Kinetics Mutual Funds
Second Quarter 2017 Commentaries

The Multi-Disciplinary Income Fund

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Dear Fellow Shareholders,

The trailing returns of various risk asset classes over the ten year period ended this quarter-end would suggest that most savers should be in fairly sound financial shape so as to meet their long-term goals. The S&P 500 Index ("S&P 500"), Bloomberg Barclays U.S. Aggregate Bond Index ("U.S. Aggregate Index"), and Markit iBoxx High Yield Corporate Bond Index ("iBoxx High Yield Index") have produced annualized returns of 7.18%, 4.48% and 6.42%, respectively, over the ten years ending June 30, 2017—all exceeding inflation rates by material margins. Of course, in order to achieve those returns, an investor would have needed to remain invested for the entire ten years, including the period of market volatility in 2008 and 2009. Returns would be materially lower had losses been realized during that volatile period, the magnitude dependent upon the point at which investments were reinitiated.

Even if one makes the sanguine assumption that most savers realized a ten year return based on a mix of these three broad asset classes, and that the current balance is in line with the investor's target balance set a decade ago, that target has shifted. The target has shifted not only because the prospective returns on risk assets have shifted, but also because as these investors have aged, their risk profiles have presumably shifted to be more conservative. The conventional solution for lower risk has been to increase exposure to investment grade bonds, away from high yield bonds and equity. While the nearly 4.5% historical return on the U.S. Aggregate Index looks appealing in today's market, its current 30-day yield is merely 2.25%. Based on the Federal Reserve target inflation rate of 2%, an investor would earn 0.25% annually in real terms from this investment (we'll ignore taxes, assuming much of the capital is tax-deferred). This translates to a 30 year investment of $1,000,000 improving in purchasing power by approximately $78,000 over 30 years (over 20 years, the purchasing power improvement would be closer to $50,000). This is a serious problem for prospective retirees – a 35 year old fortunate enough to have $1 million of retirement savings could only grow this by $78,000 (effectively) by retirement at 65 if he or she chose to invest in the U.S. Aggregate Index.

High yield bonds, as represented by the iBoxx High Yield Index, are providing a 30 day yield of approximately 4.66%, or 2.66% above target inflation levels. This return may appear attractive in absolute terms, but the spread between High Yield and Treasury bonds, as defined by the Merrill Lynch U.S. High Yield Option Adjusted Spread, stands at 3.64%. This can be compared to the average spread of 5.75%, dating back to 1997. It appears, then, that investors are not being paid very much to assume the added risk of high yield debt. Furthermore, the stated yield is based on trailing coupon payments, and doesn't account for the likelihood of defaults over time. Consider that the 6.42% 10-year return of the iBoxx High Yield Index was based on a starting yield of over 8% in June of 2007 (using the effective yield on the Merrill Lynch U.S. High Yield Master II Index). A similar default experience to this over the next ten years would reduce the real return of high yield bonds to approximately 1% annually. Over 30 years, this would equate to real purchasing growth of nearly $350,000 on a $1 million initial investment.

There is a severe shortage of attractive real returns in fixed income markets, even if one is willing to expand the risk profile considerably. In such an environment, it is reasonable to abstain from investing, and to choose to preserve capital, in preparation for investment in superior opportunities when prices become more conducive to attractive long-term returns. Additionally, there are "off the run" bonds that the Fund owns and continues to purchase: these offer idiosyncratic, attractive absolute returns. We believe that such pricing exists due in no small part to the increasing impact of indexation on fixed income investing, with the "non-conforming" bonds lacking consistent buyers. Examples of such opportunities are convertible bonds with conversion prices that are well above prevailing market prices. Typically, these bonds typically were issued when the stock prices were higher, and investors were eager to forego yield in exchange for the potential for equity gains. Once the stock prices declined, the "option value" embedded in the convertible bonds deteriorated, and, as a result, the bonds frequently trade at attractive current yields while also retaining a deep out of the money equity option. Thus, in addition to offering an attractive current yield, in the event of a highly favorable equity outcome, these convertible bonds have the potential for extraordinary returns.

Case Study: Cheniere Energy Inc. Convertible Bond

The Cheniere bonds, trading at around 70, offer a current yield of 6.1%, which is well above the iBoxx High Yield Index. There are additional potential sources of return, as well. The bond was issued two years ago at a discounted price of 80, which was its official value at that time. That figure is scheduled to increase in small increments every six months until it reaches 100 in the year 2045. In March 2020, the bond can be called by the company, and at that time, its official, or accreted, value will be 83, which is 18.6% higher than our purchase price. On an annualized basis, that would be a 6.4% rate of appreciation, should it be called at that time. Adding in the coupon yield of 6.1%, the rate of return over the next few years would be about 12.5%. If the company does not call the bonds, and if all they do is mature at 100 in 28 years, without the stock reaching its conversion break-even of approximately $138, the annualized appreciation would be 1.3%; adding the coupon income, the total rate of return would be 7.4%. Those figures represent the base return possibilities for these convertible bonds.

There are a couple of additional sources of possible return, and these would be seen by investors who perceive the company's profitability and its common shares in a more positive light. Cheniere produces liquefied natural gas (LNG) for export. For over 50 years no LNG was permitted to be exported from the contiguous U.S. In February 2016, Cheniere received the first such Department of Energy export authorization in over five decades, and shortly thereafter, a tanker left Cheniere's Louisiana terminal with the first cargo of domestically produced LNG. This marked the transition of Cheniere from a development stage company with no completed production facilities and no revenues to an operating company. The company's finances were precarious at the time: Cheniere had $16.2 billion of property, plant and equipment at the end of 2015, of which almost 90% was classified as construction in progress. Accordingly, it also had $15.1 billion of long term debt, and $322 million of annual interest expense. It had only $1.6 billion of shareholders' equity after having lost, for the year, $1 billion. The common share price was down 70% from a year and a half earlier, and the bonds, which were not rated, traded at around 50¢, and had been even lower.

By the end of 2016, though, 56 cargoes of LNG had been shipped to 17 different countries. Moreover, Cheniere, which is on schedule to be operating 5 LNG liquefaction and purification facilities ("trains") by the end of 2019 and an additional 2 in future years, has already sold about 87% of its future capacity from the first 7 trains. These were done under 20-year contracts, with estimated annual fixed fees of $4.3 billion. These "take or pay" fixed fees are guaranteed by the parent entity of each customer – all global, investment grade companies – and are payable whether or not the terminals are used. Of course, the plants had yet to be completed and the shipments and revenue yet to be forthcoming.

If the company's business does become robust, there is also the possibility for these bonds to be converted into the common shares. The shares would have to rise to $138 (roughly triple the current share price) before the convertibility would increase the value of the bonds above 100. Hence, this would be considered a deep out-of-the money call option. The long maturity date provides, in essence, a 28-year call option on the LNG market. The long-term nature of the call makes the conversion math more compelling: consider that a 10% annualized equity return for 12 years would result in a positive conversion value. This rate would not be expected from the broader equity market, but for a company with this type of optionality, we believe it's a compelling "tack-on" to the bond investment.

And there's another way to secure an equity-level return from these bonds. At the current 3-train run-rate, Cheniere is already the largest physical consumer of natural gas in the U.S. Trains 4 and 5 are expected to be operational this year and in 2019, respectively, and all five are fully contracted. In its presentations, the company is already projecting the payment of substantial dividends from its free cash flow in a few years. What if, by the end of 2019, Cheniere is able to operate these five facilities at full capacity, and is clearly profitable and creditworthy? With the thirst for yield that now dominates the bond universe, these bonds might very likely approach face value simply on a yield basis, in which case, the annualized total return would be about 21%.

Multi-Disciplinary Income Fund **Top 10 Fixed Income Holdings (%) as of June 30, 2017**	
Lamb Weston Holdings, Inc.	6.7%
Penske Automotive Group, Inc.	6.55
Brookfield Residential Properties	6.0%
Ashland Inc.	5.6%
Icahn Enterprises	5.55
Dish DBS Corp.	5.3%
PIMCO Dynamic Income Fund	4.7%
Lennar Corporation	3.7%
TRI Pointe Holdings, Inc.	3.7%
DoubleLine Opportunistic Credit Fund	2.3%

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.

The Fund invests in options and other derivative instruments, which are specialized activities and entail greater than ordinary investment risks, including that they may be illiquid, difficult to price and leveraged so that small changes may produce disproportionate losses. Additionally, the Fund may invest in debt securities. Investments in debt securities rated below investment grade (i.e., junk bonds) are subject to increased risks. International investing presents special risks including currency exchange fluctuation, government regulations, and the potential for political and economic instability. Non-investment grade debt securities (i.e., junk bonds) are subject to greater credit risk, price volatility and risk of loss than are investment grade securities. Further, options contain special risks, including the imperfect correlation between the value of the option and the value of the underlying asset.

The Kinetics Multi-Disciplinary Income Fund is classified as a diversified fund. Diversification does not ensure a profit or protect against loss in a declining market. You should consult the Fund's prospectus for a complete list of risks associated with your investment.

Unlike other investment companies that directly acquire and manage their own portfolios of securities, the Funds pursue their investment objectives by investing all of their investable assets in a corresponding portfolio series of Kinetics Portfolios Trust. The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. Bloomberg is a trademark and service mark of Bloomberg Finance L.P. Barclays indices are trademarks of Barclays Bank PLC. The CBOE Volatility Index® (VIX® Index®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. The S&P 500 Index represents an unmanaged, broad-based basket of stocks. It is typically used as a proxy for overall market performance. You cannot invest directly in an index. The iShares 20+ Year Treasury Bond ETF seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities greater than twenty years. The iShares Core High Dividend ETF (HDV) seeks to track the investment results of an index composed of relatively high dividend paying U.S. equities. iShares is property of Blackrock. Index returns assume that dividends are reinvested and do not include 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.

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