Kinetics Mutual Funds
First Quarter 2018 Commentaries

The Small Cap Opportunities Fund

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Dear Fellow Shareholders,

The first quarter of 2018 marked the return of volatility, all but absent in equity markets over the previous fifteen months. The CBOE Volatility Index (VIX) surged from a January low level of 9.22 to a closing high of 37.32 in early February. Perhaps more significant than volatility, the 10 Year U.S. Treasury yield increased from a year-end yield of 2.43% to over 2.94% in February, closing the quarter at 2.74%. While it has been argued that the rise in “risk free” rates has driven the market’s volatility, this reasoning appears lacking, as much of the yield increase came in January (30bps), which corresponded to 5.73% and 2.51% increases in the S&P 500 and S&P 600 Indexes, respectively.

The significance of the rate increase is considerable, at least for those who espouse a fundamental framework to value financial assets. We estimate that the market is discounting current equities at approximately a 7% discount rate, which, when adjusted for 2% long-term real growth, reconciles to a net discount rate of 5%, or 20x earnings. Crude as this framework is, it illustrates the net result of a 50bps increase in discount rates, as a 5.5% net discount rate delivers an earnings multiple of 18.2x, or 9% lower than previous levels, ceteris paribus. While an argument can be made for an improved growth outlook to offset the increase, the Federal Reserve Board still believes that the long-term growth potential of the U.S. economy is 1.8%, in real terms. Furthermore, over the 20 years ending this quarter, U.S. real GDP grew at approximately 4% annually, compared to 2.83% annual earnings growth for the S&P 500 Index (“S&P 500”). Nonetheless, the S&P 500 returned an annualized 6.44% over this 20 year period; hardly what equity investors are used to, or expect today.

Asset allocation models typically recommend a certain allocation to small capitalization stocks as part of a broader portfolio, providing higher returns and diversification. While it is true that the S&P 600 Index (“S&P 600”) has outperformed its larger peer S&P 500 materially over time, this is only true over the long-term, as 1, 3 and 5 year returns are currently very similar for the two benchmarks. However, dating back 20 years, the S&P 600 has returned 9.16% annually, besting the S&P 500 by over 2.7% per year. Looking back to the preconditions for these 20 year returns, we’ve previously mentioned that real GDP growth averaged 4%, while the 10 Year Treasury yield halved from over 5.5% to 2.75% today. Meanwhile the beginning earnings multiples on the S&P 500 and S&P 600 were 22.2x and 24.3x, respectively, compared to approximately 21x and 27x today. Lower GDP growth, lower initial interest rates, and comparable initial valuations don’t appear to be overly supportive of future returns.

A notable distinction between the indexes, however, is that the S&P 500 earned an operating margin of 12.2% in 1998, expanding to nearly 14% today, its highest on record. Meanwhile, the S&P 600 earned an operating margin of 8.2% twenty years ago, compared to approximately 5% today. Herein lies the distinction between the technology and financial services dominating the S&P 500, and the small cap S&P 600 – the former is operating at peak profitability during the 9th year of economic and market expansion, while the latter is operating at modest margins, as many companies grow and gain efficiency. Further, there is far more room for increased profitability with smaller companies operating at tighter margins, compared to larger companies already maximizing profits.

Although we see evidence favoring small cap allocations over large and mega capitalization portfolios, the previously mentioned variables don't indicate strong forward returns for either index. Thus, in order to achieve returns commensurate with historical levels, a highly differentiated approach will be compulsory looking ahead. The Fund has always maintained unique market exposures, and continues to benefit from these securities. In response to a less accommodative market for equity investing, the Fund currently holds higher levels of cash, coupled with higher position concentrations. We believe this will improve the likelihood of achieving uncorrelated returns, while providing capital to redeploy at more favorable levels.

Small Cap Opportunities Fund **Top 10 Holdings (%) as of March 31, 2018**	
Texas Pacific Land Trust	25.9%
Icahn Enterprises LP	7.9%
Dream Unlimited Corp. - Class A	6.7%
The Howard Hughes Corporation	5.9%
Civeo Corporation	4.6%
The Wendy's Company	3.9%
Live Nation Entertainment, Inc.	3.1%
Rubis SCA	3.0%
Onex Corporation	2.8%
Associated Capital Group, Inc. - Class A	2.6%

Important Risk 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 Fund holds investments that provide exposure to bitcoin. The value of bitcoins is determined by the supply of and demand for bitcoins in the global market for the trading of bitcoins, which consists of transactions on electronic bitcoin exchanges ("Bitcoin Exchanges"). Pricing on Bitcoin Exchanges and other venues can be volatile and can adversely affect the value of the bitcoin. Currently, there is relatively small use of bitcoins in the retail and commercial marketplace in comparison to the relatively large use of bitcoins by speculators, thus contributing to price volatility that could adversely affect a portfolio's direct or indirect investments in bitcoin. Bitcoin transactions are irrevocable, and stolen or incorrectly transferred bitcoins may be irretrievable. As a result, any incorrectly executed bitcoin transactions could adversely affect the value of a portfolio's direct or indirect investment in bitcoin. Only investors who can appreciate the risks associated with an investment should invest in cryptocurrencies or products that offer cryptocurrency exposure. As with all investments, investors should consult with their investment, legal and tax professionals before investing, as you may lose money.
The CBOE Volatility Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500® Index call and put options. The S&P 500® Index represents an unmanaged, broad-based basket of stocks. It is typically used as a proxy for overall market performance. The S&P SmallCap 600® Index measures the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable. 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.