Horizon Kinetics Inflation Beneficiaries ETF Annual Letter

After lying dormant for decades, inflation has become a primary topic for virtually every company, individual and government across the world. Suddenly rising price levels appear to have taken policy makers and the investment industry by surprise. Yet, it would have been wholly irrational – and a singular exception to 1,000 years of monetary history – *not* to have expected inflation. And the pandemic year of 2020 was not the cause, the unanticipated catalyst at the root of this seemingly sudden shift. The ground was laid long before 2020, as the eventual result of nearly 15 years of artificially low interest rates and trillions of dollars of global central bank asset purchases and money creation.

Recent events have simply accelerated and exacerbated the underlying condition, 2020 being the history marking year in which U.S. overnight lending rates returned to zero percent[1], the U.S. money supply[2] expanded by a record – and simply astounding – 35%, and approximately 47 global governments committed nearly $11 trillion dollars of fiscal stimulus[3]. That was a 13% *global* increase in money supply as a proportion of world GDP. Now, as higher inflation becomes more widely accepted as reality, many are struggling to identify effective investment strategies – because, nearly forty years after the U.S. last experienced true inflation, today's investment community lacks the personal and the institutional knowledge of 'how things work' in that environment.

The prevailing mindset merely seeks to "hedge" inflation. We believe that investment strategies for inflation should be oriented around *benefitting* from it. In our view, hedging strategies or 'products' are often inefficient and result in poor real rates of return that are simply 'less bad' than having unhedged exposure. These strategies are generally regarded as insurance, and all insurance – whether fire insurance or portfolio insurance – exacts a net expense, a premium, which merely adds to the profits of the Berkshire Hathaways[4] and other insurance providers of the world. Other than equities, there are very few asset classes that can truly benefit from a macroeconomic regime change in which chronic inflation runs higher than the historical trend: a bond's face value remains constant, while the prices of what it can buy rises[5], so it constantly loses real value; an equity is an ownership interest in an operating business that can *potentially* increase its earnings (given the right business/right management) over time at a sufficiently high rate.

Herein lies the challenge, for this is not to say that all equities will benefit, not even all equities that have exposure to inflationary end markets. Perhaps surprisingly, in our opinion, most will not. While we do believe that companies in hard-asset oriented sub-sectors such as energy, metals & mining, agriculture, and real estate have the potential to benefit, only specific business models within these sectors are likely to provide attractive economic returns to shareholders. Contrary to common belief, the stocks of what are conventionally considered to be inflation beneficiary companies, such as metals miners, oil drillers, or forest products manufacturers, actually perform poorly during extended periods of inflation. That is

[1] U.S. Federal Funds rate (effective)
[2] M2 Money Supply
[3] https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19
[4] Berkshire Hathaway is not held in the Fund.
[5] TIPS, typically cited as inflation hedges, are, in our opinion, problematic at their current elevated price levels and low starting yields.

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because their cost of doing business – their large plant and equipment requirements, their large workforces – likewise become victim to higher prices and, so, their profit margins can contract even as their output prices and sales rise. That generally only becomes obvious over time, in retrospect.

This is why we emphasize "hard-asset, capital-light" businesses, which have positive exposure to inflationary end markets, but with sustainably high profit margins and free cash flow, and scalable business models. In general, these companies have lower working capital requirements and less debt than the capital-intensive upstream peer companies within their respective industries. Additionally, capital-light businesses have minimal to no variable costs associated with incremental revenues, hence margins have far more breadth for expansion under various inflationary environments. Accordingly, we believe that these companies can generate satisfactory shareholder returns under differing inflation and interest rate scenarios, yet have the potential to perform much better as inflation rises. In other words, the most effective strategy will be one that benefits from, but is not a binary bet on, inflation – these are not 'heads you win, tails you lose' businesses.

The follow-on risk to the typical company is equity valuations. These are very likely to face pressure in the event of sustained inflation, for two primary reasons: i.) profit margin pressure, and ii.) interest rate pressure. The profit margin concern is quite intuitive – most companies have the ability to pass on some cost pressures to consumers in the form of higher prices; very few have the ability to fully offset those cost pressures. The reason is that although a company could choose to pass on all cost increases, thereby maintaining their profit margins, demand would likely fall as customers seek lower-priced alternatives. The dominant supermarket food brand names of the 1970s, whether Hellman's, Heinz or Oreos, discovered that their pricing power is what, perversely, provided the fertile ground for the dramatic rise of generic and private label brands, the supermarket brands. These are lessons past, for the future.

And if price increases impede growth, this should be reflected in lower equity valuations, which in aggregate are near record highs. Of course, valuations are invariably linked to the cost of capital and interest rates (which are the cost of money), so to the extent that higher inflation could result in higher interest rates, the most highly valued equities could face the dual pressure of lower real growth and higher discount rates. We believe that a very large portion of the index universe is extremely susceptible to this profit margin/growth/interest rate risk. Unless one assesses the risks posed by these factors as near zero, and whether one agrees with our inflation thesis or not, would it not be prudent (in the forewarned is forearmed sense of things) to seek complementary exposure for such a profound level of market risk?

The hard-asset, capital-light universe of stocks, specifically as expressed in our portfolio, benefits from: i.) hard asset exposure ii.) capital light business models and iii.) attractive valuations. The valuations are anchored by cash flows and net asset values from the current year, or next year projections based on run-rate prices/production levels. To the extent that inflation runs above expectations next year (and beyond), these cash flows will be revised higher. Of course, every financial asset is sensitive to rising interest rates, but our focus is on companies that we believe have low prevailing valuations, and the ability to grow cash flows sufficiently to offset the impact of higher interest rates. This can be summarized as: high quality asset base, high quality business model, and attractive price (valuation).

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In conclusion, we believe that this portfolio is positioned to benefit from a historically significant structural shift in the global economy and capital markets, oriented around higher long-term inflation. However, it is not a binary bet on inflation, nor beholden to reported CPI figures. Reported inflation levels are likely to be volatile in the year ahead, particularly coming off an elevated base in 2021. However, the monthly figures are far less important than the long-term trend, which we believe will remain distinctly higher than historical or expected levels. Given this volatility, we emphasize and will seek a high-quality portfolio of hard-asset businesses that can endure for a full business cycle, or cycles, in order to benefit from these variables.

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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.

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:
Treasury Inflation-Protected Securities (TIPS): TIPS are designed to provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater. **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. **Free cash flow:** Free cash flow is the cash a company has left after taking into consideration cash outflows to pay for its operating expenses and capital expenditures.

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.

HKAM does not provide tax or legal advice, all investors are encouraged to consult their tax and legal advisors regarding an investment in the Fund. No part of this material may be copied, photocopied, or duplicated in any form, by any means, or redistributed without the express written consent of HKAM.

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