Kopernik Global Investors, LLC

Edited Transcript of the 3rd Quarter 2014 Conference Call with David Iben

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Operator: Good afternoon ladies and gentlemen and thank you for joining us for the Kopernik Global Investors Quarterly Update. On today's call we have David Iben, founder, chief investment officer and lead portfolio manager to discuss Kopernik's views on the current market environment and the portfolio positioning of its global all-cap strategy.

Please note this call is being recorded. The topics on this call are for informational purposes only and should not be regarded as a recommendation or an offer to buy or sell any product or service to which such information may relate. Certain products or services may not be available to all entities or persons. Please consider all risks carefully before investing. All participants will initially be in a listen-only mode. Following Mr. Iben's discussion, there will be an opportunity to ask questions. To ask a question, please press star 1 on your touch-tone phone. At this time, I'd like to turn the conference call over to David Iben.

David Iben: Thank you very much and thanks to everybody, thanks for dialing in, especially on an afternoon, such a tough market for today, and really for the last quarter; it's been a fascinating marketplace.

For a start, I was hoping to have my next investment commentary done before the call. It pretty much is done, but it probably won't be on the website till maybe tomorrow. In that, we talk a little about what we'll talk about today. But among various ideas discussed, one is value investing, in general. Having done value investing for 33 years, it's really 85% of the time the greatest thing on earth, and it's really easy.

You just buy the things that are cheap and out of favor and the math works for you. The other 10 or 15% of the time it's very, very painful and will tend to be at the peak of momentum manias. People have asked us over the years in what kind of markets do we perform best/worst. We say we like all markets: up markets, down markets, value markets, growth markets - it's all the same. But, Momentum markets have never been our thing. Once things get really divorced from the fundamentals, it's very difficult for our relative performance.

While those have been the toughest times, the post-momentum markets have been our best times. We've done very, very well coming out of 1999 and coming out of the '08 break, and we love the way the portfolio's positioned now, so we're looking forward to the next phase in this market.

It's interesting that momentum markets generally happen when the central banks start playing fast and loose with the money supply. It's interesting that in 1971, when we took the backing of gold away and there were no constraints on the Fed anymore, you had the Nifty-Fifty, where a narrower and narrower and narrower group of stocks were going to incredible highs even as most stocks were falling. Later on, of course, the Nifty-Fifty broke and all other stocks started doing a lot better.

In 1989, the money was all going into Japanese stocks. For global investors if you didn't own Japan, you underperformed big time until the break. When the break came, the key was to own everything else and not own Japan.

Tech, media and telecom was pretty interesting, too The money supply had been pretty easy as they printed money to deal with the Asia crisis, and printed money to deal with Russia, and printed money to deal with Long-Term Capital, and printed money to deal with the Y2K problems, and as always, everything started going up.

And as that was progressing, it became narrower and narrower and narrower, and by the end, tech, media, telecom were going up and a few index stocks. The key was owning those, and for those of us that didn't own those, it was extremely painful. A lot like last quarter, fourth quarter of 1999 was more like last quarter than anything I've experienced. Eventually, of course, the last group going up finally succumbed to gravity and everything else started doing very, very well.

Now, we've seen what QE has done. It's basically made the price of everything go up a lot over the last six years. Over the last three years, one thing after another has started dropping out. Three years ago, the emerging markets started dropping, and then gold started dropping. Over the most recent year, it's mostly been just the U.S. going up, and everything else dropping by the wayside. This year owning the U.S. was the key to success, just as owning TMT was the key to success in 1999 and Japan was the key to success in 1989.

We believe this will be very similar to those in the sense that, as the U.S. runs out of gas, which it must from these levels, the key to success will be to not own the U.S. and take advantage of the great bargains that we're seeing elsewhere. Evidence of what's going on in is this bifurcated market, as fewer and fewer things are going up.

A few days ago, the U.S. market was up 9%, Germany was down 12%, and Russia was down 23%. In general when the U.S. was up 9%, Japan was down, Europe was down, a lot of the emerging markets were down. But, even within the U.S. over the last month or two, you've seen Russell all of a sudden drop 10%, while the big market cap names kept going up. Now that the latest phase of QE is about over with, I imagine days like today will become more common until they come with the next QE, which I'll assume they will, once they see weakness. That's conjecture, who knows, but that would be the expectation.

Regarding the U.S., its cyclically adjusted PE of 25, higher than it's ever been (not counting 1999). We have no intention of owning too many stocks in the U.S., with the exception of a few special situations. With the U.S. GDP-to-market cap higher than it's ever been, except 1999, there's reason to worry. Furthermore, with debt-to-GDP at one times, all debt is at about three and a half times GDP, and including unfunded liabilities, is at about 10 times.

The U.S. is pretty pricey. That's important because we meet people all the time who tell us the U.S. is a great country. We agree; we think the U.S. is a really great country, we love the country and it stands for a lot of things we believe in. But being a great country is a small part of the equation. Price is a big part of the equation. In 1929, the U.S. was a great country, and people lost 90% of their money if they invested then. In 1972, it was a great country, but you would have lost half your money if you invested then; 90% if you invested in the AMEX, which was the NASDAQ of the time.

And Japan in 89, you lost a lot. In the U.S. in 1999 you lost half your money, and 90% if you'd bought the NASDAQ of current days. And then in 2007 you lost half your money, and in 1987 you lost a third of your money in a few days. So price is everything! We love the U.S., but we do not love the U.S. stock and bond markets at these prices. We will wait for better entry price in general.

In 2007, when the U.S. got pricey, it was a problem because the whole world was pricey. Now the U.S. is pricey and the world is not pricey. Europe's corrected, a lot of Asia's corrected, and then there are places like Russia that are just amazingly cheap. Other bifurcation, as I mentioned before, large caps are staying up while small stocks are starting to get cheaper again - that's interesting to us.

You see things like health care, where three or four years ago people were selling them cheaply because they were worried about patent expirations. Whereas now they're selling at really outrageous levels and people don't worry about expirations, they look for assured price increases every year. Yet at the same time, things that they used to like three or four years ago, tangible goods and basic needs, are on sale.

They've continued to get more deeply on sale, and we view that as a wonderful thing for the future. So if we look one by one, the price of uranium having gone from $137 to $28, it has since bounced to $37, fundamentals would argue for getting back into the $70s at least. So uranium's maybe heading in the right direction now, but uranium stocks are still hitting new lows; that's a great opportunity.

The intrinsic value of gold over the last three years has gone way higher, whether you look at it as money, in which case the money supply growth is very bullish, or a commodity, in which case the incentive price of producing it being well over $2,000 is bullish. So while the intrinsic value has gone up, the market value has gone down by a third. That is a wonderful thing. The fact that the gold held in the ground by miners has gone on sale by 80%, that is a beautiful thing, one of the better things we have ever seen.

Regarding agriculture, the prices have gone up in the U.S. but they're very cheap in a lot of the growing parts of the world. Particularly, publicly traded, profitable farmland looks very interesting. People liked clean fuel a few years ago, now as I mentioned, they don't like uranium, and they also don't like hydroelectricity in some of the growing parts of the world. We view that as an incredible opportunity.

Telecom franchises around the world look pretty good, and buying basic consumer needs, cell phone service, protein foods, energy, gas and such throughout the growing parts of the world at generally very, very low prices feels a lot to us like 1999 and 2000. We were able to buy bricks and mortar, Union Pacific, Lockheed, Raytheon, Alcoa, Boeing - companies that had been decades in the making at smaller market caps than some of the Internet startups.

We have what we think are really good companies, market leaders, growing companies and yet the price-to-book of the portfolio is less than 60%. Price-to-earnings is about 11 times- it's really an incredible thing. And just as the fourth quarter of 1999, we find the last quarter partly demoralizing but mostly very, very exciting because we probably haven't seen opportunities like this since then. We're buying similar sort of companies.

I'll move on to questions that have come up a lot lately. Russia of course comes up a lot. Maybe most of you have heard, but for those of you who haven't, we (like everybody else) worry about those things. Unlike a lot of people, we try not to view it as binary. We don't think that Russia is absolutely good or absolutely bad, just as we don't think that the U.S. is absolutely good or absolutely bad. Maybe the U.S. is a nine out of ten in terms of good, and the market's pricing it at twenty out of ten, and maybe Russia's only five out of ten. Maybe the fraud, corruption, and geopolitical wars, and all the really bad stuff is important, but maybe the educated population, massive resources, very low debt and having the infrastructure that meets the needs of Europe and Asia is a good thing, so maybe five's good.

So if we can buy things at half price, we probably won't; we'll be neutral. Buying things at 90% off, that's very exciting to us, so Russia we very much like. Or not so much Russia, but great companies that happen to reside in Russia that are 90% off. This is something that's appealing to us.

People ask about catalysts. People who have known us a long time know that we don't look for a catalyst. We view value as its own catalyst, we think when things are really, really cheap, eventually they'll find their way there. So what do we expect to have happen in Russia? We expect time to go by. As emotions swing with time, low valuations eventually find their way to higher valuations.

The news will be good one day, bad one day, but I expect these stocks to be way higher in the future, just as things looked really bad a year ago in Argentina. That turned out to be one of the better markets and really bad before that. And Venezuela seemed to be one of the better markets. People don't remember three years ago just how much people hated Japan, and it turned out to be a beautiful time to buy it.

So it's not about a catalyst. It's buying really good companies at really cheap prices, more than discounted for any bad news. That's similar with coal. We like energy. Everybody liked it three years ago, but there doesn't seem to be much appetite for energy anymore. The fact is that there are over 7 billion people on the planet and they will continue to consume energy. The world will endeavor to put enough solar, wind, nuclear, hydro and gas in place, but people are still going to use oil and they're still going to use coal. We might wish they didn't It's dirty, but millions of years of solar power captured in the form of hydrocarbons, is going to be used. With these stocks, many of them down 80 or 90%, we're buying coal for less than $1 per ton, that's a beautiful thing, we're not looking for a catalyst, we think value will be its own catalyst.

Regarding the ideas of what's worked and what hasn't in the past: I think having our own opinions of the market, we are prepared to be wrong three out of seven times, and pretty much have been wrong three out of seven times, and that's worked out very well for us. We'll continue to try to do that. There are times when you buy things at way less than asset value where the assets don't turn out to be worth what you thought they were. But most importantly, I've learned that the real money is made in times like now.

Right now, like at the end of '08, beginning of '03, and in late '87, the important thing is not giving up on what you're doing in times like that, not losing your nerve, not selling your stocks, not shifting to another style, not selling the stocks that are down most.

But I've learned that when things are going well, that's the easy time. But the money is made when people are testing your resolve. From that standpoint, we like times like now.

Beyond that, I'd say there's probably plenty of questions out there so why don't I stop and spend most of the time on questions.

Operator: Once again, that is star1 on your telephone keypad to ask a question. We'll go first to Gary Magnuson with Morgan Stanley.

Gary Magnuson: Hi, Gary Magnuson. Just wanted to ask you, I know you explained your position on Russia. Do you think that 17% in the country is about, I don't know if that's about what you have now, I think it is, but is there kind of a, you have like a 35% upper limit, do you ever think that in some countries you should have less, or just curious what are your thoughts.

David Iben: Yes, we do view things on an absolute basis. So we don't like to look at the index. If we were basing it on the index, then I guess we should have been comfortable having half our money in Japan in '89. That was a mistake for those who did. And I'm not being flip when I think that with the U.S. at 49.6% of ACWI, that's what people should be worried about. To have half of the entire capital of the world positioned in a country that's roughly one-fifth of GDP, that's very, very dangerous.

To have 17% in a country that is the sixth-largest economy on earth, has the most resources of anybody and buying companies on a price-to-reserve that are 5% what other majors are in terms of Gazprom, to buy hydroelectric dams for less than a fifth what it would cost anywhere else around the world, to buy one of the most dominant banks in the world at single-digit P/Es and big discounts to book value despite generating ROEs in the 20s in the past, the high teens now, those are the sort of things that, as an investor, you wait for.

Yes, we do have limits of 35%. In reality, we have never been more than 25% in any one country with the exception of the U.S. We did get to 25% in Japan a couple of years ago. People were not quite so afraid of Japan as they are of Russia right now, but the hatred was pretty deep. People were saying debt was 225% of GDP and that meant bad things for the currency, it couldn't be paid off, and they were slow, decision makers, and things had been dropping for 23 years. That was all true, but they forgot about the educated population and the great companies and what it means to have good businesses trading at 40% of book value. It turned out to be a good investment.

So we do believe strongly in absolute limits to what we own. So with country limits, we never own more than 25%. When the market owns a lot of a country, it's usually the time when we shouldn't. And when the market has almost nothing in a country that has so much going for it in terms of resources and potential growth, that's when we should be willing to go up to 15, 20, 25%.

So that's how we view those things, and it's same regarding sectors. When energy was a third of the entire market in 1980, it was a very, very bad time to feel comfortable with energy. When energy was 4% of the market in '03, it would have been a nice time to go to 30%. We weren't, but we were still up there in the high teens and we were 25% in some of the materials. Copper, nickel, phosphate and those sort of things worked out really well. Being able to look at banking when it was at 5% of the index was a good time to buy it, when it was 22% of the S&P and a third of ACWI, was a very bad time to own it.

And so on and so forth. We limit things absolute, but generally, when a country or a sector becomes a very small weight in the index despite being very big, important sectors or countries, that's the time to go to 10, 15, 20, 25%. So now, we believe that since it is maybe the most compelling value of my lifetime, 17% is not inappropriate.

Operator: Okay, we'll go next to Brian Mackey with Advisor Investments.

Brian Mackey: Hi David, thank you for hosting the call today. I was wondering if you could talk a little bit about one of the special situations that you mentioned in the U.S. SkyWest is a name that pops up as one of the top holdings. Maybe you could just walk me through kind of the process for why you bought that.

David Iben: Yeah, off on a tangent, as I often do. But ten years ago we were buying railroads in the U.S. and people would point to us that railroads hadn't earned their cost of capital for basically a century, and a century ago they'd all gone bankrupt. We were saying the industry has changed quite a bit. There was, length of haul had gotten longer, technology and regulation, a zillion changes that meant that railroads could efficiently get things 3,000 miles from one side of the country to the other in an effective time and at effective cost.

And besides that, they were just so cheap even if I was wrong about all that, we were probably going to make money. As it turns out, railroads did figure out how to put some margins there and they were good stocks for a decade.

Airlines are interesting, Warren Buffett has so many good quotes, I think he said from the standpoint of investors, somebody should have done investors a favor and shot the Wright brothers out of the sky. There's been proof to that. It's an industry that for the last 50 years has created so much value that somehow never made it to the shareholders. So many of them have gone bankrupt, very few people have made much money. It's gone to price wars or it's gone to clients, it's gone to labor, it's gone to pensions, it's gone to different things.

That's all bad. Like the railroads ten years ago, a lot of changes happened. There has been so much consolidation and a lot of airlines are so much more entrenched. And when we look at a lot of stocks we like to ask "What Would the world be like without these companies?" And I think most of us like the fact that we can fly from here to there in a few hours. It's really a great business as long as they can learn to manage these things.

Well, there's evidence that they've made great strides. I'm not saying they're well managed; I'm saying they're no longer miserably managed. So the outlook's a lot better for airlines and we kind of like them. Over the years, sometimes we've had a little Southwest, and we've had JetBlue converts from time to time. SkyWest is better than most. It's entrenched, it's a regional, it doesn't have to compete like a lot of the other ones do. A lot of the bigger airlines want to go from point to point, they don't want to fly to the little markets off the hubs.

So they outsource that business to people like SkyWest. SkyWest done a pretty good job. If you look over the years, book value goes up pretty much every year. That's very un-airline-like. And so you see a business that can do that, and you say "All right, that's worth a premium." So what kind of premium to book value should we want to pay for this thing? We were able to buy it around five dollars per share, went to ten, went to 15, we sold a lot of it. Went back to ten, we bought a lot of it and it's kept falling.

It's a third of book value basically, a third of book value for a good, dominant franchise that grows book value and has a service that isn't going to be replaced by some other service. I don't think we're all going to give up on that. Beside that we're not going to give up the hour flight and prefer to do a six-hour drive, that sort of thing.

So we like the airlines, we especially like the regional airlines, we like these guys that have been pretty well managed and we love paying a third of book value for companies like that. So that's the quick synopsis.

Brian Mackey: Great, thank you.

Operator: We'll go next to Nikesh Kadakia with Morgan Stanley.

Nikesh Kadakia: Hey, thanks for taking the time for the call. Just a quick question to go back on Gazprom. Obviously Gazprom, you know, current situation involved situation altogether, pristine balance sheet, they've got a pretty much ultra-safe 5% yield, and as you say you've got the valuation gap between for example Exxon, I think they generated a little bit more profit last year than Exxon did in trade. You know, a lot bigger discount.

But one of the things I'm very curious about is the deal they did obviously in China in yuan, and some of the deals they're doing right now outside the dollar. Along with that, you know, in addition to that, what's your thoughts just overall in terms of de-dollarizing the Russian overall deal that they're doing and going forward.

David Iben: That's an interesting question, it brings up all kinds of fascinating topics, I read a lot of stuff, about what may be going on. Russia has been vocal about wanting to de-dollarize, China has been vocal about it, and some of the Middle Eastern countries have been too. There are some people that think it might even explain some of the repercussions that those countries have been facing

I do know that having the reserve currency is a wonderful, wonderful position. It's so advantageous for the U.S. and I believe we've been abusing that privilege for a long, long time. So the dollar lost some of its prominence when we quintupled the money supply. Quintupled! That's irresponsible.

So I guess we should all worry about what happens when the dollar starts to lose some of its status. I guess with the dollar going up lately, no one's worried about it, but I think they have to be. I think that zero is the wrong yield for the dollar, and I do think that all of us need to worry about that. Whether something happens in the near future, I don't know, but regarding an earlier question, for somebody to have 50 to 100% of their money in U.S. investments, in U.S. dollars, to me is a way bigger worry than having 17% of it in Russia.

The dollar has lost 99% of its value in the last 100 years and will continue to lose value. As far as what the deals are with China, you hear rumors about this being in gold, and that's why China's buying more gold. That might be true, it might not, I don't know. It might make sense because I don't know that either of those countries trust one another, they probably wouldn't even be dealing with each other if the West hadn't forced Russia into China's arms.

But in the long run, since they probably don't want to do it in rubles or yuan or dollars, maybe it is gold. But we should worry about, the fact that Russia is starting to deal more with China. That might turn out in the long run to slow the growth of the West and to increase the growth of Asia and Russia. It's all something to think about.

But when I look at the price of Gazprom and I look at some of the things in China - good things aren't priced into those stocks, only bad things are priced into those stocks, and that, I think, is another opportunity.

I don't think any of us have a definitive answer on what the deal is between China and Russia. We know there is a deal, we do know that it has implications both on the companies here and in the world.

Nikesh Kadakia: All right, appreciate that. And just a quick last follow-up. Overall as you said, I think before the Russian economy's about one-sixth of the world, or the case is, and I think the percentage of allocation that most investors have in Russia, there has been net huge outflows in terms of Russia so obviously as you said there's a good opportunity to be overweight there.

What do you, just in terms, I know you don't give much of a time frame perspective, but I mean, you know, any idea in terms of when you think, valuations have, well I think one of the biggest European investors liquidated his entire stake early last year and took a big hit on his positions. You know, positions in Sberbank and Gazprom, obviously lost patience, I think he admitted that he essentially made a mistake.

So I want to get your thoughts in terms of, are you essentially adding every time Gazprom or Sberbank are trading down at these valuations, or are you looking more of a overall sector, you know, overall play in the Russian market in general? And thanks for your answer, thanks.

David Iben: Whether it's Russia or it's anyplace else, we rather than looking for a specific margin of safety, the larger the margin of safety, the bigger the investment we're willing to make. And so when Russia, especially good dominant companies become cheaper and cheaper, it is our style to add. Also, in May or June, or whenever it was, when you saw the bounce, you saw Rushydro go from massive lows to a 15-month high in a few weeks time. When that happened we trimmed.

We'd gone from not that long ago buying a lot of China and Brazil to trimming a lot of China and Brazil lately, as it bounced so much. So with Russia, there have been a couple times this year when we've been trimming names, but then when they turn around and fall again, we buy them back. We have always done that, we found it added a lot of value.

In the recent few weeks not only have we added to positions but finally some of the names like technology names, Yandex and similar, that have gotten into value ranges as well. We don't see too many technology companies around the world actually becoming value stocks.

Operator: We'll go next to David Niehaus with Merrill Lynch.

David Niehaus: Hey Dave, good afternoon.

David Iben: Afternoon.

David Niehaus: I was wondering if you could comment sort of a little bit about recent changes in the portfolio. I know in the fall of '08 you used, you were one of the few investors around to use the weakness to sell things that had held up in a relatively decent way and buy even more distressed goods. Is that situation possible today, or I guess I'm just curious how you're thinking about the value in different things you've been watching relative to what you own?

David Iben: Possibly yes, less so. But it is a very important point that so many people in our industry consider volatility to be risk. We think for long-term investors volatility is not at all risk. It is for short-term players or leveraged players.

Volatility, is painful, is problematic, but it's opportunity and so '08-'09 was extremely volatile and to your point yes, we were able to go from large-caps to small-caps towards the end of that. We were able to go from value stocks to "quote" growth stocks "unquote" that had become value stocks. So all of a sudden we were owning Whole Foods and eBay and Microsoft and Tata Motors and ICICI, people were saying "You've become a growth investor" and what not.

Volatility's a good thing. You know, we're having a tough year, tough quarter, but actually doing a lot better than we could have, we're still doing better than Germany and better than a lot of markets we're in, and gold, small caps, you name it, because there has been opportunity.

That January-February run, we're able to trim some of our small gold companies that were up 60 to 100-something percent and buy Newmont that hadn't moved at all. As I mentioned earlier, we were able to trim a lot of Russian names and buy them back. We were buying a lot of Chinese names that we've actually been trimming lately on big runs and moving that elsewhere.

Japan, a couple years ago we had gone from next to nothing to 25% of our portfolio and back to 6% that year. We've been buying back into Japan this year as some of the Chinese names have run up and the Korean names have run up. We've moved some back into Japan on a company by company basis. That's been good. Things like Brazil are amazing, the massive runs they're having every time a new poll comes out, regarding who's going to win the election. So, we've been able to trim and add and trim and add and trim and add some of those things. You know, we're not usually traders but when the market does that, it's hard not to take advantage of it.

A few years ago, people hated the nuclear power. Now we've trimmed a lot of the nuclear and France, and moved it into the hydroelectric power that's still cheap. I think most of you have heard this story on nuclear but just quickly - It's not a shrinking industry, it's a growth industry. There are 60-some-odd new plants being built. That's good for the people who build them and it's certainly good for the people that sell uranium. So we own more uranium than we had a few months back and maybe less of the utilities themselves. Yeah, absolutely, we've been taking advantage of the volatility. But up until very recently, volatility's been low, but as we've, all of us that have been in the market know, that when volatility's low for a long time, it's usually about to be very high.

When that's the case, we certainly will take advantage of that. But the way we're positioned right now, it's one of the cheapest portfolios in my 33-year career, very good companies, very inexpensive prices.

David Niehaus: I guess if I could just add one more sort of follow-up question. There seems to be sort of a universal kind of acceptance right now to sort of two financial truths. One of them being that inflation is sort of low and here to stay and the markets now are embedding a fair amount of certainty into that thesis, and then the other part of it is a strong dollar, and whether it's a strategist at Merrill or PIMCO or wherever, there seems to be a belief that the dollar is just getting going.

Those seem to be very much at odds with kind of how you're positioned, and maybe they don't need to be wrong for you to make money. But I'm just curious how you think about that. Because it seems like that's gotten even stronger as the year's gone along.

David Iben: Yeah. I love times like now. Part of the reason we chose the name Kopernik is Copernicus trusting his own analysis versus what other people told him to be true. We all get told over and over and over again that inflation's dead, so much so that we almost want to believe it. Yes, look at the CPI, it's only up 1.5%. Well, we've got a chart that's in that letter that we're going to post on our website hopefully tomorrow.

First of all, the money supply's quintupled. That by definition is high inflation. What are the symptoms of inflation? Well, what do they do with that money, they buy bonds. The bond market is probably the most overpriced market in the history of mankind. It's overpriced by trillions of dollars. What the right price is, I don't know, but it's overpriced by trillions.

Eventually, the money started to spill out so the inflation wasn't all contained there. The U.S. stock market has gone up for five and a half years, it's up huge. So it takes three times as many dollars to buy many of those stocks as it did five years ago. If you look over the last 10 to 15 years, you used to be able to buy a barrel of oil for $10. Now it's $85. You used to be able to buy an ounce of gold for $255, now its $1,200.

We've gone through the price of sending your kid to college, it's been going up by 8% a year. Health care's been going up by more than 8% a year. I was just reading a piece on the art market on the Bloomberg. Some artist I've never heard of, his works have appreciated by 350,000% over the last 25 years. What's well known is that the art market has surged to all-time highs. The collectibles market has surged to all-time highs. Pretty much name something that we all spend a lot of money on or use that isn't up huge.
The exceptions have been some kinds of clothing and maybe some food, but not much, and technology, which should be falling because the cost of production comes down. So inflation's huge. The symptoms of inflation reside in bonds, then leaked into most asset markets. In fact the price of real estate in West LA, the price of real estate in London, New York, Hong Kong, you name it.

Nah, inflation's rampant. It's out of control. But over the last three years there's been a correction in a lot of the commodities, there's been a correction in gold. That's probably healthy. So I don't see this absence of inflation people talk about.

Now it's interesting. The central bank leapfrogged too. We print for a while and then the English print for a while, and the Europeans print and then the Japanese print. We've had the rate of inflation in the U.S. be faster than anything in hundreds of years probably, but all of a sudden it's slowed down lately. And the last couple of years, the Europeans have actually been deflating but now they seem poised to inflate.

But if you look at, that might be in the letter also, the amount of money that's been printed in the last ten years in all these countries, they're taking turns printing, the inflation is shifting back and forth from country to country, and the symptoms have mostly stayed in the asset markets and in some of the things the government spends money on, health care and tuition, that sort of thing.

I don't see this lack of inflation and I doubt we will see it, until such time as people start worrying about inflation or willing to have a Paul Volcker type in there. We're a long, long, long way from that. But importantly, if you're buying bonds at 3.06 or whatever for 30 years, you are making a big, big bet that there will not be inflation for the next 30 years. Because if you're wrong and rates go back to what they were in the '80s, you would lose 85% of your money.

So the market's pricing in no inflation. The market is still willing to give us an ounce of gold for $1,200, I think that will go down as a bargain, because if it goes back to its cost of production, that's big increases.

So inflation seems to be high, it's not priced into the markets. Bonds might be fine, but they're not safe, they're dangerous. Gold might continue to go nowhere, but it probably is safe, it's had its correction and its fundamentals argue for way higher, same with uranium.

So, has the market priced in the option of inflation. I don't think I need to be right to make money from here, but I don't see this absence of inflation. And then a strong dollar, I wrote a piece a number of years ago titled "Can You Hear Me Major Tom". It suggests that It's all relative, isn't it?

If the dollar has dropped against oil and dropped against gold and dropped against health care and dropped against tuition and dropped against art and dropped against real estate, but during that time sometimes the euro was dropping even faster than the dollar or the yen's dropped even faster, that gives us the illusion of a strong dollar, in my opinion. So that's one man's take on it.

Operator: We'll go next to Patricia Neubeller with Merrill Lynch.

Patricia Neubeller: Hi there Dave.

David Iben: Hi.

Patricia Neubeller : My question goes to curiosity that I've noticed as done research about the high leverage in companies I've never seen before, like 50, 60, 70% leverage. I assume that it's financial engineering and because rates have been so low, you know, they've been instructed to buy back their company stock and do it with leverage. But my question is what your perception of that is and how is that going to be unwound without great injury? Thank you.

David Iben: Sure, great question. Leverage on its own is neither good nor bad. It seems to me if somebody can put a 30-year mortgage on their house, maybe that's a good thing, especially at current interest rates. I think even Warren Buffett called it a no-brainer the other day, asking why isn't everybody shorting the bond market. It seemed uncharacteristic for him.

But it seems to me that if you have long-term assets that probably have pretty stable cash flow, leverage is not a problem. I think Howard Marks wrote a piece a number of years ago talking of having waves in the pool and saying there is no right amount of debt, other than it needs to be low enough that it doesn't get swamped when the waves hit the higher part, you need to be able to withstand the big downturns.

There are times when debt's good, and right now, since the governments of the world have conspired to keep rates too low, there's a lot of reasons to have debt. So we have no problem with debt, but to your point, it is important what the debt is used for. If the debt's used for a great long-term investment, fine. If it's used to buy shares back, we agree with what I perceive as concern on your part, as problematic in lots of ways.

They're buying these shares back, at prices that imply a lot of growth in the future, but the companies are effectively saying we don't have growth, we want to return capital, we're going to buy our shares because we can't find any growth. People are overpaying for their stock. Look at the history of buybacks, people buy back at the top and zero interest rate policy and economic value added and all these things, they sound great but they lead to malinvestment.

So if you say "All right, the bank's paying me zero and I can borrow money at 2% and I can buy my stock back at a 3% return, then it's accretive to buy my stock back with cash, it's even accretive to borrow money and buy my stock back." Borrow at 2% and invest at 3%, easy money.

Except that paying 33 times earnings for a mundane company has always been value destructive. If you borrow lots of money to pay 33 times for something that's really only worth 13 times, you are going to lose all your equity. So you're going to goose up your earnings per share but destroy value at the same time, and that sort of fools other people into thinking you're a growth company but you're not growing your company, you're just growing some accounting numbers while you're wiping out equity.

It's a concern that they all bought a bunch of stock in '07 and they bought a bunch of stock in '99 and they're buying a bunch of stock now. And when they're buying it with debt, if interest rates never go up and profit margins are double normal and never go down, then they're doing the right thing. Those are two highly improbable assumptions, I think it will end badly.

But once again, it's a big world out there. These games aren't being played all over the place. We're finding a lot of companies around the world that are actually producing things and selling them and making money. We share your concerns and that's one of the reasons that we're valuing some companies in the US lower than the market is.

Operator: We'll go next to Phil McCauley with Morgan Stanley.

Phil McCauley: Hi, Dave, thanks for doing the call. My question is, relates to historically the U.S. markets. When the U.S. markets fall, developed markets fall with them and emerging markets fall even more. Could you share your thoughts on how EM can perform even though you expect U.S. markets to decline or for even, you know, financial crises to hit potentially in the U.S.?

David Iben: So obviously none of us know the future, but if you analyze things that are quote, high beta things, for example, emerging markets have been high beta and small-cap stocks have been high beta, et cetera. But usually there's reasons why they're high beta and in reality sometimes they are and sometimes they aren't.

I was very worried in '99, I lost a small bet with a colleague. We owned all these small stocks because that's where the value was and they're high beta and the NASDAQ's going to crash and burn because this is a mania. He thought we were going to make money when they crashed and burned. I thought that was impossible.

The NASDAQ crashed and burned and we were up 27% in 2000 and up 23% in 2001 and up 7% in 2002. So small stocks should have been high beta and got killed, but what they really were was really, really cheap stocks. That's where the money went when it was piling out of the expensive stuff.

And if you look at emerging markets, in a way, they're on their own cycle. Emerging markets did pretty well in the '60s and '70s, and then they didn't do well in the '80s and '90s even as the U.S. was doing very well. So they did well when the U.S. was struggling for two decades, they did poorly when the U.S. was doing great for a while. They did pretty well in the last decade, when the U.S. really went nowhere for the decade and emerging markets did pretty well.

So if valuation is the best predictor of what's going on in the future, then maybe we can worry about India or places like that that run up to big valuations. But Brazil, China, Russia, Korea, are cheap, really, really cheap. A case can be made they go up - I'm not going to tell you they're going to go up,-I'm just saying a case can be made they go up when things go down. For us, past beta is not something we look at a lot, because it's right most of the time, it's wrong when it matters, the inflection points and things have changed and valuation in the long run is sort of gospel to us.

Operator: Once again that is star 1 to ask a question. We'll go next to Ken Moore with Global View Investment Advisors.

Ken Moore: Hi Dave. We're a small RIA, we've started doing some business with you guys. I've been doing business with Jean-Marie and then later with Chuck and Charles at IVA for a few years. I went back to look on your last comment on what happened from the NASDAQ bubble when it burst, you know from 3/1/2000 to the end of the third quarter of 2002. And you know, all the guys were focused on valuation and quality in some way, basically made money when the index was down, you know 40 to 45% depending on what you're looking at.

So I think it's quite possible you have a two- or three-year bear market in the U.S. and it can work. The question I have, there, Ray Daliol has put this thesis, and I've read your Brodsky letters and some things you've put together. The reason why we haven't had inflation is because we were in a deflationary environment. The huge money printing basically filled a hole that would have been deflationary, just like in 1929 when you had deflation. In 2007 we saw credit start to fall in an uncontrollable fashion.

Anyway, I just, I know you guys have looked at this, I know you see it as a possibility, or you thought about at least. So my question is, is it possible that we could see low inflation for you know, for a few more years and that, with the central bank policy particularly in Europe if they really can get their act together and it can make this thing go on for a while, and this just might be a short-term blip. That's it.

David Iben: All right, good question. I have huge respect for Jean-Marie and also Chuck and Charles. As far as the inflation, once again, my take is that we have had big inflation. I would think that anybody that took their money at the end of 2008 and locked it in a safe deposit box has lost massive amounts of purchasing power. I don't care what the CPI is, the CPI has almost nothing to do with inflation in my opinion.

So like I say, that dollar bill has lost over half of its purchasing power against gold, lost two-thirds of its purchasing power against oil, and it's lost probably half against real estate in the high areas and lost most of it against art and collectibles and those sort of things.

But it has not found its way into the CPI for various reasons. Now credit, that's an interesting thing. I'm in the camp that inflation's a monetary phenomenon. A lot of people say no, it's a credit phenomenon. Lots of smart minds can disagree on that, so I'm not going to say there's any one right answer.

But I believe that if you print money, that devalues the value of the existing money, you've cut the wealth into more pieces, so you haven't increased the wealth, you've cut it into more pieces. When that's happening, often you see the price, as the Brodsky stuff talks about, of unlevered assets to go up.

And so when they started printing, lots of money in '09, '10, '11, while credit was collapsing, price of gold went up a lot, price of farmland went up a lot, price of oil went up a lot. Things that people buy on credit, housing and autos and those things, they suffered. Then the Fed finally got the credit going again and those things have all gone to the moon. But I think credit is a mechanism, it leads the symptoms of inflation into levered assets or not.

I think the act of printing money devalues the value of each particular dollar bill, which eventually finds its way into the market. Like I say, this time it inflated the bond market, then it inflated the stock market, then it inflated the real estate, and art markets, and probably will continue to inflate the prices of many goods and services.

So if now the U.S. has kind of stopped for a while, then it's up to I guess Japan and Europe and others to keep inflation going, but if they do or the U.S. keeps printing, I think that holding dollar bills, or yens, or euros, will not work out all that well. I think people should rather own farmland and hydroelectric dams and railroads and cellular phone companies and gold and uranium. Even if the CPI doesn't go up.

If the CPI does start going up, God help the bond market. But we don't worry about that so much. We do think that zero is the wrong interest to hold pieces of paper that are being printed, and over the long run, short-term volatility is something we have to bear as investors. But over the long run, I believe good tangible assets that are meeting the needs of the world's middle class and providing good cash flow will be much better whether or not the CPI goes up.

Operator: We'll go next to Daniel Morgan with LPL Financial.

Daniel Morgan: Hey Dave. Question here for you, I think this is what the last caller was trying to get at. Really I think the question is, what's the worst-case scenario for the portfolio, because you know days like today and the last couple of weeks, maybe months, it seemed like it's been a little painful. So what would sort of be the worst-case scenario over the next, I don't know, year or two-year time frame.

David Iben: When I look back at 1987, when I look back at late 2008 and other times, the worst thing for any of us is to lose conviction in what we're doing. I feel bad for people that decided to throw in the towel on the equity investors or us or anybody right before we were up 50% the next year.

The worst scenario is people having come in to the equity markets when they really weren't long-term investors, and that ends up happening to most of us at some point. It's hard to have your nerve when things are plunging. That's the worst case. Stocks go up, stocks go down. Over long periods of time, they go up more than they go down. Value stocks especially go up a lot more than they go down, but boy do they get walloped in momentum markets.

So in all seriousness, losing nerve and selling rather than doubling down at the bottom is the biggest mistake. As far as what could go wrong with the portfolio, we're inclined to think the world will be a fine place and the population will continue to grow, and there'll be continued need for more food and more electricity, more of those sort of things.

Wars, pandemics, those sort of things would not be good for this portfolio. But we don't worry as much about interest rates and those sort of things. We think the valuations are providing a huge margin of safety to many kinds of risks that the world might want to throw at us.

Daniel Morgan: So just to reconfirm on this, you are buying as the market's declining then.

David Iben: Yes.

Daniel Morgan: Okay, thank you.

Operator: We have no further questions at this time, so I would like to turn the conference back over to Mr. David Iben for any additional or closing remarks.

David Iben: Once again, thanks to all of you calling in, especially on days like today. It is interesting times, and we do feel that in times like this it's more important than ever to take advantage of the values that the market's offering us, and we certainly appreciate everybody's support and you know, welcome the opportunity to talk. Thank you very much.

Operator: That does conclude today's conference, we thank you for your participation.

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