Horizon Kinetics Blockchain Development ETF (BCDF)

Semi-Annual Report 2023 Commentary

Dear Fellow Shareholders,

Acceptance of cryptocurrency as an asset class appears to be the defining feature of 2023.

Casual observers may have gotten the impression from regular news reporting that the financial establishment would fight to limit cryptocurrency's adoption. Perhaps this is because the news tends to report on regulatory sanctions of bad actors, such as the many so-called "crypto-exchanges", which, by the way, are not actually true exchanges at all. Indeed, the news often overlooks the approvals of new cryptocurrency products and services by the "true" regulated securities exchanges. This idea of an antagonistic or repressive attitude toward cryptocurrency couldn't be further from the truth.

Leading legacy institutions are now embracing crypto and supporting additional adoption through a number of measures. More and more asset managers are applying to offer spot Bitcoin ETFs, something we expect to progress in light of the recent decision by the U.S. Court of Appeals for the D.C. Circuit, which sided with Grayscale in a lawsuit against the SEC and their arbitrary and capricious denial of Grayscale's ETF application. There may be additional developments and/or delays prior to the release of this commentary, but major steps have already been taken.

In addition, high profile crypto and blockchain legislation is advancing through Congress, and we've finally seen progress in the courts where rulings have opined on whether crypto assets are securities or commodities. Cboe Digital, the digital asset arm of Cboe which is a holding in BCDF, was recently granted CFTC approval for margin futures trading for crypto products and FINRA has a growing list of Alternative Trading Systems approved for digital asset securities trading.

The specific outcomes of these developments actually matter less than the progress they represent. Each action taken legitimizes the asset class. We have no direct insight into which regulatory authority—or, more realistically—authorities will eventually be responsible for crypto assets, but these issues will be ironed out over time. Whether it is the CFTC, SEC, or some new regulatory body, participants in these markets will need protection from fraud and manipulation. We believe that crypto asset trading will gravitate towards regulated exchanges, which can provide sufficient investor protections and surveillance. There is a proven structure in place for the separation of certain functions and self-regulation through registered exchanges and clearinghouses. In the United States, there has never been a failure of a regulated clearinghouse, even during the extreme financial distress of prior crises.

We've taken a stronger preference towards the traditional finance camp when it comes to blockchain development, though we've seen legitimate applications from "crypto native" companies as well. We're less concerned with a first-mover advantage than we are with long-term capital preservation and robust business models. The portfolio's allocation toward regulated, established exchanges reflects this view.

It seems unlikely that "cryptocurrency exchanges" will be allowed to operate trading platforms without separating some pivotal functions at registered entities. The proven structure of traditional exchanges has operated with efficiency across asset classes and economic cycles, and we are just beginning to see this structure begin to incorporate crypto. In 1970's the notion of intangibles-based futures, such as for currencies and interest rates, was considered, in turn, preposterous, dangerous, even threatening to national financial security. A generation later, volatility derivatives were thought outlandish, but VIX-based futures and options are now a standard risk-management tool. Exclusively licensed index futures and options, mostly relating to VIX and SPX products, now account for over 60% of Cboe net transaction and clearing fees.

Most regulated exchanges have announced participation in crypto in some manner or another, sometimes in entirely different capacities. It is perhaps unappreciated by investors at large—certainly within the major indexes, as reflected by their low weightings—that the securities exchange business model can be some of the most profitable in those very indexes. Essentially, the securities exchange electronic trading platforms simply allow them to be the croupiers, sitting astride the breadth of the financial markets, exacting their small fees in a massive 'game', yet with exceedingly little capital at risk for the scale at which they operate.

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We're pleased to highlight some crucial developments for some of our holdings, below:

London Stock Exchange Group: LSEG's LCH Group now provides clearing services for cash-settled Bitcoin index futures and options traded on GFO-X, a digital asset trading venue.

CBOE Global Markets: Approved by the CFTC for margined crypto futures contracts on Bitcoin and Ether, CBOE orchestrated potential surveillance-sharing agreements for spot Bitcoin ETF applications through its BZX Exchange.

Deutsche Boerse AG: Its Eurex exchange became the first European exchange to launch Bitcoin index futures.

TMX Group: The organization's flagship Toronto Stock Exchange (TSX) just published a consultation paper (for feedback) detailing plans to have TSX Alpha become the "first fully regulated stock exchange to permit trading in digital assets in Canada." This offering would facilitate spot trading for Bitcoin and Ether cryptocurrencies at the start, and would require pre-funding at a TMX approved custodian to avoid settlement risk.

CME Group: The futures exchange giant continues to build its crypto derivatives business, with a Bitcoin/Ether ratio spread contract that launched in July 2023.

ASX Group: The Australian exchange received its first Bitcoin spot ETF application to be offered to retail investors.

OTC Markets Group: While an ATS is a bit different than a regulated exchange, FINRA recently granted approval for broker-dealers to trade digital asset securities on the OTC Link ATS (Alternative Trading System).

In the end, our preference for these types of companies lies in the asymmetric reward for adoption. If their crypto initiatives take hold, they stand to gain an enormous amount. Should these initiatives fail, these companies can continue to operate in their current capacities, with little or no deterioration of their core businesses. Most of these companies have only made modest investments in the crypto space thus far.

Our annual commentary highlighted some of the desirable economic attributes of the exchange business model; these are high-margin, scalable businesses with low capital expenditure (capex) requirements to achieve growth. Our co-founder and President, Steven Bregman, highlighted the exchange business model in our recent Q2 2023 Firm Commentary, which we have made available on our website. Some of the remarks relevant to the BCDF portfolio are restated below.

1. Exchanges exhibit extraordinarily high, sustainable free cash flow margins.
    a. These companies are asset-light, requiring minimal investment in PP&E, R&D, and relatively few employees to generate vast revenues.

	CME	ICE	NASDAQ	CBOE	Top IT Composite	Top Non-Financial Composite
Free Cash Flow Margin						
12/31/2018	53.9	35.9	36.3	41.0	17.4	19.0
12/31/2019	49.9	36.0	33.0	52.6	20.6	19.3
12/31/2020	51.6	30.0	36.7	112.5	20.9	19.9
12/31/2021	48.5	29.1	26.9	37.0	20.2	22.4
12/31/2022	59.1	31.9	43.4	33.9	17.1	21.8
5Yr Average	52.6	32.6	35.2	55.4	19.2	20.5

Source: Bloomberg. Composites are calculated based on an equal weight average of the largest constituents in the S&P 500. Top IT Composite: AAPL, MSFT, AMZN, NVDA, GOOGL, TSLA; Top Non-Financial Composite: UNH, JNJ, XOM, AVGO, LLY, PG, MA, HD, CVX

2. Earnings typically benefit from higher spreads and higher volatility, thriving in periods of greater uncertainty and changing economic conditions.
    a. The prior period of persistent, global declining rates presented an unfavorable backdrop for the business model. These companies were able to perform admirably despite this environment.
3. There are a limited number of regulated exchanges in each country, largely by design.
    a. Mergers and acquisitions are common. The purchaser takes on a larger market share or new product base, and is able to eliminate duplicative operating expenses.
    b. Regulators seem to prefer a lesser burden of oversight, with fewer heavily regulated exchanges requiring less use of already strained resources.

Cryptocurrencies and digital assets represent a promising new innovation for this business, one that could offer a substantial level of new asset listings and trading volume. Though estimates differ, there are potentially 20,000+ cryptocurrencies in existence, or more than three times the number of equity listings on the NYSE and Nasdaq. Seven-day value-traded for Bitcoin was larger than Apple, by significant margin (7/31/2023)[1]; Ether traded more than Johnson & Johnson[1]. These volumes were achieved without widespread institutional adoption. Now imagine a new institutional base under a regulated exchange, then factor in derivatives volume inherently linked to a legitimate spot market, and consider the data management and delivery services tied to a new asset class. There is a lot of upside without a drastic change to the business.

The portfolio does offer exposure to additional solutions that can scale with the growth of the digital asset industry. Institutional custodial solutions continue to develop, removing additional obstacles to adoption. As stated previously, there are multiple crypto ETF applications in the works in the U.S., and asset managers have already begun to tokenize their fund offerings. WisdomTree, specifically, has already grown its offerings through blockchain-enabled funds—and recently applied for a spot Bitcoin ETF in the United States.

WisdomTree's leadership in blockchain and tokenized finance can be seen through the recent launch of its WisdomTree Prime digital wallet. Without getting too complicated, one can view this as a mobile app that allows users to invest, save, and spend with digital assets. It provides a blockchain-native platform where you are able to purchase and hold popular cryptocurrency tokens, invest in WisdomTree digital funds where ownership is recorded on a blockchain, and spend digital assets within an integrated interface. The offering is meant to connect the many facets of digital asset initiatives: investing in tokens and funds, savings, payments, and transfers. True to its roots as a commodity-focused manager, WisdomTree not only offers access to Bitcoin and Ether, but also tokenized gold. One of the company's stated goals is to connect spending and investing, in a way that makes investable digital assets transactable from a payment perspective. Think floating-rate notes and the previously mentioned tokenized gold as a payment option closer to currency. These positive growth initiatives are wrapped up in a company that estimates well beyond 50% incremental margins on additional AUM and revenues.

History is littered with groundbreaking technologies that have left a wake of failed companies that struggled to adapt. Then there are a multitude of examples of companies that saw the opportunity, but still failed to succeed. (either through consolidation or collapse). The history of auto manufacturers provides countless examples of entrepreneurs who saw a fantastic technology develop, but were still unable to capitalize on their foresight. Wikipedia provides a list, albeit unofficial, of defunct U.S. automobile manufacturers2. They number in the hundreds. The most interesting detail of this list was the typical duration of these ventures. Many of these manufacturers were defunct within a handful of years.

[1] CoinMarketCap, Bloomberg

[2] https://en.wikipedia.org/wiki/List_of_defunct_automobile_manufacturers_of_the_United_States

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It can be a lottery to select the survivors of a transformative industry, and even the survivors, depending on the date and valuation paid, might not pay off. Maybe three consecutive lottery tickets, to be precise. Find a disruptive innovation, then find the winners, and then find a way to invest at a reasonable valuation. That raises the debate topic: is that investing or is it wagering? Stated least provocatively, it is surely a great challenge to identify an undervalued equity – that is, a decisive exception to the efficient market theory – when the plethora of companies in question are under the massive and excited scrutiny that is natural to a widely recognized transformative technology. However, there are ways to markedly improve the odds in one's favor, to move them from the realm of wagering to investing.

If digital assets are to reach the next level, they will likely do so through the medium of exchanges. These are the real opportunities related to blockchain. Instead of betting on individual projects, these platforms can cast a wide net, able to benefit from the wide—and sometimes unpredictable—field of digital asset offerings. In success mode, it is easy to see how adoption could meaningfully enhance the results of these businesses. Incremental revenues entail exceedingly little investment or incremental cost, meaning most of new revenues go directly to the bottom line as shareholder earnings. If these companies fail to fully integrate digital assets into the business model, the exchanges will still be able to operate in their current capacities. Blockchain-based asset adoption represents a level of optionality that is exceedingly rare to see.

Important Risk Disclosures

Please consider carefully a fund's investment objectives, risks, charges and expenses. For this and other important information, obtain a statutory prospectus and summary prospectus by contacting 646-495-7333. Read it carefully before investing.

The Horizon Kinetics Blockchain Development ETF (Symbol: BCDF) is an exchange traded fund managed by Horizon Kinetics Asset Management LLC ("HKAM").

Associated Risk of Investing in Blockchain Development Companies. The Fund will invest in Blockchain Development Companies. At times, Blockchain Development Companies may be out of favor and underperform other industries or groups of industries or the market as a whole. In such event, the value of the Shares may rise and fall more than the value of shares of a fund that invests in securities of companies in a broader range of industries.

Investing involves risk, including the possible loss of principal. Shares of any ETF are bought and sold at market price (not NAV), may trade at a discount or premium to NAV and are not individually redeemed from the Fund. Brokerage commissions will reduce returns. The Fund's investments in securities linked to real assets involve significant risks, including financial, operating, and competitive risks. Investments in securities linked to real assets expose the Fund to potentially adverse macroeconomic conditions, such as a rise in interest rates or a downturn in the economy in which the asset is located.

The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund.

Fund holdings and sector allocations are subject to change at any time and should not be considered recommendations to buy or sell any security.

The Fund does not invest directly in cryptocurrencies or initial coin offerings and as a result, its performance does not seek to, and should not be expected to, correspond to the performance of any particular cryptocurrency. The Fund invests in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater for investments in emerging markets.

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 Fund may invest in the securities of smaller and mid-capitalization companies, which may be more volatile than funds that invest in larger, more established companies. The fund is actively managed and may be affected by the investment adviser's security selections.

Diversification does not assure a profit or protect against a loss in a declining market.

HKAM does not provide tax or legal advice, all investors are encouraged to consult their tax and legal advisors regarding an investment in the Fund. You may obtain additional information about HKAM at our website at www.horizonkinetics.com.

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