Horizon Kinetics Inflation Beneficiaries ETF (INFL)
2024 Annual Letter

February 2025

"Show me the incentive and I'll show you the outcome." – Charlie Munger

Capitalism and modern economic theory assume that individuals will universally seek to maximize their own self-interest. Adam Smith popularized the concept of the "invisible hand" in the middle of the 18th century, which argues that self-interested actors in a free system will engage in competition that will maximize broader economic good for all. This implies that any interference with free competition by governments will be detrimental.

The world has experienced increasing amounts of government intervention over the past century, but particularly in the last 20 years. This has included, most prominently, the unconventional monetary policies that followed the global financial crisis, and the fiscal policies that arose during the global pandemic. However, there have also been non-economic, i.e. social policies, that have attempted to promote social or societal interests.

Societies supported these policies during periods of economic growth, stable price levels and broadly rising standards of living. However, this balance was fragile, and these policies collectively resulted in gradual price distortions. This was initially contained to financial asset prices, which has further concentrated wealth distribution. Eventually consumer prices rose (inflation), and it was only a matter of time until individuals reprioritized their own self-interests.

There is not an easy or intuitive solution for the dilemma of high debts, high deficits and low growth rates across the developed world. However, as astutely noted by Rachel Reeves, the UK chancellor of the exchequer, "without economic growth, we cannot improve the lives of ordinary working people."

It is obvious to us that the world will reprioritize economic growth above all else and accept that part of high nominal growth is higher inflation. This is both the *end game,* and *the most important thing.* Once we appreciate this, we can optimize an appropriate investment strategy – in *capital light* business models.

The Endgame

Scott Bessent, the incoming Secretary of the U.S. Treasury Department, will wind down his global macroeconomic investment firm upon his confirmation. The name of the firm is Key Square, which refers to an obscure maneuver used in the final stages, or endgame, of a chess match. Bessent notes that chess matches between elite players are seldom decided before the last 1/3 of the game (endgame) and notes the parallels to investing (and his presumed policy intentions).

Bessent has criticized the outgoing administration for U.S. fiscal deficits and federal debt levels (including the shortened structure of debt issuance), but he has stopped short of offering an explicit plan to address them. However, he has referred to his belief that we are in the midst of a "great realignment and of a Bretton Woods realignment coming in terms of global policy and trade."[1]

The original Bretton Woods Agreement established the modern international monetary system in 1944, creating the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IRDB). However, the most notable component of the pact was to peg the U.S. Dollar to gold at $35 per ounce. The "gold standard" lasted until 1971, when it was abandoned in conjunction with the implementation of price and wage controls, as well as tariffs. These were last ditch efforts to (unsuccessfully) reduce inflation. The U.S. simply could no longer afford to fund its spending if fully backed by gold. This effectively started the modern era of for-profit currency issuance: seigniorage.

We can speculate on the meaning of a "Bretton Woods realignment," but also take guidance from the predicament that the developed world finds itself in today. The U.S. currently has over $35 trillion of gross federal debt, or roughly 123% of GDP. The federal debt is often reported net of intergovernmental holdings (about $7.38 trillion), which would reduce the debt-to-GDP ratio to approximately 100%.

However, this exclusion assumes the perpetual rolling over of this debt and a recycling of the interest back into the government, both of which are not explicit. The average interest rate on U.S. federal debt is now 3.32%, resulting in an annual interest expense of some $1.18 trillion, or over 4% of GDP (inclusive of intragovernmental holdings).

This burden will only grow amid forecasted deficits in the range of $1.69-$2.64 trillion (5.2%-6.5% of GDP)[2] in the next decade. Furthermore, the lowest point on the current U.S. Treasury yield curve is close to 100 basis points above the average interest of federal debt today.

The magnitude of these figures is hard to fully appreciate, but it is imperative to frame the proportions of what is required to meaningfully impact the balances. It is logical to address the predicament directly by seeking to reduce expenses and/or increase revenues, but the constraints on improving them are considerable.

The U.S. government collected $4.9 trillion in receipts in 2024. Essentially every dollar was consumed by federal interest payments and mandatory (i.e. mandated by existing laws) outlays (Social Security, Medicare, Medicaid, Income Security, federal and military retirement, veterans' programs, and others). This means the federal government is in a deficit before any "discretionary" spending. Discretionary spending is 47% comprised of defense/national security expenditures, and also includes federal transportation, education, housing, and social service programs.

[1] Capital Allocators Podcast, Macro Maven, Episode 415
[2] Congressional Budget Office

There is good reason to castigate the government for its inefficiency, but there aren't many places on the (discretionary) expense side of the ledger to make a meaningful impact to the deficit. Furthermore, the economic impact (benefit) of this spending should not be dismissed, as any material spending cuts would not only have a negative social impact, but also likely reduce economic growth, hence government revenues.

Of all federal revenues, 95% of total receipts come from taxes—individual (49.3%), payroll (34.7%), and corporate (10.8%). This seems the most logical area for policymakers to target. However, President Trump plans to extend the Tax Cuts and Jobs Act (TCJA) of 2017, which is set to expire at the end of 2025. The Congressional Budget Office estimates this will cost approximately $4.6 trillion over the next decade (compared to letting the cuts expire).[3]

Furthermore, if the proposed tax cuts to overtime wages, tips, social security income, and domestic manufacturing profits are enacted, the result could be an incremental $3.8 trillion of costs[4] over the next decade, according to the Committee for a Responsible Federal Budget.

Now that we have framed the magnitude of the debt and deficit paradox, it appears conventional policy choices are not sufficient to remedy the problem. We can speculate about the potential for tariff revenues and resurgent economic growth, but neither of these would appear to be sustainable solutions. Bessent alluded to these limitations in his comments on Bretton Woods, and we are only left to anticipate some form of policy that seeks to promote nominal growth via currency debasement and/or financial repression.

We will refrain from speculating on the substance of such a realignment but recognize that it could address the debt and deficit issues with less societal hardship relative to austerity and or default. Such an action(s) would almost certainly inflate the values of the existing asset base, and further benefiting those who hold assets, and marginalize those seeking to accumulate assets. Bessent will have to be thoughtful of this dynamic, which he alluded to in his refrain that "capital has been favored over labor (wages), for essentially my entire career."[5]

There is not a definitive strategy to invest for this end game scenario. We can attempt to forecast the first, second and third order effects, but the complexity (uncertainty) rises rapidly on a non-linear basis. Accordingly, it will be essential to identify and remained focused on the most important variables.

The Most Important Thing

Howard Marks, co-founder and co-chairman of Oaktree Capital (now part of Brookfield Asset Management) is renowned for his insightful investment memos. He mined his voluminous archive to

[3] https://www.cbo.gov/publication/60271
[4] https://www.crfb.org/issue-area/donald-trump
[5] Thematic Investors Podcast, Scott Bessent a Global Macro Veteran on the Path Ahead

publish an aptly named book, *The Most Important Thing*, in 2011. Mr. Marks's memos and books revolve around the central idea of protecting principal—in other words, not losing money. Oaktree, famous for distressed credit investing, thus designs its investment process with loss prevention in mind, rather than the typical process that is optimized for a target rate of return.

Loss mitigation, in credit terms, is an objective calculation based on the probability of default multiplied by the severity of loss, or recovery rate. Risk can be quantified based upon the ability of the company to service its debt, and the collateral available to creditors in the event of default. Equity loss mitigation is a less tangible exercise because there is no maturity date for stocks, and they must be bought and sold based on market prices. These prices result from a combination of earnings, growth rates, interest rates, liquidity, and sentiment—just to name a few variables.

In truth, we can speculate as to why the market values a certain company at a certain price, but to do so with certainty assumes one understands the motivation of every buyer and seller at all times. Furthermore, it assumes all buyers and sellers are driven by fundamentals, rather fund flows (indexes) or momentum.

We can anchor equity values based on historical multiples, peer group multiples, and discounted cash flow assumptions. This provides a baseline for how the market views a company, though this is subject to change. So, rather than constantly guessing what the market is expecting of—and discounting for a certain company, it's more efficient to focus on only the most important thing(s) for the long-term value of the firm.

The most important things vary for every company and can also change over time. However, there are constant fundamental variables—such as cash flows, which include assumptions for profit margins and revenue growth. These variables tend to be the most important when valuations are reasonable or low, and the return is less reliant on the continuation of elevated market multiples. The logical conclusion: valuation is a very important variable.

Valuation is a critical precondition for the success of any investment, but particularly with a value-conscious strategy. The obvious reason is that an attractive entry point leaves more room for upside, and a higher margin for error on the downside. But it also increases the sensitivity of the investment to the fundamental (versus market) factors. For instance, a company with a large market value, such as an A.I. technology developer, that has yet to achieve positive cash flow may be more sensitive to market sentiment and industry growth rates than idiosyncratic business performance. Similarly, a mature cash-flowing asset, such as real estate, that trades at a very low capitalization rate (high cash flow multiple) may be more sensitive to long-term interest rates than net operating income growth.

While valuation is critical, we have learned that statistical "cheapness" is not sufficient for a successful investment. In many cases, the market discounts high degrees of uncertainty, risk and or cyclicality into real asset companies. Real asset business are generally highly capital intensive and small changes in prices, volumes and or interest rates can dramatically alter the cash flow profile of the business. In order to control for this uncertainty, we require higher quality real asset businesses. We broadly define these companies as “capital light.”

The relative predictability of capital-light business models reduces the complexity of the investment analysis, which in turn makes identifying the most important things much more straightforward. In an overly simplified exercise, we can make assumptions on the revenue drivers (generally volume and price). The margin profiles of many of these businesses are remarkably stable, as is the free cash flow conversion. Thus, if we are reasonably accurate in identifying and analyzing the revenue drivers, the next step is valuation, based on a narrow range of cash flow and discount rate assumptions. Finally, the “upside” scenarios can be estimated by revising inputs that drive incremental improvement in revenue and margin.

Investing in high quality (capital light) businesses makes our job easier and promotes a higher compounding rate of return. It took us several decades to formalize this strategy, but it is obvious in hindsight.

Capital Light (Efficient)

Quality investing is much like value—these are both subjective and relative terms that can vary by industry. The standard definition of quality combines return on equity (ROE), earnings growth, and financial leverage. However, this definition of quality ignores both the sustainability of the business and the valuation.

Our concept of quality includes stability, efficiency, and predictability, which generally result in a healthy growth rate, but must also include a reasonable valuation. The ROE and financial leverage metrics are a strong foundation for quality, as they have implicit attendant growth. Growth rates must ultimately be qualified by how they are achieved, and whether they are sustainable. Along these lines, we also consider profit margins and free cash flow conversion when attempting to quantify quality.

INFL seeks out companies with superior, advantaged business models operating in hard asset industries that are generally known for poor business models. The prevalence of cyclical low-margin, low-return, rate-sensitive business model in these industries can largely be explained by capital intensity. In other words, these industries require large amounts of invested capital to achieve modest returns over full cycles. Worse yet, these firms also require high reinvestment rates just to maintain, if not grow, the businesses.

In seeking to control for capital intensity—and emphasize “capital-light” companies—we are not only optimizing for quality, but also attempting to isolate fundamental factors as drivers of our base rate of return. Of course, higher real asset prices and/or lower interest rates (hence real funding costs) will enhance the prospective returns of capital-light businesses in a non-linear fashion. But these companies are not dependent upon improvements in these areas to generate attractive returns. Nor are these businesses dependent on higher "inflation" levels to generate returns.

The success of an investment in a capital-light business will primarily be driven by our analysis and understanding of the business model, which will in turn facilitate a disciplined purchase price. This is not easy, but one can develop a repeatable process, hence develop an expertise and competitive advantage over time. This is particularly true when compared to forecasting all of the macroeconomic variables to inherent in conventional real asset investments such as commodity prices, interest rates, currency exchange rates, and economic growth rates.

Owning any hard asset business includes exposure to a multitude of highly uncertain input assumptions. We are able to do so intelligently by emphasizing capital-light business models, within the context of the long-term, or the endgame.

Performance Review

The Fund generated strong returns in 2024 after two years of muted yet positive returns during the global monetary tightening cycle. The S&P GSCI Total Return Index appreciated 9.2% for the year, falling short of the MSCI ACWI Net TR Index return of 17.5% for the second consecutive year. The strength of these markets is notable considering the ICE U.S. Dollar Index rose over 7% and the yield on the U.S. 10-Year Treasury also rose approximately 70 basis points. A stronger dollar and higher real interest rates are typically negative for most risk assets, particularly commodities.

The Fund benefitted from its exposure to real asset end markets including energy, land, precious metals, and iron ore. Energy prices were volatile for the year but ultimately domestic U.S. benchmark oil prices fell approximately 2.3% and natural gas fell 13.7% (based on monthly averages)[6]. Energy prices weighed on upstream exploration and production company returns, as these companies are far more exposed to operating margin erosion as compared to the royalty business models favored by the Fund.

The consensus is that 2025 will be tepid for energy prices due to weak global demand and robust supply growth. We view both the supply and demand assessments as vulnerable to revisions, which could quickly rebalance a market that is already low on inventories. Looking beyond the next 12 months, we see a more favorable balance, and expect the market to begin to price this in.

Land portfolios represent an emergent real asset investment opportunity. The specific companies in the Fund are "energy adjacent" because their portfolios provide infrastructure to legacy energy companies, but also service power transmission and datacenter demand. The Permian Basin is the engine of U.S.

[6] World Bank

energy production; it is also rapidly evolving into a premier location for data centers, which require considerable amounts of (uninhabited) land, water, and power.

The land businesses currently generate most of their revenues through leases for infrastructure related to oil and gas extraction and transportation. However, this is evolving to include nascent activities such as power generation, power transmission, water handling, carbon capture, and the aforementioned data centers. Land is a perpetual asset with minimal or no operating expenses, and can have many uses over time, making it one of the most dynamic real assets. It wasn't long ago that these land banks were working ranches, with the optimal use being cattle grazing. Technological development facilitated hydraulic fracturing to extract hydrocarbons on the land over a decade ago. Today, technology is driving high performance computing functions to the land.

Precious metal companies are benefitting from the advance in gold prices; however, returns have been muted due to even higher operating cost growth. Technological advancements have improved exploration and mine efficiency; however, the ore is generally lower-quality and harder to extract and refine. This translates into higher operating costs, which can be difficult to mitigate. The Fund emphasizes gold royalty and streaming companies that are not directly subject to operating and reinvestment costs. Furthermore, many gold royalty/streams are based on copper byproduct, and copper mines generally have much longer mine (reserve) lives compared to gold/silver dedicated mines. We emphasize longevity and durability of reserves in all of our metal related investments.

Iron ore prices fell by approximately 9% in 2024 (average monthly price change)[7], primarily in response to weaker-than-expected demand in China. Steel for Chinese commercial construction has been the largest driver of iron ore demand over the past decade. The country is struggling with a transition from an investment-driven economy to a consumption-driven model. This process will likely take decades, and government will need to rebuild confidence in the real estate market to accomplish this. The Fund has iron exposure primarily through royalties on North American mines, which have less sensitivity to Chinese demand by virtue of location and ore grades that can be fed into electric arc furnaces (EAFs).

Financial exchanges are not generally considered to be real assets, but we view these companies as "financial infrastructure" assets. These businesses benefit from higher throughput (volume), which is highly correlated to nominal growth and the velocity of money. Yet unlike most financial services companies, exchanges have no proprietary capital at risk and operate at 40% or higher margins. These businesses offer all the attributes of high-quality infrastructure assets, but with less leverage, lower capital reinvestment requirements, and higher growth. We think that the market will come to agree with this assessment over time.

[7] World Bank

Agriculture and healthcare companies were the lone detractors to the Fund's returns for the year. Our primary agriculture exposure is through global agribusinesses that process and merchandise much of the world's seed oils and grains. Industry profits are dominated by soybeans, specifically the "crush margin" for soybean oil and soybean meal. Prices for soybeans, oil and meal fell between 9% and 23% for the year, but end product prices fell less than soybeans, delivering a 20% improvement in crush margins. This supported profits to some extent, but investor sentiment remains poor, resulting in depressed valuations (double-digit cash flow yields). This may be related to the fact that the soybean market has proven more cyclical and sensitive to Chinese demand than we originally thought. In any event, these companies remain indispensable for global food supply chains and we believe that their profitability will improve.

The healthcare market has bifurcated into distinct categories of "winners and losers" in recent years that can be simplified as insurers (winners), firms with GLP-1 weight loss drugs (winners), and everyone else (losers). The Fund maintains its only exposure today to a pharmaceutical royalty company with the largest and most diversified portfolio in the market. This should result in an advantageous cost of capital and scale over time. In the interim, a weak environment for biotechnology funding will support countercyclical royalty investments.

The Long Path to the End

We maintain our conviction in the long-term outlook for the companies held by the Fund, as they are uniquely positioned to prosper in a rapidly evolving global investment landscape. If we reflect on the past 30-years investing at Horizon Kinetics, the destabilizing nature of deflationary forces during the global financial crisis was a defining experience. Deflation not only reduces asset prices and cash flows in nominal terms, thereby hurting economic growth, but it increases liabilities in real terms. This is not something that can be taken lightly given the leverage within the government and private sectors today. So, while the current connotation of "inflation" is highly negative, rising price levels are at the foundation of rising standards of living and modern economies worldwide. **We believe that nominal growth will soon prove to be a global priority above all else, and moderately elevated inflation will be accepted as part of the solution.**

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.

Past performance is not a guarantee of future returns, and you may lose money. Opinions and estimates offered constitute our judgment as of the date made and are subject to change without notice. This information should not be used as a general guide to investing, or as a source of any specific investment recommendations.

Fund holdings and sector allocations are subject to change, and are not a recommendation to buy or sell any security.

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.

Definitions:

S&P 500 Energy comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector. **The Organization for Economic Co-operation and Development (OECD)** is a group of 37 member countries that discuss and develop economic and social policy.
CPI: Refers to the Consumer Price Index (CPI), a measure of the average change over time in the process paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographical areas.
PCE: Refers to the Personal Consumption Expenditures Price Index. A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.
Basis points (BPS) are used to show the change in the value or rate of a financial instrument, such as 1% change equals a change of 100 basis points and 0.01% change equals one basis point.
SOFR: The Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.

The S&P GSCI is the first major investable commodity index. It is one of the most widely recognized benchmarks that is broad-based and production weighted to represent the global commodity market beta. The index is designed to be investable by including the most liquid commodity futures, and provides diversification with low correlations to other asset classes.

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The MSCI ACWI captures large and mid-cap representation across Developed Markets (DM) and Emerging Markets (EM) countries. The index covers approximately 85% of the global investable equity opportunity set.

The U.S. Dollar Index is a geometrically-averaged calculation of six currencies weighted against the U.S. dollar.

Risks:
Investing involves risk, including the possible loss of principal. Shares of any ETF are bought and sold at market price (not NAV), may trade at a discount or premium to NAV and are not individually redeemed from the Fund. Brokerage commissions will reduce returns. The Fund's investments in securities linked to real assets involve significant risks, including financial, operating, and competitive risks. Investments in securities linked to real assets expose the Fund to potentially adverse macroeconomic conditions, such as a rise in interest rates or a downturn in the economy in which the asset is located. 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.

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