



KOPERNIK PERSPECTIVE

Russia - It's not me, it's you

"Why would you have any money invested in Russian stocks?"

"Why are you so bullish on Russia?"

"Don't you think Russia is risky?"

"Is Russia un-investable?"

"Are the risks there too murky and complex to even assess?"

"Are there risks there that are unknowable?"

These are questions we seem to get regularly. The answer is fairly straightforward. We see many risks in Russia, as we do in every other market in the world, including the U.S. That said, as we always say our job is to find companies that trade at a discount to their risk-adjusted intrinsic value. Our research work at Kopernik revolves around individual stock analysis and group vetting discussions to ensure we understand the business, have considered the risks, are buying at a big enough discount, have assessed the upside vs downside, etc.. Based on this, we are finding great values in Russia.

What is interesting is that as often as we say this is our process, we then get the question about our macro focus. I.e., if we have 18% of our portfolio in Russian stocks (we do) it must be a macro bet. Far from it. Our Russian stocks are all individually researched in a global industry context, but when you add up the values we are finding in Russia, we understand it looks like we are making a macro bet. Given all the questions about Russia, it seemed an appropriate time to offer some thoughts on this topic.

We read all the time about many investors saying they would never invest in Russia. The most common list of risks is long.

- They have no rule of law – the government can/will steal your assets arbitrarily.
- Corruption is rampant and the government will siphon off huge amounts of business economics.
- Government/Putin influence on the economy, which means companies are not aligned with shareholders' interests.
- Financial disclosure is non-existent so companies do not reveal their true economics.
- Risk of government default.
- Ukraine / risk of war.
- Russia's military ambitions outweigh its economic ambitions.

These are all valid risks and need to be considered, as we do. That said, are they unique to Russia? Certainly not.

Our view is that the market is not efficient and is frequently driven by human emotions. These emotions move stocks to distorted valuations, which ultimately creates opportunities for a disciplined value investor with a long term focus.

When things are bad, it is easy to think they will always stay bad.

- The Japanese stock market topped out at almost 39,000 at the end of 1989. For the next 23 years you lost almost 80% of your money. The common thought was that Japanese companies/stocks were in terminal decline. Since that bottom, the Japanese market has rallied well over 100% in the last 2 years.
- Not that long ago the S&P500 was down over 50% from its high during the Global Financial crisis and everybody was stricken by fear. It has been quite a ride since then, up over 200%.
- From the peak in 2000 the US Nasdaq market fell by roughly 80%, yet here we are back near the highs.
- There are countless other examples of major stock markets that have fallen 50%, which certainly implies that people think it will stay bad for a while.

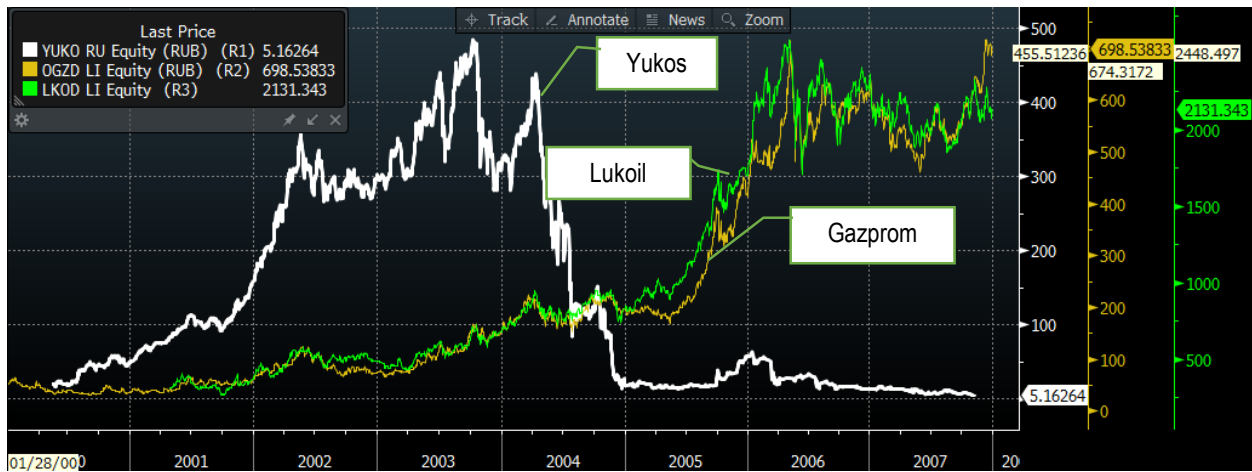


Conversely, when times are good it is easy to look away from the risks.

- In 2007 we were told by government officials there was no U.S. Housing subprime issue and we had never had a year when prices went down across the board. We know how that turned out.
- In 2000 tech stocks were hot because the internet would change the world. It has changed the world, but not how companies are valued and they crashed.
- In 2007, the term “BRIC” was coined to lump together the hottest emerging markets (Brazil, Russia, India and China) since they would grow forever at faster rates than the U.S., with the implication being those stocks were good. Those economies have grown far faster than the U.S., but that certainly didn’t mean the stocks were better.

The punchline is that EVERYONE seems to believe that Russia isn’t worth the risks, AT ANY PRICE. This is when we dig in and see if we think the worst is priced in.

One of the biggest risks is the lack of law and the risk of the government stealing from the company to serve their political agenda, or worse a full nationalization of a company. The most frequent example of Russia nationalizing companies is when Yukos was taken over in 2003 and the CEO was imprisoned and the shareholders lost everything. Leaving aside the details, what is really interesting is that the nationalization happened in late 2003, and yet even with this risk being realized, all other big energy companies kept rallying for a couple years after. As an example, highlighted in the chart below, Gazprom rose 6x and Lukoil rose 4x in the 3 years post the Yukos nationalization. Why was the market unconcerned about further expropriation back then, when it had just happened, but seems to be certain that it will happen now and is scared to death? Obviously other things were going on as well, oil was going up to \$149/barrel and stock markets were soaring, but the probability of being “robbed” should have been much higher then as compared to now.



Source: Bloomberg

Similarly interesting is that today seemingly everyone says Russia will ALWAYS trade at a steep discount to the rest of the world given all the risks. To compare to the past, maybe some facts would help. In 2007 Exxon had revenue 3.8x higher than Gazprom, net income 1.5x higher and a market cap 1.5x higher. I.e., their P/E multiple was THE SAME as Gazprom. Today, Exxon’s market capitalization is 7.5x higher than Gazprom’s, despite net income and free cash flow being only 14% and 10% higher respectively.

While we acknowledge that the rule of law is less strong in Russia (and most emerging markets) than here in the U.S., we don’t believe that Russia is a zero and western economies are perfect 10’s on a legal sanctity rating scale. Former General Motors bond holders and Fannie Mae stock holders might argue whether the US is as legally pure as we like to believe. The tens of billions of dollars being extracted out of financial institutions by the Department of Justice for alleged financial wrongs, especially since many were forced by the government to acquire the risky assets (Bank of America/Countrywide Credit, etc.), could arguably be described as a government “shakedown”. Yet very few are willing to equate this to what goes on in other countries and even fewer in the investment business seems to incorporate this sort of risk for U.S. companies in their investment decisions.



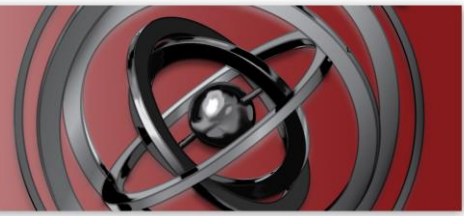
As far as corruption goes, there is no doubt that it exists in Russia. However is it any more endemic than in China, India or Brazil? For that matter is it that much worse than 'developed' countries? The answer might be yes, but is it as black and white as "Russia is 100% corrupt and the West is 100% pure"? We think not and more importantly we believe it is possible to take into account the costs and risks of corruption in certain businesses and decide whether our stocks are over or under discounting them. Is there a big difference between the government demanding to use certain approved contractors, which "bid" higher, and the U.S. forcing contractors to use the "prevailing wage" laws, which limits competition? Is there a big difference between having to pay a lobbyist to get your goals accomplished or having the government skim from you? Let alone the numerous instances where U.S. contractors have been caught paying bribes to government officials. These answers are not for us to decide, but it doesn't seem to us that Russia is infinitely worse than the West.

With regards to Russian companies not being shareholder friendly, we find this concern is also often over emphasized. Frequently the big Russian companies have controlling interests held by powerful oligarchs who have a material amount of their wealth in company stock. Irrespective of how they acquired these stakes (admittedly many got them in less than savory ways) they are currently quite aligned with shareholders. Don't most US investors like it when the founder keeps his stock while he runs the business so their interests are aligned? There are certainly government controlled companies that value employment more than profits, but that happens everywhere in the world. Even when there is some conflict with shareholders, we frequently find it no worse in Russia than in much of the developed world where unions might have a significant presence on the Board of Directors (GM, US Airlines, etc.) or governments might have veto power over corporate actions. In these types of cases we rarely find analysts bemoaning the lack of shareholder rights in developed countries like we do vis-à-vis Russia. Further, count us among those that say that US stock option plans are a form of theft from investors to employees, let alone one that isn't properly scrutinized since most investors look at "non-GAAP" earnings which exclude such expenses.

We do not claim to be the foremost experts on sovereign credit risk but we find little evidence that Russia should represent a major default risk. Government debt to GDP is only 13%, among the lowest in the world and an order of magnitude lower than the 70-130% levels of the "safe" developed countries and the 226% level in Japan. To put this in perspective, the government of Russia has borrowed about \$1,416 on behalf of every Russian citizen, while the U.S., German, Japanese and Canadian governments have borrowed about \$38,000, \$32,000, \$84,000, and \$46,000, respectively, for each of their people. On top of that, the Russian government has run surpluses in all but one of the last 15 years (during the '09 global recession) versus the U.S. running deficits for 42 of the last 45 years. Say what you want about Putin, but you can hardly call him a spendthrift.

What about the government influence of the economy? Some sectors of the Russian economy are certainly closely controlled by Moscow. However we find this is the case all over the world and is another factor that we think we can analyze and weigh the risks of in our investment analysis. Does the Russian government play favorites with some of its companies? Yes. But so do the French, German, Japanese and even the US governments. France last year issued a decree allowing it to veto foreign transactions in many sectors of the economy. The US and Canadian governments have placed restrictions of foreign ownership of energy assets. The US government blocked Dubai Ports (a United Arab Emirates state-owned business) from buying the management of 6 US port operations from a British company for national security reasons. Yet analysts do not complain that these developed countries are risky. On the contrary these countries are considered virtually risk free and virtual "libertarian paradises". When analyzing businesses around the world we often find the Russian government more pro-business than many western ones. Try building a coal fired electricity plant in the U.S., or laying off redundant refinery workers in France or coal miners in Poland, and see what kind of business partners the governments are there.

Lastly in terms of risk, Ukraine, et al. A neighboring country begins discussing joining NATO, which Russia considers to be a threat and warns them not to do it. Somewhat simultaneously a couple regions, which view themselves as historically Russian, were agitating for independence. Russia goes out of its way to support the "independence". Putin establishes direct government links with separatists. Tensions flair. Separatists (officially backed by Russia?) begin fighting with Ukraine. Russia sends in troops to assist the "peacekeepers". Things escalate. Ultimately the separatists say they are Russian and always have been and want to be recognized as part of Russia. Russia uses more direct military force to ensure the outcome. Along the way there is a vote of "independence" or joining Russia, however you want to look at it. And here we are in Ukraine. Wait, this was actually Georgia in 2008 (just 7 years ago). At the time Swedish Foreign Minister Carl Bildt, raised concerns about the situation saying, "That could look like a de facto annexation and that would be a matter of great concern if it were the case". But ultimately no sanctions were applied to Russia and everyone went on their way. How many people remember that? Why is Ukraine different? Aren't the circumstances roughly the same with Ukraine now? How is the current Ukraine situation worse than when the Soviet Union tanks rolled in and "occupied" Hungary, Poland, Czechoslovakia, Romania, Bulgaria, etc. in the post WW II era with no worldwide economic sanctions?



Specific to Ukraine, as Henry Kissinger wrote in his op-ed piece in the Washington Post, “Ukraine has been independent for only 23 years; it had previously been under some kind of foreign rule since the 14th century. The politics of post-independence Ukraine clearly demonstrates that the root of the problem lies in efforts by Ukrainian politicians to impose their will on recalcitrant parts of the country, first by one faction, then by the other. The Western part was incorporated into the Soviet Union in 1939, when Stalin and Hitler divided up the spoils. Crimea, 60 percent of whose population is Russian, became part of Ukraine only in 1954, when Nikita Khrushchev, a Ukrainian by birth, awarded it as part of the 300th-year celebration of a Russian agreement with the Cossacks. The west is largely Catholic; the east largely Russian Orthodox. The west speaks Ukrainian; the east speaks mostly Russian. Any attempt by one wing of Ukraine to dominate the other — as has been the pattern — would lead eventually to civil war or break up.”

Our point isn't to say Russia is right or wrong, or good or bad. But more the worldwide reaction (or lack thereof) seems somewhat arbitrary. **The West doesn't complain when the Scots have an election as to whether they want to leave the UK or not. The Catalan region in Spain wants to break away but we don't get involved. We let Czechoslovakia break up, Yugoslavia break up, Ethiopia break up and many others over the years. Many borders that exist are arbitrary historically. Just because something happened after the First World War or Second World War and some bureaucrats drew a border doesn't mean it's logical or should survive.**

The West says we're in favor of self-determination. The number of ethnic Russians living in the former Soviet regions may or may not have aspirations to reconnect with Russia. But these kinds of things have happened all over the world throughout history. We can argue that the Crimea election was rigged, but 97% of the Crimea region voted to join Russia. If this has happened many times in history in many different places, why does the world think this time is different and Russia is “evil” and more importantly to us, un-investable? We see the risks but try to put them in perspective.

So far we have been dwelling on the risks of investing in Russia, as risk control is one of the most important roles of an investment analyst. However, there is also much to like about Russia, especially over the long term and once the current geopolitical turmoil sorts itself out. The massive size of Russia is obvious at even a casual glance at a map. But within that huge geographical area are some impressive natural resources. The country has more arable land per capita than any other country (by far), the second most renewable water resources in the world (behind only Brazil), 5% of global oil reserves, 17% of global gas reserves, 18% of global coal reserves, 15% of iron ore reserves and 9% of world uranium reserves, all serving less than 2% of the world's population. Tax rates are low, the savings rate is high and demographically it is strong with a low dependency rate, high education levels and a relatively homogeneous population for such a large country.

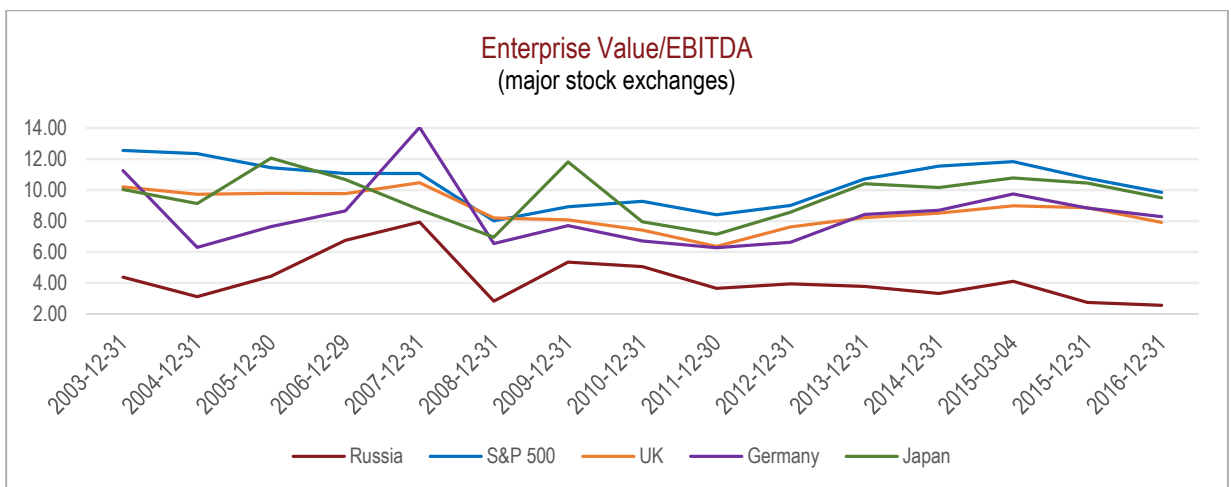
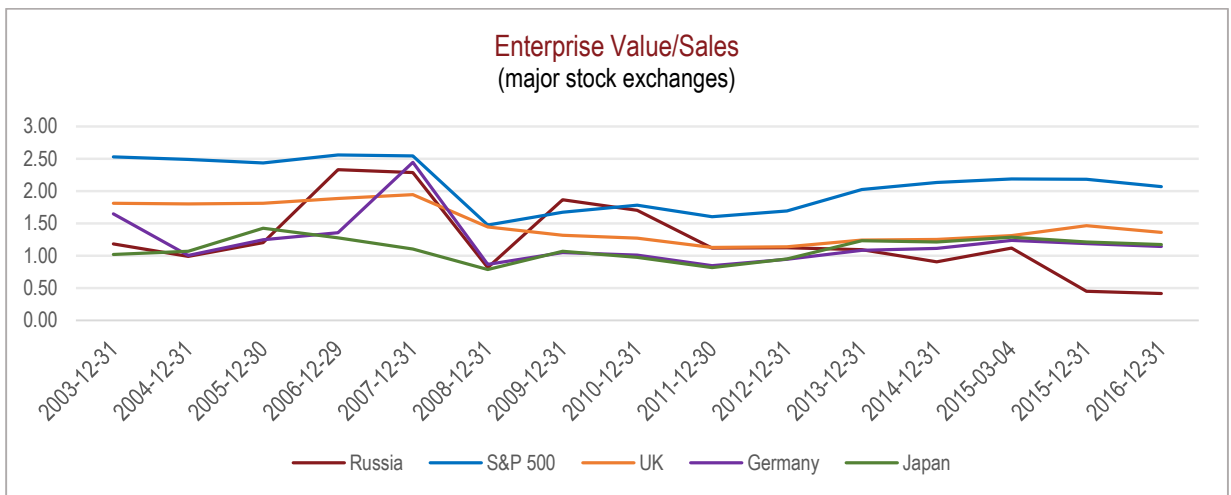
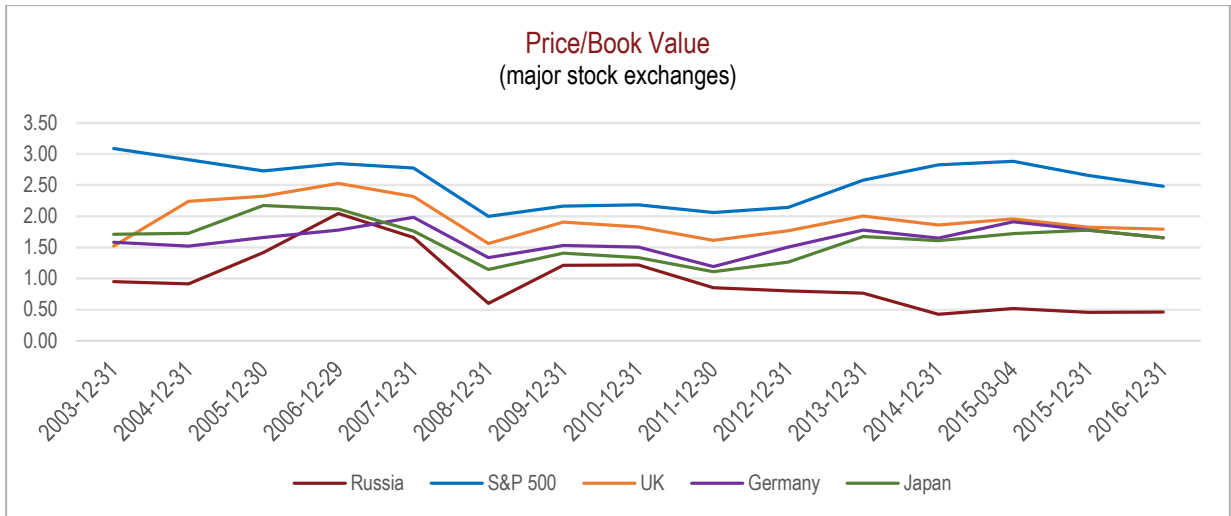
Here is a quick fiscal comparison with the U.S.

	Russia	United States
Debt/GDP	13.4% (down from 1996)	101.5% (up from 63.3% in 1996)
GDP Growth since 1996	200%	23%
Trade balance	Surplus	Negative (every year since early 80s)
Current account	Surplus	Deficit every year since 1991
Foreign Exchange reserves	\$363b	\$41b
Forex & Gold Reserves	\$516b (72% of external debt)	\$150b (1% of external debt)
Unemployment	4.90%	5.90%
Inflation (5 Yr Avg)	7.80%	1.70%

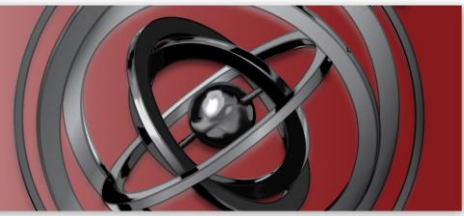
Source: Bloomberg, CIA World Factbook, World Bank

As mentioned above, debt levels are low as the country (perhaps burned by its default in the '90's) has not bought into the credit mania that seems to have gripped the rest of the world. Russia's total stock of domestic credit amounts to under \$7,000 per person versus over \$50,000 for the US, Germany, France and Italy, \$90,000 for Canada and almost \$100,000 for Japan. Even other developing countries such as Poland, Brazil and China have higher per capita credit levels than Russia.

But what excites us most about Russia is the stock valuations we are seeing there. Valuation multiples for most of the world have recovered A LOT from the levels reached in the “Global Financial Crisis”, in some cases to all-time highs. However, the stocks of Russian companies still trade at valuations at or below the levels reached when the world seemed to be falling apart. We think much of this has been due to an overly emotional response to recent events in Russia which has caused the proverbial “baby to be thrown out with the bathwater”.



Source: Bloomberg



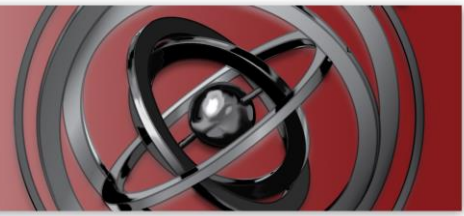
If we could make one point on all of the objections to investing in Russia it would be that we do not believe they are reasons not to invest there at all. Rather, these are the reasons we are finding bargains in Russia, as too many in the investing world take the view that Russian stocks are not worth buying AT ANY PRICE. We believe that at current valuations we have built in rather comfortable margins of safety against many of these risks actually coming to fruition. Further, we view risk as what is NOT priced in to a stock. So if a stock or market falls dramatically, all else equal, it is less risky, not more. When U.S. stocks were down between 50%-85% in 1932, 1974, 2002 and 2007, most people viewed the markets as riskier versus less risky and buying opportunities as they should have. (The flipside is also true, so today's U.S. markets, having gone up over 200% since 2009, are far more risky than they were 6 years ago at the low.)

Lastly, it is hard to talk about risks without mentioning the currency. As we have seen in Russia the risk of a weaker Ruble was very real, but again, maybe an example will give some guidance. Late 2012 it became clear that there was a real chance that Shinzo Abe could win reelection, after 5 years of leaving office, as the Prime Minister of Japan. His economic platform consisted heavily of printing Yen at a rate the world has rarely seen, thus trying to end the country's deflation via a weaker currency. While it is debatable whether the weaker currency will ultimately help Japan or not, his main goal of weakening the currency has certainly worked. From November 2012 to today the Yen / US \$ ratio has gone from roughly 79 to current 120, or a fall of 35%. Given Japan has historically been so export oriented (16.2% exports to GDP ratio in 2013), the stock market (Nikkei 225 index) took the weaker currency as a MAJOR positive. From that same starting point the Nikkei index jumped from 8,750 to a current 19,750, or a gain of 125%. For US \$ investors, when you net out the weaker Yen vs the US \$ the Nikkei index returned roughly 50%.

It is then curious that since the Russian/Ukrainian "crisis" sprung to life in the summer of 2013, the Russian Ruble /US \$ ratio has gone from roughly 36 to 55, or a fall of 35% (granted it touched 80 intra-day late January 2015). During that same time the Russian stock market index (Micex) has jumped from 1,379 to 1,700, or a gain of 23%. Again for US \$ investors, when you net out the weaker Ruble vs the US \$ the Micex index has fallen 11%. Given that Russia's export to GDP ratio in 2013 was 28.4%, logic would say that Russian stocks should benefit far more than Japanese stocks from a weaker currency, and yet the Micex has not gone up nearly as much as Japan's index, and in US \$, the Russian index is down big whereas the Nikkei index is up big.

To conclude, Russia has plenty of risk but we don't believe it is un-investable. As mentioned above, risk is the potential for loss that is not already priced into the market. Russia has gotten less risky while most developed markets have become meaningfully more risky, yet the market is pricing that in reverse. As a result, many of our analysts are finding premier companies that are quite affordable in Russia while not finding much in the more developed markets, as the U.S. and Europe. Our job is to take a long-term, disciplined approach to try to assess and quantify the risk and then determine if the discount on individual stocks is large enough. As we said in the beginning of this paper, with 18% of our portfolio in Russian equities, the answer is clearly yes. The discounts we are finding are much larger than our already significant requirements for Russia. Further, we own stocks in many different industries there, so this is not a macro call. We own leading companies in gas, electric utilities, mobile phone service, oil, home building and healthcare, and believe we will see sizable gains in the future. Maybe the bigger question should not be why do we like Russia so much, but rather why do other investors hate Russia so much?

Steve Rosenthal
Mark McKinney
Kopernik Global Investors, LLC
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