



The Passenger

*"Oh, the passenger
How, how he rides
Oh, the passenger
He rides and he rides
He looks through his window
What does he see?
He sees the sign and hollow sky
He sees the stars come out tonight"
-Iggy Pop*

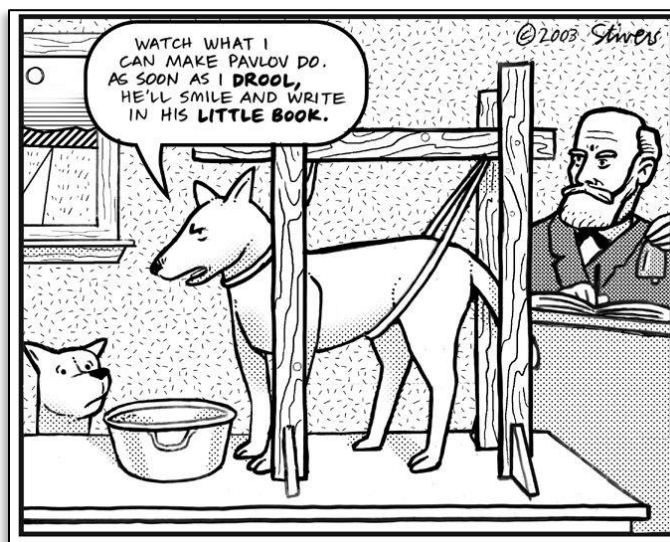
Was Iggy referring to drugs or had he anticipated the beauty of ETFs circa 2016? Reviewers suggest that 'he sees how wonderful everything is once he relinquishes control, becomes the passenger instead of the driver.' Longtime readers know that I have a proclivity to view many songs and movies as metaphors for the investment world. In this case, passive investing, *de rigueur* in the marketplace, comes to mind. The "old school" investors labor over 10-Ks, 20-Fs and other regulatory filings, struggling through those boring 'notes to the financial statements,' and 'pounding the pavement' to perform due diligence via site visits and industry conferences, while vigorously 'interrogating' company management teams and then spending hours building valuation models. Meanwhile, the passive investor hops aboard the ETF du jour and *he rides and he rides*.

He/she enjoys generally high levels of trading liquidity, and the ability to quickly gain exposure to desired industries, sectors, regions, and cap ranges. Fees are minimal and taxes can be managed. Tracking error can be kept very low, a source of much relief to many. Much of the 'unseemly' 'rolling up of the sleeves' to perform tedious bottom-up, fundamental analysis can be dispensed with. While active investors are laboring away, the passenger, *he rides and he rides*.

The driver must contend with the 'back seat drivers.' Why did you turn that direction? This road is boring, that one, too crowded. Can't you drive faster? When will we get there? And the passenger? He doesn't have to explain short-term problems with individual stocks to clients. He doesn't need to defend volatility or tracking error, or conjure catalysts. No, *he rides and he rides*.

*"And everything looks good tonight
Singin' la-la-la-la-la-la-la"
-Iggy Pop*

Sitting here, well into the 21st century, on the footsteps of the era of the driverless car, robo-advisors, and virtual reality, Kopernik hereby takes on the arduous task of defending 'reality.' This Commentary puts forth the case for active management. To jump to the conclusion, we believe that there is a need for diligent investment research. We believe that there is an investment return on independent thought, on hard work, on willingness to bear the discomfort that goes hand in hand with contrarianism. In the current environment that return is prospectively quite high. The performance battle between active/passive management is cyclical in nature, and once again it is time to invest actively. While we concede many of the virtues of passive management, it is clear that it has its pitfalls as well, which are being overlooked. The case for passive investing assumes just a few 'passengers' taking a free ride on the back of a market made 'efficient' by millions of investors working hard to gain equal access to information, staying rational at all times, performing analysis to derive a fair price, and always paying that fair price. Even if one were to believe that people are rational and that markets can be efficient, once there are too many passengers relative to too few drivers, the theory goes out the window. At that point, the premise is nullified; the tail is wagging the dog.



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The Dog Days for Active Management

It was an honor to be invited to speak at the London Value Investor Conference in late May. It is clear that these days are indeed uncomfortable, figuratively muggy, for value investors. In fact, even at a value conference, more than half of the audience preferred to be viewed as 'franchise' investors. It seems that the maxim "everyone owns quality growth stocks" is not far off the mark. It's worth noting that it was much worse last year when, apparently, the vast majority shunned the value classification. Still, at this juncture, all investors that continue to adhere to a value-based discipline must be asking: Is the stigma fading? Are the dog days finally winding down? Time will tell - either way, a discussion on passive investing may be instructive. It's important to start with the disclaimer that we've never believed that 'growth' was the antithesis of 'value.' It is merely a wonderful attribute that increases intrinsic value. ETFs on the other hand.....

There were many interesting speakers, including Jean-Marie Eveillard, Howard Marks, and James Montier, all of whom I've admired for many years. I highly recommend the conference and plan to attend again in the future. I mention the conference because, among the many great presentations was one called "Passive Aggressive: The Implications of 'Industrialized' Capital Allocation," by Michael Keller, a Partner of Brown Brothers Harriman.

Mr. Keller addresses a quick history of capital allocation, highlights the size of the current market for passives and illustrates a handful of their benefits and drawbacks, and segues to the larger implications of industrialized capital and passive investment. I found many of his bullet points to be interesting and well worthy of passing along.

(Below is a summarized version of his slides, to which we've taken some editorial license)

60 years of commercial, technological and analytical innovation in the capital markets

- Computerization, OTC, MPT, EMH, stochastic price models
- Deflation of trading commissions

Multi-decade rise of commingled products and funds

- Retail investors and advisors gravitate toward funds over stock ownership
- Major industry shifts - DB to DC, in-house to consultant led, bank trust model to open architecture
- Fund complexes became big business
- Size begins to conflict with specialization and concentration
- 'Index hugging' (intentional or not) becomes widespread
 - Being different can have career costs in a style box driven world!

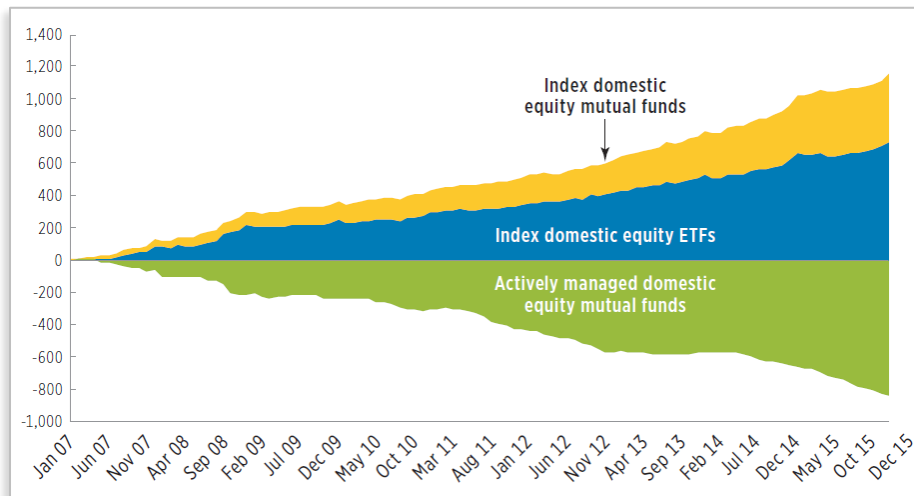


Growth of Exchange-Traded Funds

- Technology ingenuity and capital enabled the rise of index funds/ETFs
 - Today, a stunning array of varieties, including leveraged macro and factor-based
- The market has become massive
 - ETFs alone total ~3 trillion; 6x increase in AUM over 10 years
 - Including index mutual funds and separate accounts, we estimate as much as \$20 trillion is being managed passively worldwide; approximately 1/3 of total market cap
- Seven-year bull market and monetary policy excesses have played a role, particularly post-2012

Cumulative flows to and net share issuance of domestic equity mutual funds and index ETFs

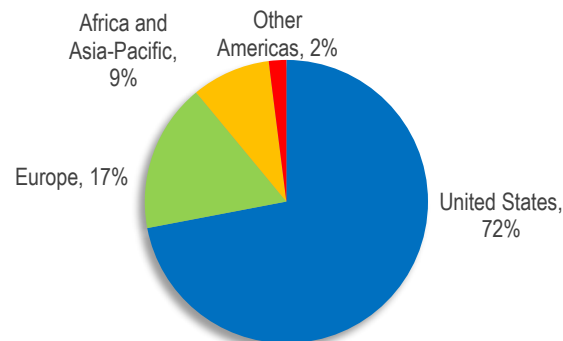
billions of dollars, January 2007–December 2015



Note: Equity mutual fund flows include net new cash flow and reinvested dividends.
Data excludes mutual funds that invest primarily in other mutual funds.

The United States Has the Largest ETF Market

Percentage of total net assets, year-end 2015

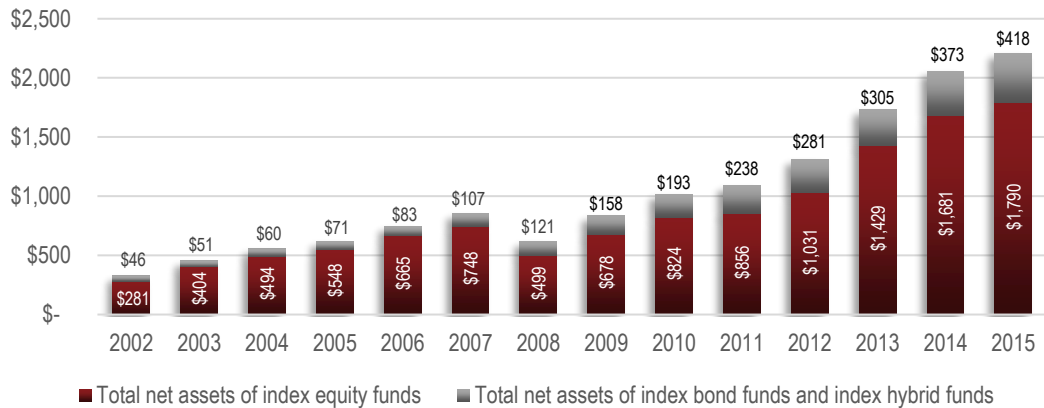


Sources: ICI Investment Company Institute, 2016 Investment Company Fact Book



Total Net Assets and Number of Index Mutual Funds Have Increased in Recent Years

Billions of dollars, 2002-2015



Sources: ICI Investment Company Institute, 2016 Investment Company Fact Book

Passive funds have continued to take market share in the asset management business globally. The “active” industry is now only four times bigger than “passive”, compared with 8.5 times in 2007. - GREED & fear, Chris Wood, CLSA

Benefits

- Low costs, low turnover, minimal tracking error, tax advantages, broad menu of options
- ETF industry structure provides liquidity and reliable pricing (most of the time)
- Low-cost ‘robo advisory’ and target date funds improve financial inclusion
- Fee drag from low value-added active managers is squeezed out

Drawbacks

- Products with cap-weighted structure dominate the market
 - **Incremental flows benefit the recent winners**
 - Higher volatility and correlation; investors use passives to chase on the way up, cut exposure on the way down
- **Active manager redemptions precipitate selling in conviction stocks**
- **Index composition determined by third party**
- Realized shareholder returns may not match benchmark
- Changes in shareholder voting power

It is worthwhile to add that the third party determining the index does not even try to identify the most attractive investment candidates, nor do they claim to.



Mr. Keller then featured the following quote from Glenn O'Donnell, Forrester Research 2010: *"A process or profession becomes industrialized when it matures from an art form to a widespread, repeatable function with a predictable result and accelerated by technology to achieve far higher levels of productivity."* This evolution from an art to an industry is interesting. A third of a century ago, I believed that our business was 80% science and 20% art but now view the ratio to be roughly the inverse. Not to be misconstrued, the science portion is important. In fact, it is prerequisite. But, as Charlie Munger points out, a multidisciplinary approach is necessary. Many of the things that managers put forth as competitive advantages are merely the bare minimum of attributes that a good manager must have. **The edge comes from augmenting the math and science with the arts.** One must consider economics, history, psychology (crowd behavior), philosophy, integrity, generosity, aptitude, incentive structure, and so much more. Mr. Keller seems to be laying out a powerful case that the investment industry's vast and impressive increase in efficiency has not served the clients well. It has inadvertently done the opposite. The proverbial forest has been lost in the trees. He points out that **the mindset has shifted from managing securities to managing exposures.** Kopernik would say, it has **shifted from investing in companies to speculating on trends.** He makes the important observation that a systemized approach may sound reasonable but it doesn't work well in real life since "the market is not a repeatable, solvable system." It is affected by human behavior, unpredictable events, and exogenous factors. Also, systems tend to look backwards creating the "risk of constantly 'fighting the last wars.'"

Why ETFs are Inherently Anti-Value

*"I am a passenger
I stay under glass"*

It is time to put the passenger 'under glass.' Let's use the magnifying glass. In our past Commentary ("When"-ing isn't Everything), we discussed how good analysis requires the rigorous use of questioning. Regarding ETFs: Is the 'science' of investing incorporated in the construction of ETFs? Is the 'artistic' side of investing incorporated in the construction of ETFs? Is the wisdom of Munger, Templeton, Marks, Klarman, Rogers, etc., etc., etc., incorporated in the construction of ETFs? Do the assumptions underpinning the efficient market hypothesis hold in the contemporary world of ETFs?

Mr. Keller devotes a slide to the anti-value (my words) characteristics of ETFs and to the resultant "Opportunities for Value Investors."

- Little attention is paid to divergences between market value and intrinsic value
 - Stocks are purchased/sold reflexively; index membership, sector or factor overrides other considerations
- Momentum orientation of index-based and factor products adds to market volatility, which erodes compounding over cycles
 - Inflows are self-conforming, little attention paid to the **incremental risks** undertaken
 - **Value-oriented investors with a full-cycle mindset can benefit**
 - 'Smart beta' and factor-driven styles aren't substitutes for fundamental strategies; they don't employ due diligence or subject matter expertise
 - **Contextual awareness as a form of risk management can be quite valuable**
 - Doesn't imply a need for macro analysis, but instead an ability to objectively study the high-level view
 - Empiricism vs. judgement; doesn't have to be a religious debate

His subsequent slide entitled "Differentiated Active Management Shines Over Full Cycles" demonstrated that the vast majority of managers that have outperformed the S&P 500 over a 10-year period, had high active share combined with moderately low turnover. (He sources eVestment and BBH analysis). We, at Kopernik, are particularly pleased with this finding.



Before moving on to the next section, a few examples of the monsters that can result as the unintended consequences of good ideas.

From the Financial Times on May 30, 2016

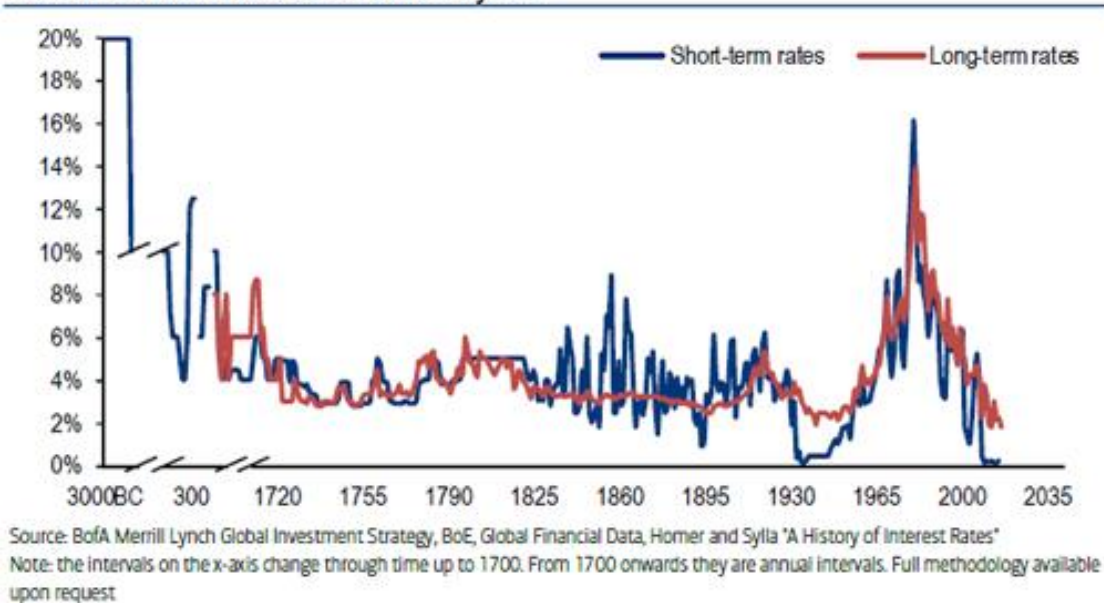
"The research group Morningstar classifies 25 ETFs as low volatility funds, with \$35bn in assets at the end of April, \$9.8bn of which had been invested in the first four months of the year. The pace of inflows picked up sharply in February, after stock markets gyrated with fears of a global recession.

Money has kept being added, even though the Vix index of market volatility has fallen back close to a one-year low. The six largest low vol ETFs alone had further inflows of \$1.6bn in May.

The \$13.1bn iShares Edge MSCI minimum volatility USA fund from BlackRock, which has doubled in size in the past 12 months, has had inflows on all but three days so far this year. A \$7.1bn sister fund that runs a minimum-volatility portfolio of non-US stocks has had inflows on every day but one this year."

The article quotes Jeffrey Gundlach, "Low volatility stock funds are probably the most dangerous thing out there." We tend to agree, but it will be interesting to see how posterity judges them relative to negative yield bonds.

Chart 1: The lowest interest rates in 5000 years



*"Nobody told me there'd be days like these
Strange days indeed strange days indeed*

*Everybody's runnin' and no one makes a move
Everyone's a winner and nothing left to lose"*
-John Lennon



Another example of good no longer being good when it becomes overdone is the Nifty-Nine (The infamous FANG stocks plus Priceline, Ebay, Starbucks, Microsoft and Salesforce (apparently coined by Ned Davis Research)).

The Pools of the late 1920s, the bank trust departments of the early 1970s, the index funds of the late 1990s and the ETFs of the current era have much in common. All were times of easy money, of great leaps forward in technology, and of people confusing good companies and good ideas with good investments. All were times when momentum investing was very popular, when crowd psychology created bubbles. We have all seen this movie before.



"Richest blend in the world."

US vs European equities, relative price performance (USD)



Monthly data. GFD Europe index is used, which reconstitutes the MSCI Europe estimate pre-1970, and includes a 12% UK weighting until 1970, after which it uses actual MSCI Europe weightings; latest UK weight is approx. 26%.
Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

*"We call it master and servant
it's a lot like life"*

-Depeche Mode

Time to move on to the all-important subject of technology. We are huge fans. Technology makes life so much easier. It makes it possible to follow the world without being everywhere at once. But, we think that it's fair to expropriate P.T. Barnum's famous quote regarding money: "'technology' makes a very excellent servant, but a terrible master." We believe that this is true for investment orthodoxies as well. Growth is good; value, prerequisite. Momentum is a factor, and quants add efficiency and reduce emotion. However, being a slave to any rigid orthodoxy is, we believe, foolish. Models and rigid processes are begging to be gamed and/or front run. Having algorithms drive the process certainly doesn't change this.

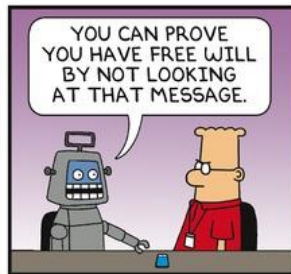
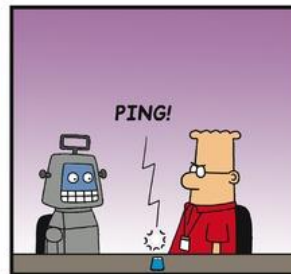
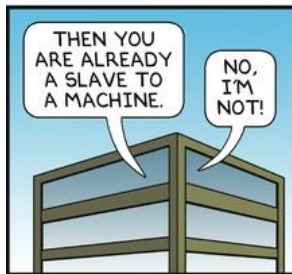
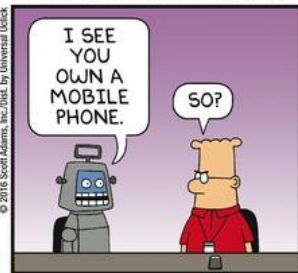
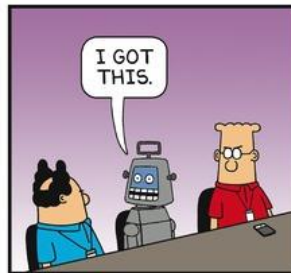
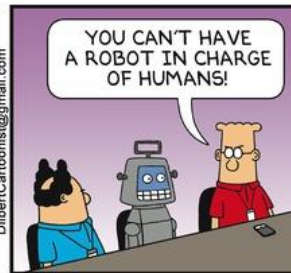
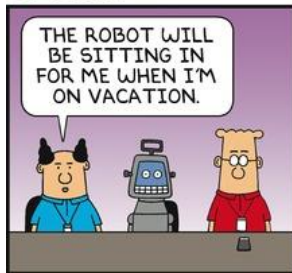
al·go·rithm

algəˌrɪθəm/

A process or set of rules to be followed in calculations or other problem-solving operations, especially by a computer.



DILBERT



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"But I am not kidding when I say that a growing number of people in the markets know a lot about computers but virtually nothing about markets."

—Jared Dillian, The 10th Man

We've talked in the past about how social sciences often seem to envy the physical sciences. Nowhere is this more true than in economics and investments. And, perhaps, nowhere is it more spurious than when it comes to risk management. I can't quickly capture in a paragraph a subject to which Howard Marks devoted three must-read chapters. But that is precisely the point. Risk can't be captured in a nutshell. It is difficult. It pertains to the future, to the unknowable. It is said that risk means that more things can happen than will happen. How can that be captured in a number? In a cyclical world, do past trends extend into the future or do they revert to the mean? It depends, of course. Beta, volatility, and tracking error do nothing to help one understand if they are overpaying for a security. They do nothing to help predict the future. But they sound impressive. And they can be calculated, and calculated quickly by computers. As Mr. Gundlach suggests above regarding low-vol ETFs, mis-defining risk can be the most dangerous thing one can do. We will add that when index benchmarks are over-priced, high tracking error is not a risky thing, it is a desirable thing. Even when it is calculated by a powerful computer.

"Running through the field where all my tracks will be concealed and there's nowhere to go."

-RHCP

In conclusion, we are not anti-passive investing. For example, it makes sense that entities managing large sums of money choose to allocate the bulk of it to a passive 'core.' Why pay for active management in situations where the size of the investment will tend to force the returns to converge towards the index returns? It is also reasonable that many choose to augment the passive core of the portfolio with active 'satellites.' Logically, the satellites choose to limit capacity and have very high 'active-share,' thus allowing for significant divergence from the core. The less like the core the better.

Our points are that anything is dangerous when taken to excess and that everything has a time and a place. Pertaining to time, one can't help but feel a little joy for the City of Cleveland, which in sporting terms, waited for more than a half-century for their time to come. For those who invest with active managers, or in value stocks, or emerging markets, gold, or other hard assets, it feels like things have been out of sync for a half-century. It has been an unusually prolonged correction. As we discussed in 'The Big Long' Commentary, it has/had lasted anywhere from 2 to 9 years through this past January. And, as the Commentary pointed out, this is a good thing. The more depressed the valuations at the nadir, the more pronounced the subsequent upswing is likely to be. In the investment arena, the importance of major inflection points can't be overemphasized. This is often when anti-value capitulates to value. Momentum stocks, like the fireworks on the Fourth of July, reach their zenith and succumb to the force of gravity, to the oohs and aahs of the crowd.



Kopernik
Global Investors, LLC



In terms of taking good things to excess, we are often told that virtually everyone is heavily invested in 'quality growth stocks', trendy ETFs, and in anything that historically has exhibited low volatility. Let the fireworks begin!

*"Oh the passenger
He rides and he rides
He sees things from under glass
He looks through his window side
He sees the things that he knows are his"*

To this we ask, does he, in fact, "see the things that he knows are his?" Or is he playing a trend, or merely following the direction received from an ivory tower, without really knowing what the ETF owns or what it is worth?

We, at Kopernik Global Investors, are active investors. We are appraisers of businesses; owners of businesses. We are passionate about rolling up our sleeves and doing fundamental research. We are obsessed with uncovering value. When it comes to investing other people's money, we don't want to be taken for a ride. We want to know what we own. We want to know why we own it. We want to have a strong grasp of how much it is worth. We utilize many of the advantages that technology has to offer, but we like being in the driver's seat.

Have a healthy and happy second half to 2016.

Cheers,

David B. Iben, CFA
Chief Investment Officer
July 2016

P.S. A lot of people are fearful of computers and robo-advisers. We welcome them as tools, to augment the intuition, creativity, interpersonal skills, independent thought that, thus far anyhow, are only possessed by human beings. We leave you with the most famous lines from 2001 A Space Odyssey:

HAL: Just what do you think you're doing, Dave?

HAL: Look Dave, I can see you're really upset about this. I honestly think you ought to sit down calmly, take a stress pill, and think things over.

HAL: I know I've made some very poor decisions recently, but I can give you my complete assurance that my work will be back to normal. I've still got the greatest enthusiasm and confidence in the mission. And I want to help you.



"And I don't want it, the things you're offering me
Symbolized bar code, quick ID, oh yeah
See I'm a 21st century digital boy
I don't know how to read but I've got a lot of toys
My daddy's a lazy middle class intellectual
My mommy's on Valium, so ineffectual
Ain't life a mystery?"

-Bad Religion



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