

## **James Davolos (Horizon Kinetics) – Elegant Equities for Higher Inflation**

**Tom Yeowart:** James, welcome to the podcast. Thank you very much for coming on.

**James Davolos:** Thanks so much for having me. Really excited to be here.

**Tom Yeowart:** So, I think you've been a lifer at Horizon Kinetics, but I'd love to hear how you got into investing and what your journey has been at Horizon Kinetics. You started on the trading desk, became an analyst, and now you are portfolio manager.

**James Davolos:** That's right. Going all the way back. My parents had a small business, which was a seasonal motel restaurant operation down on the New Jersey Shore, about four hours south of New York City. But it was really a family business, so even from a very young age, I remember in the old days stuffing brochures into envelopes to mail out our seasonal flyers, hoping that people up in Philadelphia and New York would come down to the hotel.

And my mom was a wonderful bookkeeper, and I remember her teaching me just the basics of ledger accounting with the checks and balances of the motel. Cleaning motel rooms and I just became fascinated with business and commerce from a young age, probably a lot of which came from just wanting to avoid some of the mistakes that were made where my parents at one time had multiple properties and went levered into the savings and loan crisis in the nineties and lost effectively 99% of their net worth.

And she was able to restructure the property through mostly just grit and savvy to basically sustain what ultimately raised my sister and myself. And so, that was my introduction to business. And then in college, again, pure coincidence, I came across a book, *The Warren Buffett Way*. And I found this at Barnes and Noble randomly, and it went through the tenets of Warren Buffett's investing framework. And that really stuck with me. So that set the stage to come up to New York in the fall of 2005 and so after quite a bit of trial and tribulation, through a very random seven degrees of separation, I ended up on the trading desk at Horizon Kinetics.

And so, this was December of 2005, and it was a pretty unglamorous role. It was entering orders for, mostly Murray Stahl for a variety of the hedge funds, mutual funds, managed accounts. And so that was really how I started and I got my foot in the door and ultimately was able to transition into research and get my own fund.

But a lot of chance in life. But I think that there's a lot of bedrock that when you get those chances, you can really exploit it.

**Tom Yeowart:** I'd love to talk about, I guess, those formative years at the beginning of your career where you came into the industry in the middle of a commodity boom, which was then followed by a global financial crisis. How did that impact your thinking so early on?

**James Davolos:** So, I came in, in 2005 and Horizon's funds were all, they weren't even top decile. They were top percentile, going back to inception and people were quite literally throwing money at us. And so, as a naive 22-year-old, it was quite easy to be caught up with the hubris and I joke, but I'm not joking. I thought I was going to be Stan Druckenmiller by the time I was 30. But very quickly, the reality check came in 2008 where we had some exposures that I think were incorrectly penalized by the market, some that were justifiably penalized by the market.

And, to my boss's credit, they honoured all redemptions. They didn't put up gates. And in many ways, they were a liquidity source for a lot of other people that were gated in different types of structures. But seeing how quickly things could change. It just worked in 2005, six and seven, and then you saw the real world where it was very difficult, especially where you had to earn your way out of leverage, when you had to turn around a business, when you didn't have those macro tailwinds. And so it was really such a stark juxtaposition to go from where you could almost just throw a dart at the Wall Street Journal and watch the stock go up, to three years later, you could throw a dart at the Wall Street Journal and think maybe this company's got three months of solvency.

And so as unpleasant as it was, I think that, and then the experience also with my parents, with their leverage with the family business, it was kind of a crash course in risk management and really understanding that you need to understand the risks and the fundamentals and ultimately has kind of been a big formative experience in my insistence on quality business models.

**George Viney:** And James, it's unusual that people arrive at a firm early in their career, change roles as you have, but ultimately stick with that one firm for a 20-year stretch. Tell us something about Horizon Kinetics, the environment that they've created for you and what's kept you engaged and motivated at the firm for all these years.

**James Davolos:** I have to give credit to Peter Doyle, who's really my mentor, and I think he saw that I had greater aspirations, ambition, and ultimately

capability than working on the trading desk. And not to take anything away from that role. I was very curious. I asked a lot of questions and ultimately, he suggested it, that I just take notes on Murray's research meetings.

And I remember leaving the first research meeting and having a panic attack because I understood about 10% of what he said. But I did understand that these were very special people, particularly Murray and his ability to have a mastery of so many skill sets. I joke that so many people have these multifaceted skill sets, but they're a master of none. Murray's one of maybe two people I've met in my life that can be a master of many. And so, to be exposed to Murray and absorbing all of that knowledge, I saw the value there.

But also having Peter, where Peter, from a very early point in my life, it was very clear that he took a personal interest in me and my career development. And I think that was a huge factor in giving me the confidence to stick it out and really continue to build something special. The firm ultimately, I think, showed their commitment to me, where they sponsored me for night school, where they basically said, you can get your MBA at night locally. Work all day, go to school at night. We're not really interested in a situation where you go away for two years and come back. And so, everything really coalesced and it took a lot of patience.

And I think it's a testament to all of the partners at Horizon where if you do commit to them and what you put in, you get out. And ultimately if you can create something special together, everybody benefits together.

**George Viney:** The company is still founder led. Decades of experience. And from the outside looking in it's quite an unusual firm animated by a set of ideas, which are, I suppose, home crafted and idiosyncratic. What would you say those core ideas are that have really guided the direction and the evolution of the firm over those years?

**James Davolos:** The core principle, which is in the name of the firm, horizon, which was originally Horizon Asset Management, and then merged with Kinetics Mutual Funds. Murray was running a special situations equity team at Bankers Trust Company throughout the 1980s and early nineties.

Peter Doyle and Steven Bregman worked for him as analysts, and a new chief investment officer came in and essentially was espousing modern portfolio theory, efficient market hypothesis. Your job is to basically reweight the S&P500 and keep these wealthy people wealthy. And they viewed that as anathema to everything that they stood for as being devout Warren Buffett,

Charlie Munger students, where obviously the availability of cigar butts is not what it once was, but the idea of buying something tangible for less than replacement cost really resonated with them, and they wanted to emulate that to the greatest extent possible throughout their career.

But then also the name Horizon. When they left the firm, they thought, well, the only way we can have a competitive advantage walking down Park Avenue in New York City, seeing the theoretically infinite resources of all of their competitors was to truly have a long-term horizon. And everybody says they're long term, but to actually think in three- and five-year terms and not deviate because of a compensation cycle that ends on December 31st, I think that is truly unique and they've really deeply ingrained that in the culture of Horizon. And I can't tell you how important and liberating and ultimately beneficial it is to have that freedom to truly think in three-to-five-year terms.

And if your underwriting is correct and your fundamental research is correct. You're not going to be penalized if the market disagrees with you in the interim at Horizon. At other firms you could very likely lose your job, or at a minimum lose your bonus. And so again, that anchor to some sort of tangible, fundamental value, coupled with a true long-term, long horizon, is really the bedrock upon which Horizon was founded and has had such great success.

**George Viney:** There seems to be a real strong, independent streak as well. The firm is well known for large stakes of certain companies and own them for the very long term. But these are not household names in many cases. There's a willingness not only to find value and be long term owners but also go well off the beaten track. Where do you think that independent streak comes from?

**James Davolos:** Well, I think it all stems from where do you find value and it happens, but it's pretty rare that in a S&P500 top 10 constituent, there's going to be a meaningfully non-consensus view such that you can actually have an advantage in analysing and taking a long-term view on that company. It certainly happens. I would just say it's much more uncommon. But as you go further afield of what is now being more and more concentrated in large cap names and growth names and tech names, there's always kind of been this information arbitrage.

And you know, when they started it was massive. I remember still having paper copies of Value Line mailed to our office and putting them in binders for Murray and Steve and getting physical annual reports and even going through the old arcane SEC Edgar website where you were pulling things manually.

Back then, Bloomberg did a pretty good job, but now it's ubiquitous where you can just get all of this data at your fingertips.

And so back then there was definitely an information arbitrage. Today, I think that there's still an arbitrage because if you're outside of the index, the universe of people that are willing to look at those names is just so much smaller. And then to the extent that there are names, you need kind of that critical mass because if everything is racing to the bottom in terms of fees, people aren't as interested unless they can put a lot of money to work very quickly and then exit that position very quickly.

But I think going back to your original point was the culture and what allows them to be so different is they're genuinely not concerned with the remuneration or the financial rewards, or the ego, if you will, that so many other investors are. They don't care if they don't grow as fast, they don't care if they're not held in the same esteem as somebody holding the hedge fund awards. It's a very intellectual academic pursuit for the founders here, and they do it because they love it. And so, I think that's a very different motivation.

That also gives them the freedom to invest in an ideologically sound way that might not be possible if you were more concerned with those other non-fundamental reasons where you need to sustain fee bearing AUM, et cetera, et cetera.

**Tom Yeowart:** James, I think inflation has always been at the heart of what you at Horizon Kinetics have thought about, and its damaging impact to generating returns over time. So, I'd just love to hear about the genesis of the portfolios you manage, which have inflation protection, really at the heart of what you do.

**James Davolos:** Sure. And it really goes back also to when I first started at the firm, but even that was a manifestation of really Murray's ideology of always looking for that hidden value in a tangible asset. But again, roll back to late 2007. I've transitioned into the research team and I joke to this day, I'm not sure if they were trying to weed me out by giving me ultra complex projects as my initial areas of coverage, but I had the independent power producers, which were the merchant power companies that were part of Enron. So, unlike the regulated utilities, they sell power on the wholesale market when the regulated grid needs it. They had massive amounts of leverage and a sliver of equity. And so, the number of moving parts, there were spark spreads, natural gas, there were no power purchase agreements. And so, you were basically forecasting the weather and what these peak kilowatt hours would be. Just a hornet's nest.

The other was land companies and royalties. So, Texas Pacific is something we've covered forever, and you know, I think just to get my feet wet and appreciate the nuance to that business. But you also had Franco Nevada spinning out of Newmont mining. So, the royalty assets coming out of the miner. And last but not least was the exchanges where you had the NYSE coming public via a reverse merger with Archipelago, the demutualization of bourses worldwide, going from kind of these clubs of seat holders to for-profit public entities.

About four years later, through the tumult of the global financial crisis, we did an ex post facto analysis and tried to figure out, well, which businesses worked and why. Both fundamentally, operationally, and then from a price standpoint. And we came up with this idea of capital light. So longstanding view that you want to be long scarce assets with very high switching costs and limited substitution ability, but they're bad businesses. And so, can you overlay this capital light business model to get exposure to that?

And so, royalties are probably the most eloquent business model. Essentially a revenue interest in the Capex and opex of a miner, of an oil and gas explorer, of a land developer. But then broaden that out. So, exchanges, they're basically toll booths on financial market transactional volume. They're non-proprietary business models, matching buyers and sellers of derivatives and interest rates, commodities, currencies, index futures. And you take a step back and they're basically financial infrastructure with, again, no balance sheet capital at risk.

Third, going back to Franco Nevada, again, the longevity of precious metals is a store of value, but then putting it in a 90% margin business model, instead of having the negative roll yield of futures or going into miners themselves. And so, we felt like we understood the right business models to own through a full business cycle. So, trough, peak, trough.

But this again, is in the midst of what proved to be a much longer, very low interest rate, very low inflation cycle. Call it 2014, 2015. So, we started emphasizing these business models internally. We actually started to run an internal managed account that we had a couple of institutional partners on, that focused mostly again on royalties and kind of that broader real asset market mix. But then as we got later and later into the 2010s, Murray had a really interesting investment committee where he said, look, everybody is looking at the last eight years as if this is normal. So, sub 2% inflation with, call it 2% real growth, which that allowed interest rates to stay almost at zero. And that was kind of a Goldilocks environment for any yield based or any terminal value-based asset. Right. So, a software company for all of its virtues or all of its

deficits, almost all the value of that business, if it's not scaled and not cash flow today is in that terminal value.

If you're discounting that at a very low rate by virtue of an effectively zero overnight fed funds rate, that's very valuable and it explains why those assets did so well. Same thing with global listed infrastructure and real estate. If the risk-free rate is very low and you are prioritizing yield, it inflates those assets as well. And harkening back to Murray's study of history, this was highly anomalous. To have such a prolonged period, and not to get into the macro drivers, we thought we understood why. The overcapacity that was built into the global financial crisis, the BRICS countries that were supposed to basically absorb all of that capacity. The shale revolution, which suppressed oil prices, the opening up of certain Central American and Soviet bloc mining assets, the productivity gains that were still being accrued from the internet, the immigration and globalization mobilizing those workforces. Massive, massive trends that were going to be one time.

And so, the thesis was ultimately, we don't know when, how, where, or why, or to what extent, but a 0% cost of capital just cannot last nor can this artificially low inflation rate. Pandemic hits. And to their credit, the reaction function of central banks was we need to keep the financial system running, which was appropriate. But the thesis was, okay, this is going to get us out of this rut. We're going to figure this thing out. At some point the world's going to reopen. You're not going to have 0% inflation anymore.

When we were launching the ETF, so this was the catalyst where it's like, now is the time, we've got the right assets in the right wrapper. So, in the US you have a fee and a tax advantage in an ETF. So, it made all the sense to go to market. And originally, we were going to call the fund the Horizon Kinetics Real Asset Fund and tell people, look, this is the proper vehicle for a normalized environment. All of the interested parties said, look, you definitely want to explore a more noteworthy name because you're going to need retail. Nobody's going to even talk to you until you have 50, 100, 200, 500 million and a track record.

And so just at that investment committee, Murray had mentioned, and CPI was running below 1%, get ready for a world of 3,4,5% at a minimum on a secular basis. And just so happened, another sponsor had let the ticker symbol INFL lapse, we had inflation beneficiaries' fund. And so that's how the fund launched. I think all of those variables that we mentioned hold true today. It's just a much more nuanced product than simply chasing CPI and rates. And we've done a

pretty deliberate job over the last five years now kind of explaining that, and we think that a lot of investors now appreciate that nuance.

**Tom Yeowart:** It certainly seems that we're in a very different environment, very different world to the ones in the 2010s. But can you just expand a bit on the confidence you have that over the next decade we are in that sort of secular 3,4,5% type inflation world.

**James Davolos:** So, I think there's a couple of different ways to look at it, but the number one limiting factor is government deficits and government debts are just so enormous today. So, 6-7% deficits in the US, which is around \$2 trillion. That used to be crisis level deficits, to combat a major recession to help get the economy out of those doldrums. Now, you have been able to grow out of these deficits, if you look back at prior cycles. But the problem with this cycle is if you look at the identities of what drives GDP, there's labour and there's productivity. So labour is a function of the size of the labour force as well as the participation rate.

So Western economies, people are getting older, and in the United States in particular, you're not seeing immigration. So that's going to be neutral at best. On the other hand, you have productivity where, AI enthusiasts will, I've seen people throw out these wild numbers like 10%, but bear in mind, the internet as massive as the internet was, that created about 3% annualized productivity growth from call it the mid-nineties to where it went mainstream about a decade later. So that's a pretty high burden. If productivity carries all of the weight, if labour is neutral, if we have the repeat of the internet with productivity from AI, you're at 3% real growth. To really get to where you can finance these deficits and budgets you're going to have to rely on inflation in the 2, 3, 4, at a bare minimum.

But it's also recursive, right? That government spending is a huge driver of the growth that we're seeing in the underlying economy, whether it's direct government employees, which is now a huge part of western economies or indirect government spending, which is boosting a lot of these end markets. And so, I think that's really hard to argue with.

But then let's go downstream. So, remember we've gone through 15 years or so now, when people were told, you're not going to need more copper, you're not going to need more iron, you're not going to need more hydrocarbons. So, all of these supply chains are set up for mature industries. And particularly now with AI. The US power grid essentially didn't grow for 20 years and now they're saying 3% growth. This is just a monumental task to add that many gigawatts in

that short of a time span. And again, go upstream of what goes into a power plant, the fuel sources, the water, the land, et cetera. And so, you have this demand that really is needed to sustain the government finances colliding with a real economy that's just not set up to serve it.

We can go even more granular in looking at the finite nature of copper and copper mines, of oil wells and oil, of water, and how all of this plays into providing the power and the infrastructure for AI. And you know, that's just one new area that's emergent growth. But you can also look at emerging markets. What is it, 80% of the population today is not in developed market economies, just do basic math on if their standard of living approaches 20% of a Western standard and they're at an equivalent level of installed copper, of hydrocarbon consumption, of protein consumption, just the demand on the physically constrained economy is just so enormous. And so, every way that you look at it just points to an area where particularly scarce assets are just not available and the clearing prices are going to have to go up. And that's really the fundamentals of inflation.

**George Viney:** James, I think you are always very clear in your communications that this is going to be a volatile ride. That inflation, in Horizon Kinetics view, will be structurally higher in the future, but it won't be smooth or linear. So how do you think about the risks to the downside that you get another period of lower inflation for a variety of reasons. The ones that are apparent today are clearly in the oil price or a disorderly unwinding of what is for the history books an enormous capital cycle underway in the building of data centres. How do you incorporate some of the various scenarios that may undermine, at least in the near to medium term, a view that inflation will be high and sticky for the foreseeable future.

**James Davolos:** Yeah, that's a great point. You brought up so many topics there, whether it's capital cycles or broader aggregates of inflation that are really informative in how we think about the world. Murray talks about localized inflation versus broad inflation. And so, the Bureau of Labor Statistics in the United States, our CPI composite has a lot of nuances. There are two big factors. So one is house prices and house prices has a very unique nuance called owner's equivalent rent, where instead of looking at a Case-Shiller or an online broker to estimate home prices, they do owner's equivalent rent where they basically call you up and say, what do you think you could rent your house for? And that is a huge part of CPI, as is wages.

And so, in an environment with robust productivity growth with AI, maybe softening economic growth with geopolitical uncertainty and tariffs, also just

the affordability issues that are hitting housing. Could you see a disinflation or a softening in official statistics? Absolutely. And by its very nature, it's going to be cyclical because of the dependency of the CPI benchmark. There's also the not insignificant factor that they do what's called hedonic adjustments, which is basically if beef gets too expensive, they assume you're going to eat chicken.

But then you have to focus on, again, these capital cycles within the broader capital cycle and where is their localized inflation? So, within data centres, again, the land, the copper, the power, the water, all of that ecosystem. And if you look at almost every stock that's affiliated, whether it's EPC companies that are doing the construction, copper wiring companies that are doing the wiring, turbine and companies to make the power, transformers to change the load of the power and then all the way down to the components that are doing the data centre components themselves, whether it's connections or power and cooling. I mean, all of these stocks have just gone parabolic and justifiably so because there is definitely localized inflation in those end markets.

And so, something that we're very deliberate about is recognizing the inherent uncertainty with both broad inflation but also localized inflation. Because there's even going to be volatility within these markets that are very clearly in a structural deficit for years, if not decades. And so when you think about constructing a portfolio, you want to be very thoughtful about environments where certain holdings could do well, other holdings might not do as well, and populating your portfolio for kind of that all-weather multi-cycle inflation, that's going to be very volatile and in some cases very discreet, depending on where it's experienced.

**George Viney:** You are also very careful to avoid , as you've described earlier, businesses that have high operating expenses that may themselves become a victim, temporary or otherwise, to much higher rates of inflation, but also an operational gearing that's inherent in more volatile operating environments. And so I'd love to hear you unpack an example of a business in the portfolio, one of these royalty companies or an exchange where you think there is a upside skew over the medium to long term where you don't take on the operational or capital risks of the underlying commodity or asset class. And you are effectively owning a toll booth or a royalty on the growth of the markets that they serve.

**James Davolos:** I think that you're very well insulated on a second derivative basis, but you're always going to be somewhat exposed to the industry, but a very unique company that we came across a few years ago is called Landbridge. And Landbridge you could look at it either as a land royalty or as a triple net industrial land lessor. And Landbridge is situated in West Texas, and they earn

royalty revenue for third parties to use their land primarily for water infrastructure.

Now, water infrastructure, as it stands today, is primarily taking wastewater from Permian Basin oil and gas wells. So, your listeners might not know this, for every barrel of oil and gas generated in the Delaware basin, the western portion of the Permian, four barrels of this wastewater is produced, and it needs to be transported, remediated, and disposed of. But once the well is drilled that water's going to be producing along with the oil and gas for decades. So, it's not necessarily cyclical such that you continue to just produce at current levels. So again, Landbridge is part of a sponsor company called Five Point Infrastructure. They also own a midstream business called Water Bridge. And this is where it gets really interesting. Think of Water Bridge as the company that builds the pipes and the wells themselves. So, you have a general partner that is directing capital to the midstream business, to the benefit of Landbridge as the land lessor, such that they're incurring all of the Capex and all of the opex and Landbridge is earning a 90% margin on this triple net land lease.

But again, critically to your point, while we do have an upward view on oil and gas prices longer term, the critical distinction here is that the water is really not cyclical. So, a lot of estimates have the Permian Basin probably peaking in the next couple of years, but then maybe plateauing for decades before going into a perpetual decline. Landbridge is insulated in two ways. One, their acreage is concentrated in the Delaware basin where you're running out of places to store this water called pore space, so the porosity in the rock. So, they're going to gain market share from a long-term contractual water barrel at higher rates because producers need to use them to solve their long-term water disposal needs. But then ultimately there is going to be a much bigger universe of water disposal, even if production levels do peak. But the Delaware is probably going to keep growing to offset Midland Basin declines for the foreseeable future.

So again, unpacking that, in theory you have exposure to an energy midstream business, but in this case it's a triple net land lease where it's really not cyclical, it's recurring. There's room on price, there's room on margin, there's room on volume. And what I didn't mention is that there's also this very long tail option on them providing very similar services for water and the water needs related to data centres, which are now being developed in West Texas.

Another very quick example, that I think is also germane is within the exchanges. So, Miami International is a stock exchange that we helped actually decades ago. Where Murray helped cobble together a bunch of upstart exchanges and it was listed publicly last year. But the throughput on the Miami

Securities Exchange is mostly multi listed options. So, these are options on your everyday securities and there's really no barrier to entry. And because of that, they're lower margin, but they've been very high growth. The total average daily volume in multi listed options, I think pre pandemic it was around 20 million contracts a day, and today we're running at 70 million.

The big exchanges that had all the market share, Intercontinental Exchange, CBOE, et cetera, they didn't want to compete for market share in multi list options because it was margin dilutive. So, they would rather protect their VIX franchise and their derivatives, and their very high revenue per contract franchises. And so, this actually allowed, Miami is now close to 20% market share. So now that they have this base, it's actually very profitable, but that cash flow allows them to enter into new derivatives. So one of which is the Bloomberg 500 index, which has some nuances to it, to where it's a very high margin futures index that has a lot of similarities, but it could be differentiated from the S&P such that traders could find unique attributes to that. There's also higher value in multi-leg options, et cetera.

And so, the drivers of that volume tend to be nominal growth and volatility because again, more nominal growth, more transactional volume in the system, and volatility means more hedging but also wider spreads, so now you get your speculators. And it's really this reinforcing cycle that benefits the business and then allows the product innovation, which again is that kicker.

Think about both businesses as having really interesting secular growth margin pricing profiles, but then they both have these call options on the right-hand tail that the market just doesn't price in.

**Tom Yeowart:** Can you talk a bit more about that, James? Because clearly over the last sort of year or so markets have begun to favour hard assets, low obsolescence type businesses more highly. And I guess what you're saying is, in these real asset, low capital intensity businesses, you favour, there's a huge amount of optionality and durability over the long term, which continues to be underappreciated.

How do you think about valuing that optionality and the potential for, as you say, that right tail to be realized over time?

**James Davolos:** I'm glad you brought that up. And I love the HALO analogy. But we were joking internally, high asset, low obsolescence, but many times high asset, low obsolescence also means low optionality. Think about a massive copper miner or real estate developer or infrastructure owner. Phenomenal

assets, very attractive cash flow profiles. But in order to earn more revenue outside of the finite capacity of that mine, of that apartment building, of that toll road, you're spending a very substantial amount of capital. And generally, it's at reasonable return on assets. Maybe you lever that up to get a reasonable return on equity or a high return on equity, but then there is an ongoing operating expense associated with all of that expansion.

When you think about royalties, exchanges, land banks, brokerages, et cetera, two things stick out. So, one is while they are technically finite, they're much less finite in the sense that there's a lot of capacity that's available for free. Exchanges are theoretically infinite. You could run as much volume through that as the addressable market has, you could turn that over a million times. Brokerages again, the entire industry of insurance or shipping and the turnover rates. But then with royalties, to the extent that these miners are going to expand, which they're going to, most expansion in any industry is brownfield. And what that means is you're expanding existing projects. And while that's expensive and it increased your all in sustaining costs or your break even, that goes to the royalty for free. And then as your expenses go up, again that accrues to the royalty or streamer for free.

But I think another really interesting aspect of these companies and some of the upstream miners might have large, undeveloped portfolios, but particularly the largest gold royalties, Franco Nevada, Wheaton Precious, they have hundreds and hundreds of non-producing assets. And so most people look at those as worthless because they're not generating any cash flow today. But if it's getting harder and harder to find new assets today, but also as the price of the underlying commodity goes up, buying those leases is going up as your expenses are also going up. So now there's a higher option value in those assets to be developed.

And so again, if you can underwrite a base case where the known reserves provides you an adequate rate of return for the royalties or the run rate on the volumes of the exchange or the brokerages or the land gives you an adequate rate of return, but then recognizing an increasing likelihood of that right tail to come to fruition. It's much more of a compounding return profile that's asymmetric versus the former category, which is cashflow and yield driven.

So both I think great investments for today's environment, just very different.

**Tom Yeowart:** James, you talked about Franco, clearly within these businesses there's huge amount of embedded optionality from prior royalties that were acquired. I'm just interested how the competitive dynamics within the royalty

space, within the land space, have evolved over time because clearly Franco Nevada, huge success story, as is Texas Pacific land. I imagine capital is flowing into these areas, making the acquisition of new royalties or streams or land that much more competitive. Is that right?

**James Davolos:** Absolutely. The best time to be a royalty company is a brutal bear market. And so, Franco Nevada, Wheaton Precious, they added possibly once in a generation or once in a lifetime assets in that 2010 to 2014 period when gold and bulk metals were just getting obliterated. I mean, they got in some cases, what'll probably be a hundred-year assets where it's gold and silver byproduct on world class copper mines.

But today, it's a great question because it's actually very nuanced and so, believe it or not, capital markets are not throwing money at precious metal miners today, the way that you would think for the current pricing environment. But there's an advantage to being one of these large providers because now they're doing kind of hybrid solutions where you might do a convertible preferred, you might do some equity, and again, this is at the margin, but then in exchange for that, you get the royalty.

And so, it's kind of an incubator portfolio. Franco in particular has been very good at hybrid structures that facilitate the royalty and facilitate the development of the mine. They've also partnered with very strong operators that they've seen a lot of success with to help them finance new projects and expansions. Their expertise, their engineering team, but also their balance sheet really eliminates almost all of the competition. Another great example would be Wheaton Precious just did a huge silver byproduct stream with BHP, but they already owned a third of the royalty. So, A, they're probably the only people with a check book to write the deal, but then B, they also have the information asymmetry, having been a royalty recipient on that mine for decades already.

Switching gears to energy and land, that's a really interesting market because Landbridge is a really good example as is Texas Pacific. Texas Pacific has shy of a million acres. Landbridge has just shy of 400,000 acres. An acre in their portfolio is far more valuable than a couple hundred disparate acres that are operated by a rancher or an independent. And again, going back to the Landbridge example, they can integrate those acres within the WaterBridge network, within the data centre, within what they're doing with fibre optics. And they can uplift the revenue per acre within their ecosystem such that it would not make economic sense for anybody else to buy those acres at the prevailing prices.

And so. Absolutely you want an environment when you have capital, and nobody else does by virtue of a very bad environment. But the good operators that have created this flywheel of synergies and also the capital really allow them to play a game where there's maybe one or two, in some cases, no competition.

**George Viney:** These businesses are often quite concentrated either by asset class, by customer, by dint of where they do business, physically by country or in the commodity in which they're involved. And then the option value, the long-term value creation over multiple years depends on management execution and capital allocation, which can be flawed. And so, what are the red flags? And what are the ways that investors can potentially lose their money investing in these sorts of businesses?

**James Davolos:** One of the biggest red flags and one of the hardest challenges I've seen is everybody recognizes that scale is almost essential in this business. But really talking to management and making sure they understand that growth has to be deliberate and you cannot grow just for the sake of growth. And the number one mistake I've seen royalty businesses in particular make is forcing growth, whether it's through M&A, where they overpay, going into a jurisdiction they don't understand, or worst of all, is using leverage to do a transaction because you don't have the equity or you don't have the balance sheet to do it.

But management is also extremely important and really part and parcel of that same pitfall conversation. Because if you look at every mining cycle, typically management teams just want to replace reserves and chase that cycle higher, right? And so, if you're pro cyclically investing, by definition you are going to be very vulnerable when the cycle rolls over. And so, you really want to see people that understand that you need to have prudence during the upcycle and then really be willing to capitalize when things are scary on the down cycle. And so, management is an absolute critical component of this. And you can see the ones that have executed properly and the market's pretty good at sussing out who's doing the right things, who has the right assets. But I think also how do investors protect themselves is a diversified portfolio. Having diversification within precious metal streamers, energy royalties, exchanges, that does assuage some of that idiosyncratic risk.

And I'll just give a small example that ultimately is being worked through, but Franco Nevada one of the most prestigious royalty companies. They had a royalty on one of the largest copper mines in the world. Cobre Panama. Everybody considered Panama to be one of the strongest mining jurisdictions in

the world. Very business friendly, strong financial markets, strong democracy, and very long story, they ended up closing that mine, which was approximately 20% of Franco Nevada's NAV. And it was a very painful experience if you own Franco Nevada, and you took a 20-25% hit while gold prices continued to go up. So, management has managed through this cycle very well. In fact, the mine's probably going to be brought back online this year. They did all the right things, which illustrated their senior claim in international arbitration courts. But anyway, that shows you, preeminent company in a great jurisdiction with one of the best mines in the world, you can still get hit out of left field. And so that's why we're very thoughtful about making sure we have that broad based exposure, both amongst sub industries, but also within those industries.

**Tom Yeowart:** Turning to our closing question, James. What piece of advice would you give yourself if you were to go back to the start of your career?

**James Davolos:** So, I'm going to do a personal and a career one, if I may. I've thought about this a lot and the personal one, you have so little time and really focus on what you think will matter to yourself in 5, 10, 15, 20, 25 years. Because I'm sitting here today, I'm in my early forties, I'm with three kids, and I cannot believe what I cared so dearly about when I was in my thirties and in my twenties. And I get mad at myself for not focusing on what are really important things in life. And there's so many temptations and there's so many distractions when you're young and you're in London, you're in New York, you're in Hong Kong. But just take a minute and if something's bothering you or you're really focused on something that might seem trivial, think about it. Like, will you care about this in 10, 15, 20, 30 years? And prioritize the things that you think that you will.

Career-wise. And I think other people on your show have touched on this, but I can't stress the importance of finding a mentor enough because you can be a phenomenal employee. You can work incredibly hard, but I think most people that are very, very successful have a mentor in one or two capacities. I was fortunate enough to have somebody that served both capacities, but one is to really give you advice on managing your career, on managing what you're doing, but then also in the other capacity is to take that interest in making sure that you go further in your career and hopefully that can be a superior at your existing company or a company that you strive to be at.

Bridging these two comments together. The ignorance of youth, I mentioned all the hubris in the pre GFC looking back at myself then. But the value that Peter had as a mentor, having 20 years of experience to ground me both professionally and personally, was just invaluable.

And so, seek that out at all costs and it's going to really be to your benefit.

**Tom Yeowart:** Great answer and thank you very much for coming on.

**James Davolos:** My pleasure. This was really a great time for me as well.