



Horizon Kinetics Mutual Funds Third Quarter 2023 Commentaries



The Small Cap Opportunities Fund

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Dear Fellow Shareholders,

The small capitalization universe has always been the most fertile hunting ground for undervalued securities. In fact, many of the most esteemed fund managers achieved their greatest returns focusing on small, or even microcap stocks, when their asset bases were compatibly modest.

This is logically consistent with the fact that fewer investors seek out opportunities in less scalable areas; therefore, there are more fundamental price distortions. The distortions in small capitalization stocks have only been magnified in recent years due to the enormous and growing impact of indexation, or passive investing, and the substantial relative outperformance of mega-capitalization stocks.

When it comes to small capitalization investing, the largest amount of assets under management are in funds that track the Russell 2000 Index. The iShares Russell 2000 ETF has over \$56 billion in assets,¹ and is only one of many funds that track or benchmark to this index, though it is the largest. The stated objective of the index, as is the case with most indexes, is to provide a wide exposure to the asset class. For the index provider, this is most efficiently (read: cheaply) expressed through a market capitalization weighting methodology applied to a universe of approximately 2,000 companies.

This process rewards the largest “small cap” companies—or, more accurately, the companies with the largest public float,² with an ever-higher index weighting, and concomitant fund flows as new fund shares or units are created—until the company in question is too big for the small cap designation. Concurrently, the companies with the least trading liquidity are assigned ever-smaller weightings—the bottom 50 companies in the iShares Russell 2000 ETF have an aggregate weight of approximately 4 basis points. As of this writing, a computer communications company with a direct exposure to the Artificial Intelligence supply chain is the largest index constituent, at 0.58 basis points, with a market capitalization exceeding \$15 billion. Further, as assets continue to leave active management into index-based funds, the remaining active small-cap managers are forced sellers, which means a flow-of-money-based structural discount applied to those companies, as opposed to a fundamentals-based valuation.

As well, the vicissitudes of fund flows and market manias in passive investing, especially in the case of smaller stocks, contribute to the perception that small cap stocks are more volatile—and, to some, more risky. However, a fundamental small cap investor has the ability to seek out higher quality companies at lower valuations—a valuation opportunity enhanced by indexation-based distortions—a strategy that should ultimately exhibit lower volatility and potentially higher returns.

¹ <https://www.ishares.com/us/products/239710/ishares-russell-2000-etf>

² Public float refers to the shares of a company that can be publicly traded and are not restricted (i.e., held by insiders).



Consider the aerospace and defense sector, which has historically been dominated by the major global defense contractors and aircraft manufacturers. Companies in this industry are highly dependent on global defense budgets, but generally have reliable profitability and growth, unless the world enters a prolonged period of unprecedented peace. Unfortunately, the post-pandemic world appears to be heading in the opposite direction. Concurrently, modern national security requirements are less oriented around heavy equipment, such as naval vessels, aircraft and munitions (although these industries are far from entering a decline). The nascent aspect of global security and defense is in cyber security, communications and encryption activities—and the incumbent defense contractors are largely deficient in these services.

The market void is filled by niche “defense technology” contractors, as we refer to them internally, which provide the aforementioned cyber security, surveillance, and communications services. These companies have minimal fixed costs, as they primarily provide business services—e.g., security-cleared PhDs, engineers, analysts, programmers—and incur employment expense rather than traditional capital asset intensive costs. Their contracts, which are generally with the Department of Defense or related agencies, are typically “cost-plus.” While this leaves little room for margin expansion, it protects margin profiles, even as nominal growth may be high (during periods of cost inflation, when traditional asset-heavy businesses can suffer). The businesses represent deeply entrenched franchises, with secular (non-cyclical) growth, and resilient profit margins. Yet, these companies trade at a material discount not only to large cap peers, but also to the broader small cap universe.

The defense technology businesses are an example of idiosyncratic investing in small capitalization companies that reflect distinct security-specific valuation and growth variables, as compared to representative small cap indexes, as well as large cap peers. We view this as value-add investing and expect the returns to differentiate themselves over time.

Small Cap Opportunities Fund
Top 10 Holdings (%) as of September 30, 2023

Texas Pacific Land Corp	48.9%
CACI International, Inc. - Class A	5.3%
Civeo Corp.	4.0%
DREAM Unlimited Corp.	3.2%
Inter Parfums, Inc.	2.3%
Associated Capital Group, Inc. - Class A	2.1%
Grayscale Bitcoin Trust	1.8%
Carnival Corp.	1.4%
The Wendy's Company	1.3%
Urbana Corporation - Class A	1.1%



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 bitcoin is determined by the supply of and demand for bitcoin in the global market for the trading of bitcoin, 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 bitcoin 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.

Murray Stahl is member of the Board of Directors of Texas Pacific Land Corporation (“TPL”), a large holding in certain client accounts and funds managed by Horizon Kinetics Asset Management LLC (“HKAM”). Officers, directors, and employees may also hold substantial amounts of TPL, both directly and indirectly, in their personal accounts. HKAM seeks to address potential conflicts of interest through the adoption of various policies and procedures, which include both electronic and physical safeguards. All personal and proprietary trading is also subject to HKAM’s Code of Ethics, and is monitored by the firm’s Legal and Compliance Department.

The Russell 2000 Index is a small-cap U.S. stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

The iShares Russell 2000 ETF seeks to track the investment results of an index composed of small-capitalization U.S. equities.

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