Waiting for Sebastian

The question before the house is, "are value investors, figuratively, waiting for Sebastian?" I was fortunate to spend a little time in Portugal this summer. It is a lovely country, rich in history, with some of the nicest people you'll ever meet. I recommend it to all.

It was there that I first heard of King Sebastian and of the phrase that inspired this commentary – "Waiting for Sebastian." Who was he? Let's turn to Wikipedia:

> *"Dom **Sebastian I** (Portuguese: **Sebastião**; 20 January 1554 – 4 August 1578) was King of Portugal and the Algarves from 11 June 1557 to 4 August 1578 and the penultimate Portuguese monarch of the House of Aviz.*
>
> *He was the son of João Manuel, Prince of Portugal, and his wife, Joanna of Austria. He was the grandson of King John III of Portugal and Holy Roman Emperor Charles V. He disappeared (presumably killed in action) in the battle of Alcácer Quibir. Sebastian I is often referred to as **The Desired** (Portuguese: o Desejado), as the Portuguese people longed for his return to end the decline of Portugal that began after his death."*

Apparently a whole school of thought has materialized around this belief:

> *"**Sebastianism** (Portuguese: 'sebastianismo') is a Portuguese messianic myth, based on the belief that King **Sebastian** of Portugal, disappeared in the battle of Alcácer Quibir, **will return** to save Portugal."*

In a nutshell, the phrase essentially means to **"foolishly wait for something that is never going to happen." That seems to succinctly capture the way most people feel about value investors.** The wait has been a long time. It's become an increasingly painful time. Just when it seemed that things couldn't get any worse for value managers, the horrendous third quarter of 2018 felt like the coup de grace to many. When one's core tenets appear to have become, not just useless but, actually counterproductive, for the better part of a dozen years, it seems to call for a little self-reflection. While Kopernik's unique brand of value-oriented investing performed well during the first half of this value drought, it has seriously lagged for 5 of the past 6 years. What follows are some observations, a modicum of self-evaluation, and more on the Sebastian saga.

Like Sebastian himself, his statue has been missing (for repairs) from its spot infront of the Rossi Rail Station in Lisbon

Mind the GAAP
(Have Value Investing and Accounting Principles become Obsolete?)

Times have changed, there's no doubt about it. And it's continuing to change at an accelerating rate. Most economies have become predominately services-based, with little need for massive asset-heavy capital spending. "Ideas" are the new corporate focus. Why spend on bridges, and factories and ships when the new billionaires have sprung forth from social media and services? Who needs airplanes when they can travel vicariously through others on Facebook, et al? Why waste capital on *locomotive* engines when there are *search* engines chugging out massive profits? And many of the 'new era' businesses have a tendency toward monopoly, toward a winner take all outcome. As a result of this, combined with antitrust enforcement that has gone MIA, excess profitability is seemingly endless. In this sort of environment, it is understandable that many question even the very efficacy of accounting rules. Are GAAP (generally accepted accounting principles) and IFRS (international financial reporting standards) even relevant anymore? Are they a relic of a bygone era? And what of people who still use these archaic numbers to inform their investment decisions? Does price still matter? Isn't catching the right stock all that matters? Isn't it now better to overpay for the winners than to miss these leaders by foolishly waiting for an attractive entry price? Why should value ever return to favor? Waiting for Sebastian indeed!

In addition to the countless attacks on value investing by the usual suspects, we certainly can't help but notice that many "value" investors have joined the chorus. Several have recently penned some thought-provoking letters and presentations discussing why they have migrated to new processes using valuations that are 'more appropriate' to the new era in which we now find ourselves. The Harvard Business Review recently published a piece by professors from Tuck School of Business, Columbia Business School, and Haskayne School of Business that attacks accounting as being inappropriate for the modern world, ***suggesting capitalizing ideas rather than assets***. The article contains the following quotes from people at businesses they interviewed*: "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****"; and "standard-setters might want to encourage disclosures related to (i) value per customer; (ii) earnings or revenue outcomes or other specific metrics related to specific projects in progress; and (iii) data on how the R&D and software talent of digital firms is being deployed."* Time will tell whether capitalizing ideas (capitalize means to recognize as an asset, rather than an expense, in the financial statements) is a capital idea or should be viewed more akin to a capital offense.

While a lot of the views we've alluded to above contain kernels of truth and are worthy of thought**, Kopernik remains true to our long held principles/process/philosophy**. For more on why we believe that the current environment for value investors is the antithesis of "waiting for Sebastian," - it is waiting for the inevitable – read on.

Value investing is a methodology predicated on the idea that it is much wiser, and more profitable in the long run, to pay less for something than it is worth. Conversely, it is speculative, at best, to pay more for something than it is worth. This premise should be inherently obvious to everyone. But life is complicated – consultants and index providers, amongst others, have attempted to define value and growth through contrived and spurious methodologies. Thoughtful investors will not allow themselves to be confined by these methodologies, preferring more tried and true, and useful valuation techniques. Meanwhile, other "value" managers, those who are in the process of capitulating under the duress of periodic underperformance, will also not allow themselves to be confined by these methodologies, preferring more *convenient* (as opposed to tried and true) valuation techniques. These techniques tend to get much more lenient in lockstep with the bull market's age and strength. As Charlie Munger has stated, "anyone who thinks it's easy is stupid." In the late 1990s, many capitulating 'value' managers rebranded themselves as GARP (growth-at-a-reasonable-price) or value with a 'catalyst.' The contemporary environment is rife with "Quality Franchise" managers who suggest that quality represents value. This is true if one believes that current inflated margins, engineered growth, and record low discount rates are sustainable. Most of those who migrated to more "modern" valuation techniques in the late 1990s eventually got walloped. Today, once again, new fangled views of value must be considered, studied, and viewed, we believe, with a high degree of skepticism. Let's examine further.

We concede that in many cases book value is not relevant. Yet many of the detractive arguments ring hollow. For starters, technological change has always made many companies worth much more than their book value, while damaging other companies and causing them to be worth far less than book value. This is nothing new. Social media, gene editing, search engines, and smart phones have been complete game changers. Might that have also been the case for air conditioners, telephones, telegraphs, railroads, canals, vacuum tubes, semiconductors, automobiles, airplanes, the printing press, and so on through the millennia? Book value proved a useful measure through many eras – might it still mean something?

Moving on to financial engineering – if a company buys back their own stock at a premium to book value, but at a discount to its economic value, we can all agree that book value becomes misleading; book value per share goes down while economic value per share is actually increasing. However, if the buyback occurs at a premium to book value and at an even bigger premium to economic value, then the drop in book value per share is accurately reflecting a loss in economic value. Economic value is a somewhat subjective concept but one should be cognizant of two highly relevant points: recent buybacks have been occurring at record prices and valuations and history shows that record levels of buybacks always occur near market peaks. What is the chance that managements are actually adding value through these buybacks? Investors can disregard the resultant lower book value at their own peril; doubly so when the buybacks are debt financed.

Regarding the concept of "long-term, value-creating, intangibles," giving examples of stocks that turned out to be worth a lot more than book value can be dangerous and is what is known as 'cherry-picking.' Over the decades, many companies have hired engineers, scientists, marketing whizzes, and others who have endeavored to create intangible value in the form of superior ideas, brands, products and services. Most have failed to do so, some achieved their fifteen minutes of fame, and a select few have created long-term value. Because success is a longshot, all of the major accounting authorities have always correctly mandated the costs involved with R&D, advertising, marketing, and similar efforts be expensed as they've occurred, rather than capitalized. To cherry-pick the ones which succeeded, and use them as proof that efforts to build brands and create technology should not be expensed seems disingenuous, even dangerous. Many of today's clear winners will be tomorrow's Schlitz beer, Sony Walkman, Blackberry phones, etc. We just don't know which ones, yet. (The list of *formerly* dominant companies is much too long to incorporate here.) Caveat emptor.

People should also beware of arguments that don't factor in price. For example, if a company should be purchased because they have the best technology and/or the best ecosystem, market share, management, brand, country of domicile, distribution network, etc., does that argument apply to any price? $20 per share? $40? $400? $4000? $40,000? No matter how great a business is, there exists a price that is simply too high! We are sure of it.

If price-to-book value doesn't carry the same gravitas it once did, **what about price to: earnings (normalized); sales; replacement value; liquidation value; GDP; cash flow? When the market is at, or near, the most expensive level ever when appraised on any of these metrics, can one really afford to rationalize it away?** Does the "new era" really negate the laws of mathematics? Has human nature evolved beyond emotion? Does greed no longer lead to excess? Does excess no longer lead to lower returns in the future? Can Apple, Google, Facebook, Netflix, Amazon, Baidu, Tencent, and Alibaba **compete against each other and all win**? With the size of government claims now the highest percentage of GDP ever, and debt claims against GDP the highest ever, and equities now priced near the largest percentage of GDP ever, can the new economy really support this triple threat? Keep in mind, all of these claims are senior to the claims of equity-holders.

Furthermore, can value really be found amongst a feeding frenzy for the super-popular, high-profile stocks? When everyone owns "quality franchises," can they possibly be bargains? When billions of dollars are flowing into the FAANG[1] stocks every hour, is it even conceivable that they are underpriced? **Doesn't value investing by its very nature require a contrarian bent?**

On the other side of the coin, the fact that intangible value may occasionally be overlooked does not mean that tangible assets don't still have value. **The current investor stampede into intangibles has left tangible assets neglected and underpriced**. Many dominant companies can be purchased at significant discounts to tangible book value. And while tangible assets may be way less sexy than their intangible brethren, they are safer by a wide margin. As previously mentioned, today's must-have technology is tomorrow's memorabilia. Meanwhile, mobile service infrastructure, electricity distribution systems, metal reserves, railroad systems, farmland, and many other similar assets are highly unlikely to become obsolete in our lifetimes. They will continue to be inherently valuable over time. Regardless of how the anointed stocks perform, buying these valuable tangible assets at a sliver of their intrinsic value seems destined to be a highly rewarding undertaking.

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[1] *FAANG is an acronym for the market's five most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google*

Franz Ferdinand
(Empires, Franchises, Money; Tangibles Don't Matter – Until They Do)
(Investment Strategy)

Now seems to be an important time to move at least some assets from momentum toward value. Although this environment feels more reminiscent of 1972 than 1999, it is close enough to 1999 to repeat our message to clients at that time: "it may sound like sour grapes, but if a manager had a good year in 1999, you should beware." In the current equally narrow and bifurcated market, we will reiterate that sentiment – it may be sour grapes, and we may be wrong, but we would suggest extreme caution regarding pronouncements of the death of value, and be very wary of any manager who is excelling in the recent, exuberant period. Our prior commentaries, *Runaway Train* and the *Weight of the Wait* provide more in-depth narrative on the pain and probable reward of staying true to the value discipline during the cycle extremes. We suggest, among other things, that while Buffett was smart to switch from Graham-type asset-based investing to sustainable earnings-based investing in the early 80s when few others did so, now that everyone is forecasting strong future earnings, maybe this is a good time to be one of the few scooping up cheap assets. We believe that it is a major mistake to refer to 'quality franchise' stocks as 'Buffett' stocks. When quality franchise stocks were all the rage in the late 60s/early 70s, Mr. Buffett wasn't buying them, he was returning most of the money to his investors. The last time franchise quality stocks got out over their skis, during the late 1990s, people were calling the likes of Coca-Cola a "Buffett-stock," seemingly clueless to the fact that they were touting a stock at over $80 that Mr. Buffett had purchased at less than $3. Like everyone, we appreciate the beauty of the goodwill inherent in quality franchise stocks, but believe that value is seldom found in sectors that everyone loves and everyone holds. Value usually resides where no one is. In this ever cyclical world in which we live, there's a time and a place for everything. Now is the time for value, and value, at this moment, mostly resides in the unloved "cigar-butt" stocks of Graham and Dodd fame. To continue the discussion of why we really like the present, massively bifurcated marketplace in general, and tangible assets in particular, let's return to Iberia.

Sometimes, as they say, life is stranger than fiction. Even I am surprised at the things that inspire these commentaries. A few days after being introduced to the tale of Sebastian, a group of us were at a music festival listening to Franz Ferdinand (Scottish rock band) when a mosh pit broke out in our vicinity. It had been a while since I'd been in one, but it was a lot of fun. It helps to be way bigger than everyone else. Anyhow, in the midst of it, a young Spanish gentleman comes up and yells, "Dave Iben?! - Dave Iben, the gold guy?!" My colleagues were floored. I don't know that I'd ever thought of myself as a gold guy, much less **the** gold guy. Heck, I was short gold miners in the 1980s and avoided them in the 1990s. We owned a lot of them off and on during the last decade and again over the past seven years. But, having given it some thought, I believe that if there was ever a time to be associated with gold, or purveyors thereof, **now** seems like a fortuitous time. The future looks exceptionally bright.

Let's explore the fundamentals from top to bottom. The reason that Kopernik employs a bottom-up, analytical approach, rather than top-down, is because: 1) price is paramount and 2) often, the story is best when an asset is over-owned and over-priced.

Top-down methodologies led people to buy tech in 2000 and again now. A compelling fundamental story led to the Japanese market elevating to a valuation roughly equal to the value of all the rest of the world's stocks put together in 1989. During the almost three decades since, their market is down one-third even as GDP rose 65%. A top-down approach persuaded people to sell the U.S. market when things looked bleak in 2002 and again, when they looked even bleaker in 2009. It is supporting people's decision to buy into that very same U.S. stock market now at four times the price (seven times for the NASDAQ 100). The top-down story for gold was extremely compelling at the end of the inflationary 1970s following a run from $35/oz to $800/oz. Gold later sank to $255/oz. but the top-down story led people back in during the QE[2] infused heights of 2011 when the price exceeded $1900/oz. Presumably, one should assume that the top- down story has evaporated now, since gold has been in a bear market for more than eight years. One would be very wrong. Read on.

Let's start Kopernik's self-examination process here, with gold. Gold related equities are, after all, a quarter of the portfolio. Are we wrong or is the market in one of its infamous bouts of irrationality? Time will tell, but the facts couldn't be much more encouraging. Let's examine, starting, out of curiousity, with the top-down story before moving on to the much more relevant, bottom-up analysis. We will discover that the top-down story has weakened in lock-step with the price of gold. Perhaps surprisingly, the story has become much stronger. Gold hit $1900/oz. in 2011 because the Fed had tripled the money supply in three short years and people doubted that the Fed really had an "exit

[2] *Quantitative easing is an unconventional expansionary monetary policy in which central banks buy government bonds or other financial assets with the goal of stimulating the economy.*

strategy." Were they wrong? In fact, their cynicism didn't go far enough. Not only did the Fed fail to exit, they subsequently almost doubled the money supply again. Over four years, money supply almost quadrupled. Additionally, most of the central banks contracted the disease. Their affliction turned out to be even more severe. See below:

As of 2017

Source: fred.stlouisfed.org, Bank of Japan, Bank of England, European Central Bank, tradingeconomics.com, gold.org

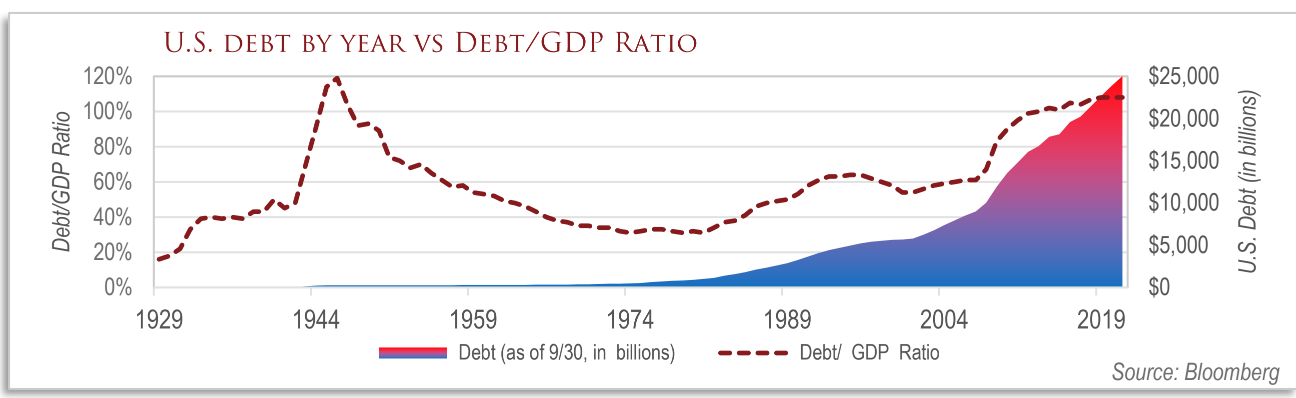
Country	Money Supply (USD, billions)	GDP (USD, bilions)	Money Supply/GDP	Gold Reserves (tonnes)	Money Supply/Gold Reserve ($/oz)
U.S	$3,585	$19,391	18.5%	8,114	$13,743
Japan	$4,467	$4,872	91.7%	765	$1,830
China	$1,044	$12,238	8.5%	1,843	$17,620
Swiss	$576	$679	84.9%	1,040	$17,227
England	$108	$2,622	4.1%	310	$10,837
Canada	$70	$1,653	4.3%	3	$725,765
Europe	$1,396	$12,590	11.1%	14,652	$2,964
Aggregate	**$90,400**	**$87,505**	**103.3%**		

	2008	2018		
Country	**Money Supply (USD, Billions)**	**Money Supply (USD, Billions)**	**Gold Reserves 10 Year Growth**	**Money Reserves 10 Year Growth**
U.S	$910	$3,585	-0.2%	294.0%
Japan	$877	$4,467	0.0%	409.5%
China	$476	$1,044	207.1%	119.4%
Swiss	$41	$576	0.0%	1304.9%
England	$96	$108	0.0%	12.5%
Canada	$51	$70	0.0%	37.3%
Europe	$893	$1,396	13.6%	56.3%

So, from the top-down, a further price appreciation versus debasing fiat currencies seemed inevitable. We suspect that it still is. We'll watch the current attempt to withdraw excess funds with great interest. (Excuse the smirk.)

Turning our attention from failed monetary policy to failed fiscal policy, governments have without question failed to get their houses in order. They were going to reduce the concentration of "too-big-to-fail" banks and bring down the level of debt in the economy. How did they do? The question is rhetorical as you're all aware that both the banks and the debt burden have become much larger.

Regarding their efforts to reduce bank concentration: 10 largest banks control 3/4 of assets; big 4 control 54% up from 45% in 2007. Number of banks has fallen from 14,000 in 1985 to 8,500 in 2000 to 4,938 in 2017[3]. See below:



[3] *Sources: www.nhbr.com, www.ameicanbanker.com, www.brookings.edu*

As the chart shows, the U.S government has taken on substantial debt. It is now the highest ever, with the exception of post-WWII victory. It now exceeds 100% of GDP. Globally, total debt has gone from 205% to around 280% of GDP over the decade.

And, as anybody with a rudimentary knowledge of Austrian economics could have confidentially told you, the severe "unintended" consequences include mal-investment, rising inequality, concentrated pockets of rapid price inflation, and the creation of another bubble. Take a look at some of the charts below and make up your own mind as to the success of central banks' policy and as to the unintended consequences.

The following charts are kind of scary:

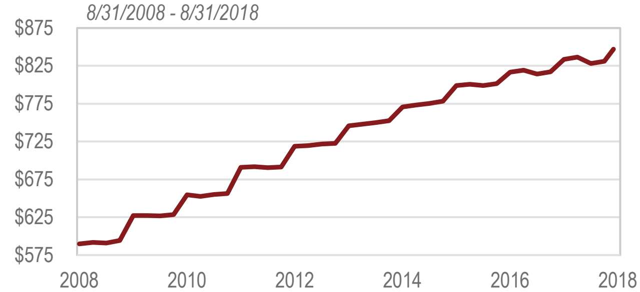
Source: Bloomberg

NASDAQ Composite
9/14/2008 - 9/14/2018

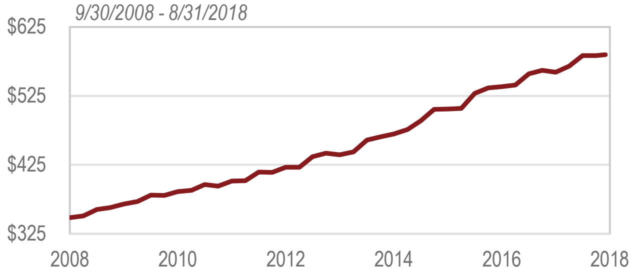
S&P 500 Index
9/14/2008 - 9/14/2018

The Consumer Price Index (CPI)
8/31/2008 - 8/31/2018

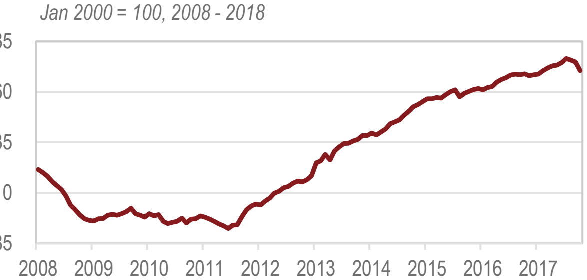
US CPI College Tuition & Fees Index
8/31/2008 - 8/31/2018



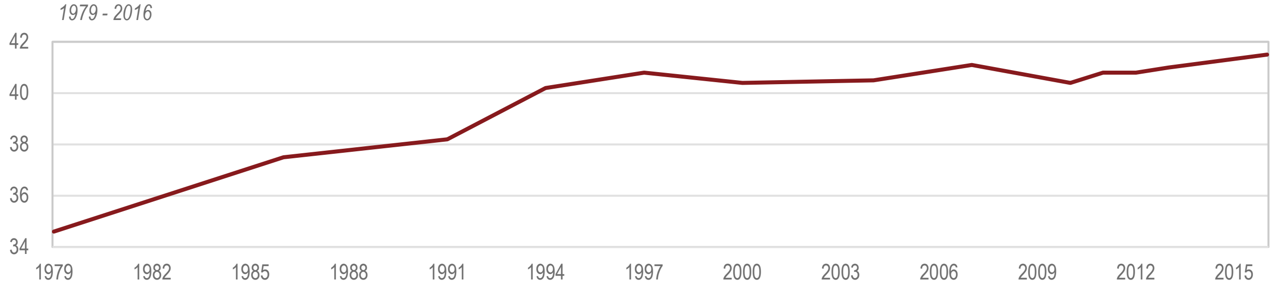
US Producers Pricing Index and Pharmaceuticals
9/30/2008 - 8/31/2018



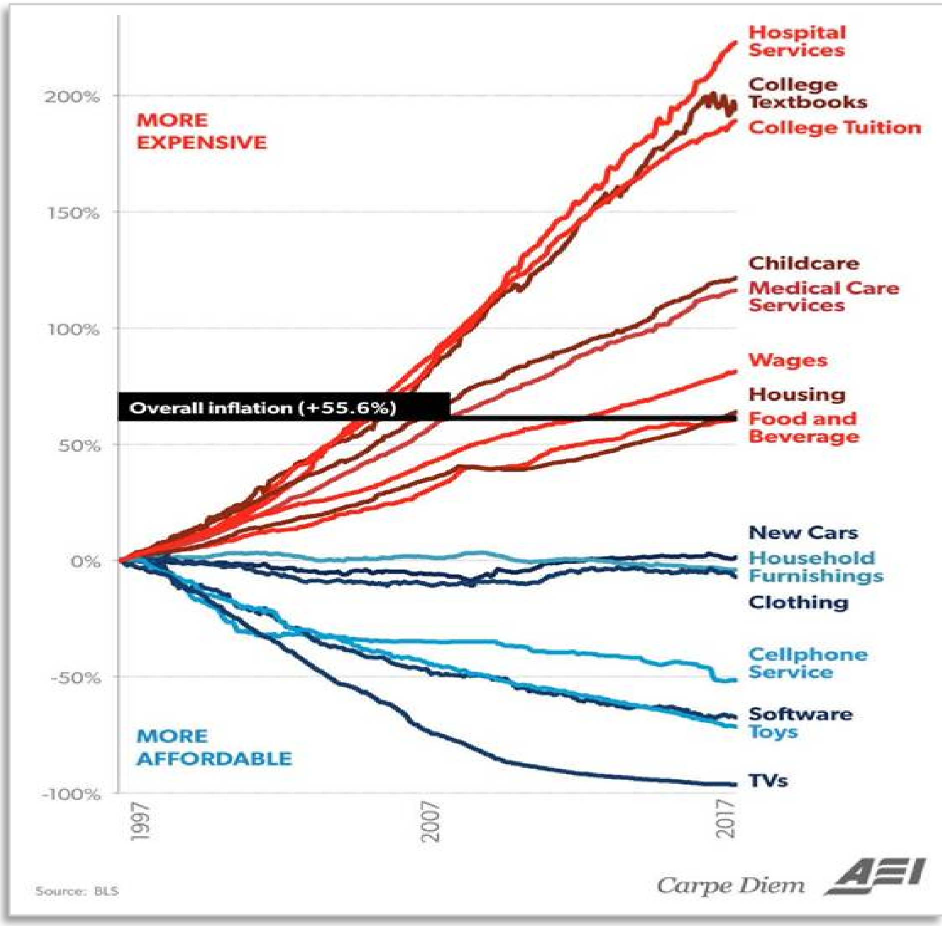
Condo Price Index for New York, New York
Jan 2000 = 100, 2008 - 2018



Gini Coefficient - US Wealth Distribution Inequality
1979 - 2016



Government deficits are widely, and logically, believed to cause inflation in the future. I'm not aware of any major political party in any country on the planet that is arguing for fiscal austerity; or even fiscal precedence for that matter. Will fiscal profligacy lead to future inflation and rising gold prices? Time will tell.



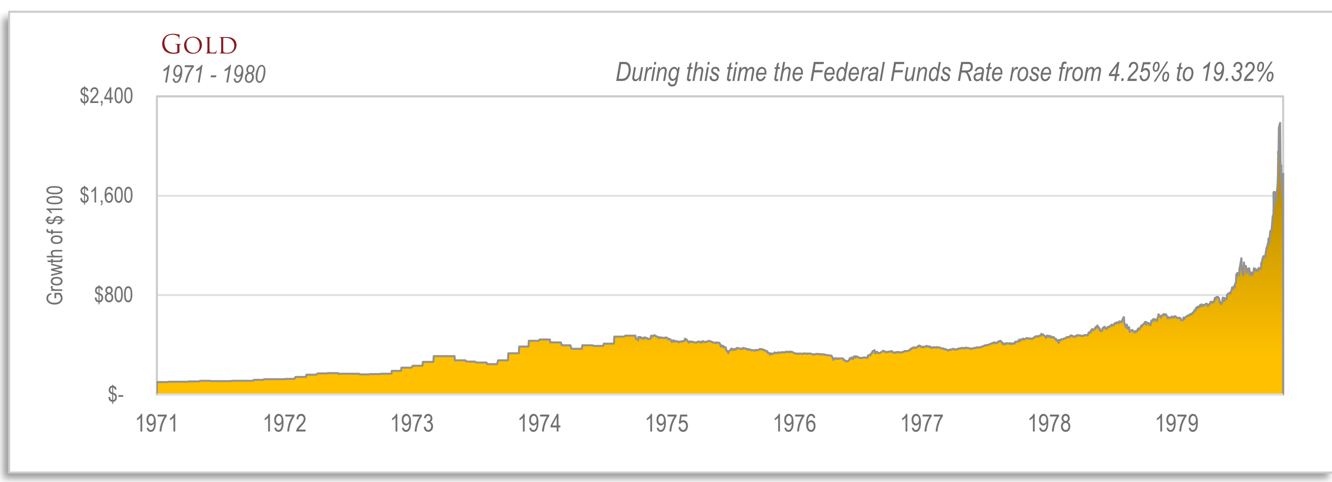
Enough said.

Okay, that concludes the top-down analysis. Moving on to the bottom-up picture, it is interesting, almost awkward, to note a rare occurence - **a compelling top-down story, hand in hand with a compelling bottom-up story.** Obscured by the pain of recent underpeformance, lies the best of all worlds for active managers willing to pursue value-laden gold miners. Top-down approaches suggest that the price of gold should go way up due to ever-inceasing fiscal irresponsibility on a massive scale with no end in sight. Bottom- up analysis reveals that supply and demand are drastically out of balance and that bringing the two back to equilibrium will require the price of gold to go higher; the price required to incentivize adequate future supply is believed to be roughly two-thirds higher than the current market price.

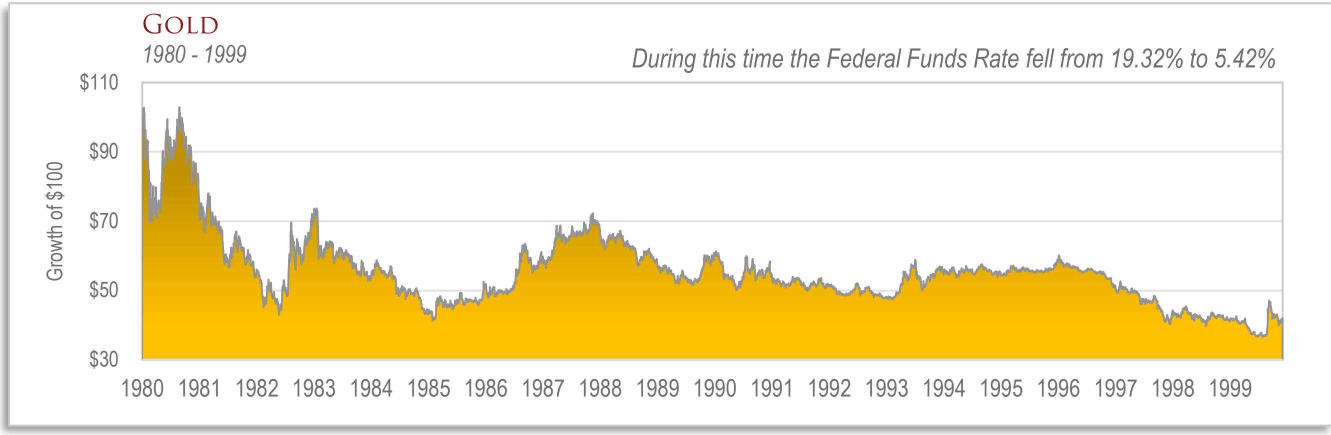
Top-down analysis would indicate that the gold price will move higher because, even after monetary policy has been lax for an entire decade, the U.S. is struggling to find an “exit strategy.” Other countries haven't even attempted to exit. The largest increase in global money supply in the history of the earth occured last year. Bottom-up analysis focuses on the fact that the U.S. monetary base is already at $3,585 billion, equivalent to $13,742/oz of gold, up from $117 billion and $450/oz in 1980. Top-down analysts might point out that gold miners are oversold whereas true bottom-up investors can't help but feel bullish due to the fact that many gold stocks are trading below their liquidation value (even at current, depressed gold prices) while offering massive upside potential. We are further excited by the anomaly that gold owned by miners is selling at a huge historical discount to gold held above ground.

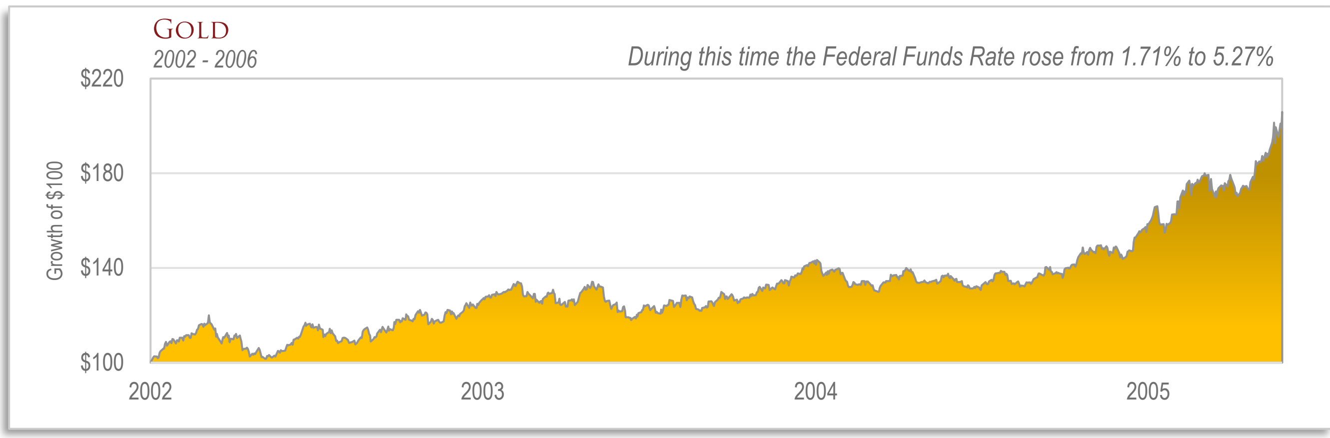
Kopernik
Global Investors, LLC

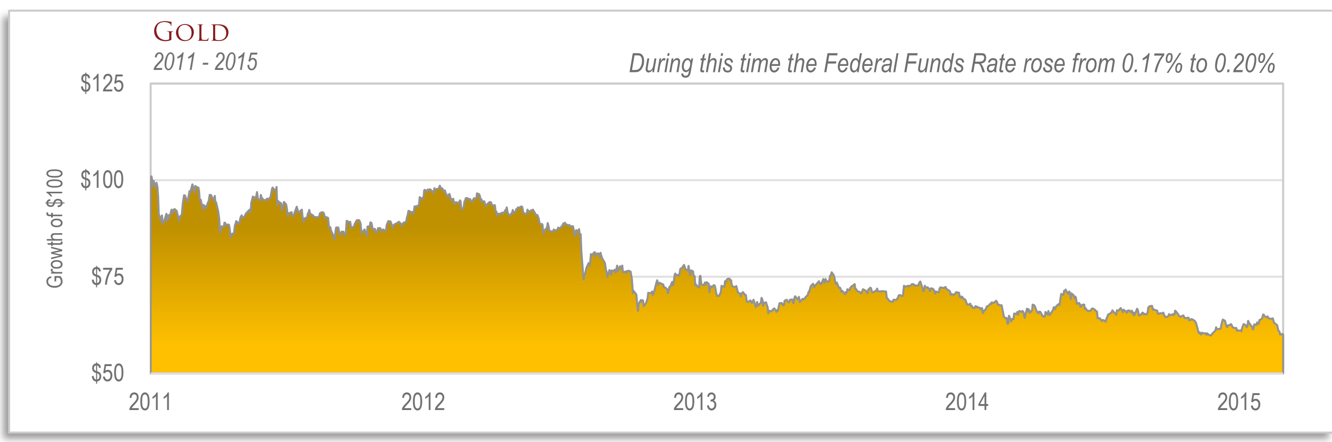
Before moving on from gold, let's evaluate the commonly repeated myth that rising interest rates cause gold prices to fall.



Sources: Bloomberg

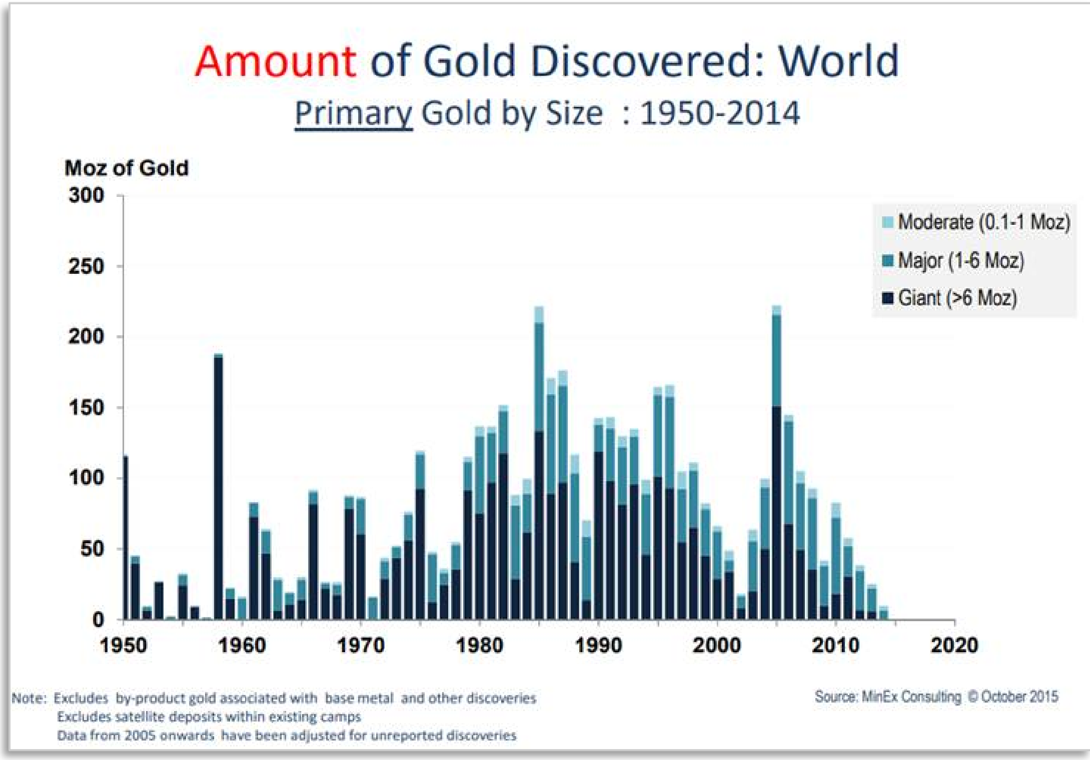


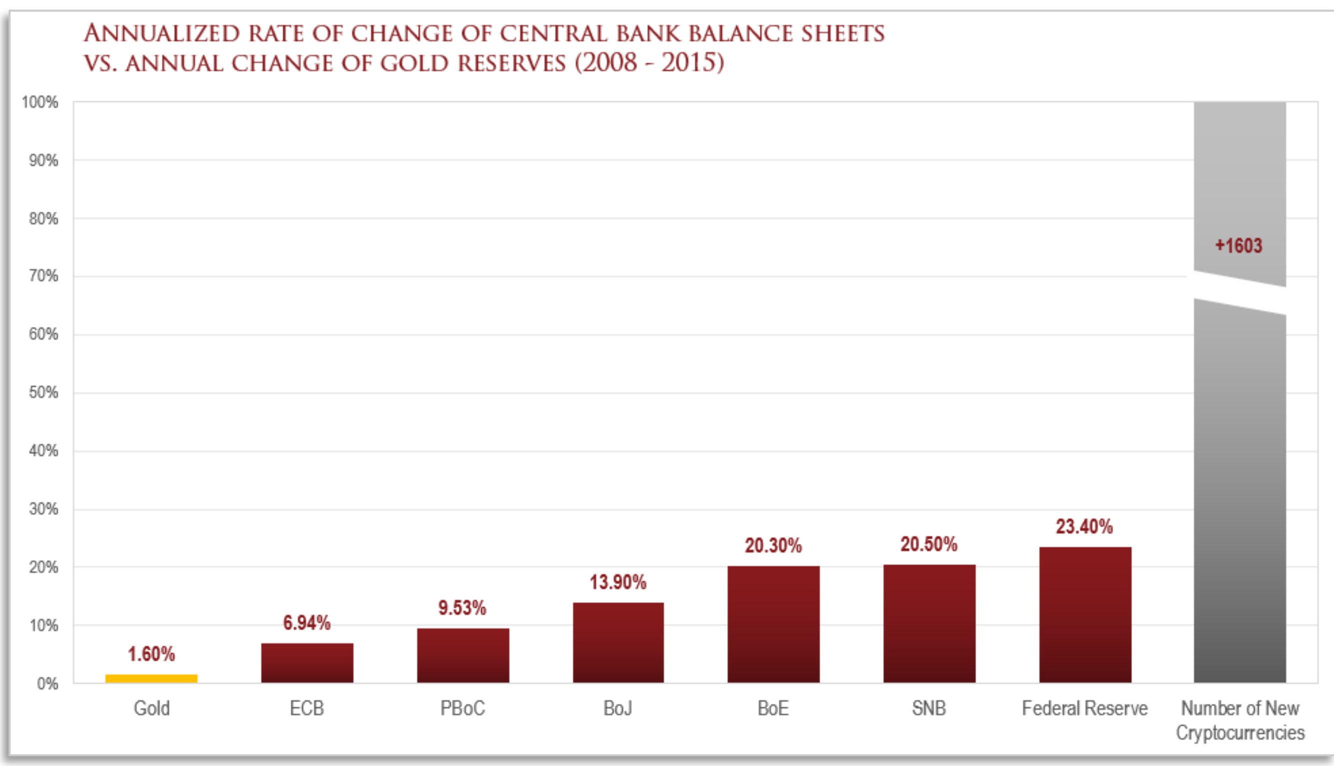




Sources: Bloomberg

Continuing to peruse the fundamentals, one may be inclined to ask: has gold become abundant? Have many gold discoveries been made in recent decades? Are the major companies replacing their mined reserves? Has a meteor of solid gold crashed into the earth? After centuries of trying, have alchemists learned to turn base metals into gold? The answer to all is a resounding "NO." The supply creeps along at a percent or two a year. Meanwhile, the supply of currency, fiat and crypto alike, has experienced a decade for the ages. New eras come and go, but in the end, supply and demand always matter.



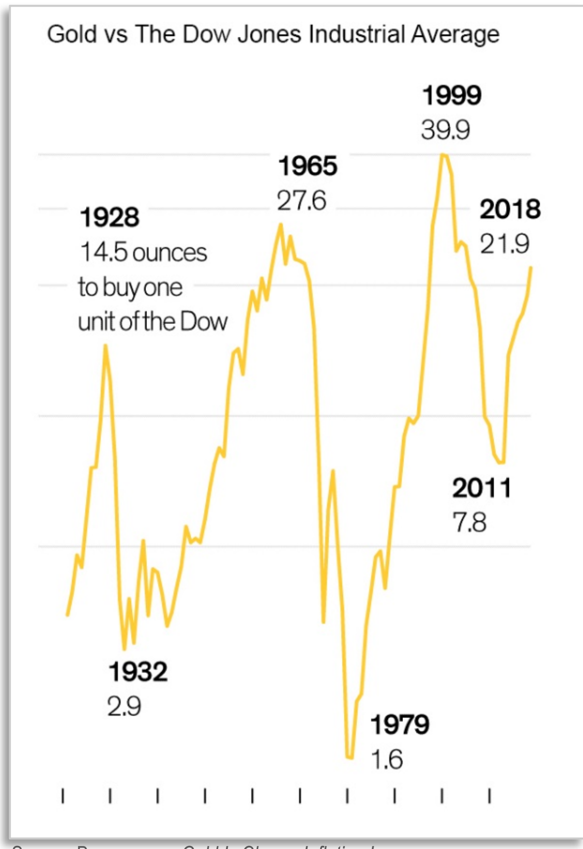


Sources: FED, SNB, BOE, PBPC, Incrementum AG, Kopernik

(*"And to say it once more. Public opinions—private laziness." - Nietzsche*)

"Did you ever have to finally decide?
And say yes to one and let the other one ride?
There's so many changes and tears you must hide."
-John Sebastian (I know, wrong Sebastian)

In an abnormally bifurcated market, people have a choice – stay with the uber-popular trend-setters or pivot to the unloved; stocks that could only look beautiful to value types. Everyone is waiting for "the catalyst." Who knows if it has arrived, but as the above referenced song suggests, "*you bet you'd better finally decide."* For Kopernik, the choice is easy. At current levels, many stocks with tangible value look downright enticing. In an otherwise overpriced world, gold is cheap. For now, I'm fine with the moniker - the Gold Guy. In a world of "too much" of most everything, I will be the scarcity guy. The "gold guy," "platinum guy," silver guy," "natural gas guy," "uranium guy," "clean water guy," "farmland guy," or the "large-growing-country-with-scarce-market-capitalization guy!"



Source: Barrons.com *Gold Is Cheap. Inflation Is Coming. You Do the Math* | Andrew Bary

Before concluding, let's quickly revisit the haves versus the have nots. Returning to Franz Ferdinand - the concert was great. And, it prompted me to revisit the history of the original Franz Ferdinand, the Archduke of Austria, whose assassination is credited with sparking World War I. He escaped an assassination attempt in Sarajevo when a bomb exploded slightly off target. Undaunted, he continued with his schedule. Later in the day, his driver made a wrong turn and got caught in traffic. One of the conspirators was sitting in a bar, mourning the failed attempt, looked up and couldn't believe his luck. He walked out, shot the Archduke, and within a few years, four empires had collapsed. That's right, empires that had lasted centuries came crashing down: Russia, Germany, Austria, Ottoman. I once read an interesting piece about life in Vienna in 1914, written, I believe, by Marc Faber. People were living large: restaurants, night-life, good times, the good life. None even imaged that their five hundred-year-old world empire was teetering on the edge, soon to disappear.

Sometimes it's dangerous to pay exuberant amounts for perceived future prosperity. Sometimes world powers get arrogant. Sometimes they overspend. Sometimes they make mistakes. Sometimes they just have bad luck. We hope that suggestions that the ¾-century "Pax Americana," which has led to relative peace and prosperity for the planet is unraveling, is off base. All the same, what an important time it appears to be, to diversify across countries, regions, sectors, asset classes, currencies, and stores of value. Now, in the era of global, monetary experimentation, this is not the time to have 54% of your eggs in one basket, even if those eggs are American (The U.S. comprises 54% of the MSCI-All Country World Index, but roughly only 20% of World GDP). As pointed out above, now is the time to buy gold, especially at the unbelievable discounts available through the gold mining stocks. Now is the time to buy uranium, at an 80% markdown from the previous price peak. The uranium ETF (URA) is down 90% from its 2011 level and has just capitulated on the metal, and begun including capital goods companies that have vague exposure to nuclear power in the portfolio. It sounds like the proverbial bell is ringing. Over the summer, the price of uranium bounced – it is now 40% above the low, and Cameco Corp., the world's largest publicly traded uranium company, won a major tax-related victory over the Canadian government. Instead of paying a fine that was estimated to be $400 million (mm), possibly even $2 billion, they will pay nothing (being appealed). Shockingly, the stock is lower now than it was at summer's onset. Over the longer-term, it is 80% lower than it was eleven years ago.

Likewise, while oil has tripled off of the depressed levels of three years ago, cleaner alternative natural gas has not. It remains at a 75% discount to the peak of 2008. And, in fellowship with gold and uranium, ownership of the resources via the stock market offers even more enticing bargains. Range Resources, for example, is down 83% from its level in 2014. Gazprom, the world's largest gas company, is 85% below its 2008 level, despite the fact that over that same period its book value per share has sextupled! Elsewhere, the Bloomberg agricultural sub-index is less than half its level of a decade ago. We will continue our strategy of opportunely buying profitable, publicly-traded farming companies, predominantly in the developing world, as they persistently go on sale on a rolling basis. The MSCI-EM Utilities index has almost been cut in half since 2007. We have opportunely trimmed and added to our utility holdings in recent years. We've been taking gains in France and Brazil while adding back our previously trimmed Russian franchises. Telecom has been similar. One of the shining stars of 1999's TMT (Technology, Media and Telecommunications) market, the MSCI-EM Telecom is not only well below the '99 level but is less than half of 2007's. Korea and China look particularly interesting here.

In summary, while we fully expect to be wrong one-third of the time, based upon self-reflection, we don't believe that this is one of those times. As we concluded in 2000, we once again conclude that it is the market that has lost touch with reality. We doubt that the "shooting-stars" of the current rally are really worth much more than they were several years back. And we strongly believe the market is foolish to be sneering at unpopular, but value-laden tangible assets. We are excited that the current, very bifurcated market offers tremendous value to those willing to prospect in the very unpopular venues where value resides. Real assets are, figuratively, being given away. Many stock markets in the emerging parts of the world are a decade into bear markets, even as many great companies that are domiciled there continue to prosper; a prosperity not reflected in the stock prices. Optionality is grossly underpriced, whether it dwells in resource companies with huge operating leverage to undervalued minerals, or in put options on indices that are momentarily untethered from fundamentals, or elsewhere. This is in large part because implied volatility is being suppressed and people have forgotten that stability itself is inherently unstable. We're excited by the opportunities created from today's historic misperceptions and concurrent mispricing. What others condescendingly snub as "cigar butts" may turn out to be, figuratively, valuable 'Cubans', wrapper intact.

We wish you all a healthy and happy holiday season,

Cheers,

David B. Iben
Chief Investment Officer
Kopernik Global Investors
October 2018

P.S. While we signed off on a positive note, those interested in hearing more about the perils represented by the 'two-sided coin' of a bifurcated market, the requisite shots at momentum stocks, and/or the other side of the Sebastion story – read on.

As pertains to prophesies of a new era, we say, "beware false prophets/profits." With that, let's segue back to King Sebastian, and **to the idea that he is not an analogue for value investing, but for momentum investors, new era investors, and others investing in the dream of a future that has evolved past the need for old-time fundamental value**. The following article provides a different view of the savior king.

> *"D Sebastião: The Return of the King*
> *Lynne Booker*
>
> *If there were to be a vote for the worst king of Portugal then you might think that D Sebastião would be a clear winner, far ahead of a field including such incompetents as D Afonso V and D Afonso VI. He led a cripplingly expensive crusade to North Africa, in which his army was completely destroyed and he himself was killed. Even more disastrously for the monarchy, he left the kingdom with no viable heir and ripe for a takeover by the King of Spain, Portugal´s long standing and mortal enemy.*
>
> *It is therefore a surprise to find that many Portuguese cannot wait for him to return! Legend has it that one misty morning D Sebastião will reappear and with him Portugal´s wealth and greatness will be restored. Before he was born he was referred to as O Desejado (the desired one) and after his catastrophic invasion of Morocco he was still called O Desejado, as indeed he is today. What is it about Portugal´s "King Arthur" that has given rise to such a myth and to such a fanatical belief in a king who brought his country to ruin?*

D Sebastião was certainly seen as a saviour at the time of his birth. The dynasty of Avis was struggling to survive. Of D Manuel´s 13 children, the only survivors were D João III and his brothers the Infantes D Luís and Cardinal D Henrique. D Luís was unmarried and had only one bastard son, and as a cardinal, D Henrique was not able to marry. Of D João III´s 9 children, the only survivor was the sickly Príncipe D João who was married to his double first cousin D Joana de Áustria as soon as possible. (They were aged 16 and 17 respectively). With bated breath, the whole of Portugal waited for the birth of a male heir. Having performed his dynastic duty, the exhausted Príncipe D João died 18 days before the birth of his son, D Sebastião who had been begged from God with so many tears, pilgrimages, processions and alms.

D Sebastião came to the throne at the age of 3 when his grandfather, D João III died at the early age of 55. At first, grandmother D Catarina was regent during D Sebastião´s minority, and then great uncle Cardinal D Henrique took over. D Sebastião was educated by the Jesuits and his greatest desire was to be a crusader. He took little interest in the task of government and he dreamed of military conquest and the expansion of the faith. His major and indeed only aim was to conquer Morocco. He was not a strategist or planner; these were cowardly traits. His motto could have been the same as that of the SAS, Who dares wins! When he assumed his duties as King at the age of 14, he took no advice from the experienced D Catarina and D Henrique and the way to his heart was through flattery and admiration. Avoiding Lisbon and the possiblity of unwanted advice, the young king traveled around the Alentejo and the Algarve with like-minded young aristocrats. He developed a craze for physical fitness and he took violent exercise in all weathers: he would hunt, go hawking, joust and he would fight bulls (but he would not kill them or allow them to be killed).

From an early age he suffered a lifelong chronic ailment which affected his sexual organs. He had an apparent dislike of women and there were grave doubts of his generative abilities. The Spanish Ambassador at Lisbon said that speaking to him about marriage was like speaking to him of death. Although he received numerous proposals on behalf of marriageable Spanish or French princesses, he was just not interested.

But he was passionately interested in Morocco. Because the Portuguese fortresses in Morocco (Alcácer Seguer, Arzila, Azamor and Safi) had become expensive to maintain and unproductive and because the increasing demands of Empire proved that there were just not enough men to occupy them, D João III had abandoned these outposts of the Empire. D Sebastião was determined on a crusade to win them back again. Having surrounded himself with useless aristocrats and fawning favourites, D Sebastião set about making concrete his vision of Empire. Needing money, he raised special taxes; he borrowed 400,000 cruzados at 8% from a banker in Augsburg (in return for a 3 year monopoly on the sale of pepper); and for 240,000 cruzados, Portuguese New Christians bought from him a papal Bull which temporarily suspended the right of the Inquisition to confiscate their captives´ property.

In 1573 D Sebastião spent six weeks in the Algarve examining his levies and the defences against the corsairs. In Tavira, after he had examined the Forte do Rato, the delighted town staged a bullfight, and the king demonstrated his great upset when one of the bulls was killed.

D Sebastião visited the Portuguese fortress of Ceuta in Morocco for the first time in 1574 and by the summer of 1578 he had finally managed to gather an invading force. It consisted of 14,500 infantry, made up of Portuguese and mercenaries from Italy, Germany and Spain and 1900 cavalry and 36 guns. That great historian of Portugal C R Boxer calls the campaign that ensued one of the worst managed in recorded history. The invading force landed at Arzila and the infantry marched 33 km southwards towards Larache and then 32 km southeastwards towards Alcácer Quibir towards the waiting Moorish army.

D Sebastião was young, nervous and incompetent. Because he had not ordered any reconnaissance whatever, he was unaware of the size of the Moorish army (50 000 men, innumerable horsemen and 27 guns) or its proximity. He insisted that he was the only one who could give the order for any attack; he physically pushed fidalgos and soldiers whom he considered out of place; he offended the Spanish commander, who publicly regretted his participation in the invasion; he delayed giving the order to attack and when he did, it was only to the cavalry, apparently forgetting everyone else. D Sebastião refused to flee even when it was obvious that the battle was lost and many aristocrats were killed because they could not leave him. D Sebastião was eventually surrounded and cut down. Only about 100 Portuguese escaped from the scene of the battle and about 6,000 survived as prisoners. The cost of this ridiculous adventure was 1,000,000 cruzados (one half of the state´s annual income). Portuguese *schoolchildren are taught that the battle was lost because of the sabotage of Spanish mercenaries. Spain of course was in a position to gain if D Sebastião were killed.*

When D Sebastião´s body was eventually returned to Portugal in 1582, it was interred in the Mostério dos Jerónimos in Belém. A century later, his tomb was completed with the following verse (here translated from the Latin):

In this tomb lies buried Sebastian - if the story is true -
Who in the sands of Africa was gathered in by impatient death
Do not say that they are mistaken who believe that the king still lives
He was fated to die, and in his death he lives on

Strangely, despite the humiliating defeat and annihilation of the expedition, Portuguese people did not blame D Sebastião. He was regarded as a tragic hero of epic proportions whose disappearance was only temporary. At first it was believed that he was in hiding and his people called him O Encoberto (the hidden one). During the years 1580 - 1640, when Spanish kings occupied the throne of Portugal, people put their faith in a Messianic deliverer, D Sebastião O Adormecido who would wake from the dead to inspire them. This strong belief is now known as Sebastianismo and is associated with a forceful and heartfelt patriotism, which may have underwritten Portuguese belief in its Empire right down to 1974. Ironically, therefore, it could be seen that this headstrong and militarily inept youth, by leading his countrymen to a tragedy of epic proportions in the sands of Africa, indirectly contributed towards the comparative longevity of his nation´s American, Asian and African empires. The ´spin´ does not work for me. I think D Sebastião emptied Portugal´s coffers, wasted thousands of lives and lost Portugal its independence. For these reasons he gets my vote as Portugal´s worst king!"

Source: Copyright (c) 2014. Algarve History Association

Ignoring the numbers and charging full-speed ahead; that doesn't sound like any value investors we've ever met! Au contraire. Surrounding himself with aristocrats and favorites? Ignoring the numbers? Charging on in the belief that this time is different? These are the traits for which momentum investors are famous. Unwavering support for "The Desired One(s)" is their very M.O. The anointed ones who will save the empire from decline in the midst of dysfunction, a heavy debt burden, and challenging overall fundamentals? Anyone picturing the FAANG stocks here?

Clearly Sebastian is a better analogue for "New Era" stocks than for value stocks, but we are not suggesting that New-Era Sebastianites are waiting. They are doing anything but - patience is not their thing. Momentum stocks attract more and more money as they rise, figuratively ever closer to the sun.

"Careful, pal. You're talking about the stocks I love!"

They embrace the rosy future of the FAANG stocks. They know no fear other than "FOMO," the "fear of missing out" on the get rich quick bonanza. Major leaps forward in technological innovation are a powerful, market driving force, especially when in conjunction with easy monetary policy. Thus it was when technology opened whole new worlds to the Dutch, English, French, et al in the early 19th century, leading previously unimagined wealth for the South Seas Company and the Mississippi Company. These stocks rocketed skyward accordingly. Likewise, a great bull market sprung from the building of the canals and again with the advent of the railroads. Later, the 1920s, almost a century ago, was an era that is still famous for technological innovation, for its go-go economy, its "Gatsby-esque" ostentation and class divide, and, of course, one hell of a bull market. Jumping forward to the late 1960's and early 70's, technology was once again hopping, the Fed's "printing press" was working overtime, and the stock market was, accordingly, in overdrive. Leading the way were tech stocks and consumer franchises, the ones which had proven especially adept at utilizing technology to create "best of breed" products, services, distribution and advertising. The stocks of many such companies became members of the "Nifty Fifty" "can't lose" stocks.

The global leader in technology during the 1980s was Japan. They dominated automobiles, consumer electronics, machining, and semi-conductor equipment, and gained prowess in media. American companies started imitating Japanese culture and processes. The market boom was one for the ages. The next decade, centering on mobile communications, fast IC's[4] and, of course, the advent of the internet, led to enormous growth, returned the technology leadership position to the U.S., and eventually sent the NASDAQ into the stratosphere.

Every investor should read "Devil Take the Hindmost and/or Extraordinary Popular Delusions and the Madness of Crowds." They tell their story in a much more interesting manner than I can. And, if anyone is in doubt as to how the above market manias ended, you'll find that in these books as well. While social media, search engines, home delivery, bio-engineering and CRISPR[5], clean energy, and autonomous vehicles are without a doubt, game changers, imagine the impact on society that was brought about by canals, railroads, airplanes, cars, air-conditioning, indoor plumbing, distributable power, telephones, telegraphs, ships that could sail the Cape of Good Hope, penicillin, computers, and so forth. To say that contemporary times are fantastic is an understatement. To say that "this time is different" from all the other speculative, technology-driven times is, in the words of John Templeton, "most dangerous."

Among the prevalent apologies for current record-high valuations are: accounting methodologies are obsolete, antitrust laws are no longer enforced, central bankers are wiser, interest rates are permanently low, financially engineered growth is tantamount to real growth, modern businesses are asset-light, perpetual government deficits are a good thing, and who knows what else. A fraction of these points arguably contain a grain of truth; most are delusions, even deliria. In the first quarter of 2000, the last "new era," we – as value oriented investors - could only batten down the hatches, and await the inevitable return to normalcy. We can also make two points:

1) *the laws that guide mathematics, finance, economics and human behavior have not been eliminated because of technological advancement and…*

2) *even if we are wrong about the potential of momentum stocks, the stampede out of value stocks into growth has left value stock at levels from which enormous future returns look almost inevitable.*

Now, eighteen and a half years after the last tech bubble, we've once again battened down the hatches. We're riding out the storm, and we reiterate the same two points. **We believe that most momentum stocks possess far more risk than potential upside, and, most importantly, that a subset of value stocks, following a decade long bear market, have reached levels that portend significant upside with lower than average risk**.

[4] *Integrated Circuits*
[5] *Clustered Regularly Interspaced Short Palindromic Repeats – CRISPR technology is a tool which allows researchers to easily alter DNA sequences and modify gene function.*

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