



**Kinetics Mutual Funds
First Quarter 2017 Commentaries**



The Small Cap Opportunities Fund

[Click Here for Performance](#)

Dear Fellow Shareholders,

Small capitalization stocks continued rising to begin the year, with returns since the U.S. Presidential election approaching 20% for the S&P 600 Small Cap Index ("S&P 600"). These gains have outpaced the larger capitalization S&P 500 Index ("S&P 500") since the election, though, in the first quarter, large capitalization stocks outperformed small caps considerably. In aggregate, both small capitalization and large capitalization stocks appear richly valued. The iShares Core S&P Small Cap ETF, which tracks the S&P 600, is trading at approximately 23x trailing earnings and 2.25x book value. While we might argue that these multiples are extended, we believe they are categorically lower than the 24x trailing earnings and 3.1x book value at which the S&P 500 is trading. This may appear perplexing to an outside observer, as smaller companies typically exhibit higher growth, and therefore command higher earnings multiples. Additionally, they have generally not amassed asset bases as significant as those of their larger peers, and so trade at higher book value multiples. Furthermore, these companies are generally less global in nature; due to their domestic focus, they have greater potential to benefit from lower tax rates, and are less sensitive to trade risks associated with protectionist policies. Political speculation aside, we are adamant in our belief that a compelling case for small capitalization focused investing remains—particularly with a disciplined value (active) approach.

A typical approach to equity investing—one that has become dominant—favors allocations to larger companies over smaller ones. Practitioners explain this phenomenon by stating the premise that larger companies are reflective of the overall economy (whether this is the exposure that their investors seek is a separate discussion). This focus also makes it easier to invest larger pools of capital, convenient for investment managers seeking to charge fees based on assets managed, making this a preferred allocation strategy. The S&P 500 represents a broad exposure to large capitalization companies, covering approximately 80% of available ("investable") market capitalizations, according to the index provider. Now, referring back to the 24x earnings and 3.1x book value valuation, consider the following examples of potentially secularly challenged businesses in the S&P 500 Index:

A: Banks and credit card companies face new payment modalities (either currently offered or on the verge of being introduced) that promise to be very disruptive to the payments business.

B: Declining ETF fees are a serious problem for the major custodian banks, because the consolidation of index assets in the hands of a few ETF providers gives them enormous negotiating power. Fees are under heavy pressure, as anyone can see.



C: Alternative media via the internet is challenging traditional media companies, threatening advertising revenue and distribution fees alike.

D: The big banks' balance sheets are so large that they create systemic problems, and regulators would prefer them not to grow at historic rates (which would exacerbate these problems). Low net interest margins driven by low interest rates and a flat yield curve only amplify these concerns.

E: The continued expansion of Amazon.com Inc. ("Amazon") challenges retailers across the spectrum.

But it is not only retailers; there are spillover effects. If the challenges to retailers continue, that situation eventually will create problems for their landlords, the real estate companies. And not only to real estate in the S&P 500, such as the real estate investment trusts (REITs), but also to the broader real estate asset class, the members of which are highly leveraged. That places the banks in danger. If retailing continues on its current path—and it shows no signs of changing in any meaningful degree—sooner or later, and probably sooner, we believe that problems in real estate are going to show up no matter the interest rate level. It will be impossible for big box retailers to sustain their rents.

Many investors may well accept these dynamics, but remain confident in index returns given the leadership of "disruptive" companies such as Amazon. However, what is the net result of the index if the top companies, Amazon et al, displace the remaining companies? In the long-term, with what may be structurally lower growth for the United States and the developed world, it appears to be a zero sum game; in that case, the only reasonable expectation is minimal or flat index returns. Yet, returns have remained robust, in our opinion, due to returns of capital in the form of leveraged share repurchases and dividend growth by the laggard companies, buoying index levels temporarily.

Small capitalization companies are not immune to these structural issues, but we believe it is possible to design portfolios that are somewhat insulated from these variables. Specifically, with an active approach, we choose to gain exposure to individual business operations, as opposed to the broader factors that dominate much of the large capitalization index returns. There has been substantial investor attrition from active investing, and in particular, from disciplined value investing. This has resulted in temporary headwinds, as fund flows have had an overbearing influence on short-term prices, but we soon expect this to turn into a tailwind, as price discovery returns to the market, and we then have far fewer investors to compete with in unearthing small companies for investment. The recent returns have been rewarding, both on relative and absolute bases.

Ten-year trailing market returns now reflect a full market cycle, from the peaks of early 2007, the nadir of early 2009, and through the late stage of the market advance that we are currently experiencing. Market proponents might point favorably to the 10-year trailing return of the iShares Core S&P Small Cap ETF of nearly 9% annually over this period. However, a sober reality is that the 10-Year U.S. Treasury yield was more than twice its current level in 2007 (4.85% compared to 2.39%). To the extent that sustainably lower rates have facilitated, or at least bolstered the full-cycle gains to this point, and are unrepeatable going forward, we remain uninspired by the prospects for long-term index returns at this point in time.



Small Cap Opportunities Fund
Top 10 Holdings (%) as of March 31, 2017

Texas Pacific Land Trust	22.5%
The Howard Hughes Corporation	9.1%
Icahn Enterprises LP	8.9%
Dream Unlimited Corp. - Class A	5.9%
The Wendy's Company	4.8%
Onex Corporation	4.3%
Tropicana Entertainment Inc.	4.2%
Live Nation Entertainment, Inc.	4.0%
Associated Capital Group, Inc. - Class A	3.1%
Rubis SCA	2.4%

Important Disclosures

You should consider the investment objectives, risks, charges and expenses of the Small Cap Opportunities 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 Small Cap Opportunities 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. You should consult the Fund's prospectus for a complete list of risks associated with your investment.

International investing presents special risks including currency exchange fluctuation, government regulations, and the potential for political and economic instability. Because smaller companies often have narrower markets and limited financial resources, they present more risk than larger, more well-established companies. Further, options contain special risks including the imperfect correlation between the value of the option and the value of the underlying asset.



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.

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.

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.