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Global Investors, LLC

Fed Bug

In mid-2019 current U.S. Federal Reserve Board nominee, Judy Shelton, was interviewed by the *Financial Times* and said, “People call me a Gold Bug, and I think, well, what does that make them? A Fed Bug?” While Ms. Shelton is a controversial nominee for the Fed due to her comments on sound money and gold, it was a funny way to turn around the oft-heard divisive comment on people who think gold is money, (like it has been throughout history.) More importantly, while being funny, it seems accurate. Well, here at Kopernik we are sometimes accused of being Gold Bugs as well. If a Gold Bug means you are ALWAYS favorable to a rising gold price, then that is not us. If a Gold Bug means you think that the Fed’s continued plan to print massive amounts of money will positively impact the gold price, then, I guess we are guilty as charged. But if a Fed Bug means you are always favorable to the Fed’s actions supporting the stock market, that seems fairly appropriate today. Fed Bugs believe either the central banks can engineer economic growth using monetary policy or that stocks will go up on this hope, most importantly, forever. Said another way, the Fed Bugs believe in financial alchemy and that the Fed can print money and buy real assets with no adverse consequence. We couldn’t disagree more.

From that same *Financial Times* interview, Ms. Shelton goes on to say that “When a central bank buys up government debt, that’s the beginning of compromised finances. …How can a dozen, slightly less than a dozen people, meeting eight times a year decide what the cost of capital should be versus some kind of organically, market supply determined rate? The Fed is not omniscient. They don’t know what the right rate should be. How could anyone?” And lastly, “It’s the distorting aspect of the Fed that is the worst aspect – it’s a wag-the-dog situation. People are fixated on the Fed and are making money by arbitraging trillions after the latest FOMC announcement.” Of course.

It is hard to see how any of the pro-Fed arguments that a Fed Bug would make survive any form of logical questioning, other than it is working right now. That part is true. For how long we don’t know. Maybe ‘this time is different’, but... maybe it isn’t. We have no sense of timing on when something bad could happen, but the risk has to be higher right? But if that risk is higher, it is fascinating to see the S&P500 at essentially all-time highs implying that the risk is low, let alone at a time when we have suffered the worst economic shock in history.

As a long-time follower/analyst of tech I read a lot of obscure stuff and I remember many random quotes. Many years ago there was a computer scientist at IBM named Fred Brooks who changed how computers were coded, thus becoming famous within the tech industry. Speaking about his alteration of the coding methodology he tweaked the old phrase “there is no free lunch” into “**You can only get something for nothing if you have previously gotten nothing for something**.” As a side note, the phrase “There is no free lunch” refers to the long-ago tradition of saloons in the U.S. providing a “free lunch” to patrons who had purchased at least one drink. The “trick” was that the saloons would make the lunch very salty which inevitably made most customers order more drinks.

Back to the quote. Clearly the point is you can’t get something for nothing. But this is seemingly what the world wants/expects in almost every direction these days. More specific to the financial world, which clearly encompasses politics, to say we can print money with no adverse consequences defies all logic, but since it has been true for a while (starting in Japan, then Europe, now the U.S.) it MUST go on forever right? Stocks only go up with no risk (clearly the sentiment we see based on Robinhood accounts, the Barstool Sports guy becoming known for his day trading profits, etc..).

If you have known us for a while you know we generally agree with the Austrian economics point of view. To quote Ludwig von Mises, “Credit expansion can bring about a temporary boom. But such a fictitious prosperity must end in a general depression of trade, a slump.” Further, "there is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of the voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved"

While many people have discussed the “Fed put” which means the Fed will do whatever it takes to support the markets, it reminds me of another great quote from Von Mises, “Credit expansion is governments’ foremost tool in their struggle against the market economy” and “Every step which leads from capitalism toward planning is necessarily a step nearer to absolutism and dictatorship.” More germain to this commentary, what happens when the Fed can’t do anymore? So far the Fed, and most major central banks, have:

- Cut interest rates to 0%, check.
- Massive money printing, check. (They can always do more, but if there is an actual economic return to quantitative easing (QE) it has to have diminishing returns).
- Using the money printing as direct hand-outs to the population as opposed to only using it to buy securities (think Universal Basic Income), check. p.s., there is no way the government won’t keep paying people since it was the government’s lockdown response to the virus that put them out of work. Where/when does that end? My guess is we will have stealth UBI in the form of payment for virus suffering for a long time.

- Since the CPI numbers have been below our government's hope for years, on average, the Fed will push policies that target above average inflation in order to move the average much higher. This is new but seems to be the consensus now within the Fed. Further, to achieve that goal, the Fed has essentially committed to keep rates at 0% for years. Wow, but check.
- Yield curve control (ie, promise to buy bonds to keep rates at a pre-determined level – happening in Japan and being discussed in Europe and the U.S., so partial check.)

How many more tricks does the Fed have up its sleeve? More importantly, when will the investing public start caring? There's the real question.

In the most recent movie of the franchise, *Spiderman, Far from Home*, when Spiderman is speaking to the villain, Mysterio, at the end after defeating him, he says "You can't trick me any more… How could you do all of this?"

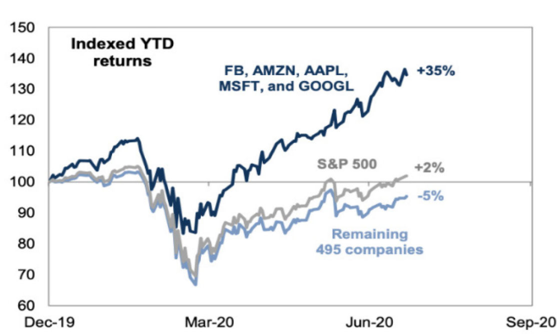
Mysterio "You'll see, Peter. People, they need to believe. And nowadays, they'll believe anything." Earlier in the movie, Mysterio said "I created Mysterio to give the world someone to believe in. I control the truth. Mysterio is the truth." If you substituted "The Fed" for "Mysterio" is it wrong? The public, including investors, want to believe.

Spiderman's most memorable quote is "With great power comes great responsibility." But if the Fed thinks its responsibility is smoothing out business/economic cycles and doing everything it can to promote growth, is it possible this is exactly what the American economist Hyman Minsky was referring to when he said that "stability is inherently destabilizing? That is to say that long periods of relative stability in risk assets causes investors to keep upping the risk during a long period of calm." Ultimately this leads to what he called a Ponzi Market, where the only reason investors keep adding to risk is the fear that prices will be higher tomorrow (or in the case of bonds, yields will be lower tomorrow.) This all sounds like today right?

In an environment where the economy is just starting to recover from its worst decline in history (U.S. GDP down 32.9% in Q2 2020), combined with high unemployment (12% down from 15% a couple months ago), massive revenue and profit declines in virtually all companies worldwide, the fact that the market is up over 50% from the bottom & 5% for the year for the S&P and 65% from the bottom and 25% for the year for the Nasdaq is head scratching to say the least. The panic from the pandemic downdraft to stocks was so rapid, a snapback of some kind wasn't unexpected, but this??

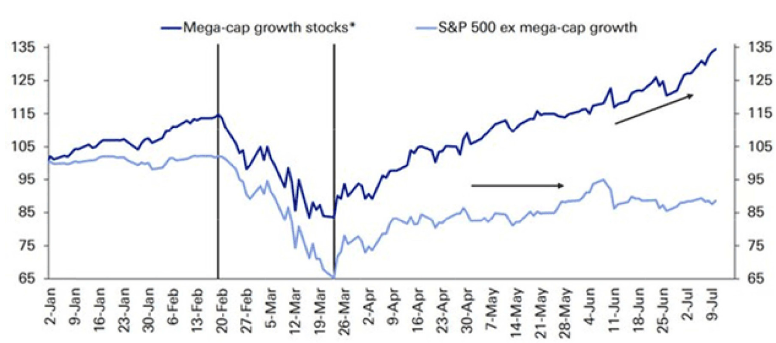
In the dot.com mania circa 2000, it was all stocks going to absurd heights. Today, while everything seemingly is pressured higher, it is the mega caps that are out of control. I'm sure you have seen the charts showing that just 3 stocks (Apple, Amazon & Microsoft) make up more than 16% of the S&P500 (Apple is over 7% by itself), and over 1/3 of the Nasdaq 100 Index. (p.s., Apple, Microsoft, Amazon, Facebook, Google and Tesla combined are roughly half of the Nasdaq market cap) Their combined market cap is now larger than the GDP of Germany and close to Japan's. No doubt you have also seen how it is the big tech stocks that are essentially responsible for all the index's move higher. If we broaden the "leaders" group out to include 5 companies: Microsoft, Apple, Amazon, Google and Facebook (ie, the "FAAMG's), they are up 35% ytd vs the S&P495 trailers which are down more than 5%. Further, the mega caps are starting to dwarf other industries in their entirety.

Exhibit 1: The five largest stocks have returned 35% YTD; the other 495 stocks have declined by 5%.



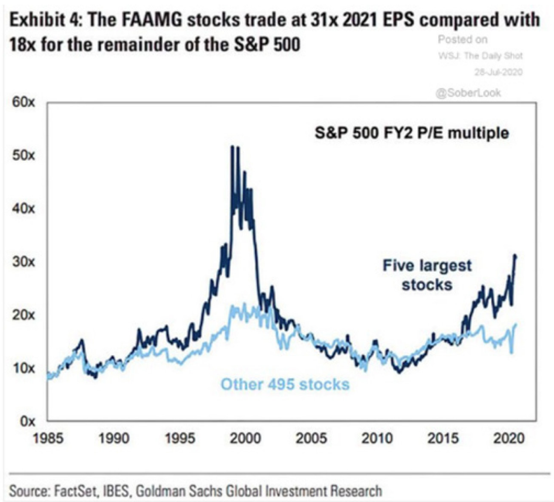
Source: FactSet, Goldman Sachs Global Investment Research

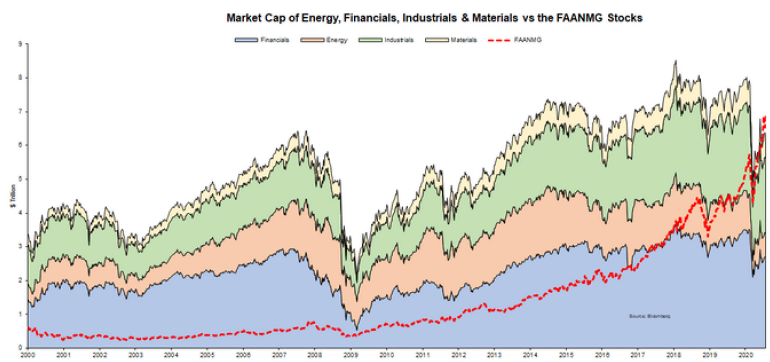
S&P 500 mega-cap growth vs others (re-indexed, Dec 31 2019=100)



*MSFT, AAPL, AMZN, GOOGL, GOOG, FB, V, MA, NVDA, NFLX, ADBE

Source: Bloomberg Finance LP, DB Asset Allocation, DB Global Research





One last thought on these mega cap tech stocks.

- It took Apple 37 years from its IPO to hit $1trillion in market cap. It has taken less than 5 months to crack $2 trillion (up 100%). It was also up close to $350bb in 1 week recently. To put this in perspective, that is like adding the market cap of the 10th biggest market cap in the S&P500 – IN 1 WEEK. On August 21st the stock was up 5.15%, which equates to over $100bb. Added in 1 day. Wow. It is just getting silly out there.
- It took Amazon 21 years from its IPO to hit $1 trillion in market cap. It has taken less than 5 months to add $750bb more (up 90%). Wow.
- It took Microsoft 34 years from its IPO to hit $1 trillion in market cap. It has taken less than 5 months to add $650bb more (up 60%). Wow.

By comparison, in 1999/early 2000, the 3 biggies were Microsoft, Intel and Cisco. In the 3 years leading up to the peak Microsoft stock was up 500%, Cisco was up 1,200% and Intel was up 350%. In the 5 months leading up to the peak Microsoft was up 38%, Cisco was up 165% and Intel was up 100%. All this said, keep in mind these companies were growing much quicker back then compared to the mega cap leaders today, other than Amazon.

So the dot com bubble was still more extreme, so maybe that means the current craziness can get worse, but it has to mean the risk is way higher today than the recent past. As the late German economist Rudi Dornbusch once said "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could." You could switch out the word 'economics' and replace it with 'the stock market' and it is just as accurate.

While the dot com era seemed like it had more examples of craziness (pets.com, etc.), there are plenty of signs today as well. How about Nikola? This company, which nobody had heard of 6 months ago, was acquired by a SPAC (special purpose acquisition company) and now has a market cap of $15bb, down from a peak of almost $30bb. Don't worry though the company has no revenue and won't for at least a couple more years. But they "will" produce an electric vehicle and a hydrogen-based fuel cell vehicle, which they hope will sell. This is worth over $15 billion?

While above we spoke of the tech leaders, don't think the smaller tech companies haven't benefited massively from this boom as well. While, again, not as bad as the dot com era, we aren't far behind. It reminds me of a great scene from HBO series, *Silicon Valley*. It is a great satire on the U.S. tech nexus of Silicon Valley and the culture of the venture backed U.S. startup. In one episode (https://www.youtube.com/watch?v=BzAdXyPYKQo), the founder of the software start-up was discussing with his team the ways they could "monetize" their traffic (ie, generate actual revenue.) Their main financial backer/venture capitalist was the character, Russ Hanneman. As the discussion starts about generating revenue, Hanneman is on his phone not paying attention but hears the word "revenue" and jumps up and yells. "No. No. No… No revenue. Why would you go after revenue?"

Start-up founder, Richard: "Because.. to make money."

Russ: "No. If you show revenue people will ask how much and it will never be enough. If you have no revenue you can say you are pre-revenue and you are a potential pure play. It's not about how much you earn. It's about what you are worth. And who is worth the most? Companies that lose money. Pinterest/Snapchat, no revenue. Amazon has lost money every quarter for the past 20 years and that Bezos MF'er is the king." (This episode is a few years old.)

Richard: "I thought the goal of companies was to make money."

Russ: "No. That's not how it works. I don't want to make a little bit of money every day. I want to make a ton of money all at once. ROI. You know what that stands for? Radio on Internet." (The last part referencing radio on internet is a not so subtle jab at how the Dallas Mavericks owner, Mark Cuban, who made his money when he made $2 billion+ selling the ridiculous startup Broadcast.com to Yahoo.) There is the current environment.

To broaden out, if we look globally at the MSCI All-Country World Index ("ACWI") index and break down the valuation by the size of the company, we see the following chart. So the valuation gap between the biggest and the smallest isn't just in tech or the U.S., it is global. No doubt the biggest companies are doing the best these days, but this valuation gap is really big and probably unsustainable. (Bloomberg data)

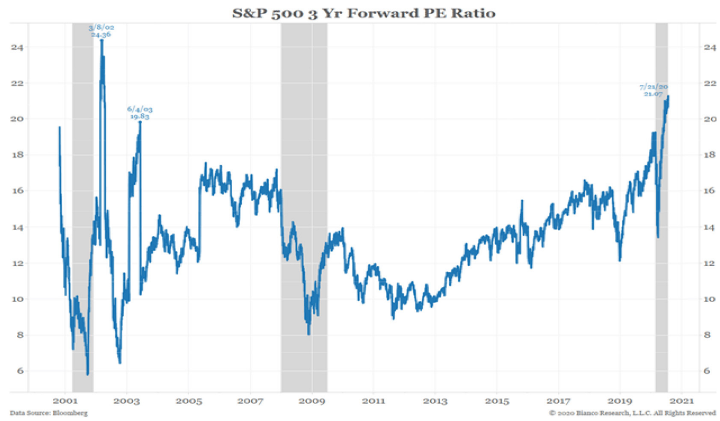
	Medians					
	Market Cap	**PE**	**PS**	**PFCF**	**PB**	**YTD returns**
Top 10	300,280	23.8	4.7	23.1	5.8	0.5
Top 50	139,986	17.7	2.4	19.5	2.6	(0.4)
51-100	66,089	17.5	1.9	16.2	2.1	(8.4)
101-200	42,864	15.8	1.9	14.3	2.1	(5.4)
201-400	26,002	18.7	2.1	15.0	2.3	(5.7)
401-800	12,870	16.4	2.0	13.3	2.0	(4.9)
801-1200	7,256	16.2	1.6	13.3	1.7	(11.2)
1201-1725	3,746	12.7	1.1	8.4	1.1	(15.7)

One last thing to note on the above chart. This is based on non-GAAP/non-IFRS accounting, ie, it is the adjusted earnings. While I don't understand why investors choose to look the other way in the face of these add-backs, and more importantly ongoing option dilution, it shouldn't surprise anyone that this trend has gotten much worse. 97% of the S&P500 companies now report "adjusted" or non-GAAP earnings as their primary metric of earnings, which is up from 59% in 1996, according to Audit Analytics. This is an all-time high. Once upon a time non-GAAP earnings were used to show the impact of significant one-time events. Now, when 97% of companies use non-GAAP earnings every quarter, it isn't significant or one-time, it is simply manipulation (higher) of earnings. The management's incentive is clearly to show higher earnings. While most companies don't go as far as WeWork did with their "community adjusted earnings," the whole point of adjusting earnings is to make them look better. If the market is allowing virtually everyone to show adjusted earnings and be valued based on that number, you don't think they are being as aggressive as they can be with that reported earnings number? Charlie Munger was recently quoted as saying: "Think of the basic intellectual dishonesty that comes when you start talking about adjusted EBITDA. You're almost announcing you're a flake." Funny, but true.

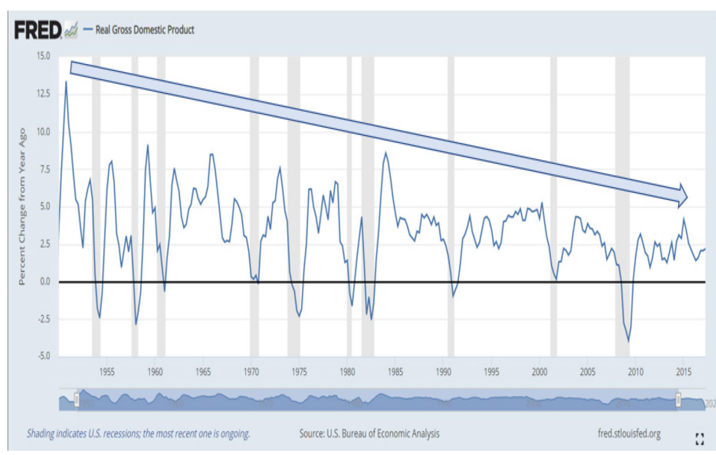
There is a great scene from the 1982 comedy, *Fast Times at Ridgemont High*, where the slacker/surfer/stoner character, Jeff Spicoli (one of the great all-time characters, played by Sean Penn in one of his first movies), interacts with a high school teacher, Mr. Hand, when he is late for class.

> Mr. Hand - "*What is the reason for your truancy*?"
> Spicoli – "*I just couldn't make it on time*."
> Mr. Hand – "*You mean you couldn't or you wouldn't*?"
> Spicoli – "*There was like a full crowd scene at the food lines*."
> Mr. Hand – "*Food will be eaten on your time. Why are you continuously late for this class Mr. Spicoli? Why do you shamelessly waste my time like this*?"
> Spicoli – "*I don't know*."
> Mr. Hand – "*I like that. 'I Don't know.' That's nice. Mr Hand, will I pass this class? Gee Mr. Spicoli, I don't know. I really like that. You know what I'm going to do? I'm going to leave your words on this chalkboard for all my classes to enjoy. Giving you full credit of course*."
> Spicoli – "*Alright*."

To the average investor in the U.S.. Why don't you care about the massive dilution from earnings and the blatant earnings misrepresentation from constant non-GAAP earnings? "Gee Mr. Spicoli, I don't know."



Here is an apropos chart I recently saw. While it is obvious that COVID has severely hammered the financials of many a business worldwide, the "V shaped recovery" narrative is still alive and well. **<u>If</u>** you believe that, then to look at current P/E or EV/Sales probably isn't quite right since earnings were hit "temporarily" from the virus lock downs. The bulls will tell you that 1 year forward earnings projections is probably better (leaving aside it is a projection, subject to all kinds of errors). How about if you go further and look at <u>3 year</u> forward P/E of the market? (Yes, the 3 year projections are wildly bullish, even compared to last year's pre-covid/lock downs.) The chart on the right from Bianco Research shows the market is still not cheap using that metric (still over 21.5x P/E). The forward forecasts are almost always too optimistic on top of this, as you would imagine.



Since many people like to look at the market multiple and compare it to the long run average, which is logical on the surface, shouldn't we look deeper at the components of the multiple? A P/E ratio is a simplified version of a discounted cash flow analysis, right? We clearly see individual company P/E ratios vary dramatically depending on the growth expectations of a company, which again matches with a DCF analysis. (ie, faster growing companies trade at higher multiples.) Shouldn't this same thought go into the overall market multiple, which is just an average of all the companies in the market? What I am getting at is if the long run, meaning 100+ years, the market multiple is roughly 16x, that clearly depends on the growth rate of the components. Again, while logical why does nobody show this chart which shows that the average U.S. GDP growth rate continues to decelerate? The law of large numbers makes this obvious, but based on this why would we use a long-term market multiple as the "correct" multiple when it is clearly based on a faster average economic growth rate historically than the trend line would show today?

Relatedly, there are many excellent resources of financial and historical data on Wall Street, but one that I look at is from Ken French (http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/index.html). He is a Dartmouth professor and was part of the team with Gene Fama at the University of Chicago in 1992 when they published the Fama-French three-factor model to describe stock returns. (We will ignore for now the fact that Fama was the originator of the Efficient Market Theory, which clearly is not quite right.) Their three factor model said the return of a stock depends on i) market risk, ii) small caps outperforming larger caps and iii) low price to book valuations. The main conclusion was that value matters over time and smaller companies have more room to grow which, all else equal, is better for future returns. Well, today's market certainly is the complete opposite of what their model "proved" so does that mean the model was wrong? In a recent Bloomberg article a Fidelity manager was quoted saying there is "no way to tell if betting on ostensibly cheap companies will work again." Hmm.

French recently wrote that that if you went back to mid-2010 when the economy was emerging from the Global Financial Crisis and somebody told you to forget the fact that speculative purchases of expensive assets caused the last market crash but right now we have a great new strategy for the next decade. You should buy the most expensive stocks with the lowest profitability and you would win big. You would hopefully say that is crazy. But, here we are and it is true.

Buried in the Ken French longer term data set is Table 1 below which I found interesting, but entirely logical. Annualized returns in Global Developed Markets going all the way back to 1993 and up to June 2020 show that cheaper valuations create better returns, all else equal. But, the last 10 years, from June 2010 to June 2020, the opposite has been true; granted, much of this divergence has been in the last two years (Table 2 below).

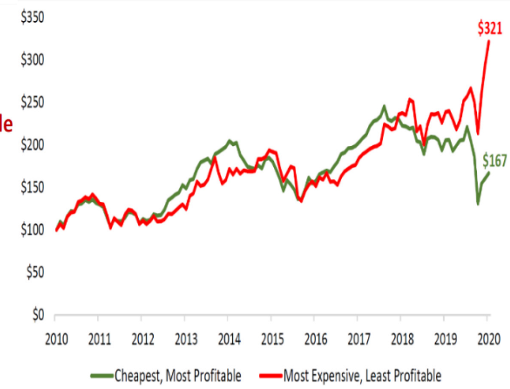
Table 1

		VALUATION			
		1: Deep Value	2	3	4: Expensive
PROFITS	1: Low	6.3%	6.0%	2.3%	2.2%
	2	9.7%	8.6%	7.0%	3.8%
	3	11.0%	10.4%	8.7%	7.4%
	4: High	11.7%	11.6%	10.6%	9.2%

Most Expensive, Least Profitable

Cheapest, Most Profitable

Table 2



So the question is, was the proof that value stocks work better over long periods of time wrong and ‘this time is different?’ While that is possible, we are firm believers that ultimately, the rational investment logic of “buy low, sell high” is well supported by decades of evidence that value matters. Whereas the speculative logic of “buy high, sell higher” seems crazy, but great… until the music stops (poster child for this, among many these days is Tesla). The stock market is noisy, and strange things can happen over three, five, even ten years. But over the long haul, investors eventually get what they pay for. Those who buy expensive equities usually realize low returns over the long run. And investors who buy cheap stocks can realize high returns—provided they stick with the strategy over the long haul. Now, make no mistake, career risk of underperforming makes this very challenging in today’s environment but we will choose to take our pain when the market is going against us and stick to a proven, and logical, long-term strategy of making money for our clients.

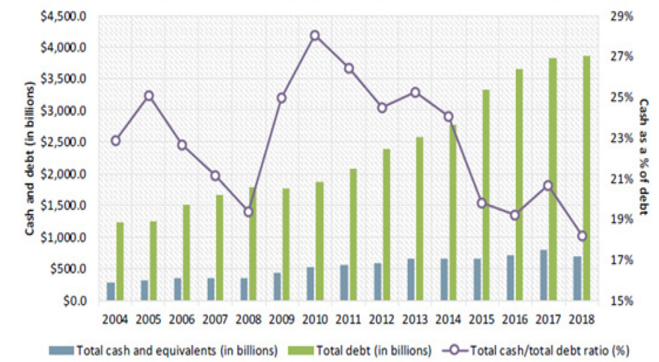
Logically, we all appreciate great, growing businesses, but as a value investor we are always skeptical that the growth can continue for long enough to justify the high valuations placed on these companies. There are clearly market cycles and thus times (and sometimes painfully long time periods like now) where the growth companies outperform. But… again logically, price matters thus we take the very long-term view that something trading below its risk adjusted intrinsic value is a better buy than hoping a growth company continues to grow rapidly and profitably. Some will, but many won’t and we don’t fancy ourselves very good at forecasting the winners in that game.

As a corollary, I love the old Warren Buffett quote from the Berkshire Hathaway annual letter in 1967 in response to pressure to pursue the “nifty fifty” whose exorbitant valuations were rationalized using a slew of new valuation methods. *“We will not abandon a previous approach whose logic we understand (although we find it difficult to apply) even though it may mean foregoing large, and apparently easy, profits to embrace an approach which we don’t fully understand, have not practiced successfully and which, possibly, could lead to substantial permanent loss of capital.”*

Switching back to today, if the average American has no savings and many/most public companies were borrowing money to pay higher dividends and buy back their stock leaving both groups with a very low buffer in case of a problem, is it surprising that any kind of shock to the system would have a really bad reaction? The Corona Virus was the trigger but I would argue the root cause of the turmoil from earlier this year was the panic which stemmed from the lack of any kind of liquidity buffer or safety net of corporations. We can give the average American somewhat of a pass as they are struggling financially, even in the “booming economy” our government has been crowing about for three years. The problem for the average American is that real inflation is far higher than CPI says and their incomes aren’t keeping up so living keeps getting harder. The bigger issue of risk is corporations.

Debt driven buybacks' drain on corporate treasuries has been massive. Between 2009 and 2019 the companies in the S&P500 spent 52% of their net income on buybacks, and an additional 39% of net income on dividends (total = 91%), leaving very little excess for capital expenditures or a safety net. In 2019 alone, with after-tax profits at record levels because of the Trump tax cuts, buybacks by S&P 500 companies reached an astounding 68% of net income, with dividends absorbing another 41% (109% total). Do/did we think companies can sustain all-time high margins, keep growing and keep a high price/earnings ratio based on that growth by continuing to borrow money to fund their buybacks while ignoring core capital expenditures and materially weakening their financial buffer in case of a problem? The problem came fast and furious because of the virus, but a recession was coming at some point and it would have had the same effect, just over more time. See the chart here which shows the extent of this net debt increase, specifically for the bottom 95% of the S&P500 companies.

Chart 2: Bottom 95% of S&P 500 firms for cash balances (excluding Financials)



Sources: Wells Fargo Investment Institute, FactSet, February 14, 2019. *For illustrative purposes only.*

Based on Bloomberg data, the percentage of listed companies in the U.S. losing money (GAAP) over 12 months is close to 40%, its highest level since the late 1990s outside of post-recession periods. For sure, this skews more to small companies and new, growthier companies, but still.. Wow. Further, trying back to the Ken French thought above, of the 100 biggest money-losing companies, roughly 75% saw their shares rise in value over the last twelve months. While some of these are losing money because they are trying to grow really fast and become the dominant player, that is a minority of the market. There are many others where the shareholders are pressing them to grow at any cost and still pay a dividend and/or buyback stock. It is clearly unsustainable.

The market rout in February seemed to get people talking this point, with a heavy focus on the airlines, but now that the market has roared all the way back to highs, this discussion has totally gone away. Rest assured, the issue will come up again.

As parents, we have the opportunity to teach our kids lessons all the time. If they break something, we could say it's ok and we can pay for it, or we can say they need to pay for it, somehow. They are upset and say it isn't fair, but you hope they learn that money isn't free and their actions have consequences. As a politician, you are afraid of being voted out of office, so you will not only not teach the hard lesson (have a safety net), but you will reward the bad behavior by bailing things out. Thus, for corporations the perverse lesson is to take on more debt since if there is a problem, the government has your back. It is all good in the short run, but has to lead to disaster in the long run. This is another way of saying that in addition to investors, even corporations are Fed Bugs.

The covid spread and resulting lock-downs of the world may go down as a historic demand collapse in almost everything, other than food and basic survival needs. But historically, when the government says something is temporary, almost always it turns out to be permanent. Based on that, it is probably safe to say that whatever the government has announced so far as a bailout/help, is nothing. The meaningful money is still to come. I'm only talking about the consumer and corporations. But this disruption is also going to put a massive hole in the states' budgets. You have seen the stats on Illinois, New Jersey, California, et all. They are all unsustainably levered and that doesn't even count the pension problem, which, by the way, has gotten much worse with the decline in interest rates. They all will have to be bailed out by the federal government, since most of their liabilities are to the workers' pensions. How can the federal government afford any of this? They clearly can't but via the magic of Modern Monetary Theory, which we have spoken about before, they will take on more debt and pay for all this. They will call all these issues 'temporary' and pay. But we already know they can't raise enough tax revenue to even make a dent in the existing debt, let alone the new debt coming. So then the Fed prints and buys all the government debt and pins rates at close to 0 (Hello Japan). Then they can afford the interest, but there is zero percent chance they can ever pay the debt back. What happens then? This is the clear path the U.S., Europe, Japan, etc are all on.

The problem with everything above is that the politicians want to be reelected and to do so they need to have economic growth, at any cost. If the cost is down the road, great. So they continue pushing policies which rely on debt and incentivize people and corporations to take on debt, all to grow. That works, until it doesn't. Given the high cost of living (ie, inflation not captured in CPI), savings have become a luxury of the rich. Unfortunately, while public corporations are almost all rich, in a relative sense, they have the capacity to save, but they don't. They pay it all out since that is what the shareholders want. But rather than live with the consequences, we keep doing it. A year ago nobody was talking about our constant $1 trillion deficits, which was really $1.3+tt if you count the liabilities not counted in the budget (look at how much U.S. gov debt rises, not what they say the deficit is.) Now that the deficit is $3 trillion, or whatever, it is no big deal since it was for the "one-time" corona virus. What happens when it doesn't go way back down? Again, sounds like non-GAAP earnings that aren't one-time at all. It seems inevitable.

A great related quote about government is from the former Secretary of the Treasury, Larry Summers, “The root cause of the financial crisis (2008) was a purely human factor. This human factor is the completely false sense of omnipotence, self-importance and entitlement among the country's elite, as well as the nurturing of these beliefs at Ivy League colleges and other elite universities the U.S. will be doomed to suffer other calamities every bit the equal of the financial crisis." And yet we, as a society, keep making the same mistake by believing our government, and more specifically as investors, the Federal Reserve.

I’m sure you know but the “con” in “con man” is short for confidence. I thought I would digress for a minute and say that it seems clear that the World’s Central Bankers and Governments have learned that they can twist the truth/lie given that it’s words and actions are unbelievably powerful in shaping the beliefs and actions of the average citizen of the U.S. and the world. Many times these words are meant to divert focus from something and convince the public of something else. Is that not essentially the definition of a “con game?” (Oxford Dictionary: “An attempt to defraud a person or group after first gaining their trust.” Hmm.

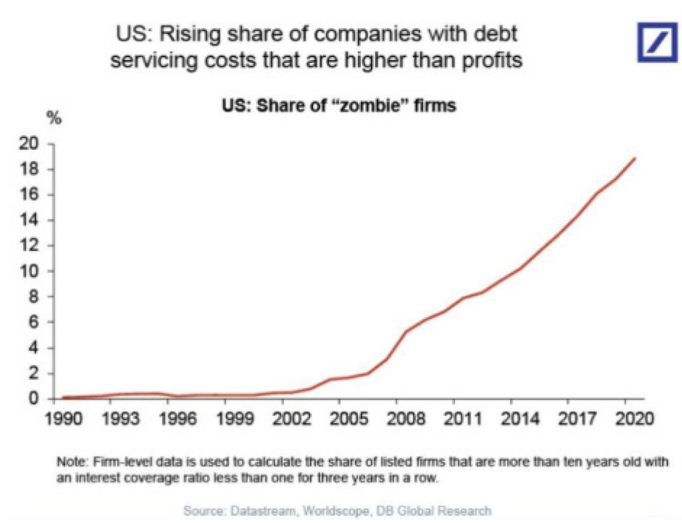
Do you remember when the head of the European Union, Jean-Claude Juncker said in April, 2011 at a Eurozone economist briefing that “Eurozone economic policies should be made in dark secret rooms, away from public scrutiny, in order to appease easily disgruntled citizens.” Then he dropped the real doozie, “When it becomes serious, you have to lie.” Yet, there was no outrage over this.

Or going to a much darker time in history, the best examples of propaganda done through the media might be from Nazi Germany. Joseph Goebbels, who was Hitler’s Minister of Propaganda in Nazi Germany, said in a government briefing in February, 1941, “If you tell a lie big enough and keep repeating it, people will eventually come to believe it. The lie can be maintained only for such time as the State can shield the people from the political, economic and or military consequences of the lie. It thus becomes vitally important for the State to use all of its powers to repress dissent, for the truth is the mortal enemy of the lie, and thus by extension, the truth is the greatest enemy of the State.”

This sounds a lot like the Austrian economist Friedrich Hayek, who wrote in his book, *The Road to Serfdom*, “the first victim of totalitarianism is the truth. Any commentary, data or opinion that calls into question the efficacy or the legal or moral consequences of the state’s actions will be repressed.”

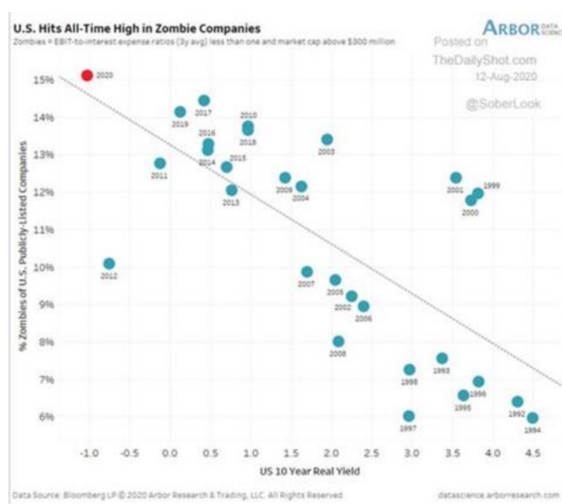
Kopernik’s belief is that we need to look for the logical truth in the actions of our elected and appointed officials, as opposed to blindly listening to them. The point of all this is to say that at some point the Fed/U.S./E.U./Japan/China/etc. saying that the next round of rate declines, or QE, or helicopter money will be seen for what it is: a desperate attempt to distort the truth that in the long run applying more debt is probably not the answer, but in the short run they are just trying to keep applying the IV drip to the masses to keep the economy rolling along.

Back to the U.S. markets. I have written before about the rise of the Zombie companies in America. That is companies whose interest expense is higher than their profits. Here is an updated chart showing this “progress” continues on. While it is easy to dismiss, think for a minute about what this means for the core profitability of our public companies or the froth of the stock market (it points to one or the other, or both). Further, think about how poor your profitability is for this to happen with interest rates sooooo low, as they are now.



Note: Firm-level data is used to calculate the share of listed firms that are more than ten years old with an interest coverage ratio less than one for three years in a row.

Source: Datastream, Worldscope, DB Global Research



Also keep in mind that with rates at current levels (U.S. 10 yr bond = .6% yield to maturity) with any inflation expectations you have negative real rates. Most people probably don’t think much about what that really means but it means you lose money by saving it. This concept is even worse in the negative interest rate countries. It is almost too strange a concept to think about and certainly only comes about when the government/U.S. Federal Reserve manipulate rates to ~~keep themselves solvent by reducing their borrowing costs to offset the higher amount of debt~~ help the average borrower. It also perverts the cost of money, as companies can now borrow money at an abnormally low rate to do whatever. In normal times, and certainly what the Fed was hoping, is that companies would borrow and invest in R&D, capital expenditures, move their production back to the U.S., etc. Instead, companies have borrowed and bought back their own shares and paid dividends. If the economy stays decent forever, this is a great strategy. But... if we have economic issues, then not having a safety net of cash, let alone no cash and lots of debt, is obviously bad.

Moving on from companies assuming nothing will ever go wrong and thus there is no need for a safety net of cash, or borrowing capacity, what if we think about stock options? As companies tell it, they are giving incentives to the key employees to align them with shareholders. By owning stock the employees will "do the right thing" and the stock will outperform as a result of this behavior. While easy to understand the concept, investors have seemingly lost sight of the short-term vs long-term incentives and more importantly that the dilution created by the options is often extreme. Tying this thought into the buybacks mentioned above, it seems quasi-criminal that management is given options and often sells the shares into the face of massive company stock buy-backs. In other words, the company is spending shareholder money to drive up its stock price by buying back shares (without regard for valuation) and frequently buying the very same shares it gave to employees a few years prior at much lower prices.

It is interesting to note that in the case of virtually all foreign and private companies that have a founder still involved with a big equity stake, the owner frequently takes a small salary and does NOT receive additional options. Their stake in the company is incentive enough to do the right thing and try to grow the value of the business. (You also see almost no options to employees which the founder sees as dilutive, but that is another story.) Well, that isn't the U.S..

Let's pick on a few examples. I'm sure you know the basics of the US airlines borrowing money and buying back stock to see the stock plunge in the wake of the Corona virus and then need/demand government bailouts. Outside of the rant of not having a safety net, let's discuss the current CEO of American Airlines, Doug Parker. First some background. He was the CEO of America West Airlines then on December 9, 2013 America West, which had already merged with US Airlines, merged with American Airlines which was just coming out of bankruptcy and Mr. Parker was named CEO of the combined entity. At that day the stock was roughly $25/share. Like virtually all big, US public companies American was pushed to buy back stock, and boy did they. From 2014 – 2019 they added $14bb in debt and bought back $13bb in stock. Now we start the bad news. From the day Mr. Parker was named CEO of the merged American until the day the market peaked in mid-February prior to the corona virus fear taking over the stock returned <u>11% TOTAL</u>. This same time period the <u>S&P500 added 90%</u>. Not ideal, but moving on. During this time period the company's revenue grew 7% cumulatively and net income fell by 40%. Further, free cash flow was negative $3.2bb. Also not ideal, which partly explains why the stock didn't perform better.

Now the really tragic part of the story. For this "leadership", the board of American has paid Mr. Parker quite well. He has sold more than $150mm from option sales. He still owns $50mm in additional shares. Further, he has received $100mm+ in cash salary, bonus and deferred comp, let alone other perks during this time period. <u>So we are up to $300mm+ for 6 years of work</u>. (side note to those that say insider sales are meaningless. Mr. Parker sold 5x his usual monthly option sale in early 2018 when the share price hit over $50/share.) Moving to today, the stock is at $13.50/share and Mr. Parker recently wrote a letter to the American employees warning them of upcoming layoffs if the federal government doesn't give American more money. So let's be clear, this was a ransom note to the US government. So even prior to being on the verge of bankruptcy, again, the company performed poorly and the stock performed REALLY poorly. But.. Mr. Parker was paid REALLY well. (He made 5% of today's total market cap in compensation for the last 6 years of work.) I'm sure he would say, like all CEOs, something to the effect of 'The Board sets my pay. I have nothing to do with it.' But... the Chairman of the American Airlines board of directors is Doug Parker. Wait, corporate boards are independent right?

How about Elon Musk? Good for him for being the face of innovation of Tesla and Space Exploration Technologies Corp (SpaceX). He founded SpaceX, but not Tesla. He was an early investor in Tesla and jumped in to run it early on. He and his trust reportedly own 54% of SpaceX worth close to $25bb, based on their last private fund raising. He currently owns roughly 135mm shares of Tesla @ $530 (up from $90 in late March) = $75 billion. He also has over $20 billion more in stock options at really low prices. Granted his options were issued when his stock was only worth $10bil or so, but the board thought that $10 billion evidently wasn't enough to motivate him so they should dilute the public shareholders by just under 10% to further incentivize him. At some point will investors start asking how much is enough incentive?

How about Boeing? The CEO was fired just prior to the Covid pandemic for the MAX plane issues/cover-up. Over the past 10 years, the now ex-CEO, Dennis Muilenburg, had been granted options on more than 430,000 shares. The exercise value is $12.4mm. He has sold over 290,000 of these shares for $54.5mm in proceeds. The remaining 143,000 shares have a value of $25mm = $80mm total. When he was fired, the board made it clear he was fired and would be given "no severance." Hmm. No severance huh? He got $29.4mm in "long-term incentive awards." He also got $28.5mm in pension and deferred comp benefits. He also received new options on 73,000 shares with an average strike price of $76. As of a couple weeks ago that was worth roughly $7mm. He also got $4.3mm in stock that Boeing gave him. That is $70mm to be fired with "no severance." Total = $150mm in 10 years, EXCLUDING his salary and bonus per year. He needed this much motivation? How does this not enrage shareholders?

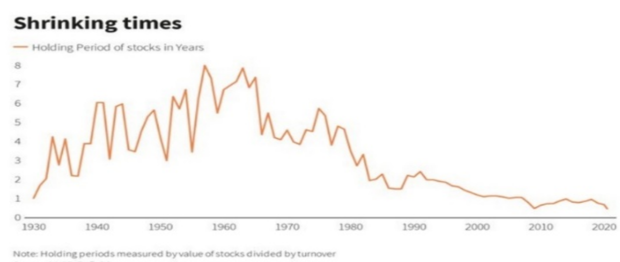
How about Kodak? On July 28, 2020, the U.S. government agreed to loan the company $765mm to initiate production of ingredients for generic drugs. Wait, what? The government was not only bailing out Kodak, but giving them a huge contract to enter an entirely new line of business? That is a thing? Based on that the stock went from $2.50 prior to the announcement to over $50 (now at $9). The day before the loan was publicly announced the company granted it's Chairman 1.75mm stock options in order to "shield the Chairman's overall stake in the company from being diluted by a $100mm convertible bond deal in May of 2019." Again, wait, what? Further, roughly 30% of those options are vested immediately. Any time there is a dilutive act, companies need to give more options to key employees so they are not diluted? What about the shareholders? Should we be given more shares so we don't have the pain of dilution? Now that this has come out the government is claiming to be reviewing the deal, but it was shady to start with and given the politics of today I would guess it will still go through.

Lastly, GE recently announced that its board has amended the new CEO's "sign-on" incentive PSU (performance stock unit) grant by lowering the reference price for his PSU stock award from $12.40 to $6.67, or (46%). If you are old enough to recall, after the dot com mania ended up with so many stocks down so much, the boards of all those companies started repricing the options they had granted employees so they would retain their incentive. Shockingly there was a mini revolt by shareholders saying how dare you reprice these options so the employees feel no pain, but we the shareholder feel everything. Of course, and this repricing of options/stock grants at GE is just a quick reminder of what is to come. Will shareholders stand up against this kind of thing? Based on today's environment it is hard to imagine.

Let's finish this section with the fact that the Big Three indexers (Vanguard, Blackrock (iShares) & State Street) are closing in on owning 25% of ALL shares in the S&P500 companies and all talk a big game about how environmental, social and governance (ESG) matters to them. Yet, I don't recall hearing that any of them routinely vote against the egregious stock options grants. The option "issue" described above is clearly a "G" issue within ESG but the environmental "E" is seemingly the only topic people want to discuss. So these passive investors, let alone the active ones, continue to allow these corporations to abuse the average shareholder, including themselves, to the benefit of the management. This includes the U.S. duopoly (97% market share) of ISS (Institutional Shareholder Services) and Glass Lewis, who advise investors how to vote on corporate proxy statements. They routinely vote yes for all option and restricted stock grants.

I could go on all day, but you get the point. It is hard to imagine that one day we will not look back and recognize that we have seen an unparalleled transfer of wealth to the company managers. Not founders and entrepreneurs, who will always start things and make money, but I am talking about just the hired managers.

I think the easiest answer to why all this happens is the average shareholder today is more of a trader, than investor. The chart below shows the average holding period of stocks in the U.S.. If you rent something (ie, a stock) you don't treat it the same way as if you owned it. While this may be the logical answer, it is just sad. Further, this is shocking when you think about the fact that we are approaching 50% of all assets in the U.S. market being held via passive index investments. Shouldn't those have longer time horizons? The flows in and out of passive are not that volatile (for now?).



I want to finish with a few thoughts on gold. Those who have known us for a while know our predisposition to say that when the central bank overtly says we want to have inflation, ie, debase the currency, that provides long-term support for a higher gold price. Furthermore, when the central bank prints money at a rate never before seen in history, we refuse to believe there won't be adverse consequences to that. The consequence has to be inflation/devaluation of the currency. When and how this hits is much harder to say but logically this has to be. From that point of view, gold has historically been the world's currency and we believe will remain so, even if in the background and not officially so. Lastly, debt funded helicopter money/transfer payment, negative real interest rates, rising nationalism, rising geopolitical tensions, rising social unrest around the world all add support to the safe haven of gold.

While all kinds of models can be created to say what price gold should be at, it is hard to know, but if at some point different sovereign currencies are backed by gold again, the price of gold based on central bank holdings needs to be much higher. More importantly to us as equity investors, do the gold mining companies reflect this? This is an interesting question given gold is up so much in 2020, with the average gold miner up even more. Gold year to date is up roughly 30%, while the GDX (large gold miner ETF) and the GDXJ (small gold miner ETF) are both up roughly 50%.

Let's take a longer term view. If we use the prior gold peak in early September 2011, we can compare gold to some of the miners. While some have risen faster than the gold price, many are still well below their prior peak. This is interesting given the miners are supposed to be positively leveraged to the price of gold. Further, we should also keep in mind that energy is a HUGE determinate of the cost to pull gold from the ground and since the peak of gold in 2011, oil prices have fallen by over 50%. It is hard to generalize this impact on profitability, but needless to say, it is pretty big. So margins should be better at this price, and yet many of the stocks are down from the prior peak.

Company	Market Cap U.S.$	Sept 5, 2011 to Aug 27, 2020
Spot Gold		+5%
Barrick Gold	$53bb	-44%
Newcrest *	$21bb	-38%
Anglogold	$13.7bb	-18%
Fresnillo *	$12bb	-38%
Kinross Gold	$12bb	-50%
Yamana Gold	$6.4bb	-61%

- Kopernik has a position in this company

In a CNBC interview on 7/30/20 the chief investment officer of private wealth management at Goldman Sachs, Sharmin Mossavar-Rahmani, said that she thinks that gold is overpriced and has no clear role in the portfolios of her private clients. More importantly she said that "Our view is that gold is only appropriate if you have a very strong view that the U.S. dollar is going to be debased." The Federal Reserve has morphed their historic 2% inflation target into letting inflation run hotter for longer so the long-term average is 2-2.5%. So when the Fed overtly says it is targeting inflation, that is by definition, them saying they are debasing the currency. Thus, we don't need to have a view on this; the Fed is telling us they will do it. Going back to an Austrian economist, "The return on gold does not depend on the fulfillment of some material condition. It is an ideological problem. It presupposes only one thing: the abandonment of the illusion that increasing the quantity of money creates prosperity." Ludwig von Mises

Going back to the main theme of this piece, we are firm believers that economic logic always wins in the long run and we should remain focused on that. For a Fed Bug to assume the government (ie, Federal Reserve) can solve all of society's problems with money printing makes no sense whatsoever. To help sell their story the government has the media to regurgitate and validate their stories so the average person believes it even though deep down it makes no sense. It always amazes me that people always think something happening today is unique to today but how often there are quotes from way back that tell the exact story. How about this? In 1785 Thomas Jefferson said "You know well that government always kept a kind of standing army of newswriters who, without any regard to truth or to what should be like truth, invented and put into the papers whatever might serve the ministers. This suffices with the mass of the people who have no means of distinguishing the false from the true paragraphs of a newspaper." As it relates to Fed Bugs, a great Charlie Munger quote is "If you're not confused, I don't think you understand." If that is true, I suppose the opposite must also be true, which is us in the world of Fed largesse. If you are confused (ie, why people are believing everything the Fed says), then you do understand.

I will wrap up with a great Buffett quote, "The (investors) that have the edge are the ones who really have the temperament to look at a business, look at an industry and not care what the person next to them thinks about it, not care what they read about it in the newspaper, not care what they hear about it on the television, not listen to people who say, 'This is going to happen,' or, 'That's going to happen.' You have to come to your own conclusions, and you have to do it based on facts that are available. If you don't have enough facts to reach a conclusion, you forget it. You go on to the next one. You have to also have the willingness to walk away from things that other people think are very simple. A lot of people don't have that. I don't know why it is. I've been asked a lot of times whether that was something that you're born with or something you learn. I'm not sure I know the answer. Temperament's important."

As the old phrase goes "may you live in interesting times" couldn't seem more appropriate than now.

Thanks again for your support.

Mark McKinney
Co-Portfolio Manager – Kopernik International Fund / Analyst
Kopernik Global Investors, LLC
August 2020

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