THE SADDLE RIDGE HOARD

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

A California couple stumbled over a coffee can filled with treasure. Predictably it took very little time to generate many theories as to how it got there and several claims by people saying it belonged to their ancestors (even though they apparently didn't even know the location). As for my take, knowing nothing about the music, literature and movies (not yet invented) of the late nineteenth century, I can't rely on my standard modus operandi of using those media to tell the story. I'll have to spin my own. I'm not interested in who owned the gold or how they got it (let's call them the Saddle Ridge Gang ("SRG")). I'm curious as to the identity of their Financial Advisor. How might their advisory sessions have gone? If nineteenth century consensus opinion looked anything like the contemporary Wall Street consensus, the advice was loud and clear: "Get the Hell out of Gold" and "Run, don't walk, to the safety of the U.S. Dollar!" Had they done so, we certainly wouldn't be reading about the discovery of $30,000. Fortunately, their advisor gave them better counsel. My theory is that they intuitively had a better understanding of risk than do most contemporary academics. **This Commentary discusses the idea that investors often obsess over the wrong type of 'risks.' This error in judgment presents the rest of us with outsized money-making opportunities.**

The **Saddle Ridge Hoard** is the name given to identify a treasure trove of 1,427 gold coins unearthed in the Gold Country of the Sierra Nevada, California in 2013. The face value of the coins totaled $27,980, but was assessed to be worth $10 million. In total, the hoard contains $27,460 in twenty-dollar coins, $500 in ten-dollar coins, and $20 in five-dollar coins, all dating from 1847 to 1894. The collection is considered to be the largest known discovery of buried gold coins that has ever been recovered in the US.

Following the initial discovery of the coins, there was widespread speculation that the hoard represented the discovery of the 1901 theft of $30,000 from the San Francisco Mint by employee Walter Dimmick. Other theories disregarded include connecting the hoard to a hidden stash of gold buried by Jesse James, as well as loot taken by Black Bart, who was known for robbing stagecoaches. Another theory is that the Saddle Ridge Hoard of gold coins was a left over remnant of hidden treasure by the Knights of the Golden Circle, part of the treasure that was to be used for the funding of a renewed Civil War effort. The predominant theory attributes the cache to an unknown mountain man who chose to bury the coins rather than trust the banks to protect his wealth.

The find comprises almost **1,400 $20 gold pieces, 50 $10 gold pieces and four $5 gold pieces, all of which were struck between 1847 and 1894**. Highlights of the cache include at least 13 finest known specimens, among them an 1866-S No Motto Double Eagle valued at close to $1 million.

The rough and tumble Wild West was undoubtedly a better vantage point from which to analyze risk than are contemporary ivory towers. At any rate, whatever the risks, from 1896 through 2013, even after a very slow start, gold performed 67 times better than idle cash balances; gold coins, given their additional numismatic (collectibles) value, performed 333 times better. If our protagonists (SRG) had chosen to hold cash, and locked in the rates of the time (3.5%) for 115 years, they could have made 52 times their money. This is far short of the performance of the coins but not dreadfully behind the pace by which the gold price multiplied.

And what if they'd chosen to invest in the stock market, you may be wondering. The academics of the 21st century, armed with computers, would have calculated the 'VAR', and 'beta', and 'vol' of stocks portfolios, then warned them of the dangers of volatility and strongly advised them to stick to the 'safety' of cash. It certainly would have sounded convincing, especially keeping in mind that the U.S. at the time was still basically an emerging market. Let's say, pre-dating neat little formulas such as, "100 minus your age is the percentage of your portfolio to allocate to stocks," they brashly put the entire $30,000.00 in a fund that replicated the nascent Dow Jones Industrial Average. (By sheer coincidence the Dow Jones Industrial Index was first calculated in 1896, the year for the newest coin.) My God, would they have had volatility in their future! But was it a risky future? Let's take a look.

For starters, the vast majority of the companies in the Dow, it turns out, would not live to witness the 21st century (see the list below).

> Dow calculated his first average purely of industrial stocks on May 26, 1896, creating what is now known as the Dow Jones Industrial Average. Of the original 12 industrials, only General Electric currently remains part of that index. The other 11 were:
>
> - **American Cotton Oil Company**, a predecessor company to Bestfoods, now part of Unilever.
> - **American Sugar Company**, became Domino Sugar in 1900, now Domino Foods, Inc.
> - **American Tobacco Company**, broken up in a 1911 antitrust action.
> - **Chicago Gas Company**, bought by Peoples Gas Light in 1897, now an operating subsidiary of Integrys Energy Group.
> - **Distilling & Cattle Feeding Company**, now Millennium Chemicals, formerly a division of LyondellBasell, the latter of which recently emerged from Chapter 11 bankruptcy.
> - **Laclede Gas Company**, still in operation as the Laclede Group, Inc., removed from the Dow Jones Industrial Average in 1899.
> - **National Lead Company**, now NL Industries, removed from the Dow Jones Industrial Average in 1916.
> - **North American Company**, an electric utility holding company, broken up by the U.S. Securities and Exchange Commission (SEC) in 1946.
> - **Tennessee Coal**, Iron and Railroad Company in Birmingham, Alabama, bought by U.S. Steel in 1907; U.S. Steel was removed from the Dow Jones Industrial Average in 1991.
> - **U.S. Leather Company**, dissolved in 1952.
> - **United States Rubber Company**, changed its name to Uniroyal in 1961, merged with private B.F. Goodrich in 1986, bought by Michelin in 1990.

SRG would not have had to wait to experience the 'thrills' of the stock market. Immediately the Panic of 1896 would have knocked the value of their portfolio down more than 50%, though it bounced right back. For the next 18 years the market was range-bound between 53 and 103 as it reacted to the Panics of 1898, 1901, 1907, 1910-11, the war against the Spanish Empire, and the closure of the New York Stock Exchange for 4-1/2 months at the onset of World War I. When the Exchange was reopened on December 12, 1914, the market plunged 24%.

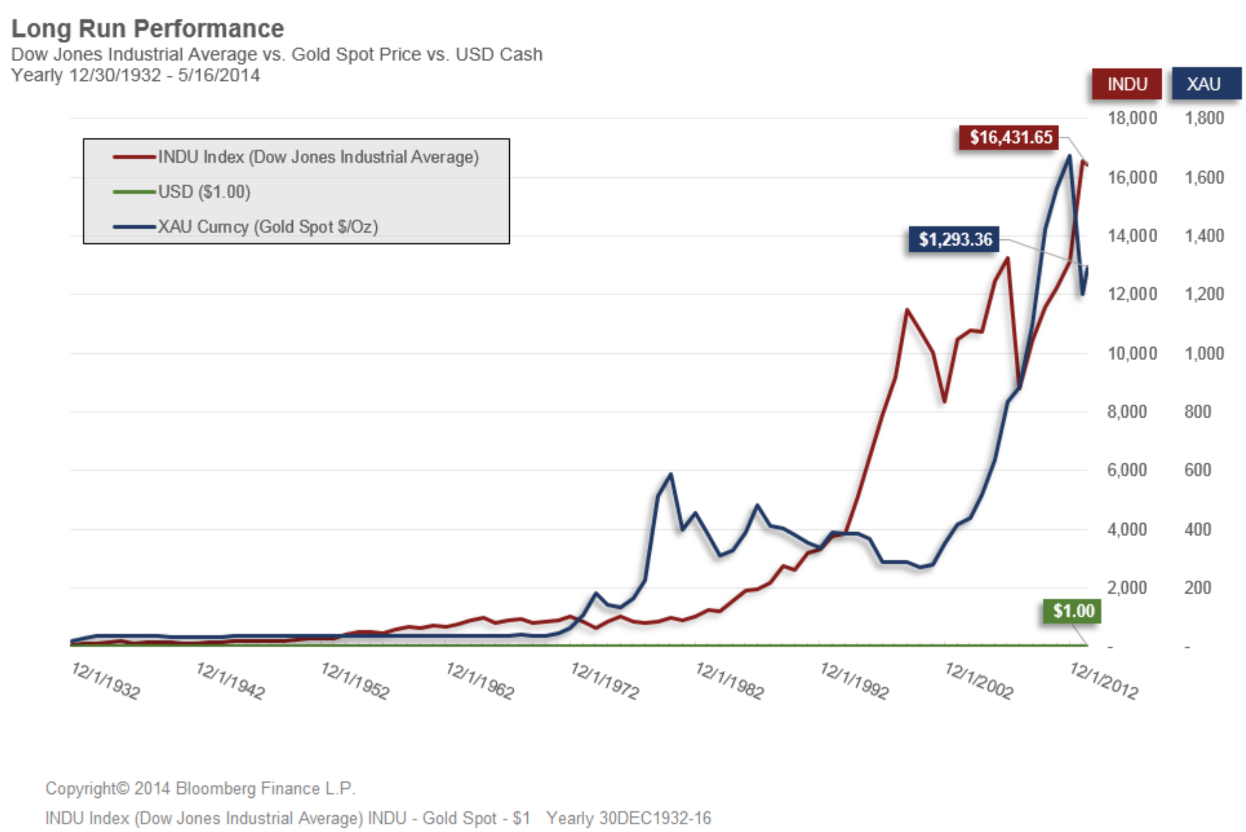
The next several decades brought the duration of WWI, the post-war recession, the recession of 1921 (Grant's Interest Rate Observer has eloquently shown that these recessions self-corrected rather than drag on like all the subsequent recessions that the government stepped in to 'fix'), the Polish Soviet War, the Irish Civil War, the Turkish War of Independence, and the Chinese Civil War. The grand finale to these two decades of volatility-inducing events was the crash of 1929 and subsequent onset of the Great Depression. The DJIA dropped to 40.56. After 37 years the gold had gained nothing. It was still worth around $30,000. Cash sitting in a safe-deposit box, still fully-convertible into gold, had also gained nothing. Importantly, neither had lost value either. The stock market was sitting one-third lower than it had so many years prior. At first blush, maybe the low volatility, 'safe' approach is far superior. But two things are important here! This does not include dividends, which averaged around 4% annually. Had they been reinvested, the investment would have quadrupled! **Secondly, everything we've examined thus far pre-dated three seminal Federal actions, which together meant that cash would never again have a fighting chance of being a good long term investment!**

The first action occurred in 1933. Franklin Delano Roosevelt, then President of the United States, outlawed the holding of gold, forced everyone to sell it back to the government for $20.67 (which had been the price going back to 1834), and then promptly reneged on the government's responsibility to maintain the purchasing power of the dollar, resetting it to $35 per ounce, a 69% devaluation of the value of people's savings accounts. (For this unconscionable act, he of course was sent to jail where he spent the rest of his years. I'm just kidding, of course.) Instead, he has been practically deified and remained in office many years more, long enough to give half of Europe to Joseph Stalin (clearly, I'm not a fan). Not to keep you in suspense, the two encores to FDR's trashing of the dollar relative to gold were Nixon's default on the obligation to have any dollar tie to gold, and Bernanke's quintupling the supply of baseless, fiat U.S. dollars between late 2008 and 2013. We'll return to these later.

At any rate, FDR's act was the inflection point for the effectiveness of the U.S. dollar as a store of value relative to other candidates. The gold in the buried coffee can was suddenly worth almost 70% more than the green paper that was so safely nested in the deposit box, and the stock market commenced an awesome trek that took the Dow from 40 to over 1000 over the ensuing 33 years! This journey took a volatile course as the market digested events such as World War II, the Spanish Civil War, the Soviet-Japanese Border War, the Second Sino-Japanese War, the Chinese Civil War, the Greek Civil War, the Indo-Pakistani War, the 1948 Arab-Israeli War, the Korean War, the Algerian War, the Cold War, the Cuban Revolution/Bay of Pigs/Cuban Missile Crisis, U.S. entry into the Vietnam War, and the beginning of the turbulent 1960s. While stocks were going up 25 times, gold, and its increasingly distant cousin cash, gained nothing.

The years from 1966 to mid-1982 were tough years for investors, almost across the board. During a time that was infamous for the escalating cost of living, the dollars in the safety deposit box continued to languish, earning nothing, and the Dow Jones Industrials remained range bound between 600 and 1000, spending the first half of 1982 at sub-1966 levels. Once again, inclusion of dividends makes returns much higher, but the accelerating rate of inflation meant that real returns were poor even including dividends. Cash and bonds were ravished by the effects of inflation as the yield on the 30-year Treasury bond went from 4% to almost 15%, with the price dropping accordingly.

An interesting point regarding this 16 year period of malaise is that a mere five years into it, our government couldn't stomach the pain any more, and as previously mentioned, President Nixon reneged on the U.S.' obligation to the world to exchange gold for dollars, at a rate of $35 per ounce. A la' FDR, he also did not go to jail, although he was run out of office as a consequence of lying about the infamous Watergate break in, a terrible but lessor crime. Like 1933, gold leapt upward. Unlike 1933, stocks struggled for 3-1/2 years before finally taking off. Gold, no longer tethered to the U.S dollar, kept rising. On its way from $35 to over $800 over an 8 year period it did endure corrections, including a nasty 50% drop lasting a year and a half (late 1974 through mid-1976). In 1979, the Federal Reserve, in an extremely uncharacteristic move actually began to rein in monetary inflation. Gold shortly thereafter began a multi-decade retreat. Stocks, as they had post-1933, ran for many more years before running out of gas. This was primarily credit driven.

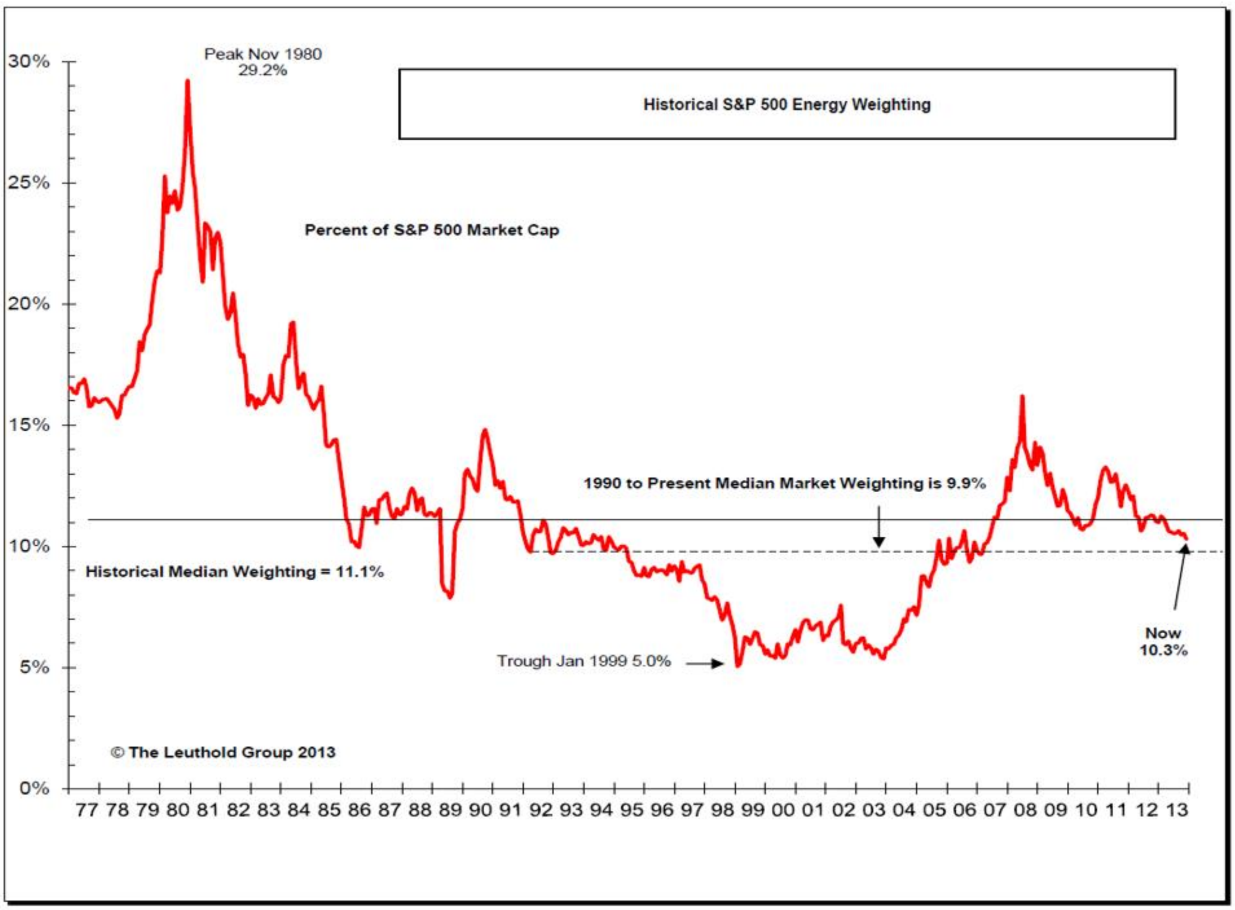


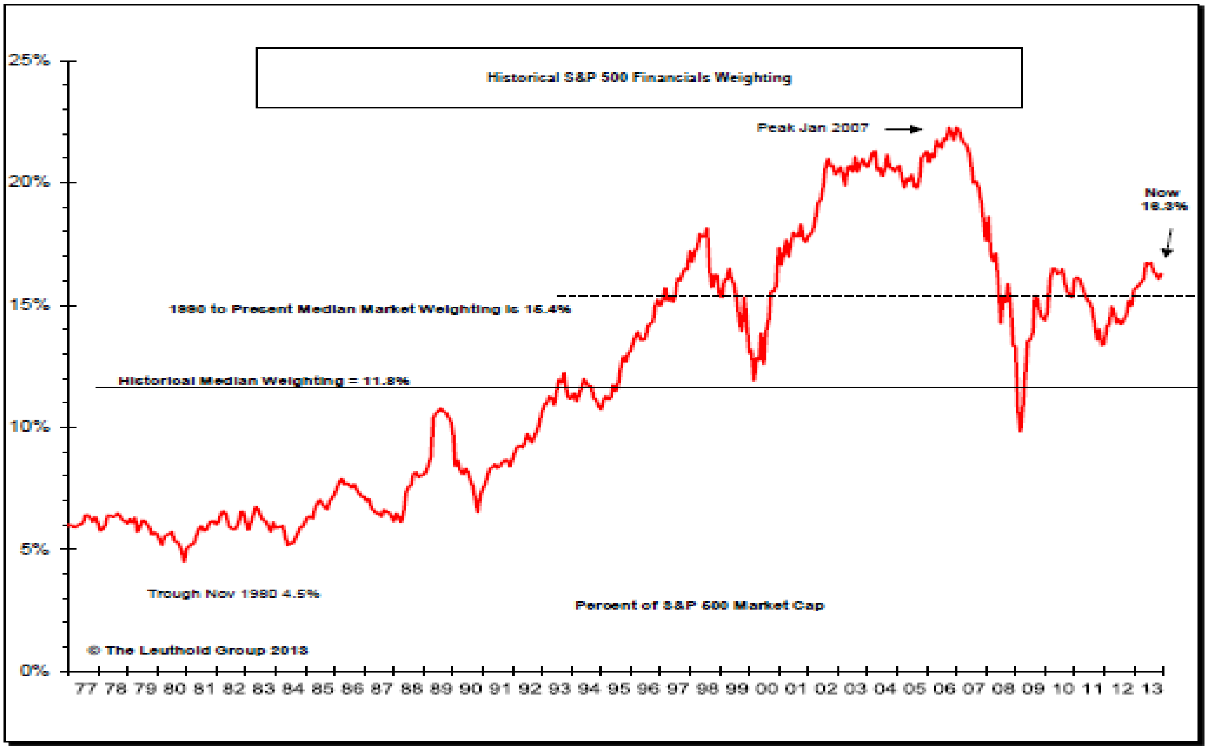
Moving forward to more contemporary history, in the late 1990s popular stocks became dreadfully over-priced, eventually succumbed to the laws of nature, and plunged for three years. Our increasingly impatient government waited even less time than they had in the seventies to begin interfering in the markets, creating an abundance of easy money. Both gold and stock, dutifully blasted upward. Lacking a fundamental underpinning, stocks faltered again 4 years later with the onset of the Great Financial Crisis. Dr. Bernanke responded with one of history's most audacious programs of currency debasement. Gold prices tripled in three years! As it had in the mid-seventies, prices spent well over a year retracing some of the move (correcting by one-third between the summer of 2011 and November 2013). While fundamentals argue for much further upside from here, that is fortuitously not factored into the price of gold mining stocks. While the market price for miners clearly seems at odds with the vastly increased level of their intrinsic value, the relationship of market prices to the intrinsic value of most other stocks is much tougher to feel confident about. But let's not jump the gun. Before getting to our current outlook and strategy, let's return to our examination of risk.

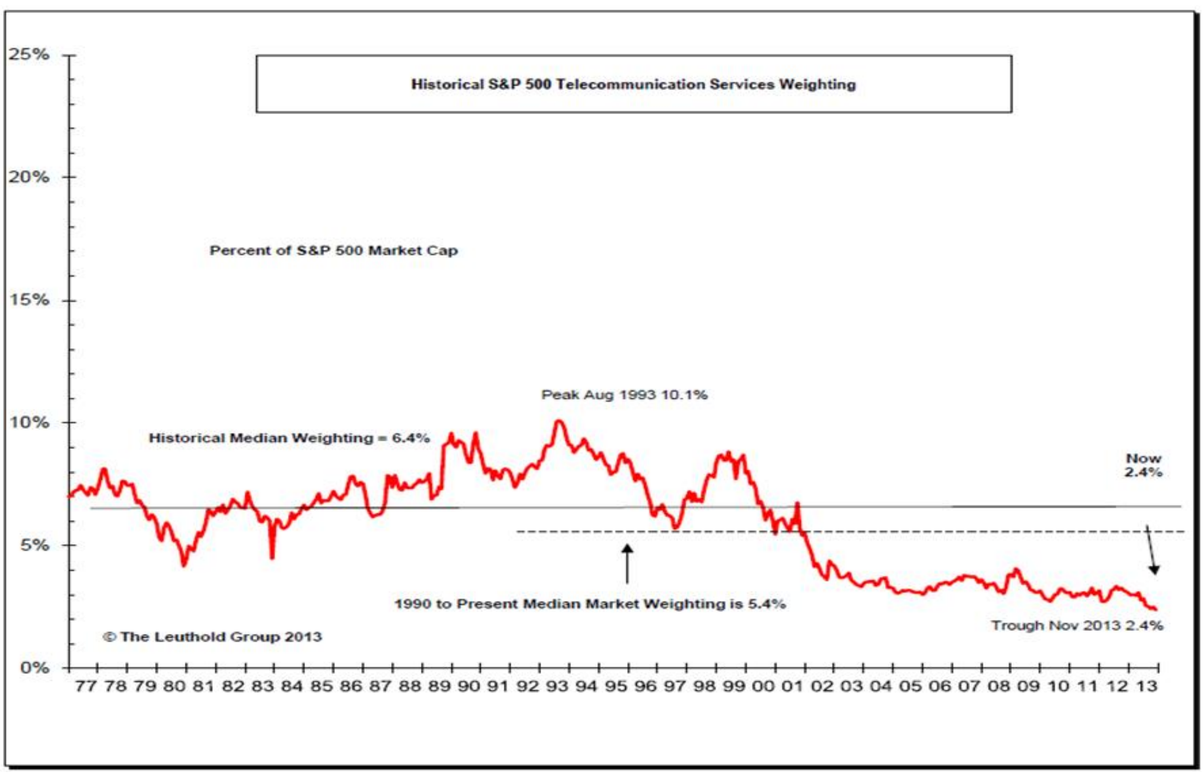
SRG, living in the Wild West, probably worried about the right things: the consumption (tuberculosis); claim jumpers; drought; outlaws; dependability of currencies; solvency of banks; etc. Life was volatile and I highly doubt market volatility ever entered their minds. I can't imagine that tracking-error was even heard of, much less considered to be a valid measure of risk. It's been a while since I was in school. (No, in response to any snide thoughts, it wasn't 1896.) But even in the 1970s and '80s, we didn't spend much time on volatility, and none on tracking-error. We were taught to respect the markets, to fear market risk. We did learn, on the other hand that business risk, as scary as it might look, can be diversified away. How different academia is today. Many seem to believe that markets need not be feared as long as one is able to boil risk down to a single, convenient number such as beta, vol, VAR or tracking-error. Better yet, investors sleep well nowadays with the implicit understanding that, even if they miscalculate, they are backstopped by the Greenspan/Bernanke/Yellen put: i.e. the Fed will certainly bail them out every time the market swoons. But, this presumed insurance policy covers only market loss, not specific business loss. Therefore, investors are avoiding the inexpensive stocks of great businesses because they fear the 'risk' attributed to specific companies, industries, sectors, countries of domicile, management, debt, or headlines. Perversely, these risks that they fear so much are the very ones that can be diversified away by inclusion into a well-structured investment portfolio.

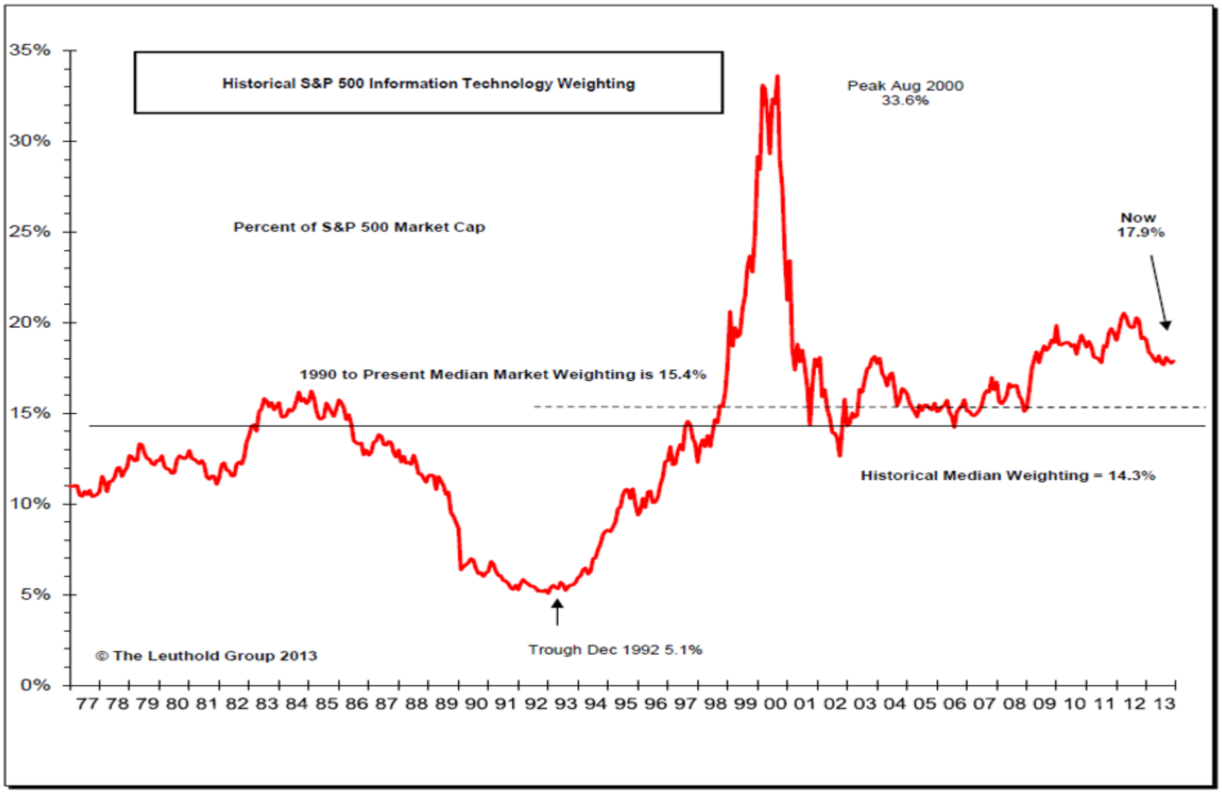
As a matter of fact, while the Dow Jones Industrials Index portfolio did much better than other investment alternatives, using a little bit of active portfolio management to embrace the opportunities resultant from periodic gross misperception of business (unsystematic) "risk", investment returns could have been meaningfully enhanced. Suppose, paying heed to Warren Buffett's 20 ticket punch card concept, an investor just took advantage of the extremes. In 1933, radio, telephone, automotive, and other "hot" stocks from 1929 could have been bought at 90% off and held for decades. Following implementation of the Marshall Plan, the extremely distressed stocks of Germany and Japan could have been purchased and held for decades. In 1974, resource, industrial and technology stocks could have been purchased at a shadow of their late 60s/early 70s prices. In 1982, the darling "Nifty Fifty" stocks could be acquired for a quarter of their lofty 1972 prices and held to this very day. Those not fully focused on stocks could have bought U.S. Treasury bonds, locking in 14 to 15% annually through 2012. Elsewhere, bonds that are convertible into stocks were available in 1990 at incredible bargain prices, steeply discounted from the heyday of the Milken era. This proved to be a much better choice than Japanese stocks, which at the time were valued as if they were worth almost as much as every other stock trading across the globe put together!!! The turn of the century simultaneously offered investors the choice of paying obscene prices for tech, media and telecom ("TMT") or investing in small capitalization stocks at the biggest discount to large caps ever recorded. 2002 proved to be an opportune time to buy the aforementioned TMT at a 90% off sale post the popping of that bubble. Around the same time, following a bear market lasting virtually a quarter-century, natural resource stocks (the darlings of the late 1970s) were offered at what proved to be amazing bargains. 2007 was more of a time to avoid stocks, especially the atrociously over-saturated financial area. 2009 until now has been a decent time to own anything other than cash. The environment now is extremely difficult, yet the choices in this extremely bifurcated market seem obvious. This will be discussed in the Strategy section.

The following charts show graphically how the crowds collectively suffer from bi-polar disorder, alternating from ecstatic bullishness to despair regarding their outlook for sectors (the same can be shown for countries/regions/market caps):




Historical S&P 500 Financials Weighting
Peak Jan 2007
Now
16.3%
1990 to Present Median Market Weighting is 15.4%
Historical Median Weighting = 11.8%
Trough Nov 1980 4.5%
Percent of S&P 500 Market Cap
© The Leuthold Group 2013
25%
20%
15%
10%
5%
0%
77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13


Historical S&P 500 Telecommunication Services Weighting
Percent of S&P 500 Market Cap
Peak Aug 1993 10.1%
Historical Median Weighting = 6.4%
Now
2.4%
1990 to Present Median Market Weighting is 5.4%
Trough Nov 2013 2.4%
© The Leuthold Group 2013
25%
20%
15%
10%
5%
0%
77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13


Historical S&P 500 Information Technology Weighting
Peak Aug 2000
33.6%
Percent of S&P 500 Market Cap
Now
17.9%
1990 to Present Median Market Weighting is 15.4%
Historical Median Weighting = 14.3%
© The Leuthold Group 2013
Trough Dec 1992 5.1%
35%
30%
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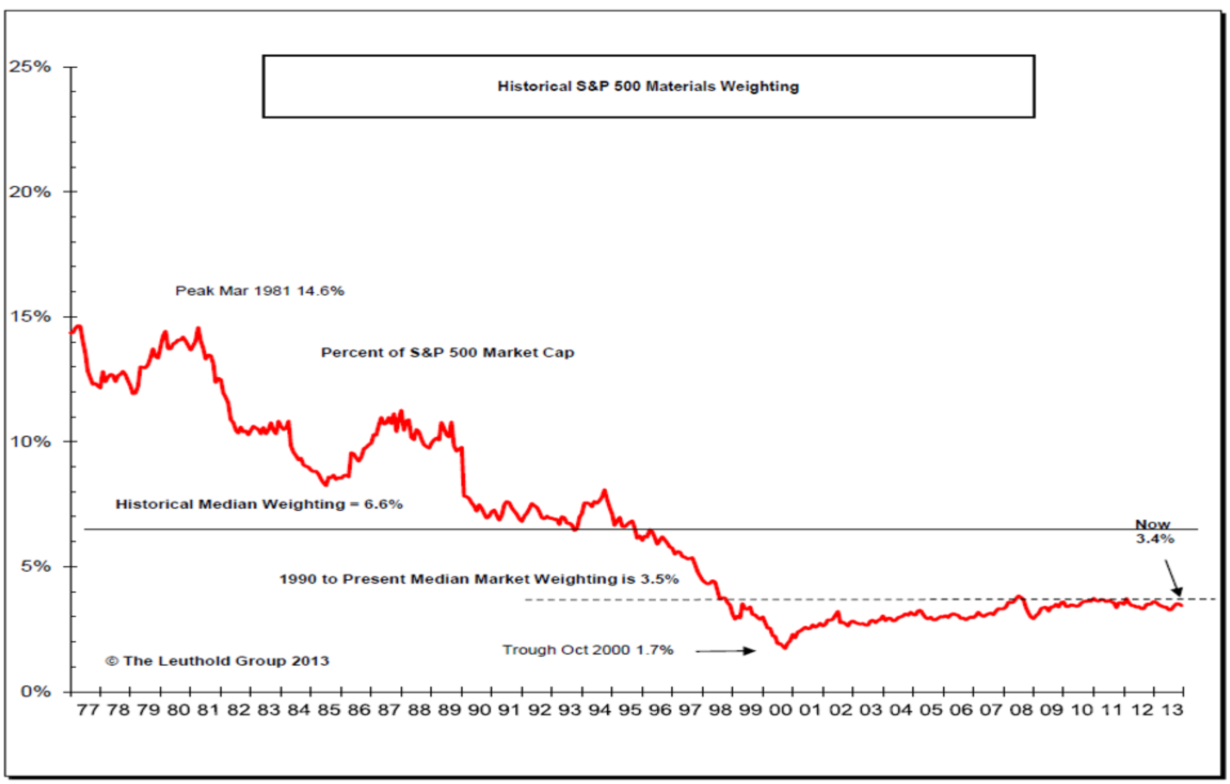
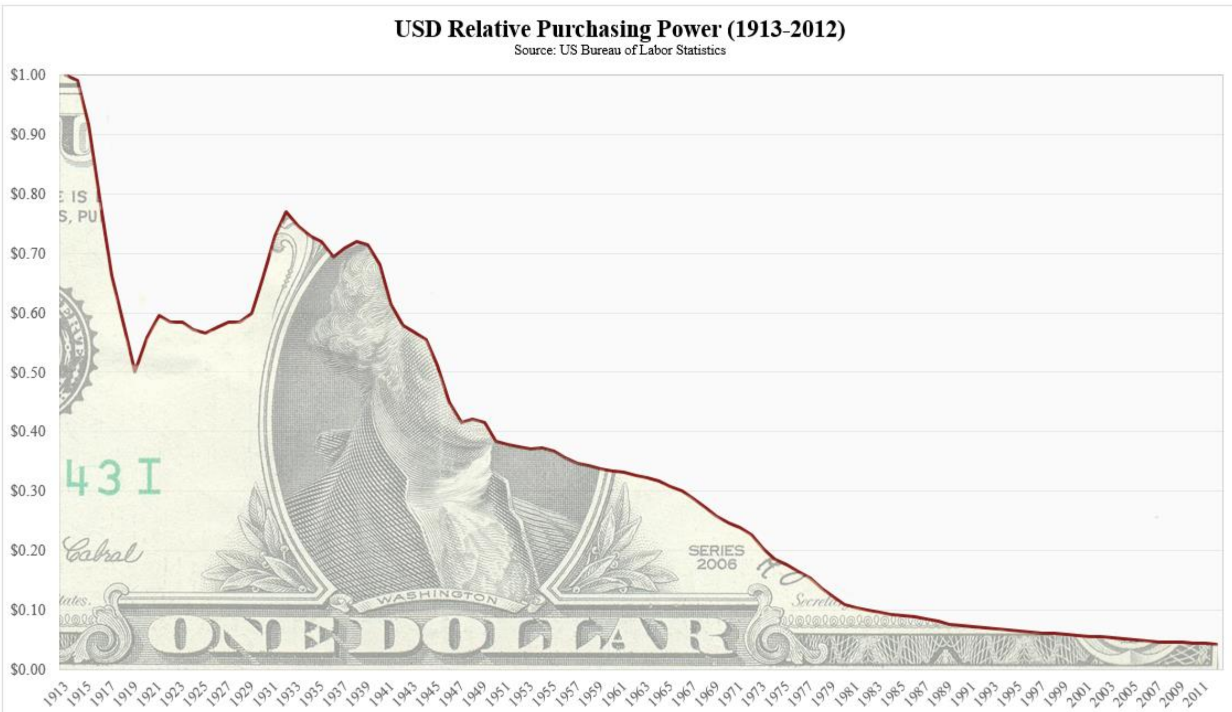
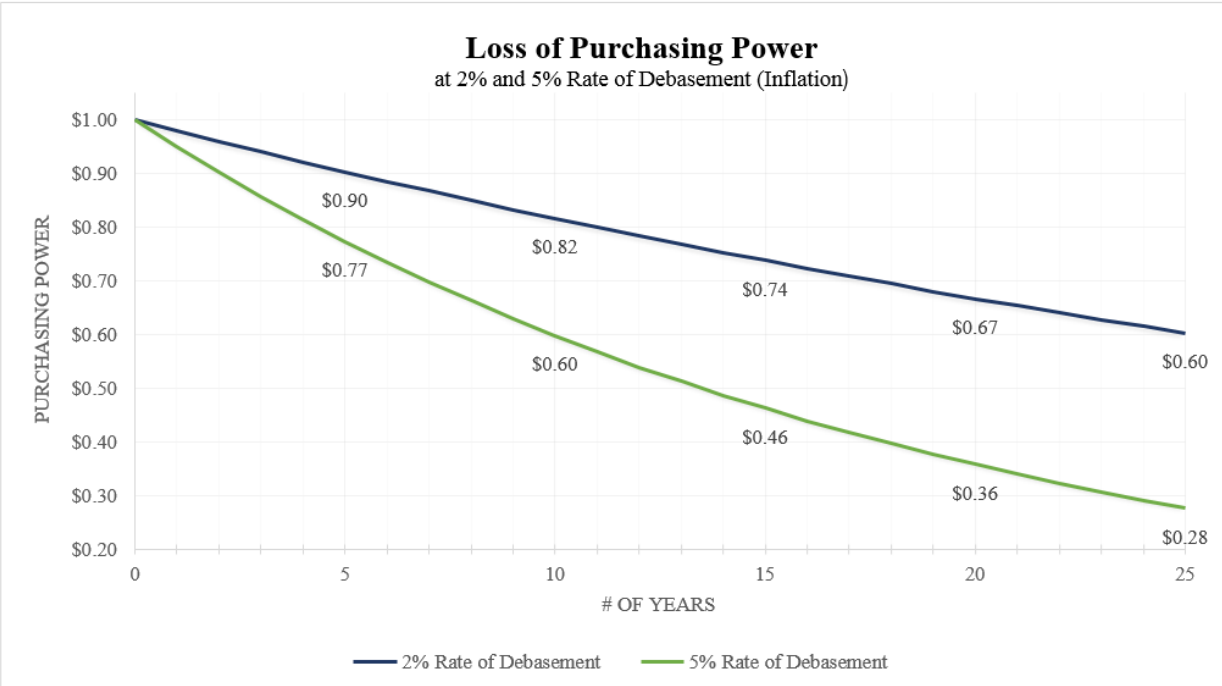

Historical S&P 500 Materials Weighting
Peak Mar 1981 14.6%
Percent of S&P 500 Market Cap
Historical Median Weighting = 6.6%
Now
3.4%
1990 to Present Median Market Weighting is 3.5%
Trough Oct 2000 1.7%
© The Leuthold Group 2013
25%
20%
15%
10%
5%
0%
77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13

To summarize our brief financial journey through the 20th century, it looks like SRG did well to anticipate Will Durant's future suggestion that **"cash is not something that a wise man hordes."** We've seen that while the dollar lost 99% of its purchasing power, gold retained its.



Data: ftp.bls.gov /pub/special.requests.cpi/cpiai.txt

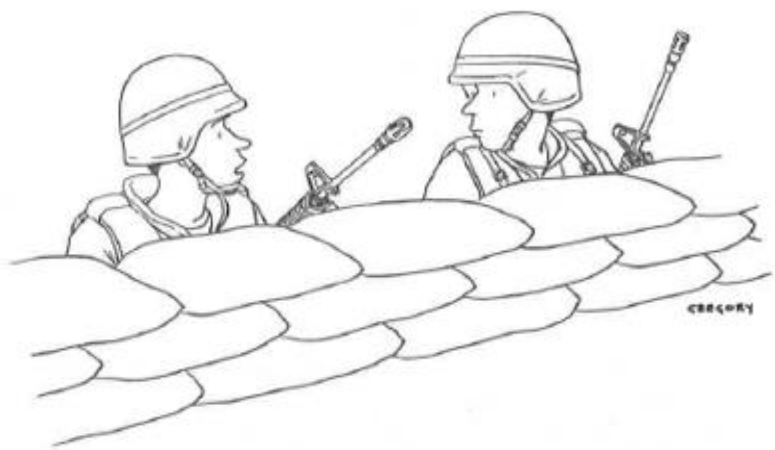
We've seen that more volatile assets such as collectible coins and the Dow Jones Industrials exceeded gold's returns, and far exceeded returns of cash and bonds. Kopernik believes that investors would do well to spend less time fearing ownership of inexpensive but valuable businesses, and more time fearing the markets. They should worry about the risk of being exposed to bonds that are being openly manipulated by central bankers and now reside at near record valuations. They should be obsessed with minimizing exposure to a market of stocks that are in the U.S., trading at all-time high prices, post a five year advance, and dependent on the sustainability of unsustainable profit margins. They should tremble at the thought of holding all of their hard-earned wealth in the form of a single fiat currency, especially one that has seen its supply quintuple over the past half-dozen years. The following table shows the loss of purchasing power at a 2% and 5% rate of debasement (inflation) over differing time periods:



Over the next quarter-century, the Fed's goal of 2% inflation would result in a 40% loss of purchasing power. I believe that most people would be very upset if the value of their stocks or their house lost 40% of their value. They should be equally upset if the "real" value of their cash savings fell 40%. If, as bureaucrats are prone to do, the Fed misses the mark and inflation averages 5%, the loss would be 72%. Not shown above, 10% inflation would result in an astounding 93% loss of purchasing power. For individuals establishing a college fund for their newborn, saving for retirement, managing a pension plan, responsible for a foundation/endowment, or any other long-term endeavor, cash is a very risky investment. Gold, common stocks and other assets, on the other hand, may increase sales of Maalox over various short time periods due to volatile market prices, but haven't proven risky to long term holders in the past. A strong case can be made that the next quarter-century will be similar. **Investors should worry about the threat of permanent loss of capital/purchasing power, not short-term aberrations!**

INVESTMENT STRATEGY

Active Investors relish those times when the market seriously misunderstands the fundamentals. Now is such a time! We believe that many academics and market participants are misperceiving risk; worrying about the wrong things.



"How do you stay so calm about the stock market?"

These are interesting times, with strong countervailing forces. The recent quintupling of the Fed's balance is a strong wind at the back of the stock market, portending much higher prices. At the same time, corporate profit margins are clearly unsustainable at twice normal levels. This inconvenient challenge coupled with aggressive valuations, fiscal problems at the national level, excessive enthusiasm, too much debt, sparse capital investment, financial shenanigans, and a decelerating rate of monetary growth all argue for a significant drop in U.S. stock prices. As the Fed continues to punish people for holding cash or bonds through their finally repressive policy, what's an investor to do? Kopernik is currently finding more attractive values beyond the U.S. borders. Certain foreign markets are less vulnerable to the aforementioned headwinds, while still potentially benefitting from central bank largesse. In our last Commentary (The Wizard of OZ), we suggested that the BRIC (Brazil, Russia, India, China) markets had become quite attractively priced. Though they've run a bit, we believe they still look good. I find John Templeton's actions during a similar (though less harsh) environment instructive.

~~JAPAN IN THE 1960s~~/RUSSIA IN 2014
THE CASE FOR INVESTING NOW

"Invest at the point of maximum pessimism." -John Templeton

Everything looks so easy in hindsight. The U.S. market was, in the mid-1960s, in some ways similar to today's market. It had had a meaningful run, leaving it expensive and primed for underperformance. At the same time, the inflationary "guns and butter" fiscal policy and concurrent accommodative monetary policy made cash and bonds unattractive as investment alternatives. The obvious solution was – invest elsewhere. John Templeton, a highly successful investor and a pioneer, in the U.S., of global investing, did just that. At one point in the 1960s, he put up to 60% of his portfolio in Japanese stocks. At this time, Japan was a growing economy, yet, to quote from the book, "Investing the Templeton Way," *(Templeton) found (stocks) trading at a P/E of only 4x his estimate for earnings!!!! Conversely, stocks in the United States were trading at a P/E of around 19.5x."* It was a lay-up, so why didn't everyone do it. Things that look easy from the vantage point of the rearview mirror were often not so easy at the time. To quote from Templeton investment literature, "Sir John Templeton began investing in Japan in the 1960s when it was considered an emerging market and a risky investment adventure." This probably understates how hard it must have been to differ so markedly from the crowd. Let's try to imagine what it was like.

Japan, as stated, was an emerging market. They had been obliterated in a world war a mere twenty years earlier. At that time, they had been the enemy of the United States and the rest of the Allied Nations. In the sixties, and even the seventies, many people still harbored deep resentment toward the Japanese people. Japan was widely believed to be corrupt – the yakuza (organized crime groups) were prevalent and the military industrial complex from the war still dominated much of the business community. Their goods were considered substandard. The banking system was different and risky. Fluctuations in stock prices were too extreme. There wasn't enough information.

"History doesn't repeat itself, but it does rhyme." — Mark Twain

It must have taken great fortitude on Templeton's part to do something that seems so obvious now. But good investments usually do. It couldn't have been easy for anyone to buy stocks in 1933 or late 1974. Buying bonds in 1982 following several decades of a relentless bear market had to be tough. Jumping into stocks post the 1987 meltdown, likewise. Gold was considered just another four letter word in 2001 when it hit $255, down from $800 in 1980. Technology investing worked much better for those who painfully searched through the debris in mid-2002 than those who participated in 1999's party. Which brings us back to the BRICs. Like tech stocks in 1999, they were so loved in 2011. But, current views on China's banks, corruption and quality of goods sounds like a recording from Japan, circa 1964. And then there's Russia! Having lost the Cold War two decades ago, still hated passionately by many, infamous for organized crime and corruption, powerful oligarchs worth billions, and an emerging market, its stock market is now selling at a mere 5 times earnings and 0.6 times book value!! (Russian RTS $ Index, per Bloomberg; second tier stocks are even less expensive.)

As inexpensive as the overall Russian market is, great companies can be purchased for even less. Despite growth opportunities, a high ROE, and residing in a country whose debt, as a percentage of GDP, is roughly a tenth of comparable levels found in the U.S. and many European countries, Russia's dominant bank sells at 83% of book value, 4.3 times earnings, and yields 4.9%. One of the world's dominant natural gas, oil and infrastructure companies sells at a third of book value, 2.6 times earnings, dividend yields 5.7%, and is capitalized at $1 per barrel of oil equivalent they own. A dominant electricity distribution company, post its 87% stock price drop, trades at 13% of book and at 2.7 times estimated earnings subsequent to its expected to return to profitability this year. One of the world's great franchises for generating cheap, clean, CO_2 free hydroelectricity is trading a small fraction of replacement cost and just over a third of book value. It's less than 10 times earnings and 3 times gross cash flow, and has a dividend yield of 1.7%. These are a sampling of a list of bargains on the Russian stock market.

Are there problems in Russia? Absolutely. But the opportunity is amongst the best I've encountered in the roughly one-third century that I've been fortunate enough to be in this business. To quote once again from Investing the Templeton Way, "investors can create negative biases against stocks, industries, stock markets, and asset classes. Those biases serve as a set of blinders that keep investors from even considering bargain ideas. If you spot these stocks or, better yet, **countries full of stocks** and are tempted to move on and look at something more popular, stop yourself immediately." And finally, at a time when investors astoundingly are willing to pay more than 2 times sales, 2-1/2 times book, and 25 times CAPE (cyclically adjusted price to earnings ratio) for the "good" outlook for stocks here in the States, I'll leave you, once again, with the words of John Templeton:

"People are always asking me where the outlook is good, but that's the wrong question…. The right question is: Where is the outlook the most miserable?"

David B. Iben
Chief Investment Officer
Kopernik Global Investors, LLC
June 2014