



KOPERNIK PERSPECTIVE:

WILLFUL BLINDNESS

I stole the title of this commentary from an interesting book I read a few years back, *Willful Blindness: Why We Ignore the Obvious at Our Peril* by Margaret Haffernan. In the book, she argues that the biggest threats and dangers we face are the ones we don't see, not because they're secret or invisible, but because we are willfully blind. She examines the intricate, pervasive cognitive and emotional mechanisms by which we *choose*, sometimes consciously but mostly not, to remain unseeing in situations where "we could know, and should know, but don't know because it makes us feel better not to know."

In this story, what we should know but don't are the risks in listening to the common narratives, both in the world and the stock market. To throw another movie quote in there, *Mallrats* was a 1995 juvenile comedy written and directed by Kevin Smith about two friends who are both dumped by their girlfriends and seek refuge in the local mall. At one point, when the two main characters are talking to each other T.S. calls out his friend, Brody, for being incorrect about something. Brody then responds "You're gonna listen to me? To something I said? Hell, most of the time I'm just talking out of my ass... Jesus, man, haven't I made it abundantly clear during the tenure of our friendship that I don't know shit?"

It is easy to call out something that a friend says that doesn't seem quite right, but much tougher to question a common narrative in life, or investing. But our job as investment managers is to think through the narratives with logic, consider history and apply logic, to see if they make sense. If not, why not? What are the implications? It is ultimately this ability to go against the grain that makes the most money over the long term.

How about a broader question? Why is it so hard socially to ask tough questions that don't quite make sense? Why does it seem like you need a certain character type to do it? Why is there social scorn for asking a difficult question when all you are doing is seeking the truth? In hindsight, when housing prices started falling hard in the U.S. in 2008, wasn't it obvious that shorting the subprime U.S. mortgage market, in any form, was a great trade, especially when you could do it VERY cheaply via credit default swaps (CDS)? Is it a coincidence that in the 2010 book and subsequent 2015 movie, *The Big Short*, that the main characters, Steve Eisman and Michael Burry, that kept at the trade, were socially awkward and described by many as eccentric? Does it not seem like many leading investment gurus who frequently go against the grain of the market are in this camp? Why?

In the interesting book, *Awkward: The Science of Why We're Socially Awkward and Why That's Awesome*, by Ty Tashiro he describes people who are less emotional, don't require social interaction to be happy, have very linear thinking and are driven primarily by logic. He goes on to say that this type of person would excel in certain professions (math, scientists, engineers, financial analysts) while less likely to thrive in professions that require mass amounts of social interaction (big companies, sales, politics, advertising, etc).

Back to the Big Short. Wasn't it obvious the trade made sense? Or did most people actually believe Fed Chairman Bernanke when he said in February 2006 "Housing markets are cooling a bit. Our expectation is that the decline in activity or the slowing in activity will be moderate, that house prices will probably continue to rise"? Or his quote in March 2008, "At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained. In particular, mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers continue to perform well, with low rates of delinquency"? The second quote was easily proven at the time to be a lie but maybe most people just blindly trusted him because he was the Fed Chair? Our government would never lie to us, right?

Once it was crystal clear that the mortgage market was suffering with delinquencies rising fast, something funny happened; the derivatives (CDS) didn't go down as they should have. At the time, nobody knew the investment banks had enough derivative exposure to be really painful so even though they were the trusted middle-man, they manipulated the market for their own benefit. I think all you need to know here is the Charlie Munger quote, "Show me the incentive and I will show you the outcome." For many investors the pain of the trade not working when it should have, became so great they gave up and got out. As we saw in the book and movie, it was only those that have a lower sense of emotion and a higher sense of linear thinking that ultimately said the outcome HAD to happen and held on. How many investors would risk their entire firm shutting down, as Michael Burry did, and tell their clients they couldn't have their money back since the outcome was inevitable?



While I would say the narratives today are not necessarily as obvious as the subprime mortgage trade, it is amazing that most people are overlooking logic (willful blindness?) and buying into the story and not questioning it more. Here are a few examples.

Narrative – The U.S. stock market isn't expensive

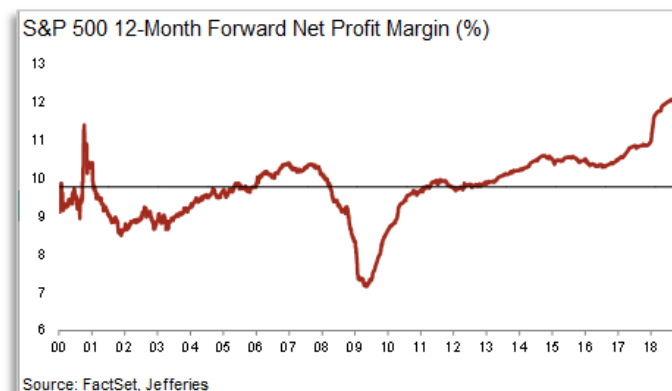
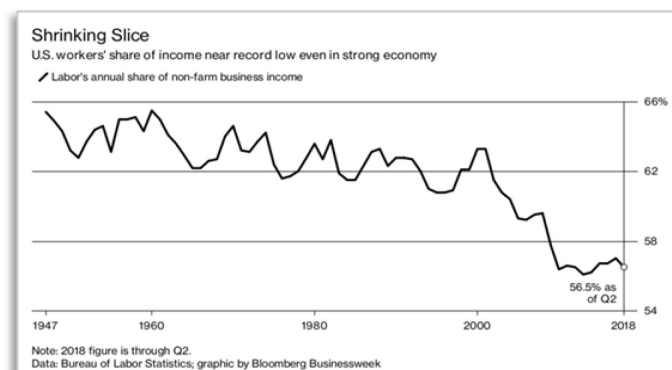
The narrative is that the U.S. stock market is reasonably priced since it is only 17-20 times 2018 expected earnings, depending on the source (the fact that there is such a dispersion is a whole separate issue/risk). Don't we hear this all the time these days? The key question for me is, how are we defining earnings?

You have no doubt seen a chart similar to the one on the right showing the U.S. S&P500 index trading at or above all-time high valuations based on Price/Sales, depending on how it is calculated. If the P/E is barely above the historically normal range but the Price/Sales looks high, it is obviously because the average profit margin today is abnormally high, historically speaking. The chart below to the right shows the after tax profit margin in the U.S. Clearly, we are in uncharted territory here. The only question is whether or not it is sustainable.

The chart to the right shows labor as a percentage of income in the U.S. This makes sense given the oft cited fact that the average worker makes less today in real terms than they did in 1974 for an hour's work. This gets more complicated when you consider the employee benefits that may not be listed or considered as part of the direct labor expense (i.e., health care) but we will leave that aside. Clearly labor as a % of revenue being down big is a key factor for profits being higher (see chart to the right at the bottom of the page), along with lower taxes.

So let's dig here a bit on why profit margins are high. One reason for a higher average is the rise of the super profitable, big tech monopolies (Google, Facebook, etc) driving the average higher. But more broadly isn't the whole theory that competition drives returns (ROEs) down toward the cost of capital? Why would anything that might lower costs and increase returns not be competed away over time? Isn't the theory that one competitor would then lower prices to gain volume/market share? If so, then the other competitors would most likely respond and follow which ultimately means productivity-led cost reductions are ultimately passed on to the customer. This means that in the very short run, which can be years, a reduction in costs with no impact of the quality of the good or service produced could lead to higher margins, but eventually somebody will respond with a quest for growth and lower prices to capture it. Usually this is a smaller competitor seeking market share gains, but sometimes it is the biggest competitor looking to squeeze the smaller players and drive them out of business.

One narrative is that technology has lowered costs so profits are higher. While it is certainly true that productivity tools of all kinds lead to cost efficiencies, this has always been the case. Why now would this lead to higher profit margins over longer periods of time? Historically, hasn't any kind of productivity tool that is available to everyone become the price of admission versus a permanent increase in margins?





As stated above, competition shouldn't allow this to happen, so this doesn't explain it. If this doesn't get at the point, then the same goes for lower interest expense from government rate manipulation, tax reductions, and any other expense reduction.

If over time margins revert to their historic norms then there is no reason to think profit margins should be permanently elevated. My only caveat is something Jeremy Grantham of GMO has written about which is that the government has been far more accommodating to mergers and acquisitions, thus some bigger companies have acquired their way toward oligopoly industries so the margins *might* be permanently higher going forward. While this is hard to refute, it is impossible to know the extent of the impact (if any) and how much higher margins should be if true. You could certainly broaden it and say there is still no shortage of competitors in most industries so this one is hard.

One last thing here. In a previous commentary, [It's Like Déjà vu All Over Again](#), I showed that there were 33 of the S&P500 companies trading at over 10x market value to revenue, which was getting close to the peak of 36 companies that traded at that value in 2000. To further this point and going broader, the Russell 3000 index tracks the 3,000 largest U.S. traded stocks, which represent about 98% of all U.S. equity securities by market value. Of this group there are now 332 of them that trade over 10x price/sales. Again, not quite at the peak in 2000 but astonishing none the less.

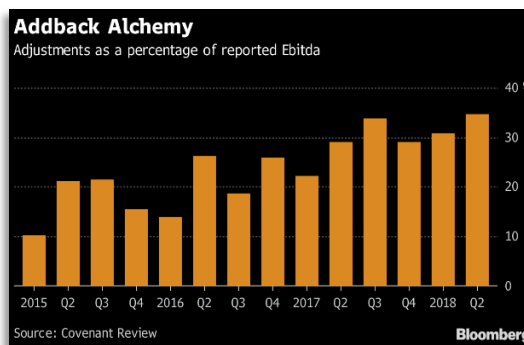
Sub narrative - Non-GAAP earnings are the right way to look at earnings

We are back to one of my favorite topics: pro-forma earnings. That is, GAAP or IFRS earnings + seemingly anything management wants to add back to give investors "a more fair view into our financials" as they all say. In this world, massive write-offs of costs don't count (except for taxes), stock-based compensation and share dilution don't count, nor do many other expenses that corporations try to strip out in order to inflate their non-GAAP EPS numbers and management stock options. Remember, it's about the incentives. Higher (non-GAAP) earnings generally will equal higher stock prices = better for managements with options. Higher stock prices translate into higher assets under management for the asset managers, all else equal, = higher revenue = more profit/bonus. As the saying goes, the fix is in.

As I wrote in my last piece, if you were going to buy a private business with your own money I would bet you wouldn't give the selling company credit for many of their addbacks to the lower GAAP earnings. However, because virtually all of the money that most people manage isn't theirs (different incentives) and it becomes a relative game rather than an absolute game, like with your own money, it is easy to justify to yourself that it is legitimate (willful blindness).

I was recently at a conference where I met with the CFO of a small semiconductor company, who we will kindly leave unnamed. They said they had \$10mm in net income annually. Later they said they were very proud that they used \$10mm in free cash flow annually to buy back shares so the stock options were "neutralized," i.e., not dilutive to shareholders, but shares outstanding didn't go down. I then asked why anybody would ever invest in their company given that they generate no profit post the buyback, which in this case is another way to account for employee compensation. They were stunned by my question and didn't understand. After a few back-and-forths I asked if he were interested in buying this company privately, would he put a multiple on the net income even though they had no free cash flow? He obviously didn't answer, so that was that. The point is that this is commonplace today. Is it the company's fault? Sort of. It is more the fault of investors for not questioning this kind of thing in a more detailed manner and pushing back. Only then will behavior change. Until then, should we look past basic economics and assume in this greater fool theory world of non-GAAP earnings that everything will be okay? Unlike many, we do not. This isn't to say that GAAP earnings are always right and all add-backs are always wrong, but the point is that you need to dig deeper and see what really makes sense.

Going further, every time I talk to a company I ask them how many investors ask about the non-GAAP to GAAP differential in earnings and they all say none. How can this be? With the general thinking about incentives, if you don't know it, let me introduce you to Campbell's Law. It states that the more any indicator is used for decision-making, the more subject it will be to corruption and the more apt it will be to distort the processes it is intended to monitor. So, if management compensation is highly dependent on non-GAAP earnings growth, lo and behold you get more aggressive about what you add back to non-GAAP earnings. Remember the incentive quote above from Charlie Munger. Thus, it won't shock anybody that the differential between non-GAAP and GAAP earnings continues to grow. See the chart to the right.





While this trend is across the board it has gotten out of control in the growthier sectors like tech and health care where the non-GAAP to GAAP earnings premium stands at 65% and 74% as of Q2 2018.

There is a growing chorus of people saying that investments in R&D should be considered more like capital investments with a future payoff, i.e., the costs should be capitalized and amortized over a period of time, as opposed to expensed in the year they are incurred. Leaving aside the uncertainty of that payoff, if you assume the amortization period is 3 years, then outside of rapid growth in R&D versus the amortization of past R&D, in 3 years shouldn't this normalize to be the same as expensing it?

I recently saw the headline on Bloomberg, *Nationwide Taking \$250 Million-Plus Charge to Keep Up on Tech*, which I found strange. Nationwide Building Services, one of Britain's largest home loan providers, just announced they will take a charge of between \$250mm-\$325mm to cover stepped-up technology spending as customers move online. Think about this. Forget the specific expense; they are saying their expenses are going up, but rather than reflect it on their financials they will just add it back and we should pretend it didn't happen and that money wasn't actually spent. Nobody cares. Maybe more interesting is the fact that this company is private. That said, they do have public debt, so it isn't just public shareholders allowing this nonsense, it is also banks and bondholders (willful blindness).

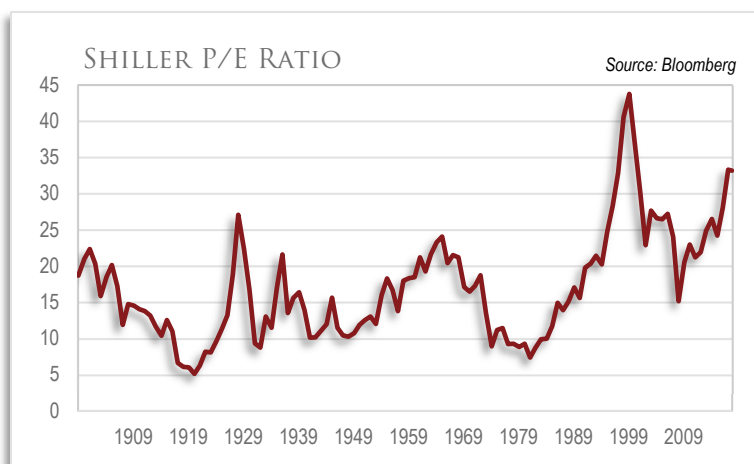
The current price-to-earnings ratio of the S&P 500 is roughly 20.5x based on 2017a, 18x for 2018e and 16.5x for 2019e versus a historical average of about 15x. Keep in mind this is all non-GAAP (but who cares about that) and based on the highest profit margins in history. Should profit margins revert to a more normal historical level, that multiple could soar as the denominator falls. In this scenario there is not only the potential risk of a reversion in valuations, but also a simultaneous reversion in profit margins, at the same time, a scenario that would be doubly painful for equity investors paying current prices. Thus, the premium embedded into today's stock market also assumes profit margins will avoid reverting to historical averages. The Shiller P/E ratio was created by the

economists Robert Shiller and John Campbell to create an actual statistic highlighting the P/E ratio if you used a ten year average profit margin versus only the current margin. Margins in companies move around for a variety of reasons (business mix might equal permanently different margins but more often margins move for cyclical reasons, meaning they are temporary) so this chart should always be taken with a grain of salt, but in the long run one would think the cyclical factors move margins more than structural changes, so it is telling.

To drive home this topic, there was an article in the June, 2018 Harvard Business Review entitled "Why we need to update financial reporting for the digital era" written by three professors from Dartmouth, Columbia and the University of Calgary.

In the article, the authors say companies are facing a "growing divergence between what companies consider as value-creating metrics and those reported as GAAP profits. Many CFOs consider financial reporting to be an exercise in mere regulatory compliance and find the resources spent on audits and financial reporting to be a waste of shareholder money. They consider the calculation of GAAP-based profitability to be more of a hinderance and distraction to their internal resource allocation decisions. One CFO commented that they now avoid inviting company accountants to their strategy meetings, while another said that CPA certification is considered a disqualification for a top finance position."

Take that in for a minute. The authors, professors at very prestigious colleges and many company executives, think understanding accounting is no longer value added at all let alone necessary to be the head of finance. It is more important to be able to be creative with the numbers and focus on using whatever means possible to manipulate your earnings higher (I mean, present a more "realistic" view). Sorry to all the accounting majors and accountants hoping to eventually move to a CFO role. You are too rigid with your understanding of accounting and not creative enough.





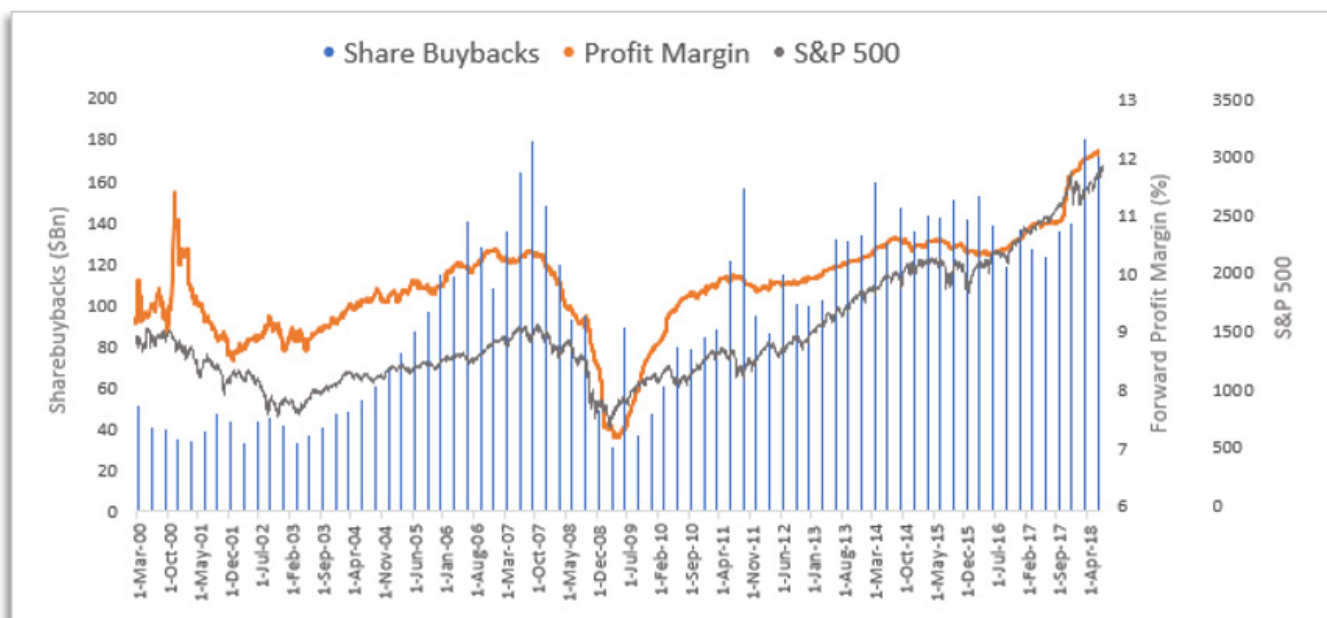
The authors finish with “*Investors are paying more attention to ideas and options than to earnings.*” The easy answer is, of course they are, just as they were in 2000. It didn’t end well then and just because investors think this today, doesn’t mean it is right, or that they always will. Again, Willful Blindness?

To quote ex-President Calvin Coolidge, the saying used to be “the business of America is business.” Now it seems to be that the business of America is figuring out how to drive stock prices higher via earnings manipulations, tax avoidance and stock buy-backs at all-time high valuations.

Sub narrative - The buyback boom is great for earnings growth

In a private business, if your business is doing well, realizing that we are 10 years into an economic up-cycle, and generating high profits, with the stock at all-time highs, would you use your corporate cash to buy out your minority shareholders? That is, you are willing to pay any price to buy back your shares because you are generating profit and your short-term oriented shareholders are telling you to. Or would you sit on the cash until the price of the stock went down and then try to buy the minority shareholders out at a much cheaper price, knowing that things are always somewhat cyclical? Again, why is the behavior of a public company different than a private one? Or does buying your own stock at any price always make sense? As Warren Buffett once said “can you imagine somebody going out and saying, we’re going to buy a business and we don’t care what the price is? You know, we’re going to spend \$5 billion this year buying a business, we don’t care what the price is. But that’s what companies do when they don’t attach some kind of a metric to what they’re doing on their buybacks.” Given this happens every day in size, evidently we can imagine it. The real question is why don’t we as shareholders question it?

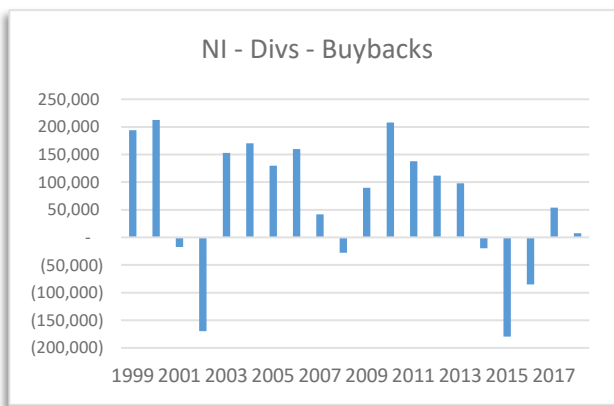
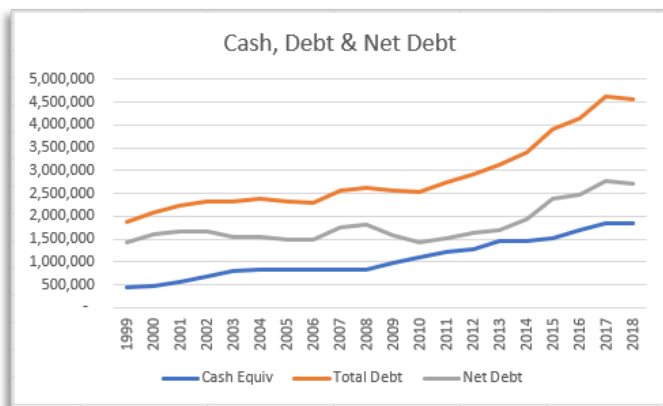
Further, when you look at the chart below, you see how buybacks follow the market. Per the above paragraph, this makes sense. The public shareholders are the boss and given their short time period to see a return, they want the fast upside, so they demand buybacks and dividends when the company earns the cash irrespective of price, as opposed to waiting when the stock is cheaper. The trend line for the share buy-back chart shows the correlation/causation between rising profit margins leading to higher profits (obvious) and thus to higher stock buybacks. That is all logical, but it leads to the uncomfortable truth that when our next recession hits we will have the proverbial double whammy of profit margins surely falling, leading to a massive reduction in stock buybacks, both of which would be bad for stock prices.





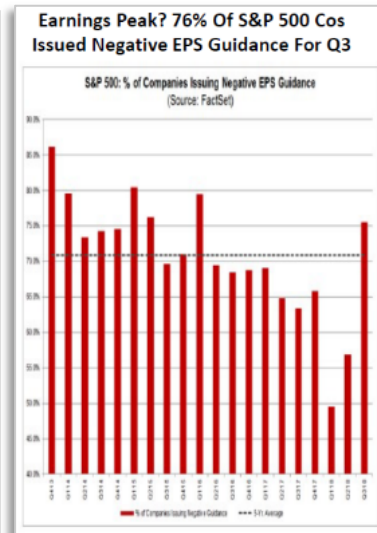
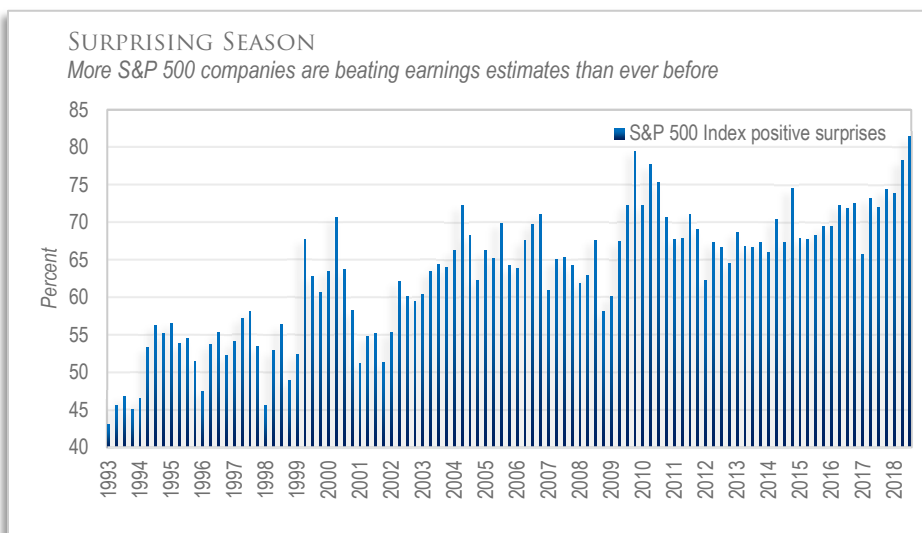
Sub Narrative – U.S. companies have the strongest balance sheets ever since corporate cash is at all-time highs

It seems like you read every day in some financial publication that U.S. corporate cash is at all-time highs, which implies corporate balance sheets have never been stronger. Well, the first part is correct. Cash is at all-time highs, but so is debt, and it has risen faster than cash, so net debt is also at all-time highs (see chart below to the left). This ties to the chart below and to the right showing companies have spent greater than 100% of their net income on buybacks and dividends in recent years. If the economy continues to be great with low interest rates, having debt is no big deal. But if business turns down, either due to company specific issues or via an economic recession, the debt becomes a much bigger problem. I'm not necessarily calling out a problem today, but certainly the risk is higher and the headlines of cash at all-time highs are misleading.



Narrative – Earnings beats is why the market is doing so well

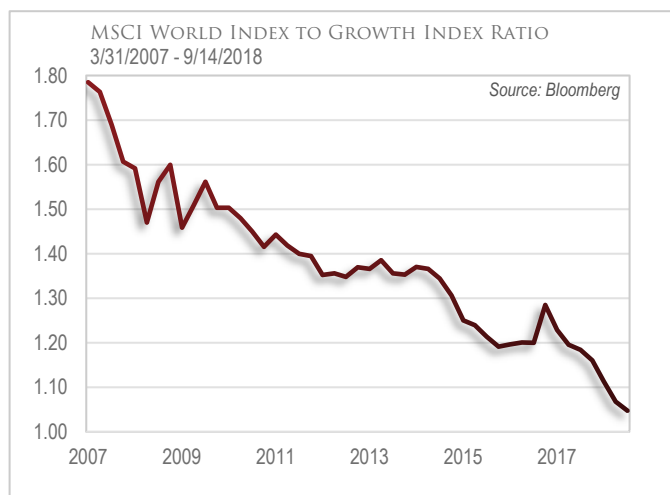
Companies Are Beating Earnings Estimates at Historic Clip, read a Bloomberg article in April 2018 (see chart on bottom right). The implication is that corporate earnings are booming, thus the economy is booming. While the U.S. economy is going well which should translate to good corporate earnings, we also have the one-time effect of the Trump tax laws on earnings. It is also instructive to think about the math as it relates to these kinds of articles. Based on the chart below to the left 80% of companies beat earnings in Q1 of this year. That is truly impressive. But when you look at the chart it looks like 60%ish is the average, over the past 25 years. Shouldn't the average be around 50%? If not, shouldn't the question be earnings are "beating" what? See the chart on the bottom right. 76% of public companies in the U.S. gave negative earnings guidance for the quarter. More impressively, the average of the past many years is 71%! So 70-something percent of companies give negative guidance to lower estimates, then magically 60-something percent of companies "beat" the earnings estimates. How insane is this game? And yet the media reports on it as if things are stupendous and it isn't a game.





Narrative – Growth beats value / tangible book value doesn't matter

The chart below on the left shows the MSCI world value index to growth index ratio from 2007 to the present. It is a clear story; growth beats value. The chart on the right is the same ratio, but from 1975 to the present, which shows a very different story, other than the last 10 years. To be clear, growth is a wonderful attribute in a company. The key is not overpaying for that growth, which is prone to disappoint for most companies. While growth has outperformed for the past 10 years, always bear in mind the famous quote by Sir John Templeton, “the four most dangerous words in investing are ‘this time it's different’.”



The chart below is somewhat interesting since it uses a rolling 10-year average. It is probably more of an accurate depiction of value versus growth since the main attribute is price-to-book, whereas the MSCI value and growth buckets above are harder to determine how they are being allocated.



Further, in a WSJ article on 9/10/18, according to data from Dartmouth College Prof. Kenneth French over the past decade growth stocks (as presented by the 50% of U.S. stocks with the highest price-to-book ratio) beat value by 1.9 percentage points annually. That's a reversal from the previous eight decades, in which value stocks (50% of stocks with lowest price-to-book ratio) beat growth by 4.6 percentage points annually.



While there are many partial truths about why book value, and more specifically tangible book value, doesn't matter anymore (the big tech companies are monopolies and book doesn't matter, buybacks distort book equity, acquisitions create goodwill and thus diminish tangible book value, etc.) it is hard to fathom that book value doesn't matter at all any more. In the U.S. it has gotten so extreme that the S&P500, ex financials, now trades at 25 times tangible book value.

In my last piece, [That Word](#), I wrote about the accounting shenanigans at IBM. Let's touch on another huge, very well respected U.S. company, General Electric. In 2009, when the share price was last at \$12.50 (down from its all-time high of \$58 in 2000 but up from the low of \$8.50 in 2009), GE was sitting on a perfectly respectable \$48 billion (bb) of tangible book. The balance sheet today reveals a negative \$47bb of tangible book - a \$95 billion dollar swing in less than 6 years. The question is, where has all the tangible book (and more) gone? Since 2009 GE has generated \$48.8bb in net profits, but has paid out \$42.5bb in cash for its relentless stock buyback program and further dished out \$73bb in dividends. Add those generous distributions up and GE has 'returned' \$115bb to shareholders since 2009 – 2.35 times or \$67bb more than it has generated in net profits. The remaining \$28bb of 'missing' tangible book has gone to goodwill for acquisitions. With all this said, since 2009 revenue has gone from \$154bb to \$120bb expected this year and net income has gone from \$11bb to roughly \$7.6bb expected this year. Their balance sheet is tough to parse given their finance business, but their total cash less the non-financial preferred stock and debt has gone from \$8bb of net debt in 2009 to \$41bb today. The end result is net debt is up huge, positive tangible book has turned into a big negative, revenue is down more than 20% and net income is down by a third. Lastly, remember the stock is at \$12.50. When you take the money spent on buybacks divided by the shares removed, the average price per share for the buyback was \$30. Nicely done. Given many companies are spending more on buybacks and dividends as shown earlier, GE is not alone here. At least the market recognizes this destruction of value with the stock down huge.

If it isn't painfully obvious, people are emotional beings and it seems human nature takes the good times and makes us think they will only get better and go on for a long time, while bad times will only get worse and also go on indefinitely; the same goes for the stock markets. It is a collective place where human emotions are displayed every day. At the bottom, people can't imagine it will get better.

- In 1987 the S&P fell 32% over 2 months and the mood was obviously terrible. Who would have guessed the market would be up 580% over the next 10 years?
- In 2002 the S&P500 fell 32% over 10 months. Who would have guessed the market would be up 100% over the next 5 years?
- From May 2008 to March 2009 the S&P fell 50%. Who would have guessed the market would be up over 325% to now? Very few is the answer.

This is all because of the emotions described above. Going back to the beginning of this piece, a key success driver of good money managers is the ability to be less emotional and cut through to the fundamentals, both at the top and the bottom. After a 325% upward move (now), don't you have to then be worried about the market being at a short-term top?

I will lastly point out that it is at the market highs that you get quotes like this. In the August 19th, 2018 Wall Street Journal there was an article about growth stocks and it quoted a portfolio manager at Franklin Templeton, "I don't talk about multiples. That's where the conversation stops." Conversely, for Kopernik, multiples and value is where the conversation begins.

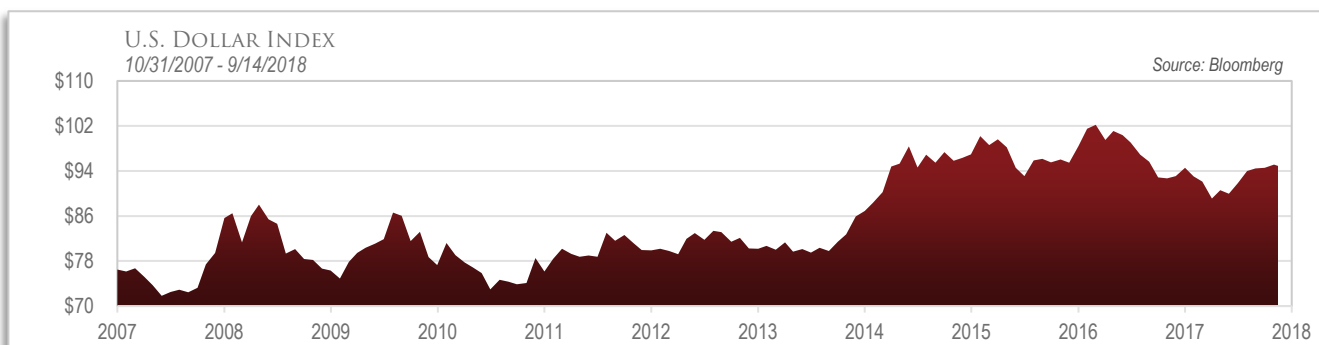
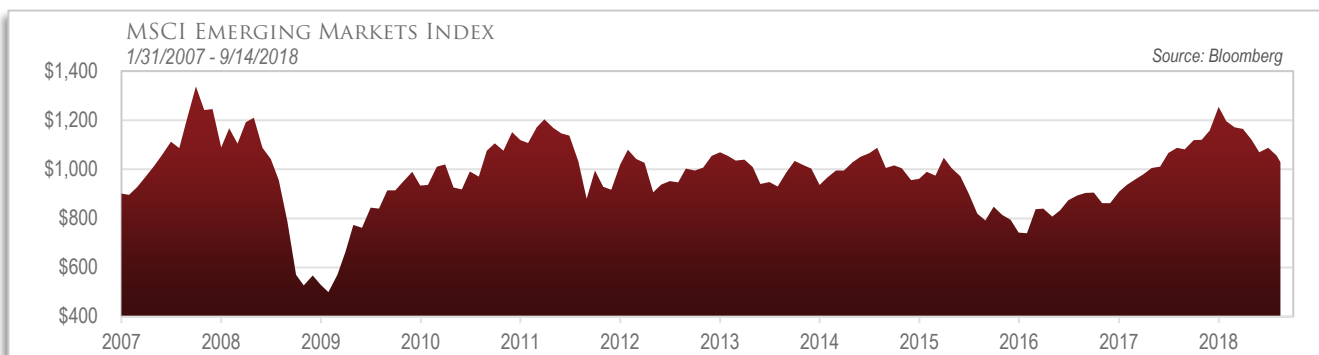
Sub Narrative - Volatility is low, especially in the U.S. / Breadth is fine

In my previous piece, [I Don't Get It](#), I showed how in 2017 there were 6 days total where the index was up or down 1%+. This was by far the all-time low in terms of number of days. Through mid-September 2018 we have had 36 days of the S&P500 index being +/- 1%. Yet, the implied volatility on a put option for the S&P500 is currently less than 8.9% compared to 6.2% at the all-time low. There is a disconnect here between the actual volatility and the implied volatility. The low implied volatility is also masking the fact that the breadth of the U.S. market, while better in the last month or so, is still terrible for the year. Tech and Consumer Discretionary (Amazon) is still driving most of the gains. Right now is one of only three times in history that there are more 52-week lows than 52-week highs in the S&P500 when the market is at an all time high. The prior two periods (1980 and 1999) had tough times follow so we will see how this plays out.



Narrative – Emerging Markets are down for the count and EM trouble doesn't affect the developed world, including the U.S.

A chart of emerging market stocks over the past 10 years shows they are down 25% in US\$ from the peak. The narrative is that EM stocks are too risky and bad (top chart below). It is a far cry from circa 2010 when the BRICs were all the rage. Now Brazil is deemed a corruption mess, Russia is uninvestible, India is ok but reforms are too slow and China manipulates its economy and is too risky. When you look at the US\$ index (bottom chart below), it is up almost 25% over the same time period. This would imply that EM equity returns are only tied to the US\$ and only go down, so why own them? Maybe a better narrative is that the U.S. dollar only goes up over the long run.



Let's start with some facts.

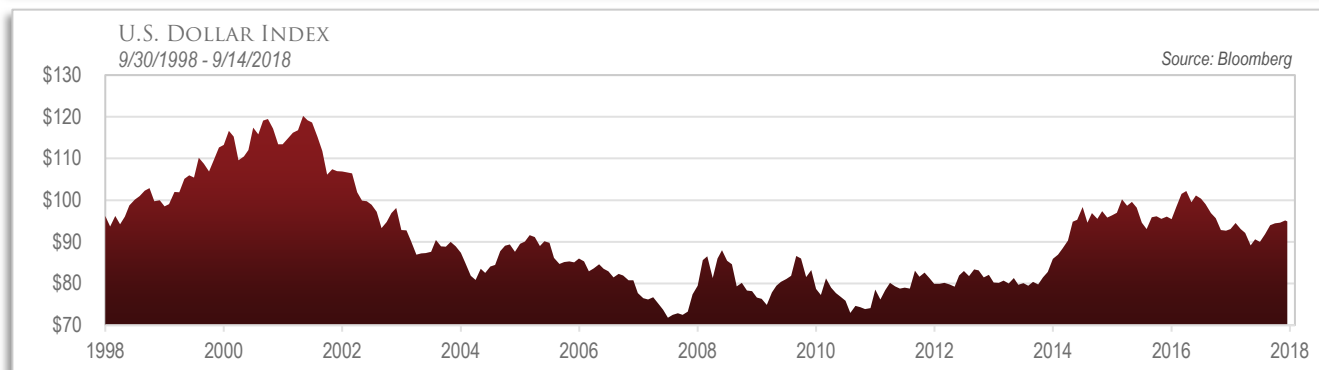
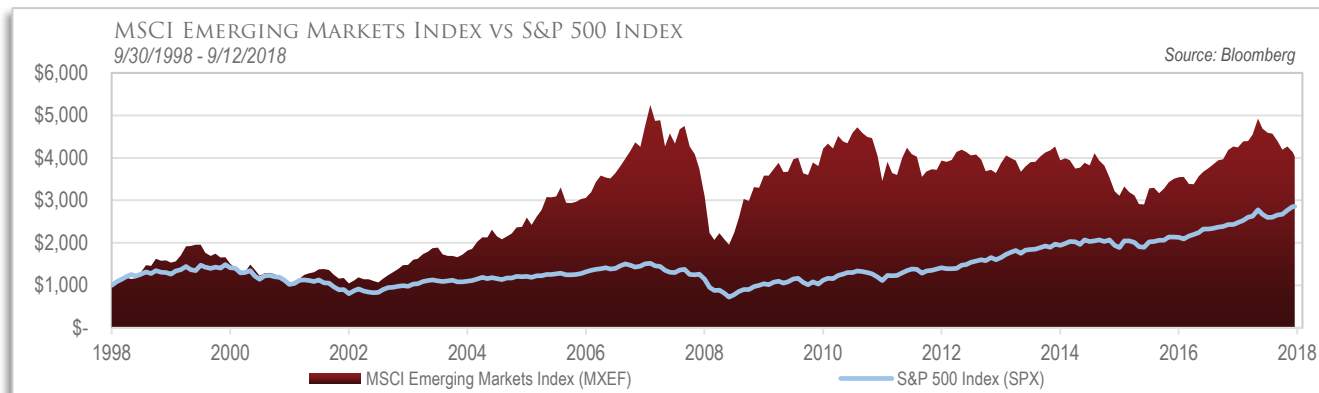
- The 20 year average real GDP growth for emerging markets is 5.5% versus 2% for developed markets.
- The 20 year average real income per capita growth for EM is 7.2% versus 3.2% for DM
- The population of EM is over 6bb versus 1.25bb for DM so positive relative growth in EM matters more for the world. Further the EM population skews far younger than DM which means more productive years ahead for their population.
- Debt (total gov + private) / GDP = 211% for emerging markets vs 380% for developed markets (IMF World Economic Outlook 2018). This said, clearly the funding currency of the debt matters enormously. If your company sells in dollars and your debt is in dollars, that is fine. But if not, it is a big risk as we are seeing in Turkey, Argentina and some other EMs. As ex-CLSA strategist, Russel Napier, recently wrote "There is something much more important and insidious undermining these exchange



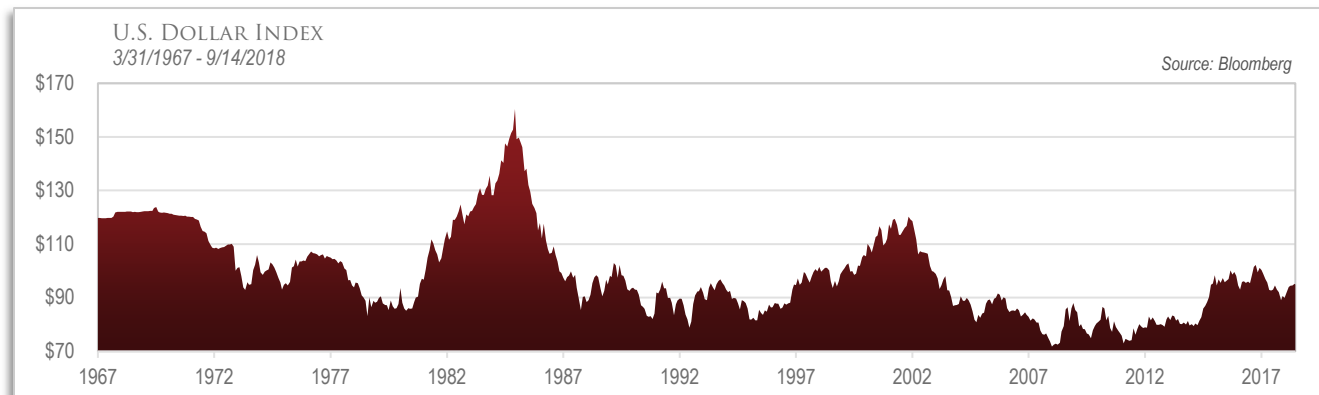


rates: the rise of the rule of man and the decline of the rule of law.” In other words, politics matter and this is magnified when the government tries to grow its power since they think they know more than the population as a whole, or are flat out just seeking power and corruption, although they will never say that. This is clearly a relative statement since governments around the world think they know better than the collective population, including in the U.S. Certainly the risks in the short run are higher in EM land, so caution is always warranted, and it always comes down to price and value.

All that said, when you take a longer horizon (20 years in the charts below), you clearly see that EM stocks have outperformed, and maybe more surprising is that the U.S. dollar is actually down worldwide over that time frame.



When you go back 50 years (chart below) the dollar has lost over 20% since 1967 and 38% from the peak in 1984.





Now for the all-important valuations.

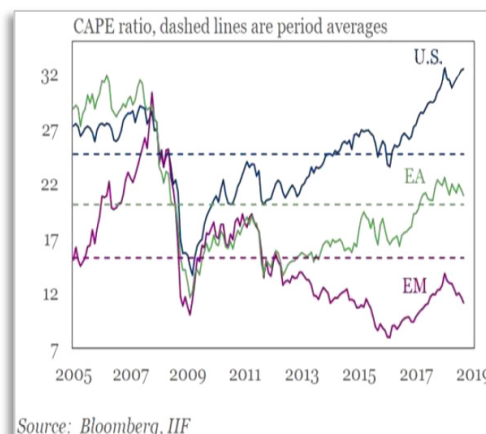
	2018 P/E	2017 P/E	2018 P/Book	2017 P/Book	2018 P/Sales	2017 P/Sales
Emerging Mkt	13.1x	15.2x	1.6x	1.7x	1.3x	1.4x
Developed Mkt	18.8x	20.1x	2.5x	2.4x	1.7x	1.7x

So EM countries have stronger balance sheets, less debt and their companies have faster growth and valuations are cheaper. That doesn't sound like a recipe for disaster to us.

As Warren Buffett once said, the key of investing is to "be fearful when others are greedy and greedy when others are fearful." We have been underweight (fearful) with the euphoria (greed) in developed market stocks (especially the U.S.) and we have been overweight (greedy) and becoming more so (greedier) as emerging markets continue to falter, as others have gotten more fearful in EM. As is common with true value managers, we were probably early with some of our stock picks, but over the long run we are confident that the corporate fundamentals and lower valuations will pay off.

If you get caught up in the narrative that EM downdrafts are independent of the U.S. stock market, here are a few data points for you showing that it is usually the EM stocks (in US\$) that lead the U.S. stocks down.

- From 10/07 to 10/08 the MSCI ACWI EM index fell 66%
 - From 10/07 to 3/09 the S&P500 fell 57%
- From 7/97 to 9/98 the MSCI ACWI EM index fell 59%
 - From 7/98 to 10/98 the S&P500 fell 20%
- From 3/00 to 9/01 the MSCI ACWI EM index fell 54%
 - From 9/00 to 10/02 the S&P500 fell 49%
- From 01/18 to the present the MSCI ACWI EM index is down 20%.
 - Future of S&P500 ??



Based on the above data, when EM stocks falter the U.S. seems to follow, with a small lag, so why would this time be different? Here are just a few of the U.S. market risks: EM currency issues means a strong U.S. dollar which is bad for U.S. exports, Trump trade conflicts, rising interest rates, quantitative tightening, rising oil prices, already unsustainable U.S. budget deficits on the rise, inflation touching 3% and rising (albeit everything we buy is going up faster than this), and political uncertainty coming in the next mid-term election are just a few of the risks. Since earlier I showed the 10 year average margin P/E chart (Shiller) for the U.S. going back to almost 1900, above is one showing the same index (also called CAPE for cyclically adjusted P/E) comparing the U.S. to other markets including EMs. You can see where the value is.

Narrative – Russia is evil

While less about the market and more about political narratives (i.e., Russia is pure evil and uninvestible), we at Kopernik have long said there is much to be afraid of in Russia, but it is all about the risk/reward trade-off. You have to be able to step back and see that some of the finger pointing at Russia is purely political. Again, when you question the common narrative, you might come to different conclusions or at least realize it is not so obvious.

In 1996 Russia had an election. Boris Yeltsin was running for re-election but his approval ratings were in the single digits given this was just after the Soviet collapse and a war in Chechnya. At the time President Clinton was quoted as saying "I guess we've just got to pull up our socks and back ol' Boris again. I know the Russian people have to pick a president, and I know that means we've got to stop short of giving a nominating speech for the guy but we've got to go all the way in helping in every other respect."



Many senior members of the U.S. Government publicly praised Yeltsin as a world-class statesman, defended Yeltsin's tactics in Chechnya and actually compared him to Abraham Lincoln for keeping a nation together. The U.S. even defended Yeltsin by saying he bent over backwards to avoid bombing the Russian Parliament in 1993, which reportedly killed 2,000 people. The U.S. lobbied the IMF to give Russia a \$10.2bb injection of cash, which, of course, they did. One of the candidates running against Yeltsin was quoted as saying American diplomats persuaded him to drop out of the race. According to Time Magazine, American political consultants were hired by Yeltsin's campaign for advice on "sophisticated methods of polling, voter contact and campaign organization. They also organized focus groups and designed advertising messages aimed at stoking voter's fears of civil unrest." [Read that again.](#) Does that not sound exactly like what we are accusing the Russians of doing in our last election, via Facebook? That said, as reported by the NY Times, the Washington Post, the LA Times and USA Today the Russians spent \$100,000 on Facebook ads total. How much of an impact could that really have had when, according to the Washington Post, political spending by the two presidential candidates, and associated super PACs, exceeded \$2bb in 2016?



In 1996 when Yeltsin won re-election Time Magazine put him on the cover holding an American flag with the story headlined "Yanks to the Rescue: The Secret Story of How American Advisors Helped Yeltsin Win." This was the basis for the 2003 Hollywood movie, "Spinning Boris," starring Jeff Goldblum, Anthony LaPaglia and Liv Schreiber. So we are accusing the Russians, on a far smaller scale, of doing exactly what the U.S. did in Russia in 1996. While I think all politicians are essentially bought by special interests at the highest levels, they can't be stupid enough to not see the irony here. Or as logic would dictate, it is purely politics.

Perhaps you remember the "Chinagate" scandal in 1998 where a Chinese-American, Johnny Chung, was convicted and sentenced for campaign finance violations, bank fraud and tax evasion for giving \$300,000 to a U.S. presidential campaign, which was sourced directly from the head of China's military intelligence agency. Where was the outrage and sanctions on China? The list is long of stories like this, let alone where the U.S. meddled in other countries' elections.

Lastly, if you haven't read it, the 2015 book, *Red Notice*, by Bill Browder is a "true" story of how he invested and earned outrageously good returns in Russia in the post-Soviet collapse. This caused the vindictive and nasty Russians to come after Mr. Browder and everybody associated with him for their success and concludes with his Russian lawyer fighting tax fraud charges and subsequently being murdered in a Russian prison. Mr. Browder then used all his political capital to have a bipartisan bill, named The Magnitsky Act, named after his late lawyer, passed by the U.S. Congress and signed by President Obama which sanctions human rights offenders by freezing their assets and banning them from entering the U.S. It is a compelling story, but after reading it, I was left thinking it didn't quite add up.

There is a docudrama that was released a year later in 2016, directed by a Russian, Andrei Nekrasov, who clearly was no fan of Putin based on his interviews and previous work, entitled, *The Magnitsky Act – Behind the Scenes*. He was essentially trying to bring the story from the book, *Red Notice*, to film. The making of the film was supported by Mr. Browder and he was interviewed extensively for the movie. As Mr. Nekrasov was fact checking while making the movie he came across numerous inconsistencies with Mr. Browder's story. As with almost everything in today's politicized world, it is hard to know what is true and what isn't, but I will say that the film points out many specific facts to at least make you think. At a minimum Mr. Browder's story isn't quite right and worst case it shows that Mr. Browder is guilty of tax evasion and the whole story was a deflection of his guilt. If you have trouble finding this movie, it is because Mr. Browder was politically able to have it banned in the U.S. and Europe. In countries that constitutionally protect free speech, how was that done? Politics clearly trump all (no pun intended). That said, if you read the book you should try to find a copy of the movie. It is well worth the time to watch. There is also a book that goes even further and directly points the finger at Mr. Browder for Russian tax evasion entitled, *Grand Deception: The Truth About Bill Browder, the Magnitsky Act, and Anti-Russian Sanctions* written by Alex Krainer. For some reason, you can only find this from the original publisher's web site, but not on Amazon.com.

In the outstanding 2007 action movie, *Shooter*, starring Mark Wahlberg as an ex-military sniper hired as a consultant by the U.S. Government but soon is framed for murder and trying to prove he was innocent, he goes to visit a ballistics expert. After describing the ballistics technique used to frame Wahlburg's character, the ballistics expert says "They (the U.S. Government) also said artificial sweeteners were safe, WMDs were in Iraq and Anna Nicole married for love. ... The moment you think you got it figured, you're wrong." Finishing with "The world ain't what it seems, is it gunny?" This is similar to today. The political, economic and company narratives are strong and we at Kopernik try to look through the narrative and think the world 'ain't what it seems.'



I will end with a quote from *Bill & Ted's Excellent Adventure*, a ridiculous 1989 comedy that follows two dim-witted friends Bill (Alex Winter) and Ted (Keanu Reeves), who travel through time to kidnap historical figures for their high school history presentation. As they are going back in time to pick up the Greek philosopher Socrates, Bill tries to look up who he was. He finds some information and reads to his friend, Ted:

Bill: "So-craitz. 'The only true wisdom consists in knowing that you know nothing.'

Ted: "That's us, dude."

I won't say Kopernik knows nothing, but said another way, we know enough to constantly question the common narratives and keep our eye on quality companies trading at prices that are below their risk-adjusted intrinsic values. To quote Lew Rockwell, an American author and founder of the Ludwig von Mises Institute, "if credit expansion, protectionism, and government spending were a path to prosperity, mankind would have long ago created heaven on earth."

Thanks again for your support.

Mark McKinney

Co-Portfolio Manager – Kopernik International Fund/Analyst

Kopernik Global Investors, LLC

September 2018



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