.7%
1832 Asset Mgmt	3.1%
Vanguard Group	2.2%
RBC Dominion Securities	2.2%

Short Interest (as of 4/15/22):

Shares Short/Float	0.3%

BAM PRICE HISTORY



THE BOTTOM LINE

The company's investment strengths are largely in end markets "that are attracting heavy capital investment, are likely to benefit from inflation, and are generally where institutional investors are going to look for returns beyond stocks and bonds in a yield-starved world," says James Davolos. His sum-of-the-parts fair value for the shares today is around $70.

Sources: Company reports, other publicly available information

ket value, assume the stake in Brookfield Property is worth what it was when taken private in the middle of last year, put a peer-group 20x multiple on a $2.5 billion run rate of annual management fees, and an 8x multiple on an estimated $2 billion in annual carried interest, we arrive at a fair value for the shares of around $70.

I would point out that management – which we think led by CEO Bruce Flatt is exceptional – has higher ambition for fee growth than we're building into our base case. We'll do very well if our base case pans out, and even better if management hits its growth targets.

Turning to an energy royalty company, describe the upside you see in PrairieSky Royalty [Toronto: PSK].

JD: PrairieSky owns an enormous oil and gas royalty portfolio that spans 18.3 million acres in Western Canada with a reserve life of 50-plus years. As I mentioned before, these types of companies don't produce the commodities directly or bear any development and operating costs, but they do participate in the revenue generated from the sales volume and prices of the reference resources. Because the reserve life is so long, PrairieSky doesn't have to constantly be in the market replacing reserves – unlike many royalty companies – which is a tremendous advantage when oil and gas prices are at or near seven-year highs and buying reserves is increasingly expensive.

We'd argue that there's an overall lack of appreciation for energy royalty streams. Part of that is investors fleeing the energy sector in general, due to years of bad returns and increasing focus on ESG criteria. Investors are also preconditioned to focus on current cash flows and growth, but the value in these companies predominantly resides in dormant or non-producing assets.

We also think in PrairieSky's case that there is a misperception of the quality of Canadian oil and gas. Most investors assume the reserves in Canada are tar-sands and sulfur heavy, very expensive to extract and the least ESG friendly. But there actually are a number of light-oil fields in the Western Canadian Sedimentary Basin – which is where the company's reserves are located – that are comparable to the best fields in the U.S.'s Permian basin. The oil produced generates high internal rates of return and is in higher demand, particularly from U.S. refiners.

Another differentiating factor here is that PrairieSky retains a lot of control over the use of its land. As a result, it's pursuing a number of carbon-capture initiatives as well as alternative-energy projects like wind and solar. Once the investing world gets more comfortable with the fact that conventional fossil fuels are necessary for the energy transition and are going to be around for decades, we think the company's flexibility to play as well in alternative energy makes it much more investable.

The last thing I'd say about what distinguishes the company is the quality of its corporate governance. Top executives are significant shareholders and their pay, which is modest relative to U.S. companies, is based intelligently on the performance of the company and the stock. The royalty playbook on the website details every asset they own. Their latest Investor Day presentation runs 200 pages, again with excellent detail on the entire portfo-

INVESTMENT SNAPSHOT

PrairieSky Royalty
(Toronto: PSK)

Business: Earns royalty revenue as oil and natural gas are produced from its owned properties, consisting primarily of 18.3 million acres across four Canadian provinces.

Share Information
(@4/29/22, Exchange Rate: $1 = C$1.28):

Price	**C$17.63**
52-Week Range	C$12.75 – C$19.48
Dividend Yield	2.7%
Market Cap	C$4.25 billion

Financials (TTM):

Revenue	C$293.6 million
Operating Profit Margin	55.4%
Net Profit Margin	42.0%

Valuation Metrics
(@4/29/22):

	PSK	S&P 500
P/E (TTM)	23.1	24.1
Forward P/E (Est.)	14.1	18.6

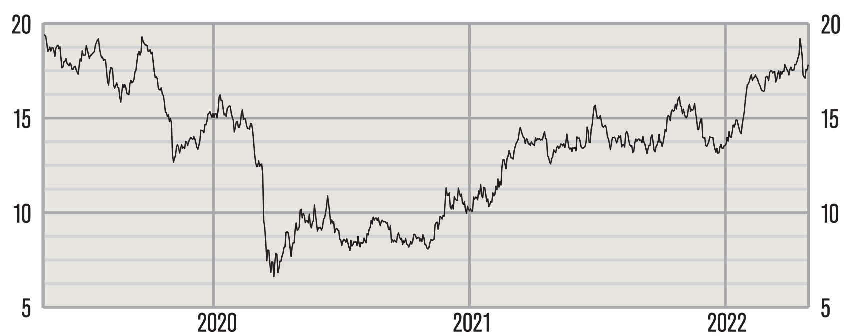
Largest Institutional Owners
(@12/31/21 or latest filing):

Company	% Owned
EdgePoint Inv	18.8%
RBC Global Asset Mgmt	10.2%
M&G Inv Mgmt	10.0%
Fidelity Mgmt & Research	7.0%
1832 Asset Mgmt	4.0%

Short Interest (as of 4/15/22):

Shares Short/Float	n/a

PSK PRICE HISTORY



THE BOTTOM LINE

James Davolos believes the market isn't recognizing the quality and size of the company's reserves, its ESG-related flexibility, or the quality of its management. From today's share price he expects to earn a free cash flow yield above 10% for seven to 10 years, while at the end of that period still having a "call option" on 75% of the current reserve base.

Sources: Company reports, other publicly available information

lio. There's just a very high level of transparency and accountability.

How are you looking at upside from today's C$17.60 share price?

JD: Assuming energy prices 10-15% below where they are today and some small increases in production, we think the company can earn its entire market cap in free cash flow over the next seven to 10 years. More importantly, they'll still at that point have at least 75% of their existing portfolio to exploit. That means I'm earning a double-digit free cash flow yield and there's still an embedded call option on the large reserve base. That to us is a compelling value opportunity.

Describe in more detail the toll-booth attributes you admire in Archer Daniels Midland.

JD: ADM is one of the global leaders – along with companies like Bunge, Cargill and Louis Dreyfus – in the business of procuring, processing and selling basic agricultural commodities. It's an oligopoly for a reason, as these companies have to have all the relationships with the farmers, the grain elevators, the crushing facilities, the truckers, the ports and other parts of the supply chain that take a long time to build. Every step of the way also tends to benefit from scale.

At a basic level, the company is buying things like soybeans, corn and wheat and processing it into an intermediate or finished product. It earns a crushing or milling margin on that, so if you expect as we do higher ag-market demand driving higher prices, ADM will be capturing a spread on ever-higher throughput. It's a low-margin business and commodity prices can move up and down, but it's one of the small number of companies capturing a spread on volume. That's why we consider it a toll taker on global food supply.

We also don't think investors are fully appreciating some of the ongoing changes in the company's business mix. It has exited or sharply curtailed less-attractive ethanol and European-trading operations and has been steadily expanding through a number of acquisitions in areas like specialty flavorings, specialty sweeteners, probiotics and plant-based food products. These products typically require additional processing and have proprietary formulations, so in addition to being in areas with incremental growth, they also generally earn higher margins. The nutrition business, as they call it, now accounts for nearly 15% of revenue and 20% of adjusted EBITDA. As that becomes a bigger part of the whole, it materially increases the quality, profitability and stability of the business.

From today's price of around just under $90, how do you see all this translating into shareholder benefit?

JD: The market seems to think the company is going to earn peak earnings this year and then revert to a more normalized earnings power. The stock trades at less than 16x our EPS estimate for this year and less than 10x earnings after netting out non-cash items.

While there may be some reversion from current earnings, we wouldn't expect much and think current profitability will turn out to be a lot more sustainable than the market believes. Over time, through organic growth, tuck-in acquisitions and higher operational efficiency, we think operating profits can grow at close to 10% per year. That alone would allow for an attractive rate of return, but there's also a good argument for multiple expansion. Consumer-products businesses are trading today at 22-24x earnings – as the stability and overall quality of ADM's business continues to improve, we think the gap between its valuation and those consumer businesses will close at least somewhat.

We noticed that you also own Asian food-processor Wilmar International [Singapore: F34]. Is the story for it similar?

JD: ADM actually has a large minority interest in Wilmar and yes, for the most part, the main drivers of the story are similar. The company primarily serves southeast Asian markets so the product mix is more focused toward eastern diets – heavier in tropical oils and rice, for example. We'd argue that given where it does business it has a better secular-growth story, but the market is giving it even less credit today than it is ADM. The stock [at around S$4.40] trades at only 10x next year's earnings.

One last general question: If you turn out to be wrong in any of the areas we've discussed – at either a micro or macro level – why would it most likely be?

JD: On a bottom-up basis, the most important risk is probably that for some reason we've misread the drivers of the business. I'm confident we've assessed the business quality fairly well and that we're not overpaying, but if higher inflation doesn't drive increased volume on derivatives exchanges, say, or if rising per-capita incomes around the world don't increase agricultural-product demand, we'll run into some issues.

From a macro standpoint, one of the bigger risks – which wouldn't necessarily result in negative performance, just less-attractive relative performance – would be if we go back relatively soon to an era of financial repression, meaning low real rates of economic growth, low interest rates and low inflation. I'm not exactly sure how that could all happen at the same time from where we are today, but that would likely again drive the most speculative parts of the market much higher. That's what value investors have been combatting for the better part of ten years now. VII

INVESTMENT SNAPSHOT

Archer Daniels Midland
(NYSE: ADM)

Business: Sources, processes, sells and distributes a wide range of agricultural commodities for use in human and animal foods, beverages, fuels and industrial products.

Share Information (@4/29/22):

Price	**89.56**
52-Week Range	56.91 – 98.88
Dividend Yield	1.8%
Market Cap	$52.03 billion

Financials (TTM):

Revenue	$85.25 billion
Operating Profit Margin	3.4%
Net Profit Margin	3.2%

Valuation Metrics
(@4/29/22):

	ADM	S&P 500
P/E (TTM)	16.5	24.1
Forward P/E (Est.)	15.4	18.6

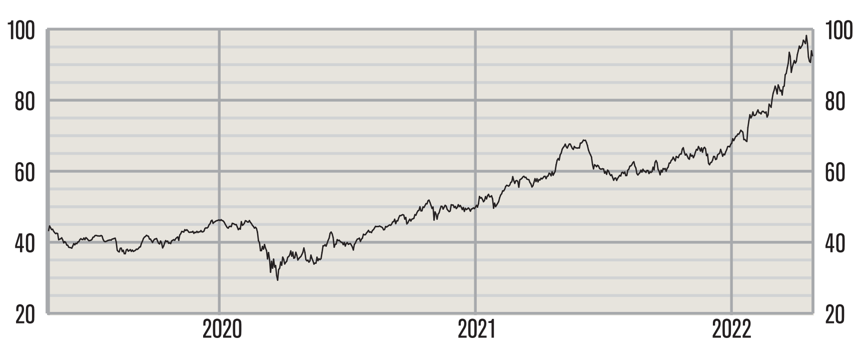
Largest Institutional Owners
(@12/31/2021 or latest filing):

Company	% Owned
Vanguard Group	10.5%
State Farm	8.3%
Capital Research & Mgmt	7.2%
BlackRock	7.0%
State Street	5.5%

Short Interest (as of 4/15/22):

Shares Short/Float	1.3%

ADM PRICE HISTORY



THE BOTTOM LINE

The company is well positioned as a "toll taker on global food supply," says James Davolos, and in expanding into higher-value nutrition areas is improving the profitability and stability of its business. He expects to benefit in the medium term as a shareholder from 10% or so annual profit growth, with added potential upside from multiple expansion.

Sources: Company reports, other publicly available information

IMPORTANT RISK DISCLOSURES

Please consider carefully a fund's investment objectives, risks, charges and expenses. For this and other important information, obtain a statutory and summary prospectus by contacting 646-495-7333. Read it carefully before investing.

The Horizon Kinetics Inflation Beneficiaries ETF (Symbol: INFL) is an exchange traded fund ("ETF") managed by Horizon Kinetics Asset Management LLC ("HKAM"). HKAM is an investment adviser registered with the U.S. Securities and Exchange Commission. You may obtain additional information about HKAM at our website at www.horizonkinetics.com.

Performance results are listed on https://horizonkinetics.com/products/etf/infl/#performance. **The performance data quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than the performance quoted. For performance current to most recent month end please call 646-495-7333.**

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The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund.

The Fund invests in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater for investments in emerging markets.

The Fund may invest in the securities of smaller and mid-capitalization companies, which may be more volatile than funds that invest in larger, more established companies. The fund is actively managed and may be affected by the investment adviser's security selections. Diversification does not assure a profit or protect against a loss in a declining market.

Definitions:

- The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

- Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock.

- Free cash flow (FCF) represents the cash a company generates after accounting for cash outflows to support operations and maintain its capital assets.

- Free cash flow yield is calculated by dividing the free cash flow per share by the current share price.

- Price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings (EPS). Fund holdings and sector allocations are subject to change and should not be considered recommendations to buy or sell any security.

- Earnings before interest, taxes, depreciation, and amortization (EBITDA) is a measure of a company's overall financial performance and is used as an alternative to net income in some circumstances. EBITDA, however, can be misleading because it does not reflect the cost of capital investments like property, plants, and equipment.

- Call option represents the option to buy a given stock (or stock index or commodity future) at a given price before a given date.

- GDMNTR is the NYSE Arca Gold Miners Index, which tracks the overall performance of companies involved in the gold mining industry.

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