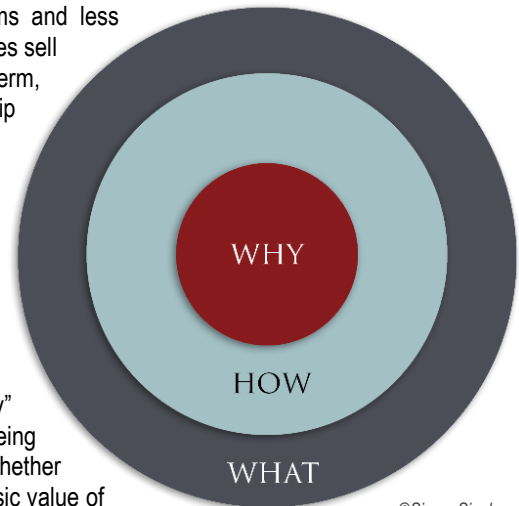


I Did Nothing (And It Was Everything I Thought It Could Be)

I recently came across a TED talk from an author named Simon Sinek which I found very interesting as it relates to the investment management businesses. He spoke about a construct he developed named the Golden Circle (see below).

It represents what he claims is a big difference between successful, lasting firms and less successful firms. Most companies sell from the outside in, whereas the successful ones sell from the inside out. His point is essentially that if you sell the “What” it is a short-term, passing sale. If you are successful selling the “Why” then you can establish a relationship with the customer and you will attract those who believe what you believe. The “Why” is your purpose or cause. Clearly this is a tougher sale, even if a company truly has a “Why”, so most stick to the “What.” As he says, “People don’t buy what you do, they buy why you do it.” What you do/sell is the proof or embodiment of what you believe. The average asset manager sells their product, the “What.” Please buy our value equity fund. Here is “How” we pick our stocks. Their primary concern is how to grow their asset management business.

Kopernik Global Investors, right or wrong, views the world very simply and similarly to the Golden Circle. We go out of our way to educate our clients and prospects on “Why” we do what we do. In our case, we believe that the “Why” is a deep rooted belief in being extremely disciplined around value and not worrying about the market as a whole. Whether a company is great or not, the only thing that really matters is the risk adjusted intrinsic value of that stock/security relative to the prospects of the company (i.e., it is all about the price). Kopernik’s approach seeks to create the best long term opportunity for growth in portfolio value, at the risk of being different and having more volatility versus the index. The “How” is what we do on a daily basis and the “What” is the fund itself.



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When Mr. Sinek describes the Golden Circle and provides examples, he says that the true believer has a much higher chance of success as they will always stick to their purpose, and the reasons behind their actions are readily understandable to their customers.

His examples include Orville and Wilbur Wright, who successfully invented the “flying machine” when the odds were stacked heavily against them in the form of much better funded and staffed competitors, such as Samuel Pierpont Langley. But the Wright brothers were obsessed with the idea, and in their quest to bring it to life, they attracted like-minded employees. They all came together and with the meager proceeds from their bicycle shop they became the first to demonstrate a working airplane.

Similarly, when the inspirational Dr. Martin Luther King Jr. spoke, he rarely gave specifics of what he wanted to change; rather, he focused on what he believed (“Why”). In doing so he attracted many like-minded believers that followed him and helped attract others. When he gave his famous speech in 1963 at the Lincoln Memorial in Washington D.C., it was the “I have a dream” speech, not the “I have a plan” speech.

Some of this reminds me of the legendary basketball coach at UCLA, John Wooden. While most of his teachings seem archaic and from a by-gone era, the reality is they are all based on this same philosophy. Coach Wooden always focused on the preparation and NEVER the outcome (winning). In his famous Pyramid of Success, the top block is Competitive Greatness and the entire premise is that you can only achieve that by focusing on and sticking to the basic building blocks. In Kopernik’s case, our daily focus is the process and picking the right investments. The performance and assets under management are a by-product of this focus. We are true believers that the intersection of price, quality and risk defines value and that is all that matters. That is what we look for in companies, and we believe that over the long-run it generates excess returns for our investors.

While there are many aspects that go into the “How” of the way Kopernik picks stocks, I thought I would focus on one point that is seemingly very different than most: time.

In the cult classic movie “Office Space” the main character, Peter, has a revelation and decides to not do what society expects from him. Shortly thereafter his boss tells him to come into the office over the weekend to work, but he chooses not to. When he comes in Monday



morning his friend asks him where he was since he was supposed to work and he responds "I did nothing, and it was everything I thought it could be." Similarly, our investment philosophy is to conduct fundamental research that is less concerned with short-term issues/timing, invest in a business, and then do "nothing," i.e., wait. If the stock goes down further for no new fundamental reason, we buy more, and wait. If we think a stock can triple and, worst case, that doesn't happen for 10 years, that is still a 12% compounded annual return. Based on this logic the analysis is less about when and more about how much upside and risk exist in that company.

Among our differences from most investment managers, perhaps the biggest is our commitment to not fear the duration mismatch between investors' expectations of returns and our investment style. In other words, we are willing to invest in companies with short-term issues with no way to determine when it gets better (within reason) assuming the stock provides enough risk-adjusted upside when things improve.

Economics is a funny thing in that the same patterns tend to repeat in a predictable, though not always with the same timing, kind of way. Specifically, capitalism and economics find a way to correct industry-wide excesses. As the saying goes, "the cure for low prices is low prices." In most industries it takes some time to add capacity, so only when things are good and prices are higher than average capacity additions do come on. Each competitor, acting in their own self-interest, decides to add so they are not left behind in terms of market share and profits. This collective capacity add naturally causes over-supply and prices fall to adjust. When prices are down you either get no new capacity added, or capacity is actually reduced, until demand catches up and prices rise to adjust. There are certainly exceptions, usually when a country decides a certain industry is "strategic" and wants market share and they don't care about short-term profits. Thus, it is easy to see how economic cyclical causes far bigger swings in industries with many competitors (i.e. various commodities). While this can be scary, it also creates opportunity.

Since we are looking for companies priced below their risk adjusted intrinsic value, frequently it is these commodity plays that get too cheap. Human emotion applied to cyclically driven pricing creates margin swings with higher highs and lower lows, which is somewhat obvious and easy to see historically, but more importantly, is what creates the opportunity. In an effort to be less emotional, Kopernik seeks to take the noise (i.e. bad news) out at the bottom of the cycle and more directly determine if "this time is different" or if it is just the usual cyclical forces driving down margins which will return in time.

Today Kopernik has a reasonably high exposure to assorted commodity companies so we are often asked if we are a closet-commodity/natural resource investor. While we understand why our holdings can create that question at times, the answer is definitively: "no". The better answer is, in addition to liking great businesses selling at wildly cheap prices we are also drawn to industries with abnormally low margins compared to their historic range and a high probability of those margins reverting to their historic averages. Sometimes that leads us to resource producers, but other times to shipping companies, airlines, semiconductor companies, etc. As always, the answer is: "it depends", and we invest where the market gives us the opportunity to find cheap stocks.

Being a value investor often means being a contrarian. According to Webster's Dictionary (yes, it still exists) "a person who takes a contrary position or attitude; specifically: an investor who buys shares of stock when most others are selling and sells when others are buying." This makes it seem as though whenever a stock is falling or down a contrarian investor buys. The reality is that when a stock goes down, that stock should, and most likely will, end up on the value investor's radar of things to investigate. It does NOT mean that we will buy it just to take the other side. In a cyclical industry, it means it is time to go to work and decide if the valuation is low enough, if the prospects are positive over the long term and if the management is saying and doing the right things to right the ship, so to speak.

One of the easiest ways to quickly tell if a company or industry sells a commodity, or is heavily cyclical, is on the gross margins on the gross margin line or EBITDA line (some service companies). If gross margins are wildly volatile, that tells you that the price of their product is wildly volatile since costs cannot fluctuate or adjust nearly as quickly as price. The margins point to this. The key here is to make sure that the price will have time to come back, meaning they don't have so much debt that they will go under while we wait for things to get better. Margin volatility tends to lead to stock volatility which scares most investors. Kopernik, on the other hand, views it as opportunity. We like industries that have volatility as it inevitably creates the opportunity to buy companies that trade below their long term risk-adjusted intrinsic value.

If you believe that emotion plays a part in the investment process, then the challenge is to ignore that emotion and stick to economic facts. I could start with the obvious quotes like "everything that's important in investing is counterintuitive, and everything that's obvious is wrong" from Howard Marks. Probably funnier is quoting from the TV show "Seinfeld". In the 1994 episode, "The Opposite" in which George Costanza laments his woeful life, "Why did it all turn out like this for me? I had so much promise. I was personable, I was bright... It became very clear to me... that every decision I've ever made, in my entire life, has been wrong. My life is the opposite of everything I want it to be. Every instinct I have, in every aspect of life... It's all been wrong." At which time Jerry Seinfeld replies "If every instinct you have is wrong, then the opposite would have to be right."



Later, George gets a job with the NY Yankees and says “This has been the dream of my life ever since I was a child, and it's all happening because I'm completely ignoring every urge towards common sense and good judgement I've ever had. This is no longer just some crazy notion... This is my religion.” George Costanza might have been a good value, contrarian investor.

As it relates to Kopernik we are as religious as George Costanza about our belief in the process of finding value and investing accordingly, and not focusing on what is “working” in the short term. While we don't seek to do the opposite, it is almost always the opposite of the common wisdom where we find extreme values. The key, for us, is to see where the current margins are relative to the historic highs and lows. If they are near the bottom, and the stock is cheap on other metrics (price/book, EV/Sales, etc.) then it is worth investigating. Here are a couple of tables illustrating companies with low current gross margins that we would be interested in exploring; some we already own, some we do not.

	Gross Margin High	Gross Margin Low	Current Gross Margin	Price / Book Low	Current P/B
IRON ORE MINING COMPANIES					
Rio Tinto	38.2%	-3.8%	11.1%	1.4x	1.5x
Vale	59.4%	15.2%	19.7%	0.6x	0.51x
BHP Billiton	45.8%	-20.9%	17.1%	1.4x	1.3x
GOLD MINING COMPANIES					
Barrick Gold	56.2%	19.2%	23.5%	1.2x	2.6x
Goldcorp	66.1%	-0.8%	6.9%	0.4x	1.1x
SHIPPING COMPANIES					
AP Moeller	69.5%	15.8%	15.8%	0.8x	0.8x
D/S Norden	48.5%	-11.5%	-11.5%	0.8x	0.8x
Golden Ocean	77.0%	-30.1%	-30.9%	0.2x	0.2x

On the other hand, if the current margins are at historic highs, we most likely see more risk than the market even if the stock looks cheap on current earnings and thus Kopernik probably will avoid those areas. Here are a couple of potential examples of this as well.

	Gross Margin High	Gross Margin Low	Current Gross Margin	Price / Book Low	Current P/B
AIRLINES					
Southwest	25.9%	8.5%	25.9%	1.0x	3.8x
Air New Zealand	17.7%	-0.3%	17.7%	0.6x	1.1x
Asia Aviation	14.6%	-4.2%	14.6%	0.9x	1.4x
JetBlue	24.3%	-16.4%	24.3%	0.8x	1.5x
	OP Margin High	OP Margin Low	Current OP Margin	Price / Book Low	Current P/B
U.S. RESTAURANTS					
BJ's Restaurants	6.8%	2.5%	6.8%	1.2x	3.3x
Starbucks	18.9%	5.7%	18.8%	4.0x	13.0x
McDonalds	31.6%	14.0%	28.5%	1.9x	22.0x

All figures have been sourced from Bloomberg and go back to when each company came public to the present.



At any given time there are usually certain industries at their all-time highs in terms of margins, which we would say presents more risk than the market is assigning, and others are closer to their bottoms, which we would say is an interesting place to do research on some of those companies. Again, this is just a starting point for additional analysis, but you can see the margin volatility which isn't discussed as broadly as it probably should be, but is an important framework for analysis for Kopernik.

The key to looking at margins is time. It seems unrealistic to ever think you can pick the bottom when industry prices are falling, but looking at margins will at least provide a framework to determine when it might be close. If gross margins have historically been significantly higher, then we will do the research. If we conclude it is likely that the cyclical factors that took margins down will reverse at some point, it is probably worth entering without knowing the timeframe of when things will improve. We are happy to wait if the upside is multiples of the current value.

Lastly and off topic, but to tie into my last piece, "Inconceivable", it seemed appropriate to show the updated correlation data on the Kopernik Global All-Cap Fund and the now 1 year old Kopernik International Fund. As you can see below, the Kopernik Global All-Cap Fund continues to stand far apart from the pack in terms of correlation to the index. Potentially as interesting is the fact that the average of the top 10 Global Value/Blend funds are 94.8% correlated with the average of the top 10 Global Growth funds. You can reach your own conclusions about that.

	Kopernik Global All Cap Fund **	Avg Top 10 Global Value/Blend US Funds ***	Avg Top 10 Global Growth US Funds ***	iShares ACWI ETF
Weekly Performance Correlation vs MSCI ACWI *	67.0%	95.5%	91.1%	98.4%

* Morgan Stanley Capital International – All Country World Index: a broad-based securities market index that captures 2,481 primarily large and mid cap companies across 23 developed and 23 emerging market countries as of June 30, 2016. The MSCI All Country World Index is different from the strategy in a number of material respects, including being much more diversified among companies and countries, having less exposure to emerging market and small cap companies, and having no ability to invest in fixed income or derivative securities.

** Since Kopernik Global All Cap Inception on 11/1/13 through 07/04/2016

*** Average of top 10 "Global Value" funds and "Global Blend" funds by AUM, as shown by Bloomberg as of 7/7/16 – time period 11/1/2013 through 07/04/2016

**** Average of top 10 "Global Growth" funds by AUM, as shown by Bloomberg as of 7/7/16 – time period 11/1/2013 through 07/04/2016

The correlation shown below for our Kopernik International Fund also is a clear outlier from the pack in terms of correlation versus the ACWI ex-US index, which isn't surprising.

	Kopernik International Fund	Avg Top 10 International Value Funds **	iShares ACWI ETF
Weekly Performance Correlation vs MSCI ACWI ex US *	70.4%	92.4%	94.3%

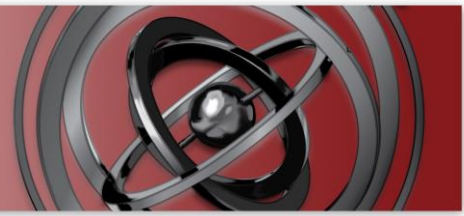
* Morgan Stanley Capital International – All Country World Index ex US: a broad-based securities market index that captures 1,859 primarily large and mid cap companies across 22 developed and 23 emerging market countries as of June 30, 2016. The MSCI All Country World Index ex USA is different from the strategy in a number of material respects, including being much more diversified among companies and countries, having less exposure to emerging markets, and having no ability to invest in fixed income or derivative securities.

** Average of top 10 "International Value" funds by AUM, as shown by Bloomberg as of 7/7/16 – time period 07/03/2015 through 07/04/2016

From the correlation data hopefully one thing is painfully obvious; Kopernik is not concerned at all with the indexes. More importantly, we do what we say we do in terms of finding businesses that are fundamentally undervalued relative to their risk adjusted intrinsic value and buy them without concern for index weighting with the single minded goal of making money for our clients over the long term.

Mark McKinney

Portfolio Manager / Analyst
Kopernik Global Investors, LLC
August 2016



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