Horizon Kinetics Inflation Beneficiaries ETF (INFL)

2023 Annual Letter

January 2024

Market Inflections & Echoes of 1972

The economy is something of a paradox right now. While some experts proclaim that inflation is finally cooling, consumers lament that prices remain so high. This situation is the result of an enduring reality: Discussions of economic indicators tend to focus on the rate of change, rather than aggregate levels.

Rate of change analysis is relevant for measures like corporate earnings and GDP, which are evaluated based on growth. Aggregate levels are more appropriate for variables with continued impact based on absolute levels: money supply, debt, and prices. Of course, rate of change is still relevant, but aggregate or cumulative data is at least as important.

Aggregate price levels (as measured by the Consumer Price Index[1]) are approximately 20% higher than they were at the outset of 2020, while overnight borrowing rates (SOFR[2]) in the United States are approximately 400 basis points higher. These shifts are even more pronounced if recent readings are compared to the period immediately preceding the pandemic lockdowns, during which the U.S. had a brief period of deflation and rates plummeted to zero. Recent deceleration in the rates of change for these variables obscures the enormous aggregate changes of the past few years.

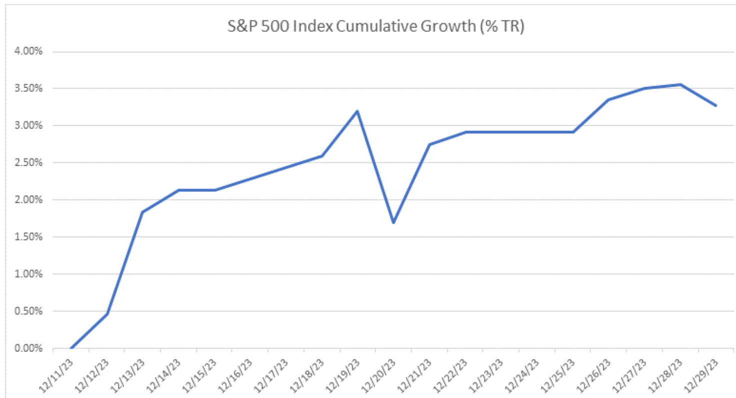
Here at the Horizon Kinetics Inflation Beneficiaries ETF ("the Fund"), we argue that even as inflationary forces moderate, current levels are already sufficient for structural regime shift. In other words: The prolonged era of synchronized global economic growth, low inflation, and low interest rates is over. And it is critical to incorporate this new reality into any investment strategy.

To be sure, our secular inflation thesis is centered on levels remaining well above the pre-2020 trend of approximately 2%—a world where levels of 3-4% are considered adequately higher. This view was largely validated by market prices throughout 2021 (when the Fund launched) and 2022; however, markets turned back to a "pre-2020" posture last year. A contributing factor was the market's aforementioned fixation on rate of change as opposed to cumulative change. Indeed, various measures of inflation growth have moderated from unsustainably high peak levels, but the rate of change remains both positive and above trend.

This deceleration has prompted a belief that global central banks will reduce interest rates. Recall that the market has been consistently wrong in the belief that rates would cause a recession and force a so-called "pivot" in policy (more on this later). However, the current belief—or hope—of

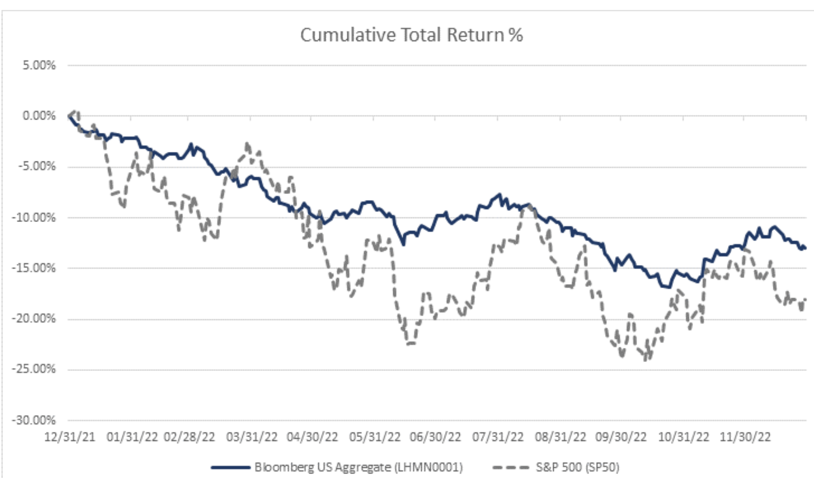
[1] The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.
[2] The Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash collateralized by Treasury securities.

rate cuts appears to have been validated at December's FOMC[3] meeting. Judging by the subsequent market price action, the (equity) market is "partying like its 2019" all over again.



This view is echoed by the bond market, as the average yield on a U.S. non-investment grade bond has fallen from 9.4% to approximately 8%. The move has been almost exclusively driven by a compression in risk premiums for high-yield bonds. At approximately 3.5%, the spread versus investment grade bonds is over 100 basis points tighter than in non-recession months dating back to 1996.

These moves are part of the broader zeitgeist shift that occurred abruptly this year. The market reverted to near euphoric conditions, thanks largely to nascent technological developments such as artificial intelligence ("AI") and language learning models ("LLMs"). We are not experts in the field whatsoever, but our judgment suggests that the potential productivity gains from such technologies will come largely at the expense of employment, so net impact on economic growth and overall consumption is ambiguous.



The exuberance surrounding technology has a subtle but pernicious impact on capital markets. Broad stock and bond indexes—ergo, passive investing—(indexes) suffered amongst their worst year of performance in 2022, as richly valued equities fell amid rising interest rates. Stock and bond correlations proved to be positive, and diversification

[3] The Federal Open Market Committee (FOMC) consists of twelve members—the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis.

added little benefit. While there have been far worse equity market declines, they have historically been offset by gains in bonds. We posited that this could be *the* inflection point for passive-dominated market flows. Yet passive equity strategies surged in 2023, almost making the modest bond losses irrelevant, and the rebound reinforced the passive narrative.

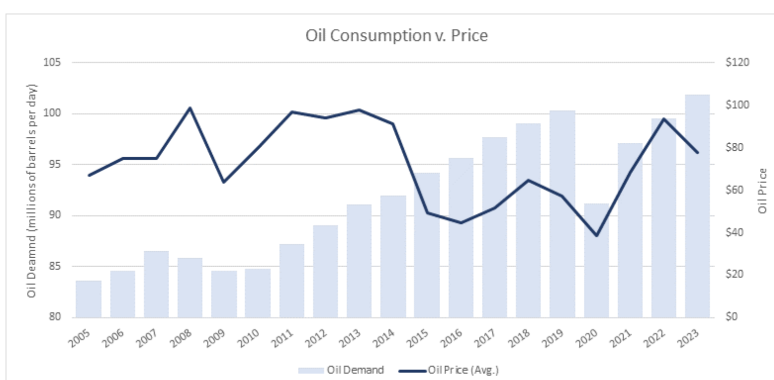
We are still waiting for the true passive inflection point to materialize, but we do believe a *market* inflection point has already commenced, and is merely paused for the moment. In the balance of this letter, we will detail why we have already reached this point, explain how our portfolio is positioned to potentially benefit, and offer some details on updated fundamentals for selected holdings.

Inflation Cycle & Commodities

The consensus opinion is that there has been an "immaculate disinflation," whereby inflation is returning to target without any damage to economic growth or employment. This has been largely credited to the higher interest rate policies implemented by the Federal Reserve. There is a clear fact pattern which includes annual CPI inflation falling to 3.3% in December, U.S. annual 2023 GDP growing 2.4%,[4] and U.S. broad unemployment (total non-farm payrolls) nearing a record low of 3.7% in November. In the eyes of many, a "soft landing" has thus been engineered thanks to the wizardry of central bankers.

Not so fast. The entire premise of monetary policy is that aggregate demand—and, hence, economic cycles—can be managed via interest rates. Higher rates reduce marginal consumption and investment, all else equal, which curtails economic growth. An aggregate demand drop should manifest in goods, services, and labor demand, all working to reduce price levels.

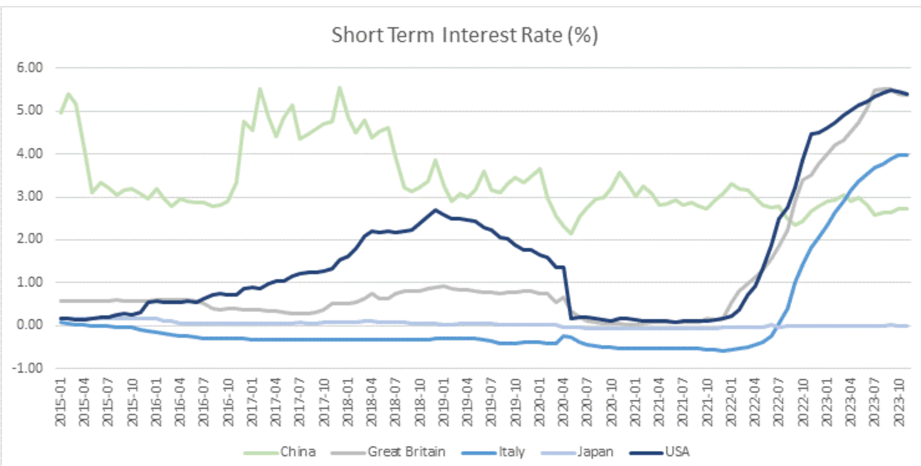
The problem with this logic is that various measures, particularly in the commodity markets, suggest record levels of demand. For example, the International Energy Agency (IEA) recently reported that global oil consumption is on track for an all-time peak level of 101.7 million barrels per day this year.



[4] Philadelphia Federal Reserve Survey

The same rings true, unfortunately, for global coal consumption, which is estimated to have, at a minimum, sustained its 2022 record demand level of 8.3 billion tons. Coal is among the most carbon intensive fossil fuels, estimated to be approximately two times worse than natural gas in terms of carbon emissions. As such, the world has been scheduled to wean off coal—both for power generation and steel making—for nearly a decade, yet the consumption persists.

Similar data abounds for nearly every raw material, and this is consistent with global growth and rising per-capita incomes in poorer parts of the world. Demand growth is resilient despite a moribund economic recovery in China, a massive driver for these markets over the past 20 years. The demand data clearly contradicts the policy-driven disinflation narrative, as do the prevailing lackluster price levels. So what else could be at play?



One underappreciated variable has been the U.S. Dollar. The ICE U.S. Dollar Index rallied a full 25% from its nadir in 2021 to its peak in 2022, which corresponds—with a lag—to U.S. leadership in the global rate-hiking cycle. Despite the recent challenges to its global hegemon status, the dollar remains the transactional currency for an overwhelming amount of global commerce. The rising dollar makes commodity prices in local currency more expensive for foreign buyers. This dynamic hasn't been enough to impede demand growth, but appears to have been highly effective in suppressing commodity prices—for the time being. This raises a question: Is this dynamic sustainable in suppressing price levels and inflation? While there is no definitive answer, the Dollar Index fell 2.5% in two weeks following the dovish December Federal Reserve meeting, perhaps indicating an inflection.

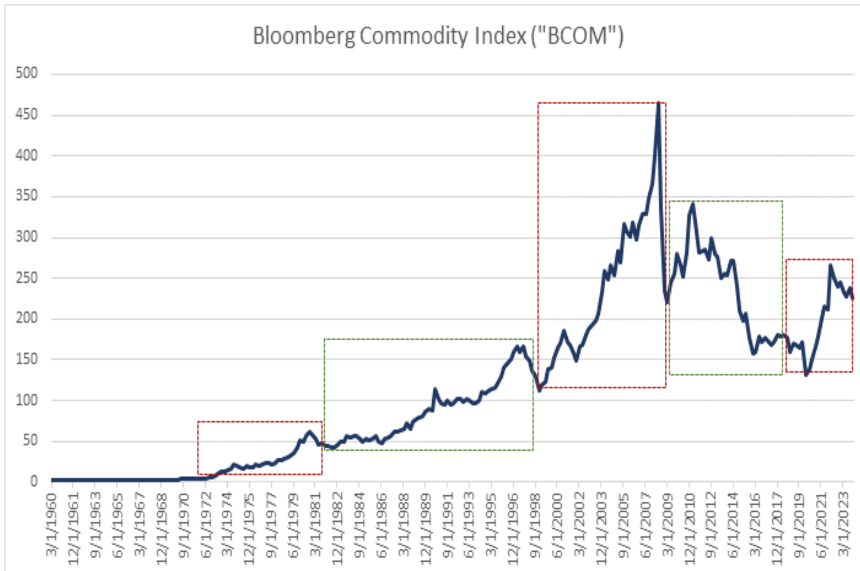
The coal consumption data might be surprising to many, particularly with the political and investment emphasis on environmental factors. A significant but nonessential component of the secular inflation thesis is the "green" investment initiative. The motivation for renewable-oriented spending is admirable, even if there is some debate around how to quantify the net benefits from an environmental standpoint. These investments are objectively more expensive than traditional energy sources, though. They also contain added costs by diverting investment from traditional energy sources, thus limiting supply and eventually driving up prices. Coal demand is indicative of a broader trend in 2023, where governments "paused" green spending and embraced (lower cost and more reliable) traditional energy, as the world sought to quell high inflation levels.

In conjunction with the "green pause," there has been substantial global destocking of raw material inventories, which is logical for many reasons. First, as interest rates rose, so did the cost to finance working capital of inventories. Second, experts were in near unanimous agreement that the global economy would fall into recession at some point in 2023, which would surely impact demand (price) at the margin.

One less-recognized driver of destocking has been deregulation, or pseudo-deregulation. The U.S. (and other western nations) technically have trade restrictions on raw materials sourced from Russia, Iran, Venezuela, and others. These countries were all able to get large quantities of stockpiled products (namely oil) onto global markets last year, largely unabetted. As we analyze the likelihood of further destocking, deregulation, and "de-greening," these variables all appear to be unrepeatable and suggestive of an inflection.

Fundamentals can change rapidly, particularly in commodity markets. Not long ago, many market pundits theorized a "commodity supercycle," an ambiguous term that refers to a protracted and significant upward demand/price movement relative to previous cycles. If we use oil as a proxy for this thesis, there have been two profound developments (in addition to those mentioned above) impacting the market balance: the withdrawal of approximately 300 million barrels (46%) of oil from the U.S. Strategic Petroleum Reserve (SPR) since 2020, and a lackluster economic recovery in China. The former added substantial—albeit unsustainable—supply to global markets, preventing commercial inventories from reaching critically low levels. The latter reduced global demand, though the precise extent is not quite clear due to poor data availability from China.

The narrative has completely flipped as we enter 2024, with nary a word on the commodity supercycle, and near record-low investor exposure to commodities as an asset class. Recall, however, that demand remains at or near record highs across nearly the entire commodity complex, and short-term supply measures have not remedied the longer-term insufficiencies. If we reexamine the supercycle thesis in the context of previous inflation and commodity cycles, the current "pause" or price consolidation is consistent with a longer cycle.



There have been two large, protracted commodity upcycles in the past 60 years. The first, in the early 1970s, lasted until nearly 1980 and culminated with the Iranian Revolution and attendant oil price surge. Commodity prices (and inflation) spent the better part of the next two decades moderating, with the Bloomberg Commodity Index reaching a nadir in 1998.

This marked the beginning of the next up cycle, which lasted until 2008 when the BRICS[5] growth miracle collapsed in the wake of the Global Financial Crisis. This cycle was distinct from prior commodity cycles because inflation was only moderately higher, in the 3%-4.5% range, for most of the cycle. The headline CPI figures were blunted by lower goods prices, largely by virtue of capacity additions to China and other emerging markets.

The two seminal events at the outset of the 1970s inflation were the termination of U.S. Dollar convertibility into gold (August 1971) and the OPEC oil embargo (October 1973). Gold averaged $36.02 per ounce in 1970, $40.62 in 1971, $58.42 in 1972, $97.39 in 1973, and finally $154 in 1974.[6] Gold quadrupled over those five years, spending the next three largely rangebound before surging through the end of the decade.

Oil spent most of the 1970-1973 period in the $3.50 per barrel range prior to the embargo, which sent it over $11 and catalyzed the recession of 1974-1975. However, even after the embargo concluded in early 1974, prices maintained a range of $11-$15 until 1979, when they ascended to nearly $40 (approximately $150 in current dollars) by mid-1980 following the Iranian Revolution.

[5] BRICS refers to Brazil, Russia, India, China, South Africa
[6] https://nma.org/wp-content/uploads/2016/09/historic_gold_prices_1833_pres.pdf

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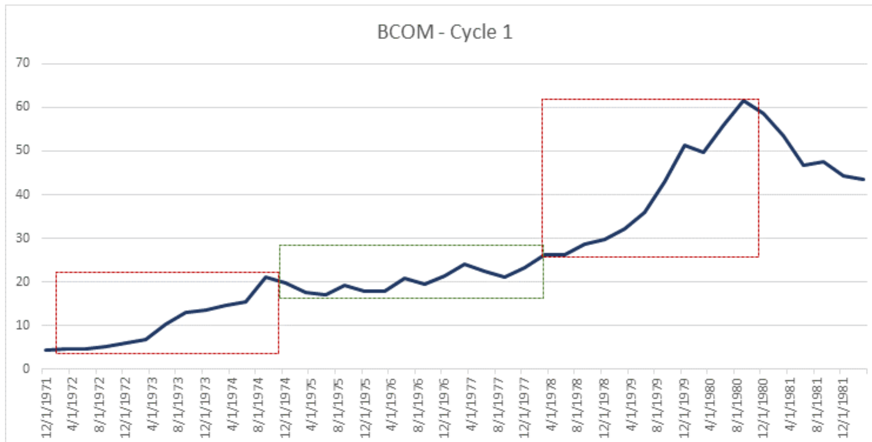
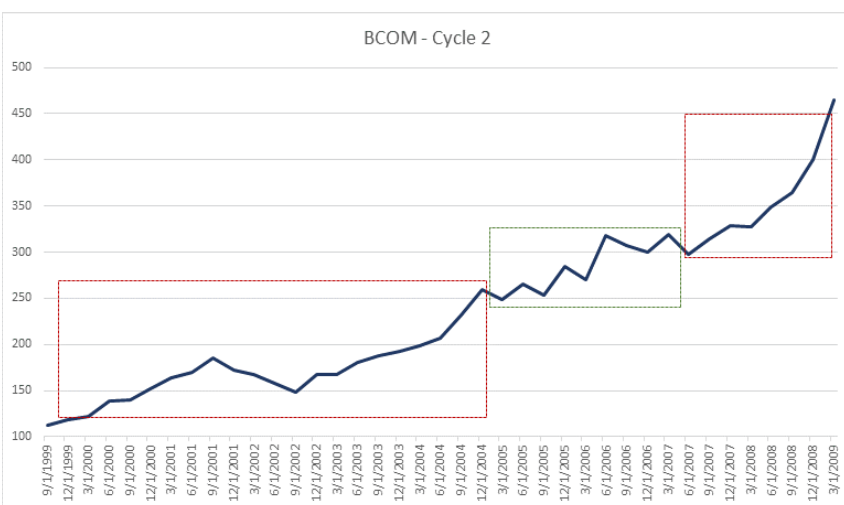


Gold and oil price movements are consistent with the Bloomberg Commodity Index ("BCOM") rising by a factor of approximately 3x between 1971 and 1973, then consolidating through 1977 before rising to new peak levels in the 1980s. A similar pattern emerged in the late 1990s when oil prices rallied under the new fear of "peak oil." This term was used to describe supply, as resources seemed to be running low. The newest iteration of "peak oil" refers to demand. For better or worse, we believe that the current "peak" rhetoric will prove to be as misguided as it was in the 1990s.

Oil prices retreated during the recession of 2001, which may have been the mildest recession in U.S. history, with minimal economic damage despite plummeting technology stock prices. However, oil rebounded and ultimately rose sevenfold through 2008—driven by "peak supply," geopolitical tensions (post-9/11), and seemingly insatiable BRICS demand. It is surely no coincidence that gold similarly found a shallow bottom in price following the 2001 recession, and more than tripled in value through 2009. But unlike oil, gold continued its ascent for several more years as U.S. Congress and the Federal Reserve flooded the market with money to stave off collapse in the aftermath of the global financial crisis.



An examination of the BCOM Index reveals alternating patterns of growth and consolidation through 2008. If we apply the same framework to the current commodity cycle, history may not repeat itself, but it could rhyme. Commodities were consolidating—and perhaps finding a bottom price level—between 2016 and early 2020, only to fall sharply during the pandemic.

Gold, of course, was the exception. After a brief, mild selloff early in the pandemic, it soared. This was presumably driven by risk-averse investors and those buying in response to the government stimulus, which dwarfed the 2009 measures. Commodities recovered along with the broader economy after worldwide lockdowns, and ultimately surged, sparking inflation. We now see commodities in consolidation mode, a pause in the longer uptrend. This is also the case for broader inflation, though we don't expect it will return to peak growth in the near-to-medium term. While this belief is backed by granular supply and demand data, it is also supported by previous commodity and inflation cycles.

History also suggests markets are often too focused on short-term variables, which can obscure the longer-term trend. Today, there is no shortage of short-term factors creating temporary headwinds to prices, but this creates an opportunity for long-term investors.

Fiscal Dominance

Industrial commodities such as copper, oil, iron, fertilizers, and aluminum declined during the global financial crisis, as expected during a period of weak demand growth. Gold rose due to higher demand related to the instability and then-unprecedented levels of fiscal spending.

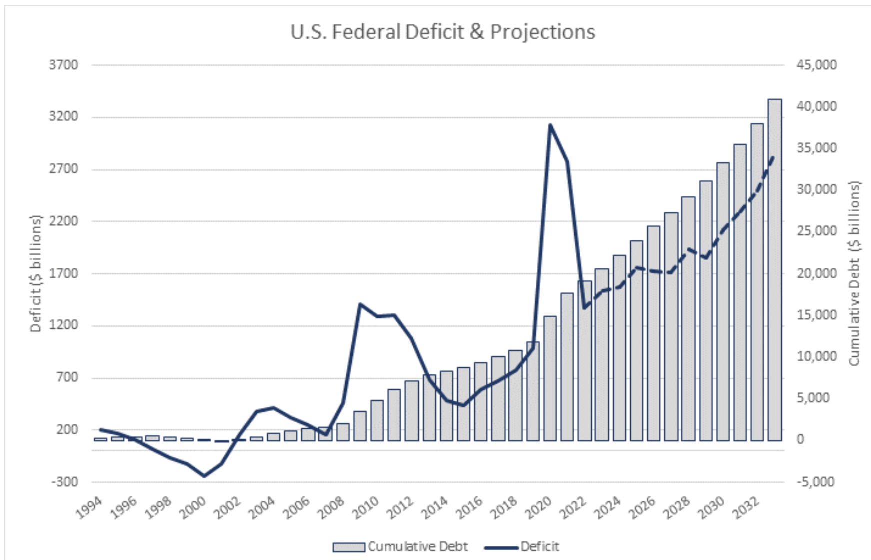
In August of 2009, Warren Buffett wrote a *New York Times* op-ed titled "The Greenback Effect,"[7] in which he commended the government for preventing financial Armageddon. But he warned the crisis budget deficit of $1.8 trillion (13% of GDP)[8] set a dangerous precedent, and noted it was the largest peacetime deficit since 1920, when the deficit was 6% of GDP. Buffett said the U.S. was in perilous territory with publicly held debt rising to 56% of GDP. He generously excluded intergovernmental debt holdings, which amounted to an additional $4.35 trillion, or 30% of GDP. The article concluded by asserting that the unfettered growth of dollars in the global financial system would eventually lead to diminished purchasing power and a decline in the value of the dollar. (We interpret "value" as being relative to hard assets, not necessarily other currencies).

Yet the U.S. has continued to run up debt. The current budget deficit for 2023 is estimated to be $1.54 trillion, or 5.9% of GDP. This compares to deficits in 2020, 2021, and 2022 of $3.1 trillion (14.9% of GDP), $2.78 trillion (12.3%), and $1.38 trillion (5.5%), respectively. While one could argue the 2020-2022 spending was crucial, the argument for 2023 is less compelling with 2.4% GDP growth and 3.7% unemployment. The Congressional Budget Office (CBO) forecasts an average deficit of $2.1 trillion (6.1%) for the next decade. The most perplexing part of the fiscal

[7] Source: https://www.nytimes.com/2009/08/19/opinion/19buffett.html
[8] CBO data reports a deficit of $1.4 trillion, or 9.8% of GDP in 2009. This is likely due to some of the spending that Mr. Buffett expected rolling into the next fiscal year

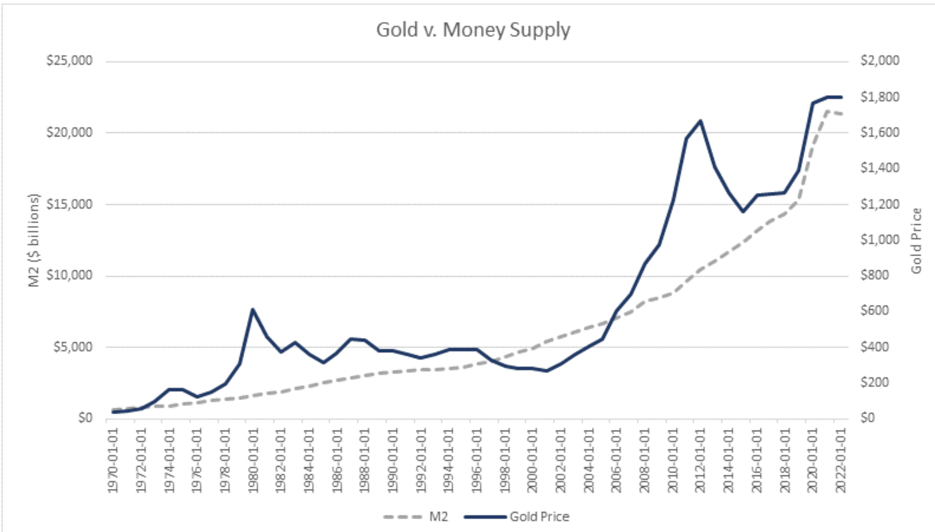
spending forecast is that it assumes no recession over this period—which makes one wonder what the deficit might be if an economic contraction or crisis requires further stimulus.

We believe that the government response to the 2008 Financial Crisis echoes the events of 1972, representing a similar structural market shift and an inflection point. The U.S. reaction to the global financial crisis amounted to a three-year deficit (2008-2010) of over $4 trillion, or an average of 8.95% of GDP per year.



As Buffett suggested, this may have been necessary in 2008-2009, but the deficits persisted, albeit at lower levels relative to GDP than before the crisis; they averaged nearly 4% of GDP between 2011 and 2019. Federal deficits were already running at elevated levels in the five years preceding the pandemic, averaging over 3.6% of GDP. In 2020-2021, the respective deficits rose to 14.9% and 12.3% of GDP. Similarly, the projections for future deficits presume 100% of the funding will be absorbed by the public, and will average 6.1% of GDP for the next decade. This will directly increase the U.S. base money supply if the public doesn't fund the issuance, but the net impact will also depend on the tenor of the debt issued. In short, monetary measures don't always tell the complete story.

This will result in 2023 debt held by the public relative to GDP reaching 98.2%, and ultimately 119% by 2033. Recall that, in 2009, Buffett was alarmed by total debt reaching 56% of GDP. We can't resist mentioning the "minor issue" of the additional $7 trillion (27% GDP) of debt held by intergovernmental agencies ($5 trillion at the Federal Reserve). That is excluded in this calculation.



U.S. Federal debt held by the public was approximately $300 billion, or 27% of GDP in 1971. The Nixon administration abandoned the gold standard late that year, ironically with the intention of combatting inflation and preventing potential systemic stress from foreign redemptions of dollars. The removal of the gold standard facilitated debt growth by a factor of 3.75 by 1983, and GDP by a factor of 3.2. However, gold *rose* by a factor of over 10 during this period. Debt to GDP "only" rose to 32%, but this is largely attributable to a 145% increase in consumer prices due to inflation. Shifting to the present day, federal debt held by the public rose from approximately $5 trillion, or 35% of GDP in 2007, to nearly $17 trillion, or 80% of GDP in 2019. Federal debt held by the public jumped by a factor of 3.4—prior to the pandemic. Federal debt increased to an estimated $25.7 trillion, or 98% of GDP in 2023, representing a 50% increase compared to pre-pandemic.

Aggregate federal debt outstanding has grown by over $20 trillion since the global financial crisis (3.6x growth), the inflection point for fiscal policy. Unlike the policy shifts in the early 1970s, these measures were supposed to be temporary. However, not only did the policies persist, but in subsequent crises, they were expanded.

The "Nixon Shock" policy measures implemented in the early 1970s were aimed at reducing inflation and shoring up the financial system. Similarly, the U.S. has recently implemented policies such as the Inflation Reduction Act and the CHIPS and Science Act, which are likely to only increase inflation and promote protectionism in global trade. Referring to the outset of this letter—if we simply consider the aggregate levels of debt, price, fiscal spending, etc.—it appears the market structure has permanently shifted, and that this regime is distinctly supportive of rising hard asset prices and higher baseline inflation.

Portfolio Positioning

The premise of investing amid a shift toward an inflationary environment might sound straightforward, but there are nuances aplenty. The simplest part includes identifying assets that should benefit from a structural increase in inflation. As the prior examples with oil, gold, and the Bloomberg Commodity Index suggest, "hard assets" in this category are among the best options. We focus on assets with limited supply and inelastic demand, with limited or no substitutions available. This includes oil, gas, copper, iron ore, gold, silver, fertilizers, and a variety of soft (agricultural) commodities. Indeed, these all have limited supply and inelastic demand, and they are very difficult to substitute (as we have seen with the slower-than-anticipated adoption of electric vehicles and renewable power generation).

Hard assets like property and infrastructure often meet these criteria, and have performed well in previous inflationary regimes. However, these assets are typically highly capital-intensive and rate-sensitive. Furthermore, even if an asset can generate inflation-indexed cash flows, the investment performance is constrained by a high valuation. Most of these capital-intensive assets were valued with the presumption of indefinite low interest rates. Now that rates are higher, these assets have the dual sensitivity of higher debt service costs and compressing valuations. This cycle is distinct due to the rate/valuation dynamic preceding the inflation/rate shift.

The Fund continues to emphasize exposure to capital-light hard asset companies. Capital intensity ultimately restricts the amount of capital that can be returned to shareholders due to working capital requirements, debt service, and/or capital expenditures. Capital-light business models facilitate the compounding of value that will ultimately accrue primarily to shareholders. This is particularly important to consider for traditional natural resource exploration and extraction companies. While we wouldn't dispute that many of them have underappreciated asset portfolios, rising operating costs and capital requirements may consume most or all residual cash flow.

Our preferred capital-light business models include royalties, streaming companies, exchanges, processing companies, brokerages, asset managers, distributors, and raw land portfolios. These companies generally exhibit long lives, limited expenses, minimal capital requirements, and positive leverage to higher price levels. The critical variables are insulation from expenses and investments, which will facilitate the compounding of capital—and expanding of profit margins.

These businesses have different drivers, depending on the nature and phase of the inflation cycle. For example, during strong pro-cyclical inflation, virtually every hard asset company should rise in value. However, during a deceleration in inflation (as we are currently experiencing) assets with less cyclicality—like gold, brokers, and exchanges—should perform better. Conversely, during stagflation, companies with idiosyncratic price drivers such as agriculture, energy, gold, and other commercial metals should outperform, while broader markets are likely to struggle.

We attempt to manage the allocations to these sub-industries, but recognize that the capital-light hard asset universe of companies is likely to benefit broadly from a structural inflation regime shift. Given the difficulty in forecasting shifts within a cycle, or the predilections of the market, we are hesitant to over-manage allocations. The diversity of performance drivers has the benefit of reducing volatility through market regime shifts. Performance history and annual returns for the Fund follow.

Performance History

As of 12/31/2023	QTD	YTD	1 Year	Since Inception* Annualized
INFL Total Return % (Price)	3.76	1.61	1.61	9.65
INFL Total Return % (NAV)	3.71	1.86	1.86	9.71

**Inception date: January 12, 2021. Expense ratio: 0.85%*
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.

	2021	2022	2023	Total Return	Annualized
INFL	26.03%	2.64%	1.62%	31.45%	9.66%
MSCI ACWI All Cap Index	15.85%	-18.06%	22.06%	15.86%	5.09%
S&P Real Asset Equity Index	25.84%	-10.69%	8.43%	21.87%	6.90%
S&P 500 Index	27.16%	-18.11%	26.29%	31.51%	9.68%

We could categorize each year as follows. In 2021, pro-cyclical inflation benefitted all asset prices, particularly hard assets. In 2022, inflation peaked, then decelerated amidst extreme policy shifts; hard asset companies preserved value during a sharp repricing of stocks and bonds. In 2023, inflation and economic deceleration continued. This included rising real yields and a stronger dollar, which should be negative to most assets. Hard assets again preserved value, but failed to keep pace with a very concentrated broader equity market.

In hindsight, we obviously would have preferred higher absolute returns over the first several years of the Fund. However, the Fund has largely performed as intended—and participated in rising price levels—while limiting the drawdowns, certainly as compared to the broader market and comparable "real asset" allocations.

The questions from here are: What does the forward return profile look like? And what is—and is not—priced into the companies?

Capital-Light Hard Asset Companies Through Market Cycles

There is limited historical data on capital-light hard asset companies for two main reasons: There just aren't that many of these businesses, and the ones that do exist usually haven't been public for long. We believe that this data asymmetry is part of the disconnect in today's market.

One of the predicaments for hard asset companies—of all types, not specifically capital-light—is that they often enter public markets at or near the top of a cycle. Viper Energy Inc. and PrairieSky Royalty Inc. did so during the first half of 2014, when benchmark oil prices averaged over $100 per barrel and energy still comprised 11% of the S&P 500 Index (versus less than 4% today). The oil price sunk below $55 by the end of the year, dropping under $30 in early 2016. The historic price collapse was catalyzed by a global oversupply, largely from nascent U.S. shale oil, and exacerbated by a Saudi-led OPEC campaign to fight for market share by increasing production.

The unprecedented volatility of the period did not prevent capital-light companies from building shareholder value. PrairieSky generated a run-rate of approximately $1.61 (Canadian) per share in funds from operations in 2014, which declined to C$1.14 in 2015 with lower energy prices. At the end of 2015, the company was producing approximately the equivalent of 40 barrels of oil (BOE) per year, and had approximately 204,000 BOE in reserves for every 1,000 shares,.

At the end of 2022, PrairieSky was producing approximately 38.5 BOE (-3%, compared to 2015) per 1,000 shares, but generated C$2.13 in funds from operations (FFO) per share (+87%), and had nearly 280,000 barrels of reserves per 1,000 shares (+37%). Though production was essentially flat for seven years, FFO/share and reserves/share grew even after the company produced over 64 million BOE during the period. The company has improved since then, both in terms of cash flow and asset base (reserves & acreage), yet the market values the shares similarly to the oil price war days of late 2015 to early 2016.

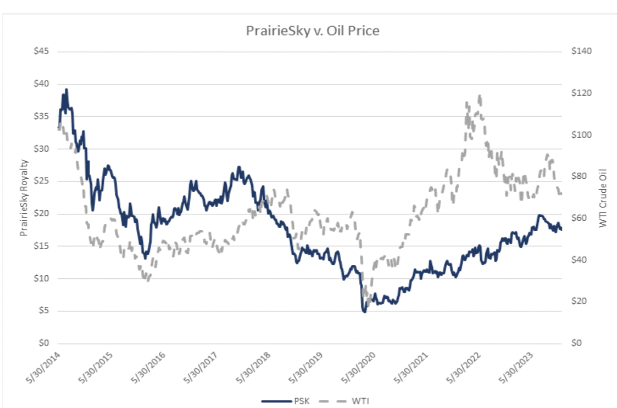
With today's temporarily depressed energy prices, PrairieSky should be able to generate C$1.50 in FFO/share, which equates to a 7.5% yield. This could be viewed as a "base case" minimum return—assuming no improvement in energy prices, production volumes, or Canadian price differentials. Assuming modest improvement here, namely with pricing and volumes, it is reasonable to expect more than C$2.00/share of FFO, or a 10% yield. If prices rebound more fully, and volume grows even moderately, FFO could exceed C$2.50 share, nearly a 12% yield.

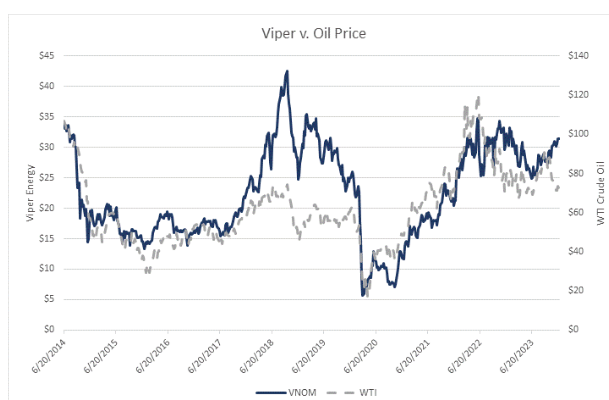
Viper Energy went public not long after PrairieSky in 2014, and endured the same extreme energy price volatility. Viper may have been more exposed to lower energy prices, because its assets are in the Permian Basin of Texas, the primary target of OPEC's price war. Some believed shorter-cycle shale wells could not endure a weak price environment due to the high reinvestment rate required to sustain and grow production. But U.S. shale proved to be resilient, and this was even more pronounced for the affiliated royalty companies.

Viper generated the equivalent $1 per share in distributable cash flow (DCF)[9] during 2014; this declined to $0.84/share in 2015. Production per million units[10] averaged 30 barrels of oil per day. By 2022, DCF per share had grown to $4.10 (+310%), and daily oil production per million units had risen to 120 barrels per day (+300%). Accounting is unusual for shale oil: Reserves cannot be booked until acreage has been developed and oil can be extracted, economically, at prevailing price levels. However, Viper has maintained equivalent total recoverable reserves per unit, while growing acreage per unit. Like PrairieSky, it is a more profitable company with a superior asset base than at its IPO.

We estimate Viper can generate over $3.35 per share in distributable cash flow at prevailing prices, nearly an 11% free cash flow yield. Similarly, this could rise to over $4, or a 13% yield, with modest price improvements—and over $4.50, or a 15% yield, in a more robust price recovery. Viper has been among the fastest-growing energy royalty portfolios, with fourfold production growth per share since its IPO. This can be credited to its parent company, Diamondback Energy, which will continue to drive above-market growth for Viper through perhaps the end of this decade.

As the graphs below suggest, both PrairieSky and Viper trade below their respective IPO prices from seven years ago, despite material fundamental improvements. Price declines have contributed to the performance, but Viper traded over 40% higher than today when oil prices were at similar





[9] DCF is similar to FFO in Canadian reporting for PrairieSky
[10] Viper has "units" as opposed to shares due to its legacy Limited Partnership structure

levels in 2018. Similarly, PrarieSky traded over 45% higher during the same period in 2018. Thus, the multiple on the cash flows/net asset value (NAV) of the companies have compressed.

The valuations of hard asset royalty companies reflect market views on—in decreasing order of importance—the hard asset price, the production/volume growth profile, and interest rates. While one can argue whether the growth and interest rate outlooks were more accommodative in 2014 and 2018, we believe the valuation disconnect mostly stems from general market pessimism and apathy on energy prices. To the extent that we are in a protracted commodity cycle, and these companies regain the market's favor in due course, the combination of cash flow growth and re-rating has the potential to more than double the value of these companies—over a fairly short period of time.

Conversely, even in a low growth, low valuation, and low hard asset environment like today's, the cash flow and growth can compound value at double-digit rates. ***This is the most critical variable of capital-light companies: They have the potential to compound without prices rising, but returns can be significant if prices rise.***

Conclusion

This type of return profile is limited to a subset of hard asset companies—particularly high-quality, capital-light businesses. These opportunities are not ubiquitous in the broader market, or even in the portfolio. But they contain the features we seek: an attractive base-case return profile, "free" upside return potential, limited permanent capital impairment risk, and distinct return drivers.

Many in our industry are eager to cite the profiles of various asset classes and extrapolate future returns. This ignores the fundamentals of individual companies, as well as structural shifts like globalization, technological innovation, growing global populations, declining interest rates, etc. It would be myopic to argue that the drivers for the broader market are anywhere near as accommodating as they have been previously, or that valuations are particularly low.

The inverse can be argued for most hard asset companies: improving drivers and compressed valuations. Thus, we believe the market is in the midst of a shift—an inflection—toward a different regime. This regime will favor capital-light hard asset companies, which happen to trade at material discounts to the broader market. However, most allocators have little to no exposure to these sectors and sub-industries.

The inflection in 1971 was far more obvious—there are direct and profound implications of removing the dollar's convertibility into gold. The current inflection, which began in 2008 and compounded in 2020, was subtle but no less impactful. In fact, this is all an extension of the events of 1971, and the culmination of over 50 years of money supply growth and debt accumulation.

In hindsight, this outcome may have been inevitable in a fiat-based system, as it requires ever-growing amounts of capital in order to continue to keep functioning. The implications are self-evident, as recognized by Warren Buffett in 2009. The end result will likely be a decline in the value of the dollar relative to hard assets. We expect hard assets to lead capital market returns for many years to come, and we are positioned in the preeminent businesses.

Sources:

Chart 1 – S&P 500 Index Cumulative Growth: FactSet

Chart 2 – Cumulative Total Return for Bloomberg US Aggregate Bond Index and the S&P 500 Index: Bloomberg

Chart 3 – Oil Consumption vs Price: Statista & Federal Reserve Bank of St. Louis

Chart 4 – Short-term Interest Rates: Bloomberg

Charts 5-7 – Bloomberg Commodity Index: Bloomberg

Chart 8 (Deficits) – US Federal Deficit and Projections: Congressional Budget Office

Chart 9 – Gold vs. Money Supply: Statista & Federal Reserve Bank of St. Louis

Chart 10-11 – PrairieSky and Viper Price vs Oil: FactSet

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.

Bloomberg Commodity Index (BCOM) is calculated on an excess return basis and reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector and group level for diversification. Roll period typically occurs from 6th-10th business day based on the roll schedule.

The Bloomberg Barclays US Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency). An investor cannot invest directly in an index.

The S&P 500® Index represents an unmanaged, broad-based basket of stocks. It is typically used as a proxy for overall market performance.

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.

The Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.

The **ICE U.S. Dollar Index (USDX)** is a leading benchmark for the international value of the US dollar.

The **MSCI ACWI All Cap index** is a free float weighted equity index.

The **S&P Real Assets Equity Index** is a static weighted return of investable and liquid equity indexed components that measures the performance of real return strategies that invest in listed global property, infrastructure, natural resources, and timber and forestry companies.

Free cash flow yield is a financial solvency ratio that compares the free cash flow per share a company is expected to earn against its market value per share. **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.

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.

For the Fund's current holdings click here.

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