



Dear Clients and Friends,

Over his 70-year+ investment career, Warren Buffett has relied on three pillars underlying his investment philosophy: 1) treat stocks as fractional representations of real businesses, not as playing cards to be routinely traded; 2) maintain a proper disposition toward the stock market (i.e., control your emotions such that you can act with caution when everyone else is overly optimistic, and you can act courageously when everyone else is overly fearful); and 3) select companies that reside within your circle of competence, and then buy those companies at valuations that you believe provide a *margin of safety*. Margin of safety is principally concerned with avoiding a permanent erosion of capital. It uses market volatility not as a measure of risk, but as a barometer of market sentiment.

In order to mitigate the likelihood of permanent loss, you should endeavor to purchase companies below their intrinsic value, or with a margin of safety. There is, of course, no exact intrinsic value for any company; rather, there is a range of estimates for a company's future cash flows, discounted at some chosen interest rate. For many investors, the appropriate discount rate is the "risk-free" 10-year United States Treasury Note. However, if you wish to be more conservative, you can discount expected cash flows at much higher rates. For instance, in 2021, when the 10-year Treasury Note was yielding 0.60%, using that discount rate against future cash flows produced very high expected stock values. It also created a logical absurdity, as a 0.60% Treasury yield would have almost guaranteed the holder a real loss in purchasing power through maturity, thus proving to be anything but "risk free". With the Federal Reserve's rate hikes over the last 21 months, those "risk-free" 0.60% Treasuries also suffered very serious market price declines.

The practice of margin of safety investing has two very powerful corollaries. First, it fully incorporates the concept of Siegel's Paradox, which states that a given negative return requires a larger positive return to get you back to even. For example, a \$1,000,000 portfolio that is down 25% (\$750,000) requires 33% appreciation to get back to \$1,000,000—that is, a \$250,000 gain on the now lower base of \$750,000. Second, the greater the margin of safety, the higher the expected return. Buying a company at 50% of its estimated intrinsic value would result in a much greater expected return than buying a company at 90% of its intrinsic value, all else being equal. That is, buying companies at 50 cents on the dollar will likely produce far greater returns than buying the same businesses at 90 cents on the dollar.

None of these concepts are original to Warren Buffett. He learned them from his mentor and friend, Benjamin Graham. The practice of this investment philosophy has frequently placed Mr. Buffett at odds with the general thinking at any given time, has produced a much more concentrated portfolio than is typically displayed by most investment professionals, and has resulted in lumpy (more volatile), albeit, superior, long-term investment results. Why hasn't this approach, which has a long history of success and which we endeavor to practice ourselves, been more widely replicated by investment professionals? This grand and pivotal question is hardly new or a product of modern investment techniques and instruments. Perhaps the best answer was given by John Maynard Keynes many years ago.

In his 1936 magnum opus, *The General Theory of Employment, Interest and Money*, Keynes wrote, in Chapter 12, the following regarding investors who have the propensity to base their decisions on long-term business fundamentals rather than on short-term average opinion (market timing).



"For it is in the essence of his behavior that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful that will only confirm the general belief in his rashness; and if, in the short run, he is unsuccessful, which is very likely, he will not likely receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

For the year 2023, Horizon Kinetics' investment results for certain products may be deemed as having failed unconventionally. Our "poor" episodic returns were largely attributable to our outsized holding in Texas Pacific Land Corporation (TPL). We have professionally owned this company since the mid-1980s, and the company itself dates from the 1880s. Despite its recent "underperformance", we believe the defining characteristics of TPL remain remarkably compelling as an investment. TPL's financial health is impeccable, with zero debt and over \$650 million in cash. The company is, in our estimation, among the most attractive publicly traded companies, owing to its capital-light nature and its ability to produce copious amounts of free cash flow. Some companies generate high reported earnings but have to continually reinvest the majority of those earnings back into the business just to remain competitive. For example, a company may report \$1 in per share earnings but, in order to remain competitive, must reinvest \$0.90 per share (whether on plant and equipment, physical reserves replacement, R&D, or whatever its particular business requires), leaving little in free cash flow, the \$0.10 that can be returned to shareholders in the form of dividends or share repurchases.

For the nine months ending September 30, 2023, TPL reported \$464 million in revenue and \$299 million of free cash flow, for an after-tax free cash flow margin of 64.4%. While the 2023 year-over-year numbers are lower than the comparable 2022 period, owing principally to lower oil and gas prices, we believe this volatility is just the price of admission to own a fabulous business. Between 2016 and 2022, TPL's free cash grew by approximately 40% *per year*. While down in 2023, we believe this is just a small bump in the progression of ever higher free cash flow for the company.

While most of you are aware of our dispute with TPL's plan to authorize 46,536,936 shares, we do agree with the management and the Board of Directors on many important issues. Philosophically, we are not opposed to acquisitions or to asset disposals, we just desire that rigorous financial analysis be presented. It would need to be a unique and rare asset (acquisition target) to justify trading away a single TPL share, as there are exceedingly few companies or opportunities that we believe can compete with TPL's return or prospects.

Bitcoin

Bitcoin is a decentralized digital currency, often referred to as a cryptocurrency. It was designed with the explicit characteristic of digital scarcity, having a potential full supply of only 21 million coins, with each coin being convertible into 100 million smaller units known as satoshis, similar to how the U.S. dollar is convertible into 100 pennies. Think of it as a fixed monetary policy. Bitcoin's decentralized computer network means that no one country, company or individual controls the network. Anyone is free to opt into the system. Bitcoin can be sent or received anywhere in the world 24/7, 365 days a year without the need for a financial intermediary. Since its inception in 2009, it has gained traction as a new asset class, as a store of value, and as a medium of exchange.



The general consensus pertaining to the permanence of Bitcoin has shifted dramatically in the last year. Many large financial institutions, including Blackrock, Fidelity and VanEck, have filed to bring forward public spot Bitcoin ETFs. It now appears to be a question of when, not if, the Securities and Exchange Commission approves a slew of Bitcoin-related ETFs. As such, it's quite likely that the world's largest financial marketing campaign to introduce a "new" asset class is on the eve of commencement.

While we always had high expectations for Bitcoin's mainstream adoption, they were rooted in bitcoin's underlying technology and its uniqueness. There has never before been a money or currency that could not be diluted or debased by the issuer, ultimately to the point of collapse—even for past, historical reserve currencies of long standing, the incentive to 'print' more was too great. Now, however, Bitcoin's adoption will be accelerated by Wall Street's profit motive. The opportunity to make money via trading, lending and arbitrage will be too great to resist. It is extremely rare to find a currency or any asset that has not depreciated against Bitcoin since its inception.

Sometime in the year 2011, Bitcoin reached a price of \$1. As of the time of this writing, it hovers around \$43,000. If you purchased a \$2 million home in 2011 with Bitcoin you would have needed 2 million bitcoins. Today, you would need only 46.5 bitcoin to purchase the same \$2 million home. It's not inconceivable, at least to us, that the \$2 million home will be priced in a fraction of a bitcoin not too many years hence. It's not that Bitcoin is appreciating in price, it's that other assets are deflating in price against Bitcoin—like an exchange rate shift between two conventional currencies. Much of the reason for this is the continued debasement of Fiat currencies by governments around the world. Monetary debasement is the primary reason for inflation and why many are looking for alternatives outside the traditional financial system.

We should emphasize that Bitcoin is not a cash flowing asset (as outlined above in determining a company's intrinsic value), although you can be paid in dollars for lending your Bitcoin.

The rise of the "Bitcoin standard" has profound implications for the pricing of global assets. If the Bitcoin lending rate is substantially above the commonly used risk-free rate, the 10-year U.S. Treasury Note, as mentioned above, it will likely influence government monetary policies and Treasury markets around the world as it achieves greater adoption. It's very conceivable that the pure, unfettered Bitcoin lending rate will become the global benchmark and all assets will be priced against that rate.

While we initially made Bitcoin a very modest position, it has grown to become a sizable percentage in many accounts and products. Prior to 2009, when Bitcoin was introduced, decentralized digital scarcity was just a concept. As this concept has proven to be durable, the likelihood of it revolutionizing how the global system functions has also grown. Should this revolution progress, the Bitcoin position will become an ever larger weighting within our portfolios.

We wish you much health, joy and prosperity in 2024!