



KOPERNIK PERSPECTIVE

CURRENCY

“Hedging” currency risk in equity portfolios is usually not hedging at all.

It is the transfer of the exposure to one currency to exposure of another currency.

Introduction

The foreign exchange (FX) markets have been in turmoil over the last couple of years. Between 2011- 2016, the Russian Ruble depreciated 60%. During that same timeframe, the Canadian, Australian and Brazilian currencies dropped 27%, 26% and 55% respectively against the dollar. In August 2015, the PBoC devalued the yuan by 4%, temporarily wreaking havoc in the global markets. This change, however, doesn't even come close to the movement of the Swiss franc (CHF) when the Swiss National Bank decided to end the peg to the Euro in 2015 and caused the currency to soar by more than 21% in a single day.

As a U.S. domiciled global manager we are painfully aware of these recent currency movements as they have impacted our performance for the worse. Thus, clients have questioned if we should hedge foreign currency exposure. The answer is quite simple: we do not hedge currency.

This may be surprising as currency hedging is promoted as a less risky way to invest in foreign stocks. The dollar-based return on an investment is the product of the company's stock return in local terms times the change in foreign currency against the dollar.

$$\text{Total Return} = \frac{\text{Stock Return in Local Currency}}{\text{Change in the Exchange Rate}}$$

If, for instance, one invested in Japan and the yen falls in half, one's dollar-based return is negative if the stock does not at least double.

Currency hedging is often explained to investors as an insurance policy against these movements in foreign currency and as a way to isolate their investment to the business fundamentals of the stock. In times like the past 4 years, when the dollar has done nothing but strengthen, global investors have seen the exchange rate changes detract from performance in USD terms. Thus, we can understand the appeal of wanting to “eliminate” or “hedge out” that pesky latter half of the equation.

Unfortunately, eliminating currency risk from equity investments is not actually possible. It is the goal of this white paper to explain why Kopernik does not hedge currency and demonstrate that hedging currency is not actually reducing risk but rather is transferring risk from one currency to another. Always “hedging” all currencies back to the dollar amounts to a concentration of risk to one currency.



Why hedging is a misnomer for global equity portfolios

In recent years, FX-hedged global equity portfolios have become all the rage. However, Kopernik's view is that these strategies are not what they purport to be. These portfolios that claim to be currency agnostic or fully hedged typically short the currency of the stock's denomination. Buying Nestle would be accompanied by a short position in the CHF. And this is done with every non-USD denominated stock in the portfolio. However, on multiple levels this does not represent FX agnosticism.

First, it is often difficult to determine to which currencies a particular stock is exposed. In an increasingly globalized economy, companies have exposures to a number of currencies, thus, "hedging" the currency of the stock's denomination does not necessarily reduce risk but rather adds an additional short currency position to the portfolio. Nestle operates in 123 different countries, many of which have their own functional currency. A USD based investor simplistically shorting the CHF to "hedge" Nestle's FX exposure would not eliminate FX risk but expose himself/herself to the risk that the CHF appreciates. As mentioned earlier, the Swiss National Bank removed the CHF peg to the Euro on January 14th 2015, causing the CHF to appreciate 21% in a single day. If one had "hedged" Nestle's FX exposure, one would have lost both on the CHF short position and the Nestle long position, which fell 7% on that day. Other Swiss-listed companies including Roche, Novartis, UBS, Credit Suisse and Swatch also fell between 9% and 16%.

Second, it is difficult to know how a company's stock return might perform as the currency changes. Some businesses benefit from local currency depreciation/appreciation while some may be harmed. Natural resource companies, for example, that have dollar-based revenues and local currency costs would probably see some margin expansion with a fall in currency. If the Canadian dollar bounced back from its lows, a long position in a Canadian natural resource company might decline in value as operating margins shrink. An investor who had shorted the Canadian dollar would lose on both sides, magnifying losses rather than insuring against them.

To reiterate, unlike bonds, equities are interests in an underlying business, many of which are affected vastly differently by currency moves. As such, they should be analyzed distinctly from one another. Below we have outlined five different company classifications and identified their FX exposure. Natural resources mark the lower range of FX exposure while the importers have the most.

TYPE OF COMPANY	NATURAL RESOURCE COMPANIES	EXPORTERS	MULTINATIONALS	DOMESTICALLY ORIENTED	IMPORTERS
COMPANY DESCRIPTION	Companies that produce gold, oil, copper, etc	Companies that produce a good locally and sell globally	Companies that operate in many different countries	Companies that are primarily based in one country	Companies that import globally and sell locally
COMPANY EXAMPLES	Newmont Gold, Chevron, Freeport McMoran	Toyota, Hyundai	Nestle, Coca-Cola, McDonalds	Sberbank, Rushydro, Eletrobras, China Railway	Target
USD BASED INVESTOR FX EXPOSURE	Very little - Natural Resource companies are exposed to commodities produced, which are priced in USD	Companies with costs mostly in local currencies and sales in multiple currencies would likely benefit with a local currency depreciation.	Revenues and costs are in multiple currencies, therefore currency exposure is very hard to quantify. Company is not linked to the home currency.	There is currency risk since revenues and costs are directly linked to the home currency. Regulated businesses including utilities and railroads are at the highest risk if they are not able to negotiate higher rates with the government.	Currency risk is the highest. A company that needs to import goods using devalued currency would see margins compress.
SHOULD INVESTORS CONSIDER HEDGING?	No	No	No	Possibly	Possibly
FX EXPOSURE					

Of the five categories, investors should only consider currency hedging the domestically-oriented and importer companies since their cash flows are directly linked to their domestic currency. As of mid-2016, only 35% of the companies in which Kopernik invests would classify



as domestically oriented or importers. A currency piece written by GMO¹ found a similar result: companies that are potential candidates for hedging made up 15-25% of the global market cap in the ACWI. Therefore, it is hard to rationalize hedging an entire portfolio.

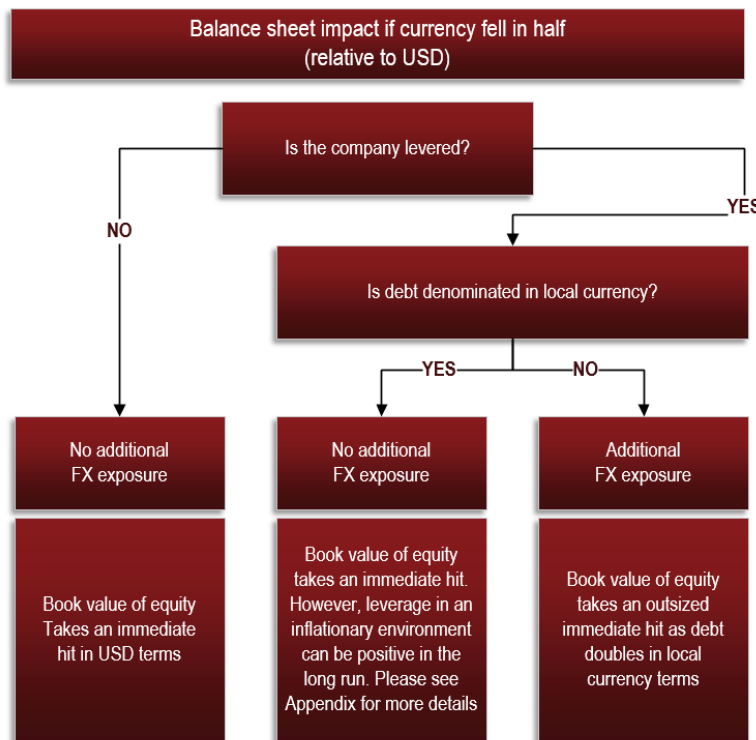
Assessing FX exposure when making an equity investment

Our policy is to not hedge, however, we strongly take into consideration FX risk when making an investment. Kopernik demands a margin of safety when investing, requiring a larger or smaller margin of safety depending upon asset quality, geopolitical risk, industry dynamics, management, and ESG factors. FX exposure is also an important consideration since movements in foreign currency can affect the fundamentals of businesses. Exploring this further, we demonstrate how FX can impact both the P&L and balance sheet in the next two paragraphs:

Balance Sheet and P&L Exposures

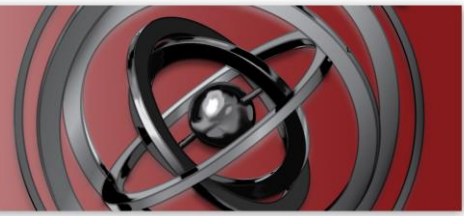
Analyzing balance sheet impacts of FX movements is relatively straightforward, particularly for liabilities. Let's say, for instance, we are researching a Japanese utility with a balance sheet levered in yen terms. We know for certain that should the yen depreciate 50% in USD terms overnight, the yen-denominated liabilities have done so as well. If the value of the assets depreciates less than the value of the debt, the yen devaluation can work to the utility's advantage. However, determining how assets are impacted is more challenging. With a devaluation of currency we can expect that the country will see inflation, and the value of the assets will be determined by how well the utility can pass along that inflation.

We have developed a flow-chart to help evaluate the balance sheet FX exposure. Companies that have debt denominated in foreign currencies have additional FX exposure. The Japanese utility would have a high FX exposure if it had borrowed money in USD and the yen fell in half: assets would fall in half in USD terms while the debt stays flat and thus reducing the equity by more than 50%.



A company with no debt would have no additional FX balance sheet exposure, however, it still might have FX exposure if the business is domestically based or an importer as discussed above.

¹ https://www.gmo.com/docs/default-source/research-and-commentary/strategies/asset-allocation/cl_currencyhedging_4-153cd2212e8b9d64339213ff0000a1a898.pdf?sfvrsn=6



P&L in Reference Currency Terms

As discussed previously, different types of businesses have more or less P&L FX exposure. Keeping with our Japanese utility example, the yen devaluation would have considerable impacts on the operating margins of the business. Operating margin impacts are dependent on how fast the utility is allowed to raise rates in relation to how fast cost inflation seeps into the utility's cost structure. If the Japanese government did not allow the utility to raise prices, and costs were inflating, the utility would see margins compress. On the flip-side, a Japanese exporter might see margin expansion.

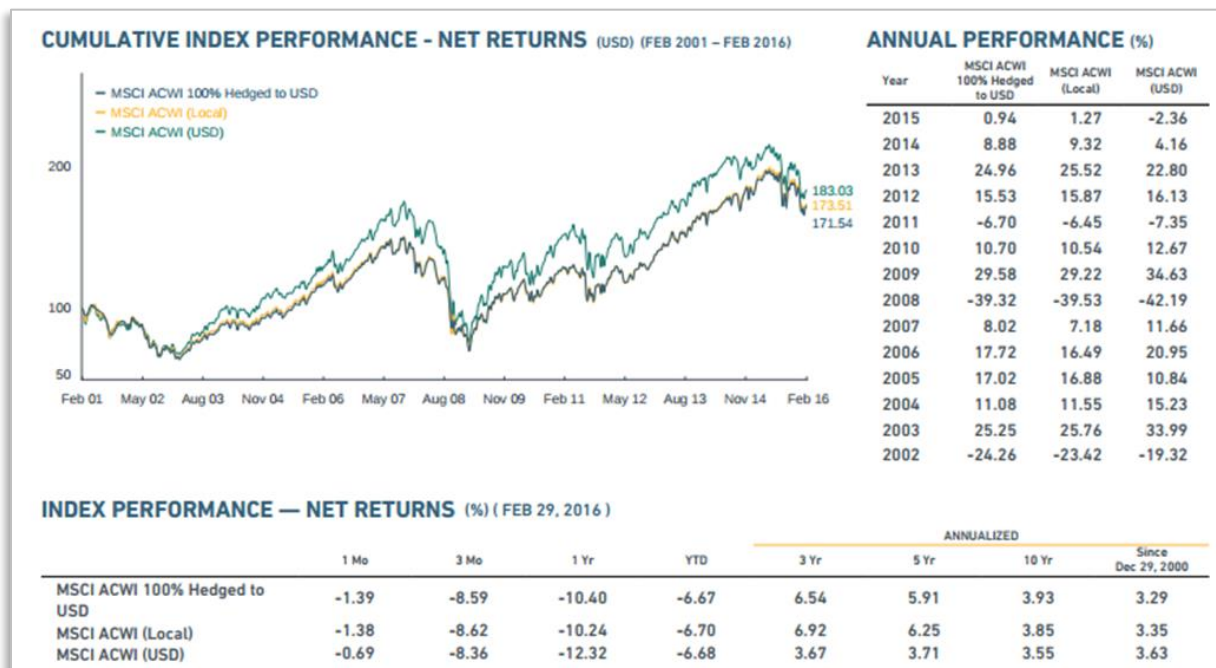
For more detail on FX impacts on the balance sheet and income statement please see the Appendix which gives specific examples.

Does currency hedging reduce equity portfolio risk?

We take this opportunity to reiterate our thoughts on the definition of risk. While much of the market views volatility as risk, we view risk as the prospect of a permanent loss of purchasing power. Volatility can be career risk for investment advisors and portfolio managers and risk for levered funds that could potentially face margin calls; however, volatility is not risk for long term investors. Buying companies at too high of a price is risky, and therefore our risk management strategy is to only own companies that are trading for less than their estimated intrinsic value.

Additionally, we diversify; our portfolio typically holds between 50-100 stocks since it is risky to proverbially "put all the eggs in one basket." If we presented a client a portfolio that held 100% in one stock, it is safe to say we would kindly be shown the exit door. Why should currency exposure be any different? The short answer is it shouldn't. An unlevered USD based investor that "hedged" foreign currencies would have an outsized position in the dollar which, over the last four years, would have been a great bet. The US Dollar Index (DXY), a measure of the value of the USD against a basket of foreign currencies, appreciated 37% between April 2011 and March 2015. Between June 2014 and March of 2015, the DXY appreciated an unprecedented 26%! Anyone who "hedged" into USD is looking very smart today.

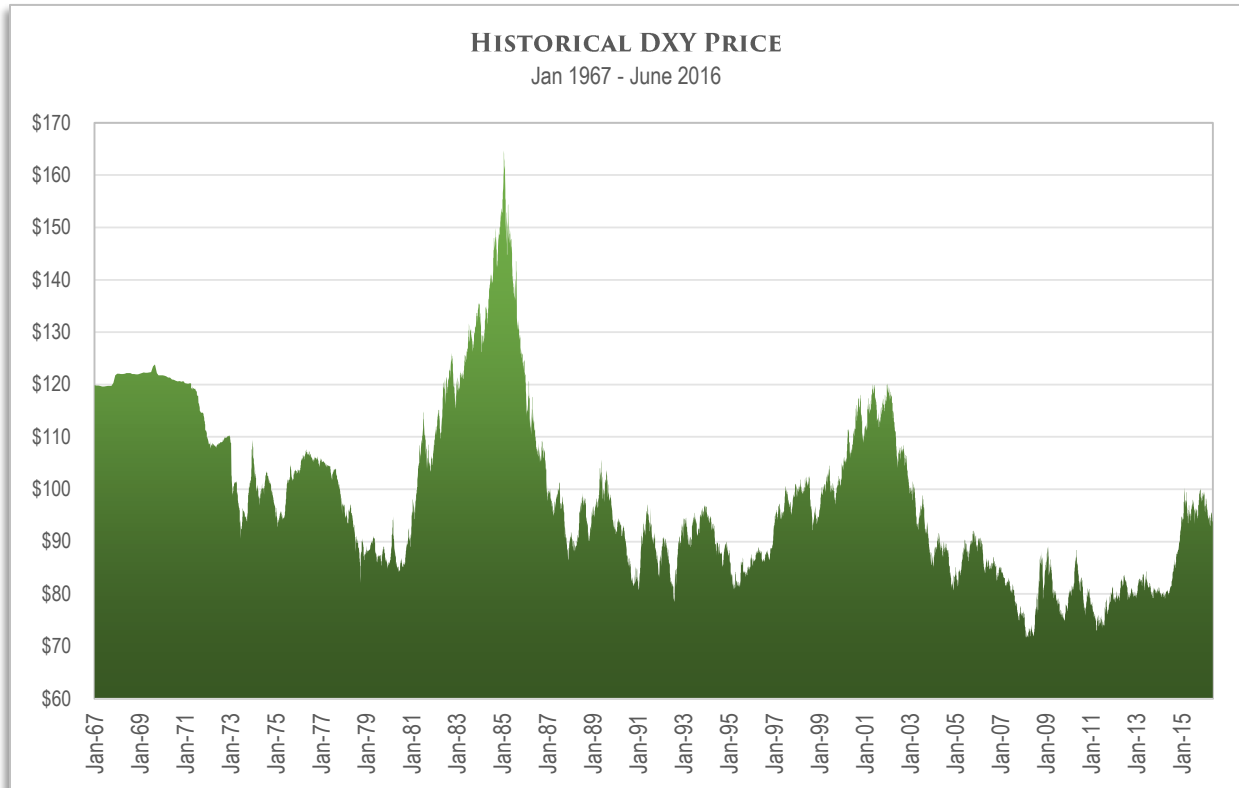
The chart below shows the relative performance of the USD hedged MSCI ACWI, the MSCI ACWI in local currency terms and the MSCI ACWI in USD terms. The annual performance chart on the right shows that the MSCI ACWI in USD terms underperformed the MSCI ACWI 100% Hedged portfolio over the last three years; 2014, unsurprisingly, being the worst year of underperformance. However, step back from the last three years and the story is a bit different. Between 2002 and 2012, there were only 3 years when the hedged MSCI ACWI outperformed the MSCI ACWI in USD terms (2005, 2008, and 2011). Since inception (Dec 2000) the hedged MSCI ACWI annualized returns are 3.29%. The MSCI ACWI USD annualized returns over that same timeframe are 3.63%. If the dollar weakens, we can expect the unhedged ACWI to outperform the hedged ACWI.



Source: MSCI



Despite its massive rally the past 5 years, the chart below shows that over the past half-century the dollar has fallen from 120 to 94 versus a basket of major world currencies.



Source: Bloomberg

Conclusion

We think about foreign currency risk like any other risk that we can't control: we require a healthy margin of safety to our risk-adjusted intrinsic value when we commit capital and we diversify. As we have outlined in this paper, eliminating risk is impossible. A "hedged" equity portfolio has not reduced risk but merely transferred risk. To quote GMO², "Some investors may believe that an unhedged equity position has unintended risks; we believe a hedged equity position has the potential for even greater unintended risks." We at Kopernik agree. We believe that we add value by appraising businesses, and taking advantage of opportunities where the market mis-appraises them. A good appraisal requires a strong grasp of many company, industry and country fundamentals. Currency exposure is one important factor which we spend a large amount of time analyzing; the larger the exposure to adverse outcomes, the larger the margin of safety we require. For the reasons presented above, we do not feel much value can be added by appraising currencies, nor by attempting to "hedge" them. We believe that exposures should be diversified across companies, industries, sectors, countries, regions, and certainly across currencies, as well.

Alissa Corcoran
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August 2016

² https://www.gmo.com/docs/default-source/research-and-commentary/strategies/asset-allocation/cl_currencyhedging_4-153cd2212e8b9d64339213ff0000a1a898.pdf?sfvrsn=6



Appendix

Generic Examples & Illustrations

1. Balance sheet impact of a yen devaluation on a hypothetical Japanese land-owner that has yen denominated debt.

In the table on page 7, a simple balance sheet analysis flows as various scenarios are considered in the immediate aftermath of a 50% yen devaluation in USD terms (from 100 to 200).

The Original model lays out the initial balance sheet structure quite simply. Progressing down through Scenario 3, we entertain potential modelling responses to the yen devaluation. What we do know immediately is that in each scenario following the devaluation, the yen-denominated debt's value is reduced 50% in USD terms. That's a given. The more difficult chore for an analyst of course is to assess the devaluation's impact on the Japanese land bank held on the left side of the balance sheet in USD terms. If the Japanese land bank is able to pass through the inflation, assets should revalue higher in yen terms over time.

Scenario 1 reflects a scenario where the land-owner is not able to pass along any of the inflation. We model no changes in value of the land bank in yen terms and thus equity value remains unchanged in yen terms but drops 50% in USD terms (from USD 10mn to USD 5mn). The drop in USD asset value is uniquely a function of the 50% yen devaluation just experienced. For all intents and purposes, this approach would most likely be too conservative as the analyst is assuming that the land bank is not able to pass along *any* of the inflation.

Scenario 2 assumes the company is able to pass through 100% of the inflation and maintains a constant valuation for the land bank in USD terms. In this case, the asset value doubles in yen terms (from yen 2bn to yen 4bn) while liabilities stay constant. This scenario generates a tripling of equity value in yen terms (from yen 1bn to yen 3bn). In USD terms, equity value increases 50% (from USD 10mn to USD 15mn). Thus, as our balance sheet flow chart points out, local currency denominated debt can actually be a long term positive for companies that can pass along inflation.

Scenario 3 assumes that only 50% of the inflation is able to be passed through. The yen valuation of the land bank rises 50% while the USD valuation of the land drops 25% (from 20mn to 15mn). In terms of equity valuation, the USD value remains unchanged from the Original Scenario of USD 10mn while the yen value rises from 2bn to 3bn.



In all three scenarios following the devaluation, the acumen of the analyst is called upon.

Original Scenario

USD/JPY:	100
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Assets		
Description	JPY Value	USD Value
1 mil land acres	2,000	20

Liabilities		
Description	JPY Value	USD Value
Outstanding debt	1,000	10
Equity Value	1,000	10

Scenario 1

Landowner is not able to pass along any inflation

USD/JPY	200
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Assets		
Description	JPY Value	USD Value
1 mil land acres	2,000	10

Liabilities		
Description	JPY Value	USD Value
Outstanding debt	1,000	5
Equity Value	1,000	5

Scenario 2

Land-owner is able to pass through 100% of inflation

USD/JPY	200
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Assets		
Description	JPY Value	USD Value
1 mil land acres	4,000	20

Liabilities		
Description	JPY Value	USD Value
Outstanding debt	1,000	5
Equity Value	3,000	15

Scenario 3

Land-owner is able to pass through 50% of inflation

USD/JPY	200
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Assets		
Description	JPY Value	USD Value
1 mil land acres	3,000	15

Liabilities		
Description	JPY Value	USD Value
Outstanding debt	1,000	5
Equity Value	2,000	10



2. P&L impacts across various hypothetical business structures

Modeling P&L forecasts in response to FX movements in many cases is more of an art than a science.

The exhibits below illustrate some generic examples in very rough, qualitative terms. The impact of the same yen devaluation (from 100 to 200 per 1 USD) considered in our balance sheet revaluation examples above are outlined for a generic base case model and then for a hypothetical Japanese exporter, importer & entirely domestic business. In general, most business models follow some form of these examples either uniquely or in some blended sense.

Starting with the generic P&L estimates of the exhibit immediately below, both revenues and expenses are forecast to grow at a 5% annual rate over the next 5 years. Accordingly, net income in both yen and USD terms grows at 5% and the net income margin stays flat at 20%. This is the base case model for each of the three examples to follow.

Original P&L Model						
JPY/USD	100					
P&L (mil)	2015a	2016e	2017e	2018e	2019e	2020e
Revenue JPY	1,000	1,050	1,103	1,158	1,216	1,276
Y-o-Y Growth Rate	n/a	5.0%	5.0%	5.0%	5.0%	5.0%
Expenses JPY	800	840	882	926	972	1,021
Y-o-Y Growth Rate	n/a	5.0%	5.0%	5.0%	5.0%	5.0%
Net Income JPY	200	210	221	232	243	255
Y-o-Y Growth Rate	n/a	5.0%	5.0%	5.0%	5.0%	5.0%
Net Income Margin	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%
JPY/USD Assumption	100	100	100	100	100	100
Revenue (USD)	10	11	11	12	12	13
Y-o-Y Growth Rate	n/a	5.0%	5.0%	5.0%	5.0%	5.0%
Expenses (USD)	8	8	9	9	10	10
Y-o-Y Growth Rate	n/a	5.0%	5.0%	5.0%	5.0%	5.0%
Net Income (USD)	2.0	2.1	2.2	2.3	2.4	2.6
Y-o-Y Growth Rate	n/a	5.0%	5.0%	5.0%	5.0%	5.0%
Net Income Margin	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%



Now we consider three general business types in the aftermath of the yen move from 100 to the USD to 200. The first business P&L to consider is a hypothetical Japanese exporter whose forecasts require revision to adjust the yen revenue stream forecasts sharply higher in the first couple of years to reflect the global pricing (non-yen) of the exporter's products. At the expense line, it may be rational to make no change to the 5% forecast in the first year if all input costs are incurred locally (labor and fixed costs such as rent would be prime examples). Thus net income margins for an exporter can grow very quickly in the early years. The cost inflation might take longer to show up in the financials since fixed costs and wages are stickier, however eventually the cost inflation will come and margins should return to more normal levels.

Japanese Exporter:

JPY/USD	200					
P&L (mil)	2015a	2016e	2017e	2018e	2019e	2020e
Revenue JPY	1,000	1,750	2,013	2,113	2,219	2,330
Y-o-Y Growth Rate	n/a	75.0%	15.0%	5.0%	5.0%	5.0%
Expenses JPY	800	840	1,008	1,361	1,701	1,871
Y-o-Y Growth Rate	n/a	5.0%	20.0%	35.0%	25.0%	10.0%
Net Income JPY	200	910	1,005	752	518	459
Y-o-Y Growth Rate	n/a	355.0%	10.4%	-25.1%	-31.2%	-11.4%
Net Income Margin	20.0%	52.0%	49.9%	35.6%	23.3%	19.7%
JPY/USD Assumption	100	200	200	200	200	200
Revenue (USD)	10	9	10	11	11	12
Y-o-Y Growth Rate	n/a	-12.5%	15.0%	5.0%	5.0%	5.0%
Expenses (USD)	8	4	5	7	9	9
Y-o-Y Growth Rate	n/a	-47.5%	20.0%	35.0%	25.0%	10.0%
Net Income (USD)	2.0	4.6	5.0	3.8	2.6	2.3
Y-o-Y Growth Rate	n/a	127.5%	10.4%	-25.1%	-31.2%	-11.4%

While this is admittedly a very crude model, the changing estimates do reflect the logical transmission of the yen devaluation through the line items in the P&L in both yen and USD terms.



Next we consider the P&L forecast revisions for a Japanese importer. Not surprisingly, the positive effect of a JPY devaluation on the exporter turns into a correspondingly negative effect on the importer. Looking through the exhibit below, we now see the net income turn negative in 2016 and 2017 as costs inflate almost immediately, while the company's ability to pass along the inflation will take longer. Like the Japanese exporter model, we assume that margins will eventually return to normal by 2020.

Japanese Importer						
JPY/USD	200					
P&L (mil)	2015a	2016e	2017e	2018e	2019e	2020e
Revenue JPY	1,000	1,050	1,260	1,701	2,126	2,339
Y-o-Y Growth Rate	n/a	5.0%	20.0%	35.0%	25.0%	10.0%
Expenses JPY	800	1,400	1,610	1,691	1,775	1,864
Y-o-Y Growth Rate	n/a	75.0%	15.0%	5.0%	5.0%	5.0%
Net Income JPY	200	-350	-350	11	351	475
Y-o-Y Growth Rate	n/a	-275.0%	0.0%	-103.0%	3245.0%	35.3%
Net Income Margin	20%	-33%	-28%	1%	17%	20%
JPY/USD Assumption	100	200	200	200	200	200
Revenue (USD)	10	5	6	9	11	12
Y-o-Y Growth Rate	n/a	-47.5%	20.0%	35.0%	25.0%	10.0%
Expenses (USD)	8	7	8	8	9	9
Y-o-Y Growth Rate	n/a	-12.5%	15.0%	5.0%	5.0%	5.0%
Net Income (USD)	2.0	-1.8	-1.8	0.1	1.8	2.4
Y-o-Y Growth Rate	n/a	-187.5%	0.0%	-103.0%	3245.0%	35.3%

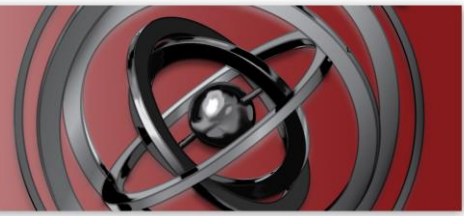


The last scenario to consider represents a domestic Japanese business in which all its revenues and expenses are generated locally (JPY). Alteration of the model then assumes that both revenue and expense grow at roughly the same speed. We have assumed that revenue grows slightly faster than expenses at the beginning since fixed costs will take longer to inflate. However, by 2020 revenue and expenses are growing at the same rate and net income margins have normalized at 20%.

Japanese Domestically Oriented						
JPY/USD	200					
P&L (mil)	2015a	2016e	2017e	2018e	2019e	2020e
Revenue JPY	1,000	1,200	1,440	1,728	2,074	2,177
Y-o-Y Growth Rate	n/a	20.0%	20.0%	20.0%	20.0%	5.0%
Expenses JPY	800	944	1,114	1,359	1,658	1,741
Y-o-Y Growth Rate	n/a	18.0%	18.0%	22.0%	22.0%	5.0%
Net Income JPY	200	256	326	369	416	436
Y-o-Y Growth Rate	n/a	28.0%	27.4%	13.2%	12.6%	5.0%
Net Income Margin	20%	21%	23%	21%	20%	20%
JPY/USD Assumption	100	200	200	200	200	200
Revenue (USD)	10	6	7	9	10	11
Y-o-Y Growth Rate	n/a	-40.0%	20.0%	20.0%	20.0%	5.0%
Expenses (USD)	8	5	6	7	8	9
Y-o-Y Growth Rate	n/a	-41.0%	18.0%	22.0%	22.0%	5.0%
Net Income (USD)	2.0	1.3	1.6	1.8	2.1	2.2
Y-o-Y Growth Rate	n/a	-36.0%	27.4%	13.2%	12.6%	5.0%

In this particular example, while net income in JPY terms continues to grow per annum over the sample period, net income in USD terms takes a big hit in 2016 which simply reflects the one-time JPY devaluation experienced in 2016. Also, due to the JPY devaluation, net income in USD terms doesn't climb back to the level experienced in 2015 until 2019.

Implicit in all of the above scenarios is the notion that JPY devaluation today portends some measure of domestic price inflation tomorrow. We think this is a reasonable presumption to make given historical experience. This presumption could prove to be wrong-footed though if it is determined that the devaluation today is merely a reconciliation of a market mispricing of JPY/USD yesterday. We are not FX experts nor, for the most part, forecasters. To the extent that we assume that FX markets are efficiently-priced, we further assume that today's FX crosses reflect tomorrow's. What else are bottom-up value investors to do? That said, we do reserve the right to reflect an occasional predisposition with regard to FX relative valuation. In practice though, that's the exception rather than the rule.



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