

Executive Summary

My Fair Lady, (MFL) has been reprised many times over the decades. It started as Pygmalion in London, later coming across the Pond as MFL, and as many versions continued to be cast on various stages throughout the world, it was adapted for film and became a popular, award winning movie. Therefore, it seems in the spirit of things to reprise my Commentary from four months ago. As with art, life tends to recast past dramas and present them as remarkable new things. Currently, we are told that quantitative easing takes us into uncharted waters when in fact it has occurred often, never ending well. We are told that high priced securities are not risky if volatility is low. They assure us that return on capital can remain at extremely high levels even while the cost of capital is pegged at much lower levels. Central planning is in vogue and free markets are passé. Many confuse crony-capitalism with free markets. They are very different. CPI, a tortured index of prices for consumer goods, adjusted and issued by government bureaucrats, is passed off as the way to measure inflation à la 1999, and so many times previously, many prefer a strong trend and a good story to tangible value. As during past episodes, for those who trust their own analysis and are students of history, this is an excellent opportunity to profit handsomely from the resultant market anomalies.

My Fair Lady

“Why can’t a stock be more like a bond?” Thus spoke/sang Professor Higgins as he segued in to the song “A Hymn to Him” in the great play/movie “My Fair Lady” (MFL). I know, what he actually sang was, “Why Can’t a Woman be More Like a Man,” but with apologies to Lerner & Loewe, I am taking some artistic license here.

Over the past 17 years, these commentaries have found pertinent, market related messages in popular songs, movies, and sayings. This is the first use of a Broadway play. I’m not a play aficionado, but I’ve always loved this one. The play and subsequent movie were based upon the play “Pygmalion.” Per Wikipedia:

“Pygmalion is a play by George Bernard Shaw, which was staged in 1912 and it was named after a Greek mythological character. Professor of phonetics Henry Higgins makes a bet that he can train a bedraggled Cockney flower girl, Eliza Doolittle, to pass for a duchess at an ambassador’s garden party by teaching her to assume a veneer of gentility, the most important element of which, he believes, is impeccable speech. The play is a sharp lampoon of the rigid British class system of the day and a commentary on women’s independence.”

I find this play, about Victorian England, to contain messages that are pertinent to the modern-day investment environment. In addition to having great music, it is a charming **story about hubris (Henry Higgins), avoidance of responsibility (Alfred P. Doolittle) and finding value and beauty in the under-appreciated and disdained of the world (Eliza Doolittle). How perfect an analogy it is for today's political and investment theaters.** I see parallels to contemporary government, fiat currencies, central bankers, bonds, emerging market stocks, natural resources and related stocks, and to the subjective topic of exactly what is money, and more importantly, what is value.

MFL explores the wants and desires of the upper class versus those of the poor. This is apropos in this increasingly “flat” world, especially with the growing prospects of global class warfare. In many ways, the play is about values. We are not going to suggest we know what values society ought to hold. Rather, we are very interested in recognizing beauty and worth in those investments which have been thoughtlessly relegated to the scrap heap. Conversely, we are eager to short securities to which the market is erroneously ascribing excess-value.

A Hymn to Him “Bonds”

(Once again with apologies to Lerner and Loewe).

Henry Higgins (HH): *“Why can’t a stock be more like a bond? Bonds seem so honest, so thoroughly square. Eternally noble, historical fair. What, when its time, will always give your principal back? Why is that an attribute that stocks simply lack?”*

“Would the market be slighted if a bond didn’t trade for hours?”

Colonel Pickering (CP): *“Of course not.”*

HH: *“Would bondholders be livid, if earnings missed by a penny or two?”*

CP: *“Nonsense.”*

HH: *“Would the bond market act wounded when the stock market cowers?”*

CP: *“Never”*

HH: *“Why can’t a stock behave likewise on cue?”*

HH: *“One bond in a million may sink a bit. Now and then, there’s one with slight defects. Its “I” Banker whose truthfulness you doubt a bit. But by and large, investors prefer them to sex.”*

“Why can’t a stock take after a bond? Bonds are investor friendly, paying cash or in-kind. A better investment you never will find.”

HH: *"Would bonds ever flash crash, causing many to sell low?"*

CP: *"Of course not."*

HH: *"If a company pulled its silly guidance, would the bond market fuss?"*

CP: *"Nonsense"*

HH: *"Would bondholders complain if I changed that auditing fellow?"*

CP: *"Never."*

HH: *"Why do stocks always cause us to cuss?"*

How things change with this fickle, cyclical, emotional creature we call the investment market. In 1982, bonds were hated with a passion (so were stocks). Following several decades of bear market, bonds were derided as "Certificates of Confiscation." Investors were unable to appreciate the sheer beauty of 15% per annum guaranteed for 30 years at a time when the brakes had been slammed on monetary inflation.

They shouldn't have missed it. The writing was on the wall. Paul Volcker had reined in the money supply. The rate of price increases in the economy had slowed substantially. Even the CPI was down, from double-digit levels, to around 4% per annum. The public had no taste for further inflation and the 'bond market vigilantes' slammed the market every time money supply spurted a little. Real rates were over 10% on the long bond, closer to 20% on the short-end. But investors, with the 1960s and 1970s fresh on their minds, refused to believe that inflation could ever be conquered. 'Volker would break.' 'Inflation was endemic to a democratic society.' Fiat currencies always go to zero. 'Stocks and bonds may be cheap, but so what, they were destined to become cheaper.'

Today is the mirror image of 1982. Nobody is afraid of inflation. In fact, many are quite fearful of the prospect of deflation. Bernanke, in particular, has an obsession with the 1930s, not wanting a repeat of depressionary times. He erroneously believes that the depression was caused by the Fed's 'tight' monetary policy rather than it being the inescapable consequence of the preceding mania that resulted from the Fed's uber-easy monetary policy during the 1920s. Just as people failed to understand that slow money growth in the early 1980s was disinflationary, they are now failing to understand that rapid money growth from 2007 through 2011 was very inflationary. After a lull in 2012, the Fed is back at it. The \$1 Trillion that it has promised to print in 2013 will be extremely inflationary too. It took multiple years for the effects of the disinflation to trickle into the economy back then, but it eventually did. It is taking multiple years in the contemporary world for the symptoms of the rapid monetary inflation to be fully felt in the general economy, but increasingly they will be. To reiterate: **money printing is (by definition) inflation.** "Positive" *symptoms* of inflation include rising prices of houses, stocks, bonds, and often a resultant, temporary increase in economic activity. "Negative" *symptoms* of inflation include a rising cost of living as prices of goods, services, and housing rise, often faster than income. This tends to

be a de facto regressive tax. Inflation also often encourages speculation and discourages saving and investment.

Now we are told that we have 5 years of history to prove that we needn't worry. The money supply has almost quadrupled since 2007 and yet CPI remains around 2%. I'm reminded of 1999/2000, five years into a money-printing fueled stock frenzy (and three years after Greenspan's 'irrational exuberance' comment). That is when it first occurred to me that speculating on bubbles was like playing a (career-threatening rather than life threatening) form of Russian roulette. Suppose that a six-shooter is loaded with one bullet and five chambers are left empty. If a participant pulls the trigger and survives, he wins (\$10 million or whatever). Feeling lucky he continues a second time, and so on. Suppose the *incredibly lucky* gambler wins five times in a row. Should he ride his luck and try a sixth time. Most on Wall Street would say, 'absolutely!' He has 'momentum.' 'We now have empirical evidence to support the premise that it in fact is not risky.' 'Research concludes that the world has evolved and there is no bullet.'



The more logical and mathematical inclined will instead conclude that failure is all but assured during the sixth attempt. Surely, pressing the NASDAQ bet in 2000 proved to be deadly to one's portfolio. Following five straight years where bonds have defiantly rallied strongly into the face of a rapidly inflating supply of money, one could conclude that monetary-inflation is, in fact, not bad for bonds, or conversely could decide that betting on a continuation of the bond bull-market may prove deadly to one's wealth. Let's explore.

First off, I understand that the consequences of being wrong are MUCH less serious than death. On the other hand, the prize for correctly owning bonds is de minimus. Nominal rates on 30-year Treasuries are near 3%, real rates are virtually zero (possibly much less depending on one's view of inflation). Since the prospective returns on bonds are virtually nil one should ask: What is the downside of owning bonds when the tide turns? Please see the nearby table. Not shown on that chart is the data point that, should rates return to 1982 levels, long bonds would drop 80%!! That is in nominal terms; real terms would be more painful. Who knows the proper compensation for taking the risk of owning long-duration bonds in a world where the Fed's balance sheet has expanded, from \$800 billion in 2008 to \$4 trillion expected at year-end 2013, and all major central banks are exhibiting similar behavior, but it is certainly far higher than 3% per annum!

20 Year T-Bond: 5 3/8's

Maturity: 2/15/2031 YTM 2.28% (Now)

Six Months	Interest		Pct	Pct	Pct	For Stocks To Keep Pace	
	Rate	Bond	Bond	Income	Total	Normalized	
	Level	Price	Gain/Loss	Return	Return	S&P 500	P/E
	2.00%	\$150.11	3%	2%	5%	1466	20.2X
NOW →	2.50%	\$140.92	-3%	2%	-2%	1378	19.0X
	3.00%	\$132.44	-9%	2%	-7%	1297	17.9X
	3.50%	\$124.59	-15%	2%	-13%	1222	16.9X
	4.00%	\$117.32	-20%	2%	-18%	1152	15.9X
	4.50%	\$110.60	-24%	2%	-22%	1087	15.0X
	5.00%	\$104.37	-28%	2%	-27%	1028	14.2X
	5.50%	\$98.60	-32%	2%	-31%	972	13.4X
	6.00%	\$93.24	-36%	2%	-34%	921	12.7X
	6.50%	\$88.27	-39%	2%	-38%	873	12.0X
	7.00%	\$83.65	-43%	2%	-41%	829	11.4X
	7.50%	\$79.36	-46%	2%	-44%	787	10.9X
	8.00%	\$75.37	-48%	2%	-46%	749	10.3X

A well-known hedge fund manager recently said that buying bonds was “like stepping in front of steam-roller to pick up a dime.”

Currency Wars – the race to the bottom.

Ascot Gavotte

“Pulses rushing! Faces flushing!

Heartbeats speed up! I have never been so keyed up!

Any second now they’ll begin to run. Hark!

A bell is ringing, they are springing forward! Look!

It has begun...! What a frenzied moment that was!

Didn't they maintain an exhausting pace?

'Twas a thrilling, absolutely chilling Running of the

Ascot op'ning race

To the extent that the Central Banks insist on supporting the bond market, something must give. That ‘something’ is the value of the currency. One of the great scenes in the movie is when they dress up Eliza and take her to the horse races. Now I admit to being a race fan and thoroughly enjoy the Breeder’s Cup (sort of like the World Series of horse racing) every autumn. As an American, I’m used to the track being a far cry from ‘upscale’. There is an interesting mixture of young and old, rich and poor, introvert and extrovert. There are no shortages of ways to bet the horses and no lack of inebriated players. And if you don’t care for profanity, don’t go; people loudly express their opinion of their horse’s (or jockey’s) effort.

The Ascot of the day, as portrayed in the movie, with ladies and gentleman dressed in their Sunday best, sipping champagne and exchanging pleasantries, while showing no emotion even during the heat of the stretch run, is nothing like current day horse racing. Yet, it is everything like the current-day “Competitive Currency Devaluation” races. Here, a bunch of prim and proper academics and financiers with very impressive resumes (though generally lacking any real-world experience) use a lot of rhetoric and a few econometric models to explain why their “horse” (currency) should/could win the race to the bottom. Some are better sprinters, others are better at distance. It is hard not to picture Ben Bernanke or Mario Draghi dressed in suits and ties and serious demeanors, while going hard to the whip every time another currency starts dropping faster than their own. In the film, it is a major faux pas when Eliza screams out, “move your bloomin arse”. Not so recently when Shinzo Abe, disappointed at the yen’s slow pace of descent, figuratively shouted the Japanese equivalent of “move your bloomin ass”. His jockey, BOJ Governor Masaaki Shirakawa merely *showed* the whip to his horse (the yen), to get him to surge to the lead, and the crowd thundered their applause. But wanting even more, he appointed a new ~~governor~~ jockey who is sure to *use* the whip aggressively.



On Why QE will never be reversed!

*“I doubted you'd do it. But now I must admit it
That succeed you did. You should get a medal
Or be even made a knight.”*

Henry: “It was nothing. Really nothing.”

*Pickering: “All alone you hurdled
Ev'ry obstacle in sight.”*

Henry: “Now, wait! Now, wait!”

Give credit where it's due, A lot of the glory goes to you.”

*Pickering: “But you're the one who did it,
Who did it, who did it! As sturdy as Gibraltar,
Not a second did you falter. There's no doubt about it,
You did it!”*

- “You Did It” from the soundtrack

A similar message in the movie is when Higgins and Pickering are making sport at Eliza’s expense, wagering on whether they can pass her off as a ‘lady.’ When she presents herself quite favorably at the

Embassy Ball and the experts believe she comes from royal blood, Higgins and Pickering heap praise upon each other while blatantly giving her no credit. Once again, we have a fitting analogy for today's central bankers who repeatedly take credit for economic growth when in fact the economy usually makes some headway despite their errant, growth-inhibiting policies. Most central bankers appear to be every bit as arrogant as Henry Higgins.

What are we, as investors, to do in a world where Central Bankers make sport of competitively devaluing the very currencies in which we hold a significant portion of our net worth? Let's start with the good news. **This isn't new. Central Banks and governments always have, and always will, destroy the value of their currencies and yet we've always survived. It is the easiest way to tax their citizens.**

Take note of these interesting quotes:

"Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and while the process impoverishes many, it actually enriches some. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.

Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."

-Keynes's *"The Economic Consequences of the Peace"*

"Bankers know that history is inflationary and that money is the last thing a wise man will hoard."

-Will Durant, from his must-read book, *The Lessons of History*

"Paper money eventually returns to its intrinsic value—zero."

- Voltaire

Or, to quote the author of our play, *"If the governments devalue the currency in order to betray all creditors, you politely call this procedure "inflation."*

- George Bernard Shaw

Currency debasement has happened since the beginning of civilization and yet life goes on. It will this time too. But, it is important to acknowledge some differences from the contemporary past. In the post-

civil war era, the U.S. had not had **rapid** money supply growth prior to 2008. We had also generally been paid a rate of interest sufficient to compensate for the ongoing debasement of the currency. Before 1971, the dollar was generally tied to gold, making it more difficult to debase in a rapid manner. Often there were “bond market vigilantes” to restore discipline to a profligate financial system. These days, the vigilantes don’t seem to have a place in a world where the central banks are the predominate buyers of sovereign bonds. The financial situation worldwide is probably worse now than at any time in the history of man. The amount of debt, and other promises, that governments have accrued, as a percentage of GDP, are insurmountable. They must be defaulted on, outright and/or inflated away. History and logic suggest price increases are on the way. Currency, while an excellent medium of exchange, no longer is able to fulfill its role as a store of value. In my opinion, investors should not hold a significant percentage of their net worth in the form of fiat currency. You don’t want to be there when the “race-to-the-bottom” picks up speed.

There is good news, however. Very good news! **You don’t have to hold currency**; it is perfectly legal to exchange your dollars (Euro, yen, franks, etc.) for gold. Or you can buy land. You can buy businesses (publically traded or privately held), or buy funds that do so. There have been, and could be, times when currencies are controlled, gold is outlawed, stock investing is made difficult. We believe **that now is an opportune time to buy great businesses around the globe**. Gold deserves a spot in every portfolio, as well. Get while the getting is good!

“In the absence of the gold standard, there is no way to protect savings from confiscation through inflation [...] Deficit spending is simply a scheme for the “hidden” confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights.”

- Alan Greenspan, Gold and Economic Freedom (1968)

On Fiscal Policy

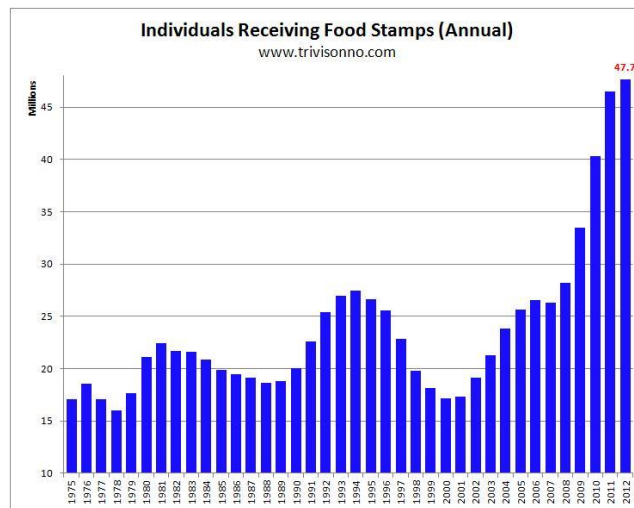
*“The Lord above gave man an arm of iron
So he could do his job and never shirk.
The Lord gave man an arm of iron-but
With a little bit of luck, With a little bit of luck,
Someone else'll do the blinkin' work!
With a little bit...with a little bit...
With a little bit of luck you'll never work!”*

- “With a Little Bit of Luck” from the soundtrack

It should be clear that even in a ‘perfect’ world, at current valuations, bonds offer way more risk than potential return. And it should further be evident that the current state of global monetary policy is far from perfect. But, we are told that monetary policy needs to be loose until fiscal policy can be reined in. Unfortunately, a quick perusal of fiscal prospects can only leave one depressed. Most governments of the world make Alfred P. Doolittle seem parsimonious. Unfortunately, one must ask, what are

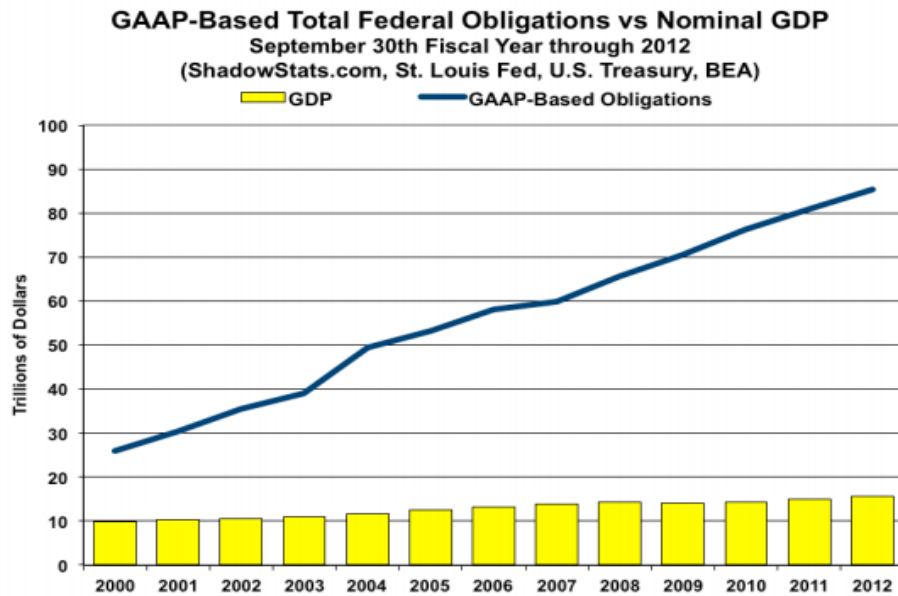
democratic governments but a reflection of the populace whom elected them? Churchill may have been correct, “It has been said that democracy is the worst form of government except all the others that have been tried.” Or maybe it’s a great form of government while it lasts which, as Alexis de Tocqueville is purported to have pointed out, isn’t long:

“A democracy cannot exist as a permanent form of government. It can only exist until the majority discovers it can vote itself largess out of the public treasury. After that, the majority always votes for the candidate promising the most benefits with the result the democracy collapses because of the loose fiscal policy ensuing, always to be followed by a dictatorship, then a monarchy.”



If this is true, how far along in the process might we be? A quick perusal of the tables at the back of every issue of the Economist Magazine shows that almost **every major country is spending money that it doesn't have!**

To quote Michael Lewis from his Vanity Fair article on California, the state where I lived for 48 years, “When people pile up debts they will find difficult and perhaps even impossible to repay, they are saying several things at once. They are obviously saying that they want more than they can immediately afford. They are saying, less obviously, that their present wants are so important that, to satisfy them, it is worth some future difficulty. But in making that bargain they are implying that, when the future difficulty arrives, they’ll figure it out....”



Source: ShadowStats.com

It doesn't seem to matter much from which country one hails, or from which political party, there is no appetite for sacrifice. A politician who campaigns for personal responsibility doesn't have 'a snowball's chance in hell' of being elected. In our personal lives, I think most of us understand that borrowing and over-spending may allow us to thoroughly enjoy life for a while but will eventually lead to ruin. Why would it possibly be any different for a bunch of people in aggregate? The Piper is overdue! In the meantime, I do not intend to lend one cent to profligate governments.

“Get me to the Church on Time”

*“For Gawd's sake, get me to the church on time!
 Starlight is reelin' home to bed now.
 Mornin' is smearin' up the sky. London is wakin'.
 Daylight is breakin'. Good luck, old chum,
 Good health, goodbye.”*

The contemporary mood is interesting. Almost everyone seems to agree that the economy is on course for eventual disaster. Yet, virtually everyone believes that this is not 2013's concern. I don't think I've witnessed such a consensus before. We'll get religion in the morning, but for now, let's party the night away. (Another great song from the musical, "I could've danced all night," would have been an equally effective analogy.) Remember Chuck Prince's (formerly Citi CEO) now infamous statement, "But as long as the music is playing, you've got to get up and dance. We're still dancing".

While I have no idea whether everyone's premise regarding 2013 will prove correct, I'm pretty sure that the risk/return proposition is quite unfavorable. Importantly, investors don't have to spend the night partying with the 'in crowd', (i.e. investments that offer skimpy prospective returns in addition to requiring a hiccup free economy and that the worldwide financial apparatus experiences no loss of confidence). From our vantage point, the best investments are priced to do well in either a strong or weak environment. A la 1999/2000, this is a highly bifurcated market. Now, like then, we choose the values.

Value – so much more than a low P/E

Higgins to Eliza: *“Yes you squashed cabbage leaf, you disgrace to the noble architecture of these columns, you incarnate insult to the English language, I could pass you off as the Queen of Sheba.”*

When it comes to investing, we have always had a contrarian bent, but that is not the same as being a contrarian. *Always* acting contrary to the crowd, just like *always* following the crowd, amounts to abdication of independent thought. Kopernik Global hold independent thought in high regard, viewing it as essential to profitable investing. Success requires having ones' own set of values and forming ones' own appraisal of what a business or security is intrinsically worth. When that appraisal differs meaningfully from consensus views, opportunity awaits.

Before getting into thoughts about what constitutes value, let's discuss what doesn't necessarily qualify as value. As pointed out in MFL, value shouldn't be judged by proper use of the English language. Nor, (are you listening Ben?), should value be appraised based upon fiat emissions, econometric models, Keynesian hypothesis, academic spewing, or government statistics. Turning to investments, value is not, as we learned in school, merely the present value (PV) of estimated future cash flow (CF). I can imagine the cries of "sacrilege" from all the "value" investors out there. And I must confess to being a frequent user of DCF models myself. But, one must admit that discounting the future is just one of many ways of assessing worth. And while it has proven to be quite helpful and reliable over the past century and a half, it has deep flaws. These flaws are becoming more serious in the current world of experimental monetary policy. The main flaw has always been that we are not modeling the PV of future CF, but rather the PV of our **estimate** of future CF. I would strongly suggest that the current environment of twice-normal profit margins is riskier than most, since margin normalization is just a matter of when, not if. I concede that estimating earnings has always been difficult, so let's move on. In addition to margins, growth rate assumptions are very important. In an era of torrential currency printing, it is increasingly difficult to differentiate real growth from nominal growth. For example, as Stephanie Pomboy at Macro Mavens has been illustrating, the excitement over steadily increasing retail sales overlooks the fact that on a unit basis we are still mired at 2007 levels. The entire gain over its past half-dozen years has come from price-inflation.

But let's move on to perhaps the most important guestimate in the DCF model: the discount rate (DR). Should investors use a DR that is derived from the "risk-free" rate on Treasury bonds when that rate is being blatantly suppressed by the Fed? Should one use a rate that is derived from CPI, a manipulated, hedonically adjusted, estimate of prices of goods used by consumers only, put out by government employees, which is repeatedly revised and arguably has little relationship to true inflation? Should it be derived from the market, always falling in a rising market and rising in a falling market? How much higher should discount rates be in an era where central banks are trying to rapidly debase the value of currencies expected to be received in the future? **Put bluntly, if fiat currencies are intrinsically of dubious value, how can they be a key input into a model trying to ascertain intrinsic value?** Can a metal coin be worth \$1 trillion just because the Treasury says it is? (As shown below, at current market prices, the coin would have to be 1100 times as big as all the platinum ever mined). Can the two trillion dollars that the Fed recently conjured out of the air, at essentially no cost, really be worth anywhere near as much as \$2 trillion had previously been worth? Might the reigning reserve currency be dethroned due to "raining" currency creation?

- A coin valued at \$1 trillion and made out of platinum would, at today's price of \$1557/ounce, weigh in at 642.3 **million** ounces.
- 642.3 million ounces is also roughly **18 thousand tons, or about 1100 times more than all the platinum mined.**

Source: zerohedge.com

No, I think we've all had it backwards. **Value isn't created from money; money can be earned from valuable goods and services!** Warren Buffett's value is *not* a derivative of his wealth; his wealth was generated from his valuable investment skills, business skills, and reputation. If he were stripped of all of his wealth, he could earn back substantial wealth quite quickly. Likewise, a new building has value before it has cash flow. Its value allows its owner to attract tenants and thus future cash flow. The Mona Lisa, despite generating no annual cash flow has tremendous value. That value presumably can be monetized in the future. Value generates future cash flow, not the converse. Nikola Tesla died penniless. Was he lacking in value? Au contraire, the man who "electrified" America over a century ago with his A/C power would be a leading candidate for the largest contributor to America's wealth and success. His value did create tremendous wealth, although much of that wealth accrued to J. Pierpont Morgan, to the citizens of the U.S., and to the citizens of the world. To whom wealth accrues is another issue that we'll come back to.

To be of value, one must have, or provide, a good or service for which there is demand. Additionally, that good or service's value increases with scarcity. Scarcity value can come from limited supply or through ability to supply the desired good or service at a better price, with more timeliness and efficiency, or more reliability. In terms of business: the higher the demand, the higher the value; the higher the barriers to competition, the higher the value. Once again, the higher the value, the higher the likelihood that cash flows will be generated in the future. Currently, we see a lot of intrinsically valuable companies trading on stock exchanges around the globe. Fortunately, despite a tremendous four-year market advance, a good many of them are trading at a steep discount to what we believe their wealth-generating capability to be. The bulk of these opportunities are based overseas.



Source: CLSA, Bits & Pieces

Importantly, the current market is not only bifurcated, but is extremely so. The 14% yield-to-maturity that 30 year Treasury bonds offered when I came into the business was clearly one extreme. Hindsight confirms that bonds were alluringly underpriced. At the other extreme, history should validate that bonds currently yielding 3% are one of the most overvalued major asset classes of all time. Consumer stocks became way over-extended in 2007, when consumers were said to be 'using their homes as an ATM machine.' The current stratospheric level of consumer discretionary stocks almost makes 2007 look like the good ole bargain days. If one assumes that growth continues at current, impressive rates and that profit margins expand beyond the current, twice-normal levels, our models suggest that, even these assumptions, consumer stocks are horribly over-priced. Yet, try as we might, we can't make a case that high growth rates persist or that profit margins do anything other than collapse. Like bonds, U.S. consumer stocks are compelling short candidates.

Investment Outlook

Beyond these two categories (bonds and 'consumer' stocks), we are finding most investments to be attractive relative to cash and bonds, and many securities to be outright persuasive investment candidates, even in an absolute sense.

“Wouldn't it be Loverly”

All I want is a room somewhere,

Far away from the cold night air.

With one enormous chair,

Aow, wouldn't it be loverly?

Lots of choc'lates for me to eat,

Lots of coal makin' lots of 'eat.

Warm face, warm 'ands, warm feet,

Aow, wouldn't it be loverly?

From the long side, let's also start with consumer stocks. As addressed above, investors love them! We do too, just not the same ones that they do. In the past we've used a diagram of Maslow's Hierarchy of Needs to help illustrate the difference. At the base are food, water, clothing, and shelter. Near the top are self-esteem and self-actualization desires. The market is fully tuned into the fact that as the 'top 1%' get richer, enormous sums will likely be spent on esteem-building items from designer clothes and accessories to trendy restaurants and luxury vehicles. We take no exception to that, only to the prices people are paying for the stocks. But we are more interested in what the other 99% are buying. Particularly noteworthy is the huge incremental growth in size and spending power of the emerging middle class in the developing world. As Eliza highlights in song, they don't yearn for Chanel purses so much as 'chocolate' and 'heat' and other items at the base of Maslow's pyramid. We believe that **the 'true' growth companies are those involved in meeting the basic needs of the emerging middle class, rather than those satiating the wants of the over-indebted developed markets.** In particular, we are finding great value in the stocks of companies involved with food, agriculture, hydroelectric power, nuclear power, hydrocarbons, water purification, transportation, communications, and healthcare.

- Natural Gas - Cheap, clean, abundant natural gas, historically selling at a premium in the U.S., now trades 3 to 5 times more expensive outside of North America. It is also very cheap relative to oil.
- Uranium - Despite superb supply/demand fundamentals, the price of Uranium languishes at roughly ½ of production costs.
- Transportation - For the first time since the 1950s, many common stocks are yielding more than corporate bonds. A great example is the Japanese railroads where dividend yields have gone from less than ½ of the comparable bond yield to 8 times the yield of associated bonds.
- Electricity – See below

The Search for Yield

As investors stampede for yield, they oddly enough have “thrown in the towel” on high-yielding electricity generation companies outside the U.S. While investors are overreacting, they are not completely irrational. This is where we return to Nikola Tesla’s ill-fortune, to have created wealth that accrued to others rather than to him. Governments in most of the world are broke and searching for places from which to extract wealth. They can only abscond with wealth from where wealth resides and it appears the governments of the world share our view that it resides in gold mines and oil wells and phone companies and, last but not least, electric utilities. For example, the Russians force their utilities to sell shares to the government at large discounts to book value. The Koreans force utilities to sell electricity to industrial companies at below market prices. The French transfer the wealth (also through cut-rate pricing) to consumers rather than corporations. The Brazilians aren’t sure what they want. Can they force their utilities to borrow massively to build much-needed infrastructure only to force them into bankruptcy through hugely confiscatory product pricing? Will they? Doubtful! Inconceivable? No, clearly the marketplace does conceive it. When all is said and done, the governments of the world **will** confiscate an important amount of wealth from basic needs providing corporations. We believe, however, that at current market prices, there is huge upside to the stocks and very attractive (post confiscation) cash on cash returns to be realized. Some broad examples of mispriced, yielding securities include European telecoms and utilities. They are attractive in an absolute sense and are especially inexpensive relative to their U.S. brethren. They are also extremely compelling in comparison to the yield on sovereign bonds in the very same countries in which they reside. Those same two industries are attractively priced in the faster growing regions of the world as well. Speaking of emerging markets...

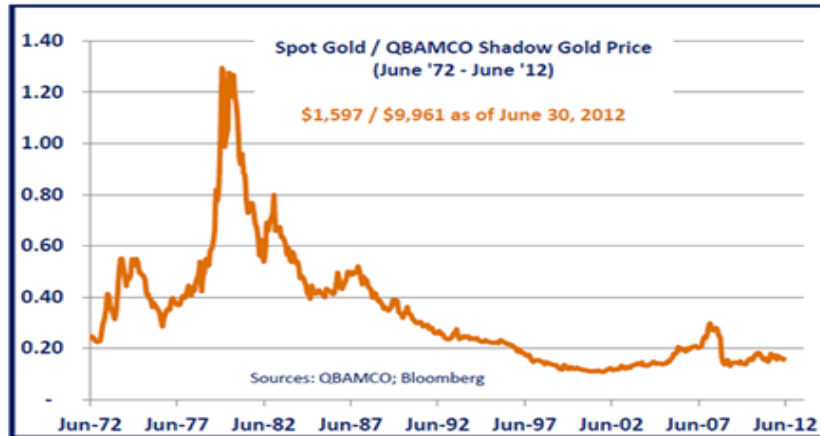
BRICs in particular have had far superior economic growth yet have had far inferior stock returns. U.S. is now pricing in growth, but not delivering. India is pricing in growth but is delivering. Russia, China, and Brazil are growing, but investors don’t have to pay for it.

Real GDP (%Q, SAAR)	Quarterly												Annual		
	2012				2013				2014				2012E	2013E	2014E
	1Q	2Q	3QE	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE			
Global**	2.9	2.3	3.0	2.6	2.7	3.2	3.7	4.1	3.9	3.7	3.8	3.8	3.1	3.1	4.0
G10	1.7	0.4	1.1	-0.2	0.4	0.9	1.7	2.1	2.1	1.6	1.9	2.0	1.2	0.7	1.9
US	2.0	1.3	2.8	0.7*	0.8	1.2	2.2	2.8	2.8	2.9	2.9	2.9	2.2	1.4	2.7
Euro Area	0.0	-0.7	-0.5	-1.6	-0.8	0.0	0.6	1.0	1.0	1.0	1.0	1.0	-0.5	-0.5	0.9
Japan	5.2	0.3	-3.5	-0.2	0.6	1.7	1.9	2.3	2.0	-2.4	-0.2	0.9	2.0	0.4	0.8
UK	-1.2	-1.5	3.9	-1.2	1.2	0.0	1.6	1.6	1.9	2.0	1.2	1.2	-0.2	0.8	1.6
EM (%Y)	5.3	4.9	4.6	5.0	5.1	5.2	5.6	5.5	5.8	5.9	5.9	5.9	5.0	5.4	5.9
China (%Y)	8.1	7.6	7.4	7.7	8.0	8.2	8.4	8.2	8.1	8.1	7.9	7.7	7.7	8.2	8.0
India (%Y)	5.3	5.5	5.3	5.1	5.8	6.0	6.2	6.3	6.4	6.9	7.1	7.1	5.3	6.1	6.9
Brazil (%Y)	0.8	0.5	0.9	1.8	2.3	2.5	3.3	2.9	3.1	3.1	3.9	3.6	1.6	2.8	3.4
Russia (%Y)	4.9	4.0	2.9	2.7	2.6	3.0	3.1	3.5	4.0	4.3	4.3	4.1	3.6	3.1	3.7

Source: Morgan Stanley

And of course we like gold. Whereas a recent sell-side report gained a lot of attention by pronouncing the end of the gold bull market, while suggesting that gold has never been more expensive, the following chart persuasively suggests that **gold has seldom been cheaper**.

Gold versus Shadow Gold Price



Source: QBAMCO

Since 1980, the money supply has increased 25 times while U.S. gold holdings did not increase at all.

Gold Stocks versus Gold Price

And while gold is perhaps the cheapest it has ever been relative to quantity adjusted fiat paper, gold owned by mining companies is the cheapest it has ever been relative to gold trading on the spot market.



Sources: Cormark Securities Inc., Thomson ONE

In 2012, yet again, gold went up in price (12th straight year), while gold mining stocks dropped. The divergence over the past several years (and continuing thus far in 2013) has created an occasion where the cheapest way to buy gold is on “Wall Street”.

Conclusion

We live in an odd era where market participants hold in high regard central planning bureaucrats and their fiat paper emissions. At the same time, the market appears to place inadequate value on business franchises that have been built over decades, provide goods and services that meet basic human needs, control irreplaceable tangible assets, and /or possess strong barriers to competition. This disconnect, resulting in high prices for things of dubious value, and low prices for inherently valuable properties, portends strong future investment returns. We are sanguine!

Cheers,

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Value isn't created from money; money can be earned from valuable goods and services!

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