



## It's Still Rock and Roll to Me

*"What's the matter with the clothes I'm wearing?  
"Can't you tell that your tie's too wide?"  
Maybe I should buy some old tab collars?  
"Welcome back to the age of jive.  
Where have you been hidin' out lately, honey?  
You can't dress trashy till you spend a lot of money."  
Everybody's talkin' 'bout the new sound  
Funny, but it's still rock and roll to me"  
-Billy Joel*

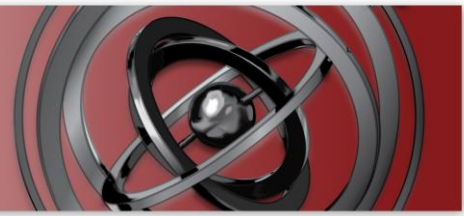
Equities are aggressively priced. Bond prices are obscene. But we are told not to worry because we live in a low-risk, high-potential world. Omnipotent central bankers have the financial-markets' backs, Neo-Keynesian politicians have eliminated the business cycle and will provide for all, the mapping of the genome and biotech industry in general will eliminate disease while creating untold jobs and wealth, robotics will replace menial jobs with material wealth, and commodities will be forever in oversupply. While we believe that Keynesianism and monetarism are in the process of earning their just notoriety for posterity, we are big fans of technological progress, but believe 'twas ever thus.' Progress is often erroneously used to justify dangerous securities price levels. We agree with Mr. Joel:

*"It's the next phase, new wave, dance craze, anyways  
It's still rock and roll to me"*

This Commentary is about cyclicity, a seemingly forgotten phenomenon. And yet, it is such an inescapable part of nature. This note appears to be timely; as we go to press, ["Bloomberg reports momentum stocks, or shares with the most price appreciation in the last 2-12 months, are rising three times as fast as the S&P 500 this year, on par with the best years ever recorded."](#) That's right, people are buying things because they have gone up a lot and selling things because they have gone down a lot! Trendiness is at near record levels in the marketplace! This is truly a market with an **extraordinarily** high level of peril and of opportunity. Before getting to a discussion of business cycles and market cycles, it makes sense to start with the most fickle and ruthless of all - the fashion cycle. Whether it be clothes, entertainment or currencies, tastes are unpredictable and ever changing. One day Nehru jackets are hip, later they're the object of jokes. Blue jeans are in, then out, then in. Hemlines go up and down, some say with the stock market (there is a hemline index). Following fashion has become an industry unto itself.

*"Dirty little secrets  
Dirty little lies  
We got our dirty little fingers  
In everybody's pie  
We love to cut you down to size  
We love dirty laundry"  
-The Fed-Don Henley*

With Don Henley's help, we transition from the type of cloth that covers people, to the type of cloth that covers financial obligations, 'legal tender.' In the modern, designer crazy world, nothing seems to be more "de rigeur" than fiat currencies. And the U.S. dollar is the currency du jour! The left-handed compliment, **"it's the cleanest dirty shirt in the hamper!"** is often bantered about in tones suggesting the highest praise. In fact, the dollar should require much more legitimate accolades to justify the lofty heights to which it has risen. At any



rate, it's hard not to recall Hans Christian Andersen's famous parable, "The Emperor's New Clothes." Here's a slightly doctored version of the ending:

*So off went the Emperor in procession under his splendid canopy. Everyone in the streets and the windows said (In comparison to all the others), "Oh how relatively clean is the Emperor's dirty shirt." Nobody would confess that he couldn't see any shirt at all, for that would prove him either unfit for academia, or a fool. No costume the Emperor had ever worn before was ever such a complete success.*

*"But he hasn't got anything on!" a little child said.*

*"Did you ever hear such innocent prattle?" said its father. And one person whispered to another what the child had said, "He hasn't anything on. A child says he hasn't got anything on."*

*"But he hasn't got anything on!" the whole town cried out at last.*

*The Emperor shivered for he suspected they were right. But he thought, "This procession has got to go on." So he walked more proudly than ever, as his nobleman held high the train that wasn't there at all.*

The story is apropos. The quantity of dollars has quintupled in recent years and yet we are told that it has lost no soundness and is perfectly safe. We are told to disregard the prices of tuition, healthcare, collectibles, stocks, bonds, housing, and art in deference to the CPI index that the government publishes. As our namesake, Copernicus, always did, we employ our own analysis. Exhibit number one, the data in the following table, addresses how "clean" the financials are that adorn the sovereigns of the contemporary era:

Country	Currency	Shadow Gold Price*	Public Debt (% of GDP)	Total Liabilities/ GDP \$	Trade Balance (\$Billion)	Budget % GDP (2014)	MB Growth % 2005-2015
ECB	Euro	4.1	91.9%	-	27,298.0	-2.4%	130.18%
US	Dollar	15.4	71.8%	303%	-53,495.0	-5.5%	445.5%
UK	Pound	10.5	91.1%	158%	-9,669.6	-5.0%	76.2%
GER	Euro	3.3	79.9%	137%	16,378.5	0.3%	112.6%
FRA	Euro	9.3	93.4%	128%	-5,294.2	-4.4%	66.7%
NOR	Krone	-	30.1%	149%	3,806.2	10.7%	133.5%
SWISS	Franc	13.1	33.8%	187%	4,390.7	0.4%	874.7%
BRZ	Real	35.5	59.2%	205%	-4,150.8	-3.6%	264.1%
RUS	Ruble	3.1	7.9%	119%	9,134.5	-1.0%	484.2%
INDIA	Rupee	20.4	51.8%	73%	-16,888.9	-7.6%	713.9%
CHINA	Yuan	86.8	22.4%	157%	54,477.0	-1.0%	451.5%
AUST	Dollar	26.3	75.7%	117%	-2,040.1	-3.4%	122.1%
JAPAN	Yen	97.0	226.1%	294%	-7,702.9	-7.1%	153.6%

\*Price required to fully back the currency

Sources: tradingeconomics.com, IMF, Gold.org, World Fact Book Central Intelligence Agency (cia.gov), Bloomberg, Sdw.ecb.europa.eu (European Central Bank Eurosystem)

Glancing at the chart, several facts jump out. None of the "shirts" are clean. Maybe new Fab, with action enzymes, lemon-freshened borax, would help. And, in comparison to its hamper-mates, we'll leave it to the reader to decide if the U.S. Dollar looks cleaner, the same, or dirtier. Or, perhaps the above chart details the apparel at a nudist camp. That being as it may, the world's investment fashionistas, who had such contempt for the dollar four years ago, now effectively rave that it is "to die for." Fashion being what it is, this will probably turn out to be a poor time to build a large inventory of greenbacks. "Green" could become "so yesterday."



It appears that the dollar is overly esteemed, even before exploring the interesting topics of whether the U.S. has gone too far in its abuse of privilege regarding reserve currency status, whether the petro-dollar is under attack, or the possibility of the Yuan, the Euro, or SDRs (Special Drawing Rights) becoming reasonable alternates. The fashion cycle that we find most interesting, and of longer duration, does not pertain to the trendiness of one fiat currency versus another, but to the length of time that the public finds baseless money to be chic. It appears that credulity is also cyclical. Hans Christian Andersen's tale, reprinted below using significant artistic license, continues to be a useful metaphor for the current tragedy that is central banking (feel free to skip the next few pages, we're looking for humor in the current situation):

*Many years ago there was an Emperor so exceedingly fond of "guns and butter," as a previous Emperor had been a half-century prior. He spent all his money on both social programs and on policing the world. In the great city where he lived, life was always gay. Every day many strangers came to town, and among them one day came swindlers. They let it be known they were weavers, and they said they could weave the most magnificent fabrics imaginable and pass it off as money. Not only were their colors and patterns uncommonly fine, but currency made of this cloth had intrinsic value that was invisible to anyone who was unfit for his office, or who was unusually stupid.*

*"That would be just the currency for me," thought the Emperor. "If I print it, I would be able to discover which men in my empire are unfit for their posts. And I could tell the wise men from the fools. Yes, I certainly must get some of the currency woven for me right away." He paid the two swindlers a large sum of money and put them in charge of the central bank.*

*They set up two printing presses and began to print, though there was no substance backing what they printed. All the finest gold which they demanded went into their traveling bags, while they printed baseless chit far into the night.*

*"I'd like to know how these bankers are creating this value," the Emperor thought, but he felt slightly uncomfortable when he remembered that those who were unfit for their position would not be able to see the value. It couldn't have been that he doubted himself, yet he thought he'd rather send someone else to see how things were going. The whole town knew about the central bank's power, and all were impatient to find out how stupid their neighbors were.*

*"I'll send my Nobel prize winning academics," the Emperor decided. "They'll be the best ones to tell me how the economics work, for they are accomplished men and no one articulates their view better."*

*So the acclaimed economists went to the Fed, where the swindlers sat working away at their baseless money. "Heaven help us," they thought as their eyes flew wide open, "we can't see any value at all". But they did not say so.*

*The swindlers begged them to be so kind as to come near to approve their excellent theories and beautiful programs. They pointed to the debt-based backing, and the poor old economists stared as hard as they dared. They couldn't see anything of intrinsic worth, because there was none to see. "Heaven have mercy," they thought. "Can it be that we're fools? We'd have never guessed it, and not a soul must know. Are we unfit to be professors? It would never do to let on that we can't see the value."*

*"Don't hesitate to tell us what you think of it," said one of the Reserve Board Members.*

*"Oh, it's beautiful - it's enchanting." The old economists peered past their gray beards. "Such a pattern, what spin! We'll be sure to tell the Emperor how delighted we are with it."*

*"We're pleased to hear that," the swindlers said. They proceeded to name all their strategies such as "quantitative easing" and "operation twist" and to explain the intricate patterns. The old professors paid the closest attention, so that they could tell it all to the Emperor. And so they did.*

*The swindlers at once asked for more money, more silk and gold thread, to get on with their printing. But, as Gresham's Law predicted centuries before, all the gold went into their own pockets, and also was purchased by central bankers afar. Not an ounce of gold went into the economy, though they conjured new money as fast as ever. (Interestingly enough, our namesake Copernicus predated Gresham in predicting that undervalued money will disappear from circulation while overvalued money will flood into circulation.)*



The Emperor presently sent another 'trustworthy' official, the "Fourth Estate," to see how the work progressed and how soon it would be ready. The same thing happened to them that had happened to the minister. They looked and they looked, but as there was nothing in the vaults, they couldn't see anything tangible.

"Isn't it a beautiful piece of paper?" the swindlers asked themselves, supporting their assertion by displaying their imaginary numbers.

"We know we're not stupid," the journalists thought, "so it must be that we're unworthy to opine. That's strange. We mustn't let anyone find it out, though." So they praised the concept they could not visualize. They declared they were delighted with the beautiful economy and the exquisite growth. To the Emperor they said, "It holds us spellbound."

All the town was talking of this splendid monetary policy, and the Emperor wanted to understand it for himself while it was still being pressed. Attended by a band of chosen men, among whom were his two old trusted officials—the ones who had studied the Fed—he set out to see the two swindlers. He found them printing with might and main, but without a thread more gold in the vaults.

"Magnificent," said the two officials already duped. "Just look, Your Majesty, what art! What design!" They pointed to the empty hypotheses, each supposing that the others could understand the stuff.

"What's this?" thought the Emperor. "I can't see anything of value. This is terrible!

Am I a fool? Am I unfit to be the Emperor? What a thing to happen to me of all people! - Oh! It's very impressive," he said. "It has my highest approval." And he nodded approbation at the empty data and commended them for having "saved the financial system from unparalleled disaster." Nothing could make him say that he couldn't see how it made any sense.

His whole retinue stared and stared. One saw no more than another, but they all joined the Emperor in exclaiming, "Oh! It's magnificent," and they advised him to finance pensions, and transfer payments for food and ~~Emperor care~~ healthcare, and foreign campaigns, and pet projects, and of course pork barrels of all shapes and sizes. All enabled by the new miracle paper. "Magnificent! Excellent! Unsurpassed!" were banded from mouth to mouth, and everyone did his best to seem well pleased. The swindlers were knighted and given titles like "Sir Printer" and "Maestro."

Before the procession the swindlers sat up all night and burned more than six candles, to show how busy they were finishing the Emperor's new money. They pretended to have an 'exit strategy.' They implemented a "taper", while simultaneously coordinating cuts in rates abroad. And at last they said, "Now the Emperor's new funds are ready for him to spend."

Then the Emperor himself came with his noblest noblemen, and the swindlers each raised an arm as if they were holding something. They said, "These are the productivity numbers, here's the CPI, and this is the mantra," naming each attribute. "In substance, the substantiating data are as light as a spider web. One would almost think QE had no adverse side effects, but that's what makes it so fine."

"Exactly," all the noblemen agreed, though they could understand nothing, for there was nothing to understand.

So the Emperor's procession continues to this day. Everyone in "the Street" and in the windows say, "Oh, how fine is the Emperor's new money! Doesn't it fit society's needs, to perfection? And see the long, profitable carry trade!" Nobody would confess that he couldn't see deflation, for that would prove him either unfit for his position, or a fool. No scheme the Emperor had sworn to before was ever such a complete success for the top 1%.

Sooner or later, it is inevitable that "one person will whisper to another what the child had said, "He hasn't anything on. A child says he hasn't anything on."

"But he hasn't got anything on!" the whole town will cry out at last.



## Money for Nothing

Continuing with a focus on money, over and over in history, the cycle repeats. Mankind searches for The Philosopher's Stone, the ability to turn lesser substances into gold. And why not, gold is an ideal form of money, partly because it is scarce and hard to come by. It doesn't hurt that it is divisible, precious, noncorrosive, beautiful, and tried and true. Rather than earn wealth, alchemists have tried to create gold, governments have clipped the edges of gold coins, and charlatans have created "money" by fiat. As the cycle expectedly goes, new currency begins life backed by something of tangible value, often a precious metal. With the passage of time governments succumb to the temptation to cheat, issuing incremental currency in amounts vastly exceeding the metal available for its backing. Politicians often find cheating a little bit here and there much more palatable than asking voters to pay tax or forego largess. This fraud usually leads to many positive outcomes early on since the currency is still readily accepted by the public, who remain blissfully unaware of the devaluation. More bills accepted at face value creates an increase in "apparent" wealth. Society feels richer, and spends and invests more. The up-cycle increases as the fraud increases. Mark Knopfler wrote facetiously that playing rock and roll was like getting "money for nothing." Rock and rollers, while rolling in the dough probably thought life couldn't be easier. They couldn't have comprehended how easy it is to make money as a central banker. As the last three decades have evolved from the era of MTV to the era of central bankers, Dire Straits should consider an updated version. We offer the following stanzas:

*"Now look at them yo-yo's that's the way you do it  
You become a member of the F.R.B.\*  
That ain't workin' that's the way you do it  
Money for nothing,' making chits for free  
Let me tell you those guys ain't dumb,  
Just tap the keyboard with your little finger  
Conjure up a trillion with your thumb.*

*See the academic at the hearings; what he makes up  
Yeah buddy, his theory's got a lot of hair  
That academics says dump money from a large jet airplane,  
Each speech is making him a millionaire.*

*I shoulda learned to be a banker,  
I shoulda learned 'bout seigniorage*

*They're printing money from nothing  
On which the banks charge fees."*

*-apologies to Dire Straits  
\*Federal Reserve Board*

The past half century has been one of those rare times when the charlatans have boldly gone beyond cheating. A' la the charlatans in Mr. Andersen's fable, they've convinced the financial nobility to proclaim the monetary beauty of nothingness. People who testify to the lack of any intrinsic value in fiat currency are deemed to be unfit for their jobs or just fools. Societies' many cyclical flirtations with unsound money have always ended poorly and eventually people return to the soundness of gold.

We've been using lyrics and fables to make light of the fiat currency mania. When things get painfully ridiculous, it is often best to just have fun with it. But the topic shouldn't be handled too cavalierly; it is serious. People are storing a large amount of their wealth in depreciating currencies that yield nothing. History and logic forewarn us of the dangers. The cycle will turn. An analyst recently referred to gold as being in a 6,000 year bubble. We believe that though men have always flirted with the new thing, when it comes to money they have always eventually *come crawling back* to the tangible, durable, divisible, precious, noncorrosive, beautiful, tried and true form. This time will be no different.



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*"Crawling Back to You  
Ever thought of calling when you've had a few?  
'Cause I always do  
Maybe I'm too busy being yours to fall for somebody new  
Now that I've thought it through  
Crawling back to you"  
-Arctic Monkeys*

While a lot of time has been spent on the Everest-like peak in the monetary cycle to its monumental importance, there are many other cycles that are currently worthy of mention. For example, economies are cyclical. Good times come, good times go, yielding once again to better times. We mentioned previously that when governments begin to cheat, the world appears a richer place. A better place. Markets boom. Often the economy booms. Jobs are created. People spend more. Companies add more capacity to meet increasing demand, thus creating more jobs and more spending as a seemingly virtuous cycle falls into place. "Seemingly" is the operative word since in the real world perpetual motion does not exist. At some point it becomes clear that capacity has been over-built, leading to closures and job loss, and resultant decreased spending and more closures and more job loss, etc. While the down-cycle can be painful, the process of 'creative destruction' leads to a healthier, more productive economy. The chart below suggests that profit margins are at a cyclical peak, possibly a secular peak. Investing currently in high margin stocks, with the expectations that margins will stay this high, is potentially quite risky!

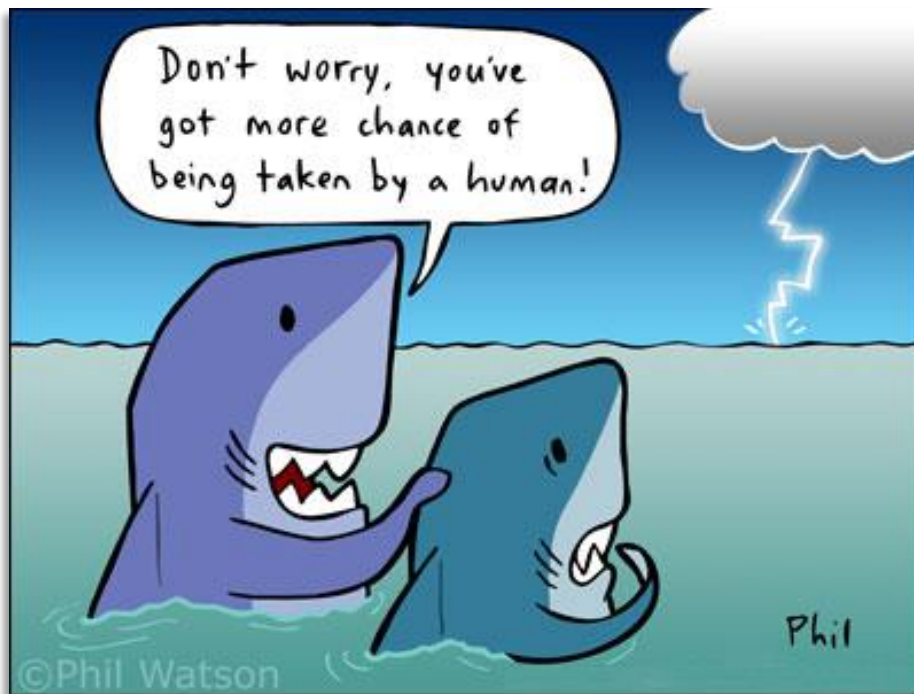




The investment markets are famously cyclical; very cyclical. The upswings are fun, almost intoxicating. But, there's a well-known saying, "don't confuse brains with a bull market." Yet people always do. Similarly, one should be reluctant to "confuse economic prowess with a financial bubble." Don't get us wrong, we have nothing against bubbles and the associated gains in science, technology and the quality of life. They are a natural part of the cycle. The Roaring 20's in the States, and the associated sky-high stock market, provided cheap capital to fund the development of radio, telephone, electricity, automobiles, etc. Japan, during its 1980's absurdity, led many a technological breakthrough. Much of the wonders of the internet would probably still not be available to us today if the 'TMT' bubble during the late '90's hadn't financed many great ideas, which unfortunately lacked economic merit. These are examples of times that made society better off in many ways, but proved to be quite unfortunate for those who invested near the top. Certainly there were winners and losers when Holland boomed during the Tulip-mania episode. This was also the case in France and England during the Mississippi Scheme and South Seas bubble.

Similarly, we believe that the current, massive bubble in currencies, along with the associated bubbles in bonds and healthcare, are contributing enormously to society. Bonds are allowing governments to fund programs that help many but would be absolutely otherwise unaffordable. Obscene prices for biotech company stocks are funding the development of incredible treatments and cures. When the bubble pops, society should still be thankful for the breakthroughs that are being accomplished. Investors will be the ones left with wounds!

*"Step back, here comes the shark attack"*  
-Wailing Souls, Shark Attack



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Risk is a very important topic, perhaps now more than ever. While different individuals have different levels of tolerance for risk, cyclicity plays an important role in terms of understanding and managing risk as well. Each person's own level of risk-tolerance fluctuates, often in response to the length of time since loss was last incurred. People worry about earthquakes and hurricanes more after they occur than they did before they occurred. They're willing to pay more for insurance afterward as well. They misprice risk! Furthermore, it's illustrative to note the inconsistencies of people's attitude towards shopping for goods versus shopping for stocks. Shoppers typically will search endlessly for bargains on clothes and cars and groceries, yet shun bargain prices on common stocks. Perversely, they have shown a strong preference for buying stocks immediately after they've become more expensive. A reverse sale, if you will. But, generally, *price is inversely proportional to risk*. Expensive stocks are more likely to permanently drop in value.

Clearly, people can be quite illogical when it comes to analyzing risk. Maybe Hollywood has been a contributor to people's tendency to obsess about extremely low probability risks; shark attacks are a prime example. At the same time we spend little time worrying about lifestyle factors that contribute to high probability risks such as heart problems or cancer. Humans tend to fret about air travel, but seldom about car travel, which is much riskier. The following data from a quick internet search is illustrative:

Risk	Annual Deaths	Lifetime risk
Heart disease	652,486	1 in 5
Cancer	553,888	1 in 7
Stroke	150,074	1 in 24
Hospital infections	99,000	1 in 38
Flu	59,664	1 in 63
Car accidents	44,757	1 in 84
Suicide	31,484	1 in 119
Accidental poisoning	19,456	1 in 193
MRSA (resistant bacteria)	19,000	1 in 197
Falls	17,229	1 in 218
Drowning	3,306	1 in 1,134
Bike accident	762	1 in 4,919
Air/space accident	742	1 in 5,051
Excessive cold	620	1 in 6,045
Sun/heat exposure	273	1 in 13,729
Lightning	47	1 in 79, 746
Train crash	24	1 in 156,169
Fireworks	11	1 in 340,733
Shark attack	5	1 in 3,748,067

Source: Florida Museum of Natural History  
The International Shark Attack File





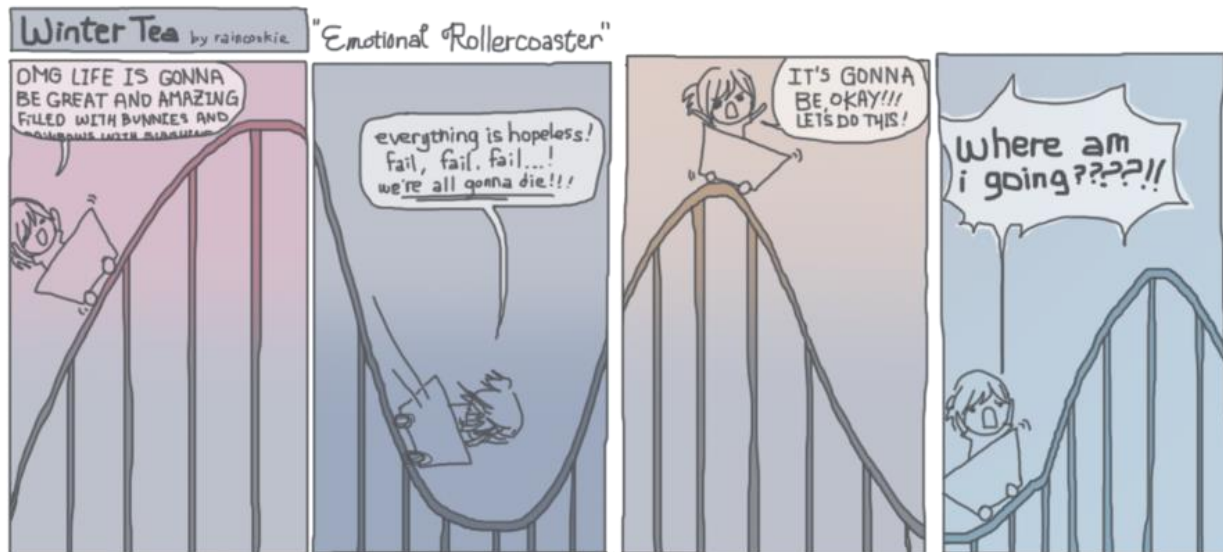
Odds of dying from a shark attack: 1 in 3,748,067

Odds that you will die from the collision of an asteroid hitting the earth in the next one hundred years: 1 in 500,000

Odds of a non-felon being murdered with a gun: 1 in 500,000

Odds of being in a plane crash: 1 in 500,000

Numbers from various searches are conflicted. Many are undoubtedly imprecise. And the odds of a shark attack are much lower than the odds of actually *dying* in a shark attack. But I think that the point is clear – most of us worry about the wrong things. We misperceive risk. My friend Mike Ritter, of resultcult.com and co-author of *The Fitness Revival*, who does research on risk as it pertains to the field of athletics, including effects of stress on the body, shared some of his thoughts and correspondence on the subject. Included in the research was the idea that people *appear* to be risk-seekers, paying money to ride a rollercoaster, or perhaps to skydive or to bungee jump. But, after a little thought, it is clear that people don't seek out risk, they seek out the thrill of the theme park knowing that there is a 99.999% chance that they will not die. The rollercoaster is a cyclical device, the drops are safely followed by the next ascent. Importantly, people do not pay money to fight in wars (generally requiring remuneration) or to walk through violent neighborhoods alone at night.



How different is the investment world, where people will avoid the 'thrill' of the 'rollercoaster' at all cost. They shun volatile investments like the plague while embracing overvalued securities, a much riskier proposition. In fact, going beyond risky, many investors currently prefer assured failure to volatility. This is intuitively clear when, for example, a pension or endowment that requires a 6% annual return, locks in returns of 3% for thirty years in the fixed-income market. It should be clear that, **like passengers on a rollercoaster, long term ownership of a portfolio of volatile stocks generally isn't dangerous unless one jumps out during the descent.** Owning non-volatile, but expensive securities is more akin to walking a perfectly stable tightrope without a net. Another important way that investors differ from rollercoaster riders is how investors' level of fear and anxiety tends to decrease the closer the market gets to the top, and their fear peaks near the 'safety' of the bottom.

"Yes it's a new world order  
 Another new world order, oh yeah  
 A crucial world order, oh yeah  
 A wicked world order, oh yeah  
 Back back, coming with a double attack  
 Step back, here comes the shark attack  
 Back back, coming with a double attack  
 Step back, here comes the shark attack"  
 -Wailing Souls



We've probably beaten this dead horse too much. On the other hand, one has to wonder whether this isn't a topic that really can't be over-emphasized. People claim to understand cyclicity, yet they confuse it with risk. They have trouble differentiating temporary loss from the permanent kind. They sit on the beach downing cola and Fritos, avoiding the water because they fear sharks when they ought to fear health issues. The Wailing Souls seem to have been singing about the risk presented by the 'new world order' rather than by sea predators.

Mr. Ritter, referenced above, understands that life is cyclical, the body has cycles. There are times to workout hard and times to rest and recover. There are times for the sympathetic nervous system to kick in ('fight or flight'), and times for the parasympathetic nervous system to take over and return the body to homeostasis. Expressions of both systems are necessary to create equilibrium. The Mandarins running the world's governments and central banks don't seem to understand that a healthy economic system needs to go through cycles, to return to homeostasis. They need to recognize that the downward plunge of the coaster builds the momentum for the next leg up. Energy is required.

Investors, too, have trouble grasping the importance of the down cycle. That the potential energy of the ascent eventually leads to a drop and the momentum of the drop, and associated attractive valuations, power the next upward charge. They claim to understand that the object is to 'buy low, sell high', but all the evidence demonstrates that they behave otherwise. They figuratively leap out of the coaster at the most dangerous time. Why did society collectively idolize anything Japanese in 1989 and shun them in 2012? Why did they allocate a third of the S&P 500 to energy in 1980 but only 4% of it in 2001? Why did they have disdain for bonds at 14% and cherish them at 2.5%? Why were small value stocks effectively given away in 2001, yet run up to such dangerous levels by 2007? Was real estate really worth 30% to 50% less in 2009 than in 2007? It is hard to find much greater contrast than 'the folly of buying stocks in 1929' relative to the cunning of 'scooping up values in those same stocks in 1932.' It is clear that the marketplace errs colossally on occasion. How interesting that at a time when the 'train car' carrying biotech stocks, art, collectibles, real estate, bonds, and many stocks is at or near the highest peak on the rollercoaster's course, the 'train car' carrying commodities, infrastructure, and certain emerging economy stocks, sits at the nadir. The line waiting to board is sparse. The opportunity is historic. We found the following article from Kiril Sokoloff, in his always interesting "What I Learned This Week" publication from 13-D Research, to be particularly enlightening. Hopefully you will too.

**Buy when they give it away. What are they giving away now?** *In 1977, we were walking uptown in New York City with a friend who worked for a prominent trust company. He told us that the trustees of an estate had just sold a triplex on East End Avenue for \$1. The reason? The \$3,000 per month maintenance was "depleting the assets of the estate". We can't imagine the return on that apartment ever since. Around the same time, top Manhattan townhouses were selling for \$40,000—and today are easily worth 1,000 times that. This was also the era when two of the greatest real estate investments in modern American history were made—the purchase of the Uris properties by the Reichmanns' Olympia & York and the Irvine Ranch by Don Bren.*

**We were very familiar with both deals.** *In 1977, the National Kinney Corporation was trying to sell eight Manhattan office buildings known as the Uris portfolio because the city was flirting with bankruptcy and the real estate market was severely depressed. The Reichmanns concluded the Uris land alone was worth more than the \$320 million asking price. Within a few years, the glut of office space had turned to a shortage and the Reichmanns were able to triple rents with almost full occupancy. **Within five years, their \$320 million investment grew to an estimated \$3 billion.***

*From intense deflation to double-digit inflation in only a few years. Could it happen again? The Real Deal of March 16, 2015 writes the following on Bren: "Donald Bren, the California-based investor who is the majority owner of Manhattan's MetLife Building, is worth \$15.2 billion, making him the richest real estate investor in the country, according to Forbes. His firm, Irvine Co., owns 500 office properties, 50,000 apartments and more than 40 shopping centers. But how did he get his start?... By 1977, Bren and his investment partners started buying shares of the Irvine Co., a former cattle ranch-turned developer active in Orange County. **Bren started with a 35% stake, and armed with a \$560 million loan, spent the next few years buying out his partners to become the absolute owner of the firm by 1996.**"*

*Fast forward to the collapse in commodities in the early to mid-1980s. A friend of ours was the controller of a major oil company, which had purchased at very high prices, a number of aluminum and base metal assets during the hyperinflation of the late 1970s. By the mid-1980s, these assets were hemorrhaging losses and my friend was able to*



*purchase from his employer an aluminum property in the West at zero cost. **Within a few years, that aluminum smelter was generating profits of \$100 million a year.***

*In 1985, the soaring U.S. dollar was devastating U.S. exports. **If you had walked into almost any CAT dealership, they would have given you the keys to a brand new CAT for nothing down** and probably the dealership along with it. By the fall of 1985, however, pressure on exports had become so painful that the U.S. orchestrated a major devaluation through the Plaza Accord, which continued until the long dollar basing of 1991-1995. What are they giving away now?*

***Last week, Glencore sold the Cosmos nickel mine for AU\$24.5 million.** In 2008, Xstrata Plc paid AU\$3.1 billion for Jubilee Mines to gain control of Cosmos—the Perth-based company's flagship operation. Last year, Glencore sold the secondary Sinclair project to Talisman Mining for \$8 million plus a \$2 million contingency. While full accounting is not so straightforward, in simplest form, the properties were bought and resold 7 years later at a 99% loss. Xstrata, which was purchased by Glencore in 2013, acquired Jubilee when nickel was selling for about \$32,000 a metric ton—2.5 times higher than where it now trades. Bloomberg recently noted that Rio Tinto Group similarly sold Mozambique coal assets last year that it bought in 2011 with the AU\$3.9 billion takeover of Riversdale Mining.*

*The selling price? \$50 million. For what it's worth, Javier Blas tweeted this week that, based on data from Citi Research, 90% of all M&A that miners did since 2007 has been written off. Makes you wonder about the current M&A boom...*

***It is interesting to note how little is being written in the West about One Belt, One Road (see related themes).** China Development Bank notes that the number of cross-border projects underway in the Silk Road effort already amount to **\$980 billion**. Reportedly, Asia's infrastructure needs are close to **\$8 trillion** by 2020.*

***Last week, the Financial Times' Investment Management Summit took place in Hong Kong.** Zhou Yuan, head of strategy at China Investment Corporation, told the conference: "If you can't expect a return—that is, if you can't expect infrastructure projects to pay you a dividend some time down the road, you can't call that investment any more. You might as well call that a Marshall Plan." Jennifer Hughes of the FT elaborated on this subject, as follows: "Inevitably, comparisons abound between China's AIIB and the U.S.-financed 1948 Marshall Plan that supported European rebuilding after the second world war, and that deployed its current account surpluses in a way that backed American economic and geopolitical goals. China's current plans include its Silk Road economic initiative (One Belt, One Road), its interest in a Brics development bank as well as the AIIB and other investments such as those funded by CIC, its sovereign wealth fund."*

***In other words, there is a giant infrastructure investment boom just getting started in Asia and along the Silk Road.** Wasn't the whole commodity boom of the last decade based on infrastructure investment in China? Now, it will expand to all of Asia and beyond.*

-13D Research What I Learned This Week 6/25/15

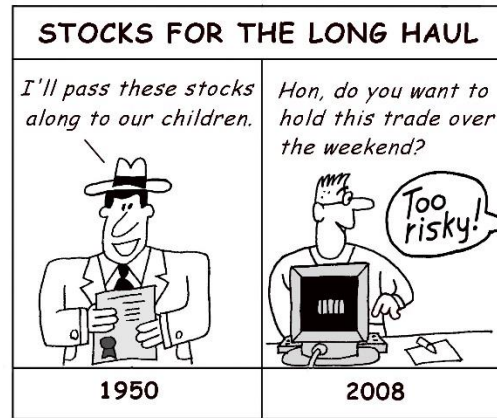


*The only reason for time, is so that everything doesn't happen at once.*  
-Albert Einstein

In addition to the incredible opportunities availing themselves as a result of investors' confusion regarding risk, their entirely misplaced concept of time is presenting unmatched investment opportunities. Successful investing requires patience. Paying attention to valuation generally leads to superior investment returns, usually sooner rather than later. But, seriously manic markets like the "Nifty-Fifties" market of the early 1970's, the TMT (tech, media, telecom) of the late 1990's, and the QE-induced frenzy of the past several years can be punishing to value-focused investors, in the short/intermediate term. Patience and conviction are paramount to success.



*So, let's assume I buy 100 shares of this stock – how many minutes should I hold it?*



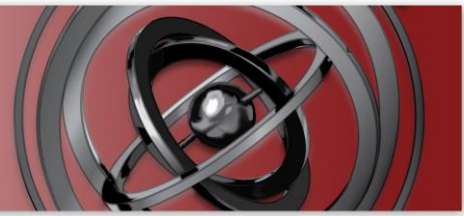
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Patience isn't always easy when value-focused styles remain out of favor for months on end. It may be helpful to remind oneself that the decades following 1972 and 1999 clearly rewarded value investors. Better still, it may be helpful to put the long waiting time into perspective. After all, investing should be a long-term endeavor.

By way of example, let's start with hydro-electric dams. Anyone who has spent much time around rivers knows how powerful the flow of water can be. This force is used to drive turbines that, in turn, generate electricity. This process generally requires the construction of a dam. I highly recommend the book *Colossus* by Mike Hiltzik to anyone interested in getting a glimpse of the difficulty of building a dam (or of an interesting period in U.S. history). The political haggling literally lasted decades. The engineering and construction were expensive and contentious. But the result was in large part responsible for the subsequent prosperity of Los Angeles, Phoenix, and other western cities. Aswan High Dam, Three Gorges Dam and others have been marvels. Hydro-electricity is essentially pollution free, emits no greenhouse gases, has a variable cost of virtually zero, and as an offshoot provides irrigation and flood management. It is clearly a valuable property. As to whether it is worth the cost or the hassle, we are agnostic.

But the patient investor need not worry about such concerns. The stock market, that truly fascinating, bipolar entity, will periodically provide us with the opportunity to purchase the product of years' worth of toil, aggravation, pain, industry, and productive value, and do so in a millisecond. And, to do so at a small fraction of the capital already invested into the business. In 2003 and 2009, we were fortunate to own part of Idaho Power at discounts to book value. We also held EDP (Portuguese hydro company), which has traded at 75% of book value several times over the past decade. Wildly bifurcated markets, while exceptionally frustrating, are the best environments for finding valuable assets priced as amazing bargains. Currently, investors' collective phobia toward Brazil and Russia have put two of the world's premiere hydroelectric franchises on the auction block for 15% and 35% of book value, respectively.

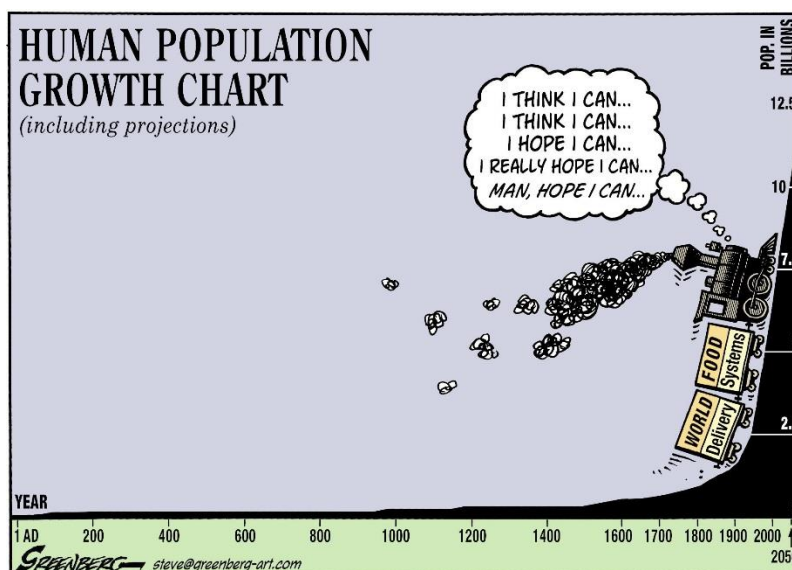
Looking elsewhere, conjuring incremental money takes no time at all, if by money we are referring to fiat currencies. Printing presses are fast, computers are even faster. Digital trillions require merely a key stroke. Patience has been neither required nor exhibited. Conversely,



producing an incremental gold coin requires rigorous effort, a lot of capital investment, and the patience of a saint. New gold mines generally require more than a decade to find, drill, assess, permit, finance, divvy the economics between owners, government, and other stakeholders, and to build and begin to operate. There is a reason only a few major mines have been built over the past 30 years. Entering the gold mining business is arguably crazy. Yet, once again, a patient investor need not be exposed to the anguish and expense. Here too, the valuable product of successful exploration, years of toil, fruitful negotiation, and massive capital investment, is periodically wholesaled on Wall Street (or Bay Street, etc) for cents on the dollar. If being a few years too early sounds terrible, imagine how the guys who built the mine feel as they are forced to sell the product of decades of “successful exploration and development,” and do so at extremely distressed prices. Their wealth being “lost” in the midst of panic and unfortunate circumstance. Fortunate buyers of underpriced mining properties might also find encouragement in the facts that, the price required to incentivize meaningful production is 50-100% higher than current spot prices, and that since 1980, the US Federal Reserve has been busy. The amount of base money in circulation, per ounce of gold held by the Treasury, has swelled from \$400 to \$16,000!

Uranium is next on our list of valuable, yet unloved commodities. Like hydro, uranium is used to produce electricity at an extremely low variable cost, and without much air pollution or greenhouse gases. Unfortunately (fortunately for investors?), uranium is relatively scarce and getting more scarce. Consumption has been exceeding mine supply for the past 20 years. Chapter 9 of *The Colder War*, by Marin Katusa, is dedicated to uranium, and is a good source for readers looking for a quick primer on the industry. Among other things, it points out that while mine supply is insufficient to meet current demand, it will become even more challenging because “71 new plants are under construction, another 163 planned and 329 proposed.” It suggests that the annual deficit could be 55 million pounds by 2020. Only 20 countries have uranium mines, and “half of global production comes from just 10 mines in six countries.” New mines take many years to develop and generally would require significantly higher prices. How odd, yet fortuitous for investors, that Cameco’s (owner of many of the world’s best mines) stock price has been smacked by the market. It is bouncing along near the lowest levels since 2004 (briefly in 2009 as well).

The list of bargains is long, but space doesn’t permit many more examples. I’ll highlight just two more. SkyWest Airlines dominates a regional niche. It would be difficult to replicate a franchise that took them many years to build. Over the past 17 years, book value per share has multiplied twelve times! Amazingly, the stock is still trading at the same level as it was back then (1998). Bargain hunters can own it now, in the current, bifurcated market, at roughly half of book value. Similarly, at the height of the telecom mania in 1999, KT Corp (Korea Telecom) ADRs sold for \$75. Patient investors now have the opportunity to pay less than \$13 for the very same, irreplicable franchise. This amounts to two-thirds of book value. Clearly, an A.D.D. infused marketplace is providing unparalleled opportunities.

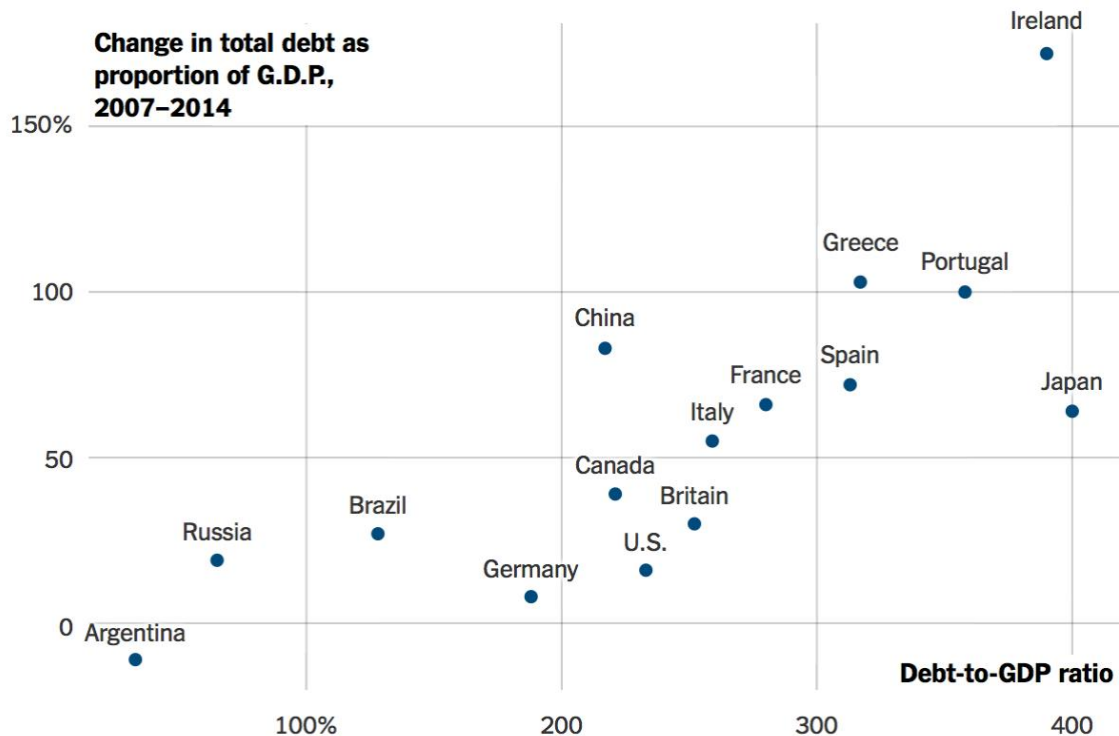


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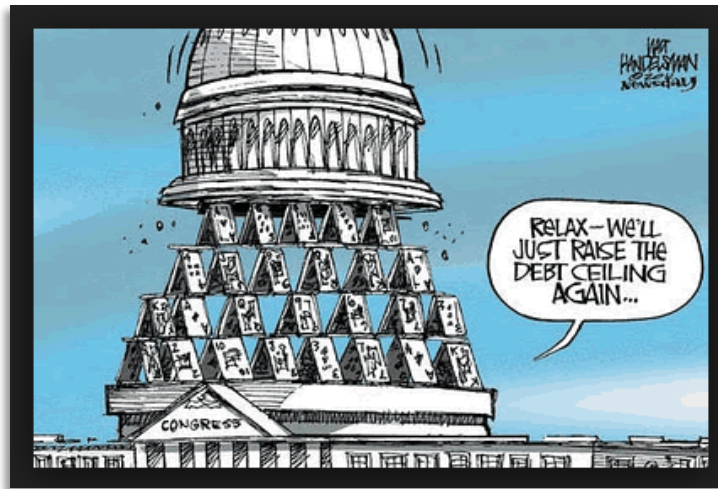


Before signing off, let's quickly touch on some other interesting cycles/fads that appear to be at extremes: Debt; Commodities; Faith in Authorities; Faith in Models.

It is interesting how at times people fear debt and at other times do not, perhaps even seeking indebtedness. Occasionally, a society collectively borrows more than it can pay off. This ultimately leads to technical default, default through devaluation, and/or debt forgiveness. Technical defaults can lead to price deflation and recessions in the short term. The world's leaders are very much against that in the current era. As the chart earlier in this commentary demonstrates, along with the brouhaha out of Greece, etc. the world is clearly at one of those junctures where the debt levels have become too large to manage. They will, and currently are, defaulting in real terms via currency debasements. Interestingly enough, there is talk about forgiveness, whether it be forgiving some of a country's debt in return for increased austerity, or a country's central bank writing off the sovereign debt that they've been accumulating. The historical precedent goes back to near the beginning of written history. Over 3,500 years ago in Mesopotamia, the Code of Hammurabi mandated debt forgiveness in response to drought or crop failure. There was a tradition of debt forgiveness in early Jewish and Christian history. The Book of Deuteronomy notes the obligation to cancel debts every seven years. In the early 1800's, U.S. States required debt moratoriums when ag prices plunged. Other times when debt was forgiven included post WWI, the Allied countries did not have to pay back all of their debt to the U.S.; after WWII German debt was forgiven; during the Great Depression FDR defaulted on the U.S. obligation to repay debt in dollars that were worth \$20.67/ounce of gold. The list goes on. We have no predictions, only an observation. Rates are at historic lows at a time when debt levels are at historic highs and the world is actively debating how much debt to forgive versus competitive currency devaluations. There's a reason that bonds have earned the sobriquet of 'return-free risk.' We'll leave bonds to others.



Source: McKinsey Global Institute analysis of data from International Monetary Fund, Bank for International Settlements, Haver Analytics, and national central banks.



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Commodities are famously cyclical. Simply buying when things look bleak (now?) and selling when the future is rosy (a' la four years ago) works well. We, however, like to buy when prices are well below the incentive price required to spur incremental production. We still believe that supply, demand, and price are interrelated. Call us old school. At any rate, the nearby chart shows that commodities have been amongst the worst performing asset classes over the past decade. Gold, on the other hand, was the top performing asset class. Oddly enough, the stocks of companies that hold massive quantities of the best performing asset class have been miserable investments. Gold is currently undergoing a major correction in the bull-market that started 15 years ago, but is still selling for four times the price level of 2001. Gold stocks have been pummeled for four years, having lost over \$19 billion of market value over the past week alone. Barrick, by far the industry leader, is trading at levels not seen since 1989, more than a quarter-century ago. Talk about buying opportunities!

Total Returns by Asset Class Rankings												10-Years 2005-'14 Annualized	January- June 2015
2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014			
REITs 30.4%	MSCI EmMkts 33.6%	REITs 34.0%	MSCI EmMkts 39.2%	Barclays Agg Bond 5.2%	MSCI EmMkts 78.0%	Gold 29.3%	Gold 9.6%	REITs 19.7%	Russell 2000 38.6%	REITs 27.2%	Gold 10.0%	MSCI EAFE 7.0%	
MSCI EmMkts 25.5%	Gold 17.8%	MSCI EmMkts 32.1%	Gold 30.5%	Gold 4.9%	S&P 400 36.9%	REITs 400 27.6%	Barclays Agg Bond 7.8%	MSCI EmMkts 18.3%	S&P 400 33.2%	S&P 500 13.5%	S&P 400 9.6%	Russell 2000 4.8%	
MSCI EAFE 20.5%	B'berg Commod 17.5%	MSCI EAFE 26.8%	MSCI EAFE 11.8%	Russell 2000 -33.6%	MSCI EAFE 31.7%	Russell 2000 26.6%	REITs 7.3%	S&P 400 17.7%	S&P 500 32.0%	S&P 400 9.7%	MSCI EmMkts 8.8%	S&P 400 4.2%	
Russell 2000 18.1%	MSCI EAFE 14.0%	Gold 22.5%	B'berg Commod 11.1%	S&P 400 -35.9%	REITs 27.8%	S&P 400 26.4%	Mkt Neut HF 4.5%	MSCI EAFE 17.7%	MSCI EAFE 23.1%	Barclays Agg Bond 6.0%	Russell 2000 7.7%	MSCI EmMkts 3.1%	
S&P 400 16.3%	S&P 400 12.5%	Russell 2000 18.2%	Mkt Neut HF 9.3%	S&P 500 -36.6%	Russell 2000 26.7%	MSCI EmMkts 18.9%	S&P 500 2.1%	Russell 2000 16.3%	Mkt Neut HF 9.3%	Russell 2000 4.8%	S&P 500 7.6%	S&P 500 1.2%	
S&P 500 10.7%	REITs 8.3%	S&P 500 15.6%	S&P 400 8.0%	B'berg Commod -36.6%	S&P 500 25.9%	B'berg Commod 16.7%	S&P 400 -1.7%	S&P 500 15.9%	REITs 2.3%	Mkt Neut HF -1.2%	REITs 7.3%	Gold 0.5%	
B'berg Commod 7.6%	Mkt Neut HF 6.1%	Mkt Neut HF 11.2%	Barclays Agg Bond 7.0%	REITs -37.8%	Gold 24.0%	S&P 500 14.8%	Russell 2000 -4.2%	Gold 6.6%	Barclays Agg Bond -2.0%	MSCI EmMkts -2.0%	MSCI EAFE 5.2%	Barclays Agg Bond -0.1%	
Mkt Neut HF 6.5%	S&P 500 4.8%	S&P 400 10.3%	S&P 500 5.6%	Mkt Neut HF -40.3%	B'berg Commod 18.7%	MSCI EAFE 8.1%	MSCI EAFE -11.1%	Barclays Agg Bond 4.2%	MSCI EmMkts -2.3%	Gold -2.2%	Barclays Agg Bond 4.7%	B'berg Commod -1.6%	
Gold 4.6%	Russell 2000 4.4%	Barclays Agg Bond 4.3%	Russell 2000 -1.5%	MSCI EAFE -41.8%	Barclays Agg Bond 5.9%	Barclays Agg Bond 6.5%	B'berg Commod -13.4%	Mkt Neut HF 0.9%	B'berg Commod -9.6%	MSCI EAFE -4.0%	Mkt Neut HF -1.0%	Mkt Neut HF -1.9%	
Barclays Agg Bond 4.3%	Barclays Agg Bond 2.4%	B'berg Commod -2.7%	REITs -17.8%	MSCI EmMkts -52.2%	Mkt Neut HF 4.1%	Mkt Neut HF -0.8%	MSCI EmMkts -17.8%	B'berg Commod -1.1%	Gold -28.3%	B'berg Commod -17.0%	B'berg Commod -3.3%	REITs -5.4%	

Source: Oppenheimer Asset Management Research, Bloomberg's total returns calculator, Standard and Poor's, Credit Suisse, Barclays, MSCI, Bloomberg, and NAREIT. At press time, June, 2015 data for the Credit Suisse Hedge Fund Neutral Index was not yet available. Return calculations exclude applicable costs including interest and commissions.



Faith in authorities is a fascinating phenomenon. Interestingly enough, polls seem to indicate that in many countries governments are regarded with historically low esteem. How odd then, that society truly believes that government is the answer to its problems. Everywhere, government is becoming a bigger part of the economy. Additionally, international government bodies are more involved with policymaking. And central banks have probably not been held in higher esteem since the days of John Law. The business world, which used to be considered rather laissez faire is now amongst the biggest proponents of centrally mandated interest rate suppression. Looking at the rise and fall of communism over the past century around the globe, it should be clear that faith in central planning is cyclical in nature. And in the west, communism gained much popularity in 1960's, was heavily dissed in the 1980's, and is so in vogue contemporaneously. Once again, call us 'old school' but we believe that, as has always been true, attempts by bureaucrats to override the laws of economics will fail. This too shall pass; sooner rather than later is our guess.

Austrian economists suggest that the study of human nature and the application of common sense is a much better approach than trying to force everything to fit a model or be reduced to a number. It seems clear from their writing that Charlie Munger, Howard Marks and other successful investors wholeheartedly concur. For what it is worth, so do we at Kopernik. Now people look to models such as  $C+I+G$ , or  $MV = PQ$ , or  $PV = CF/(k-g)$ , or  $E(R_i) = R_f + \beta(E(R_m) - R_f)$ , or 'the Taylor Rule' or 'the Buffett Rule' or 'the Fed Model,' etc. Using trendy models is much easier than is rigorous thought and analysis. Often it is easier to defend as well. "My analysis wasn't wrong, the model was." Unfortunately, or fortunately for many of us, models will never replace ratiocination.

Perhaps one of the most apropos examples of investors abrogating their obligation to employ reason, thought, and diligence, is passive investing. Buying an ETF or other passive product is certainly way easier than actually researching, analyzing, understanding, and valuing each and every company in the portfolio. It does have advantages, including higher liquidity, tax-effectiveness, and periods of time when it outperforms many true investors. Again, call us old-fashioned, but to buy without researching and without valuing sure sounds more like speculating than investing. And to buy a stock after others have front-run you on the knowledge that it was being added to an index or ETF and selling after it has dropped and is being eliminated is tough logic to follow. But, whereas we feel that passive investing is inferior to active investing, that is not our point here. No commentary on cyclical and fads would be complete without a brief mention of the tug of war between passive and active strategies. As we've mentioned in the past, due to the advantages that passive does offer, it gets popular at times. This popularity leads to outperformance as people dump active managers and add to passive portfolios, forcing those stocks higher. Eventually, stocks in ETFs become very expensive relative to similar stocks that are not prominent in ETFs. This in turn leads to years of under-performance of passive portfolios as people sell them, leading to the same self-fulfilling cycle on the downside that was recently completed on the upside. Clearly index funds outperformed significantly in the late 90's, underperformed markedly for much of the ought decade, and in recent years they (ETFs now) have been strongly outperforming again. They have momentum, and as mentioned earlier, momentum is as over-extended now as ever. It seems clear to us that in the rollercoaster analogy ETFs are sitting at the top of the track while many non-trending alternatives languish near the bottom. It is a perilous time for passive investing. Time will tell how it plays out.





## Conclusion

**In finance, just like in art, music, and fashion, fads come and go. The world is volatile; is cyclical. Rigorous bottom-up fundamental analysis and a disciplined adherence to value-based principles, in contrast to fads, have stood the test of time. The talking heads and luminaries can continue to be active apologists for the 'next phase,' but anyways, at Kopernik, "It's still rock and roll to us!"**

In summary, perhaps more than at any time in the past, investors are willing to pay extremely high prices for what they perceive to be consistent, high-probability, future cash flows. This has always proved dangerous in the past. If a great asset's prospective cash flows are cyclically depressed, tainted by regulation or geopolitical concerns, or are uncomfortably off in the distance, the market seems to have little use for them at any price. Misunderstanding risk, they avoid the stocks whose historic price charts have looked like a rollercoaster track, even though they are located harmlessly near the nadir of the course. Meanwhile they flock to the net-less high-wire act that exemplifies the current bond market. The common stocks with the most 'bond-like' stability are now at valuations that figuratively put their investors on similarly elevated tightropes. They tip-toe across, hopelessly trying to balance their 2% yields with their investment needs, secure in the knowledge that the tightrope is not volatile. It is a dangerous act, indeed! Fortunately there are alternatives. There is hope. Climb aboard the low valued stocks. They should prove to be lower risk, higher reward in the long-run. This appears to be an unparalleled opportunity to accumulate some of the world's valuable, scarce, hard to replicate, and desirable franchises and resources.

*"I'm up on the tightwire  
one side's ice and one is fire  
it's a circus game with you and me  
I'm up on the tightrope*

*I'm up in the spotlight  
ohh does it feel right  
ohh the altitude  
seems to get to me"*  
-Leon Russell

In the current, extremely highly-correlated investment arena, we are pleased that our portfolio increasingly looks to be the "antidote to correlation." This is not by design, just a pleasant outcome of our rigorous, bottom-up research process. While the masses flock to the tightrope, we are happily stepping aboard the rollercoaster at what appears to be the bottom.

Thank you all for your continued support!

Cheers,

David B. Iben, CFA  
Chief Investment Officer  
Kopernik Global Investors  
July 2015



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