Kinetics Mutual Funds
Second Quarter 2017 Commentaries

The Internet Fund

Click Here for Standardized Performance

Dear Fellow Shareholders,

The Fund continues to eschew investments in most of the leading technology companies that continue to drive relevant equity indexes higher. We don't dispute the ability of Amazon, Netflix and Facebook to generate copious amounts of revenue, but meaningful profitability eludes the former two companies, while we question the market saturation of the latter. In short, it is very difficult to justify the valuations of these leading companies, despite their revenue growth. Delving deeper into the slightly smaller information technology companies, it is even more concerning to see many of these businesses, with far less growth compared to the leaders, commanding multiples that only seem reasonable when compared to Amazon and Netflix. It appears as though the inflation of the leading companies has spread into the broader sector/market. Fortunately, we know where to look for value investment within the otherwise categorically "pricey" market.

We've held Liberty Sirius XM Group ("Liberty Sirius") and its predecessor company Liberty Media (and various other permutations of the underlying business) for many years. Liberty Sirius shares have a trailing P/E ratio of 34.2x and, according to Wall Street estimates, trade at 30.4x this year's expected earnings. Those P/E ratios are just the kind of misinformation that an active manager appreciates, because the valuation is really about half that. We expect to continue holding the shares. As to why, we must first review some interesting growth statistics about a slightly different company that is necessary to our understanding of Liberty Sirius XM. As can be seen from the table below, the following assertions are true for this other company:

- Revenues have been rising at a 10.1% annualized rate for the past 5 years.
- It benefits from scale economies, as evidenced by an operating margin that has expanded from 22.4% to 28.5% in 2016, and even more in the first quarter of 2017. The company believes its margins can expand by another 4% points in the coming years.
- As a result, net income over the last five years has increased by 11.8% a year.
- More impressive, unlike most companies, its after-tax free cash flow, after making capital expenditures, is much higher than its net income, and has increased by 18.6% a year. Cumulative free cash flow over those five years was $4.9 billion.
- Of the same rank of impressiveness, this company has reduced its share count by 24% over the last four calendar years, repurchasing $7.95 billion of stock.
- As a beneficial consequence of shrinking the share base, all of the above earnings figures are far higher in the way that is meaningful: on an annualized *per-share* basis. Per-share, revenues are up 16.9% a year, net income is up 18%, and free cash flow is up 25%.
- The free cash flow margin is 23% of revenues, which is strikingly high. As a high-end basis of comparison, Microsoft, has a 20% net profit margin, also strikingly high, but its free cash flow margin, after capital expenditures, is 11%.
- Part of the reason the free cash flow is so high is that the company pays no federal income taxes, due to its $1.4 billion of net operating loss carryforwards and tax credits. At the state level, it did pay $21 million in 2016, $12 million the year before, and $9 million the year before that.
- And the reason for these factors, in large measure, is that the company is controlled by John Malone.

	5-Year Increase	**5-Year Per-share Increase**	2016	2015	2014	2013	2012	2011
Revenues	66.5%	**118%**	$5,017	$4,570	$4,181	$3,799	$3,402	$3,014
Operating margin	27.2%		*28.5%*	*25.8%*	*26.8%*	*27.5%*	*25.6%*	*22.4%*
Net income	74.7%	**129%**	$746	$510	$493	$377	$3,473	$427
Free cash flow	135%	**207%**	1,164	1,033	1,006	943	774	496
Shares, fully diluted	(23.6%)		4,965	5,435	5,862	6,385	6,874	6,501

Source: Company reports, Horizon Kinetics research

In many ways, this seems like a classic growth company. And it has a $25 billion stock market value, to boot; therefore, it should be a prime candidate for major index inclusion, and with a premium valuation. However, only 1.85% of its shares are held by ETFs. Of that, almost half are a constituent of, coincidentally, the Power Shares QQQ ETF, with which we began this review, in which it is a 0.38% position—underweighted. The reasons for its being largely outside of the indexation and ETF vortex are several, but they are closely related. This company is called Sirius XM Holdings Inc. (Sirius), and it is the provider of the dominant subscription based satellite radio service, the equipment for which is installed in 75% of the new cars sold in the U.S.

The economics of satellite radio are vastly superior to those of streaming music providers, as content costs are approximately 90% of revenue at streaming services compared to less than 40% for satellite radio. Furthermore, SIRI provides exclusive content, including sports and talk radio, so that someone can drive from Maine to California while listening to the same station. The content has gotten richer, as well, and now includes Major League Baseball and college sports programming, and special programming such as music festivals, examples of which are South by Southwest and Lollapalooza. Sirius is also launching a new service that provides two-way communications into automobiles that has the potential to add many new revenue sources.

Over 67% of the Sirius shares are held by the entity that we do own in the Fund, Liberty Sirius. Accordingly, Sirius's freely tradeable shares – its float – are fairly limited. Thus, though investors typically assign a premium to companies that might be takeover targets, and though an independent Sirius certainly would be, Sirius isn't independent and can't be acquired, since it is controlled by Liberty Sirius. It is, therefore, of much less interest to the short-term investor.

As to valuation, Sirius trades at 21.96x our calculation of trailing free cash flow (the company measures free cash flow more liberally), net of capital expenditures, which is a far more conservative measure of earnings than are net income or the P/E ratio; most companies' free cash flow is far lower than their earnings. And 21.96x is almost precisely the P/E ratio of the S&P 500. And while that is hardly a low valuation, the Sirius growth rate far exceeds that of the S&P 500. Moreover, if Sirius can indeed increase its operating margins by 4% points over the next few years, and allowing for only 5% revenue growth, which is one-half the historical 10% experience, then the current price is equivalent to less than 13x the free cash flow which the company is likely to generate in 2020. Nor does that include the beneficial impact upon the per-share value of continued share repurchases. In this year's first quarter, the company repurchased another $306 million worth of its shares.

Moreover, we purchased Sirius at a discount – through Liberty Sirius. Liberty Sirius has a stock market capitalization of $14 billion. Its only asset is the shares it holds of Sirius; therefore, Liberty Sirius can be valued like a fund with a net asset value. In this case, the net asset value is simply the market value of the Sirius shares, less the Liberty Sirius debt. And the Liberty Sirius shares trade at about a 20% discount to that NAV, which would be roughly 18x trailing free cash flow.

There are reasons for this additional discount. Liberty Sirius is presently what is known as a tracking stock, as many John Malone companies have been from time to time, and is not an independent corporation. It is one class of the stock of Liberty Media, with separately measured earnings; however, the Liberty Sirius assets are consolidated on the Liberty Media balance sheet, and are really a proportionate element of Liberty Media's assets. Therefore, in the event, for instance, of a major liability or dissolution, the Sirius shareholder could not lay a specific claim to Liberty Sirius' assets. Indexes don't purchase tracking stocks. And over 47% of the voting power of Liberty Media is held by John Malone.

Of course, it is possible that the Liberty Sirius discount will persist indefinitely. That is a reason why many investors avoid stocks with holding-company structures that trade at discounts. But the history of the many, many corporate realignments which John Malone has engaged in over time is that they are designed specifically to take advantage of either the excessive discounts or premiums that the market applies to entities in the constellation of his business interests. These tactics include buying in shares of undervalued subsidiaries, full or partial spin-offs of subsidiaries, often as tracking stocks, recombining or reacquiring them, to name but a few. They are structured so as to maximize or retain tax assets, close discounts and otherwise take advantage of public clearing prices that diverge from the underlying value of these businesses. A sequential listing of major transactions of this sort since the early 1990s would number in the dozens.

Speaking of tactics, Sirius initiated its first quarterly dividend at the end of last year, which might attract a different investor class. Ordinarily, dividends from a C-corp are quite wasteful from a tax perspective. In this case, being that Sirius is majority owned by Liberty Sirius/Liberty Media, though, Liberty is entitled to a high "dividends received deduction," which confers an additional tax advantage.

Internet Fund
Top 10 Holdings (%) as of June 30, 2017

The Bitcoin Investment Trust	7.2%
EchoStar Corporation - Class A	6.3%
Liberty Media Corp.-Liberty SiriusXM - Class C	4.8%
Alphabet, Inc. - Class A	3.1%
CACI International, Inc. - Class A	3.0%
Alphabet, Inc. - Class C	3.0%
PayPal Holdings, Inc.	2.85
The Madison Square Garden Company - Class A	2.6%
Liberty Broadband Corporation - Series C	2.6%
Visa, Inc. - Class A	2.1%

Important Disclosures

You should consider the investment objectives, risks, charges and expenses of the Fund carefully before investing. For a free copy of the most recent Prospectus, which contains this and other information, visit our website at www.kineticsfunds.com or call 1-800-930-3828. You should read the Prospectus carefully before you invest. Performance data quoted represents past performance, which does not guarantee future results. Investment return and principal value of an investment may fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Please visit http://kineticsfunds.com/ for the most recent month-end performance data.

Portfolio holdings information, if any, is subject to change at any time and is as of the date shown.

The opinions expressed are not intended to be a forecast of future events, or a guarantee of future results, or investment advice. Additionally, the views expressed herein may change at any time subsequent to the date of issue hereof.

Because the Fund invests in a single industry, its shares do not represent a complete investment program. Internet stocks are subject to a rate of change in technology, obsolescence, and competition that is generally higher than that of other industries, and have experienced extreme price and volume fluctuations. International investing presents special risks including currency exchange fluctuation, government regulations, and the potential for political and economic instability.

The Internet Fund is classified as a non-diversified fund. Therefore, the value of its shares may fluctuate more than shares invested in a broader range of industries. In a non-diversified fund, more of the Fund's assets may be concentrated in the common stock of any single issuer, which may make the value of the Fund's shares more susceptible to certain risks than shares of a diversified mutual fund.

Unlike other investment companies that directly acquire and manage their own portfolios of securities, the Fund pursues its investment objectives by investing all of their investable assets in a corresponding portfolio series of Kinetics Portfolios Trust.

The S&P 500® Index represents an unmanaged, broad-based basket of stocks. It is typically used as a proxy for overall market performance. Index returns assume that dividends are reinvested and do not include the effect of management fees or expenses. You cannot invest directly in an index. You will be charged a redemption fee of 2.0% of the net amount of the redemption if you redeem or exchange your shares 30 days or less after you purchase them.

Distributor: Kinetics Funds Distributor LLC is an affiliate of Kinetics Asset Management LLC, and is not an affiliate of Kinetics Mutual Funds, Inc.