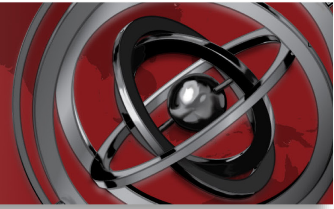
Kopernik
Global Investors, LLC



The Subtle Art …

It is always interesting to meet with current and potential clients to hear their questions as some form of barometer on the market and the perception of Kopernik. Given the active management outflows within the industry we are very lucky to have had positive flows in the face of the underperformance of value stocks globally and this becomes a topic at many of our meetings. How are we growing given the headwinds we are facing? While we ultimately don't know the answer to this question, we can give a guess. It seems that many asset managers are seeking to minimize their underperformance (ie, protect their assets) by continuing to move closer to the index, without saying that is what they are doing. Kopernik, on the other hand, has no regard for the index as it has no bearing on what is a value and what isn't. Evidently by sticking to "absolute" value investing, as opposed to relative value, we are very different and there are enough asset allocators that respect this in us. For that we thank all our clients, but we find it strange as we don't think we do anything different than any value manager should be doing.

A great quote from George S. Patton is applicable here "If everyone is thinking alike, then somebody isn't thinking." Or maybe better a couple from Sir Winston Churchill, "One man with conviction will overwhelm a hundred who have only opinions." and "Success is not final. Failure is not fatal. It is the courage to continue that counts."

The title of this commentary is from the 2016 book, *The Subtle Art of Not Giving a ****,* by Mark Manson. If you get past the crude and meant-to-shock title, it is a really interesting read. While I don't usually read self-help books it was highly recommended, and it didn't disappoint. The book is about figuring out what is most important in any situation, focusing intensely on that and spending very little time worrying about the rest. While this has interesting applicability in your personal life, if you take the thought to the investment world, it yields some interesting insights. The topic can certainly be applied to individual stock selection, but for now let's define what is most important for Kopernik. We would say what is most important is achieving great investment returns over the long run. That's it. Everything else is noise and/or a byproduct of that pursuit. If we grow assets, great, but that is not the goal. If that asset growth produces a profit and we can pay all the employees exceptionally well, great, but again not the goal but a byproduct. This singular goal certainly has negatives as well. Because the time horizon is "the long run" we don't really think/care about short-term volatility. In fact, we would say volatility creates opportunity to buy stocks at a discount, so it is a positive. Short-term volatility in our stocks most likely creates more short-term volatility in our portfolio returns, which is scary/bad to many asset allocators. Said another way, our return volatility creates career risk, which is really scary. But, shouldn't the singular focus of achieving great returns over the long run be everyone's goal? I don't recall reading anything in Graham and Dodd's book from 1934, *Security Analysis*, about short-term results or how selecting stocks has anything to do with an index. So, '*The Subtle Art'* to Kopernik is to keep our overriding focus on long-term performance as that is what truly matters.

In terms of picking stocks, we often say at Kopernik that we take what the market gives us. The flip side of this same coin is the ideology that some level of reversion to the mean is usually likely. Let's go further and say the market is emotional (a collection of emotional human beings) and is even more emotional at tops and bottoms. "The trend is your friend" is a frequently used phrase which captures this notion. In the short run it is probably right, but if your focus is on the long term and value, like ours, then you have to at least question this phrase and consider what might cause the trend to reverse, both on the way up and down.

Going further, one of my favorite lines is 'the cure for low prices is low prices.' The obvious point is when an industry is having a rough time due to overcapacity, Darwinian economics takes care of it and you will see bankruptcies and shuttering of capacity to bring supply and demand back in equilibrium. This means prices and profitability will rise for the survivors. You could similarly say that extreme moves in markets and economies are self-correcting, over time, as adjustments are made to bring things back into alignment. But, because there is a lag between the extreme high or low and the implementation of the actions that will correct the extremes, there are frequently exaggerated moves in one direction followed by a correction in the other direction. These "overshots" are simply human behavior of assuming what has happened will continue (the trend is your friend). The key is figuring out what is unsustainable. If prices are so low that EVERY company producing product x is unprofitable, that will not go on if the product is needed. If profitability and returns are so high, somebody somewhere will find a way to compete against it and bring down margins, or in more monopolistic scenarios the government will probably intervene at some point to lower returns. This leads to the key point: we have no edge in knowing if something will retain its lead, but we become fearful when it has outperformed for a long period of time, and vice versa. We believe that by trimming the winners and adding to the cheaper opportunities we will have better portfolio returns and reduce risk, over the long term.

This is a long set up for another question we are frequently asked. How do we think about catalysts for either the company fundamentals or the valuation to revert to the longer-term average? The easy answer is we don't. The more nuanced answer is we don't know the time frame but it depends on the upside and how that relates to the potential time frame. That is, if the upside is 20% and we don't know when something good will happen, we won't buy. If the upside to our risk adjusted valuation is 300% but it might take ten years, that is fine. The internal rate of return (IRR) on that investment on almost any logical time-frame is more than acceptable. Again, the focus is on the long term. John Malone once said, "You just have to be opportunistic and try to figure out what creates value – where the bottom is, what creates incremental value, and in what combinations." In other words, do the work (be ready) and look for optionality (upside), even if no catalyst exists in the short run.

Going back to the idea of the long-term trend of taking what the market gives us (i.e., is discounting) and avoiding what the market loves, here is a chart showing the top ten stocks globally by market cap at the start of the last four decades, including today. I have also included the narrative of the time, which was correct in the short run, but not correct in the long run. It isn't easy to see when this upward trend will falter but the valuation premiums of the historic winners almost always assure that they will struggle to maintain their leadership.

The start of the 1990's was all about Japan. We were told that Japan had won, broadly defined, and will remain the winners. Their management was better, quality of product and manufacturing was better, banks were better, etc. We should all learn Japanese since they were going to take over the world. Side note, the song, "I Think I'm Turning Japanese" by the Vapors was released in 1980, which shows this trend of "Japan is the best" had been coming on for a long time. Japan was 45% of the MSCI All Country World Index (ACWI) in January 1990. A short decade later in 2000 Japan was only 12.7% of the ACWI and only two Japanese companies were still on the Top ten list. Today Japan is down to 8% of the ACWI Index and they have zero companies in the top ten.

1/1/1990			
Country	**Top 10 Companies by Mkt Cap US$**	**Prior 10 yr return**	**Next 10 yr return**
	ACWI	n/a	145%
Japan	NTT	-8%	81%
Japan	Bank of Tokyo Mitsubishi	1502%	-31%
Japan	Industral Bank of Japan	3940%	-76%
Japan	Sumitomo Mitsui Banking	1621%	-42%
Japan	Toyota Motor	423%	263%
Japan	Fuji Bank	1566%	-57%
Japan	Adi-Ichi Kangyo Bank	1392%	-52%
US	IBM	120%	483%
Japan	UFJ Bank	1177%	-35%
US	Exxon	448%	376%
	Average	*1218%*	*91%*

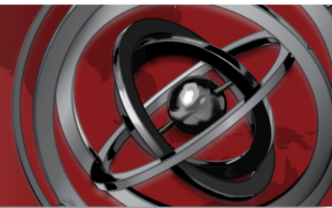
Source: Bloomberg

Here is a related fact for you. In 1989 the Topix (Japan) Bank Index peaked at roughly 1,500. Today it trades at 129. Yep, down 91%. Ouch. If you want to carry this thought forward, the European Bank Index peaked in mid-2007 at roughly 160. Today it trades at 40, down 75%. The MSCI US Bank Index peaked in December 2006 at 125. In March of 2009 it traded at 24, but now trades at 91, or down only 28% from the all-time high. If you have any thought that the US will follow Europe and Japan down the rabbit hole of zero/negative rates, then isn't it likely that the US banks have a long way to fall? Yet, they aren't trading like it.

1/1/2000			
Country	**Top 10 Companies by mkt cap US$**	**Prior 10 yr return**	**Next 10 yr return**
	ACWI	1.45	-12%
US	Microsoft	9562%	-36%
US	General Electric	1121%	-61%
Japan	NTT DoCoMo	387%	-79%
US	Cisco Systems	66970%	-55%
US	Wal-Mart	1205%	-13%
US	Intel	3788%	-43%
Japan	NTT	81%	-74%
Finland	Nokia	27518%	-80%
US	Lucent Technologies	892%	-96%
Germany	Deutsche Telekom	255%	-70%
	Average	*11178%*	*-61%*

Source: Bloomberg

The start of the 2000's was the final stage of the tech/internet bubble. Any and all tech stocks were white hot and "old economy" stocks were mostly at reasonable valuations. In January 2000, TMT (tech, media & telco) stocks were roughly 35% of the ACWI. A decade later in 2010 TMT stocks were down to 12.2% of the ACWI Index with only two names still on the top ten. Today TMT is back above 25% so we will see going forward. What is amazing is how many companies failed after the bubble burst, and yet today many of these same concepts are back. Pets.com sold pet supplies/food over the internet. It started in 1998; public in 2000; bankrupt in 2001. The current version is Chewy. Chewy has a market cap of $13bb and lost over $250mm last year. What could go wrong? Delivery of stuff was Kozmo. Started in 1998; bankrupt in 2001. Delivery of groceries was Webvan. Started in 1996; public in late 1999; bankrupt in 2001. We now



have Grubhub (mkt cap = $5.5bb on $1bb in revenue), Uber Eats, Delivery Hero in Germany ($10bb mkt cap and net losses of $300mm), etc. among others. Did this magically become a better business?

The start of the 2010's was all about China and their appetite for raw materials. China's continuing growth meant it will 'take over the world' and virtually all commodities went in short supply because of China's insatiable demand. In Jan 2010 five of the top ten companies pulled a commodity out of the ground and three of the Top ten were Chinese state-owned companies. As of today, none of those companies are still on the Top ten list. It is interesting to note that while China's GDP growth is currently just above 6% (if you believe the numbers) compared to roughly 8.5% in 2010, the narrative of the insatiable demand has disappeared. Funny how that works.

1/1/2010			
Country	Top 10 Companies by mkt cap US$	Prior 10 yr return	Next 10 yr return
	ACWI	-0.12	53%
US	Exxon Mobil	110%	40%
China	PetroChina	1104%	-43%
US	Apple	720%	665%
Australia	BHP Billiton	653%	12%
US	Microsoft	-36%	470%
China	ICBC	115%	62%
Brazil	Petrobras	948%	-60%
China	China Construction Bank	215%	46%
Holland	Royal Dutch Shell	15%	64%
Switzerland	Nestle	231%	208%
	Average	*408%*	*146%*

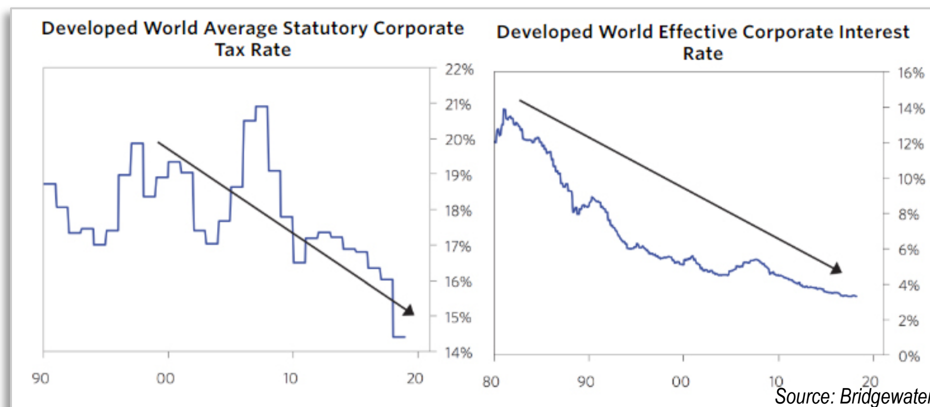
Source: Bloomberg

In today's market, it is "clear" that deflation will last forever, hence tiny to negative interest rates out for decades make sense. Since global growth is somewhat tame any company with sustainable growth prospects will be valued at extremes, especially intellectual property/software/platform companies (i.e., tech, and fake meat patty companies). Further, even though the US is running huge deficits with no signs of abating on the horizon, it is assumed that not only is this not a negative, but the US is the least dirty shirt so owning the US dollar and US stocks is mandatory to outperform. Today eight of the top ten companies are from the US and seven of the Top ten are tech companies. Further the US is 56% and TMT is above 25% of the ACWI Index, respectively.

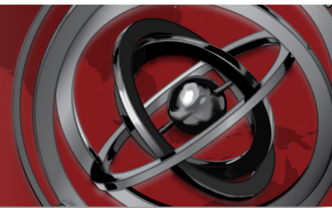
8/30/2019			
Country	Top 10 Companies by mkt cap US$	Prior 10 yr return	Next 10 yr return
	ACWI	0.53	??
US	Microsoft	470%	??
US	Apple	665%	??
US	Amazon	1244%	??
US	Alphabet	283%	??
US	Facebook	394%	??
US	Berkshire Hathaway	203%	??
China	Alibaba	134%	??
China	Tencent	919%	??
US	Visa	778%	??
US	JPMorgan Chase	232%	??
	Average	*532%*	*??*

Source: Bloomberg

Given today is so US and tech heavy and the shares are so strong/expensive, let's have a quick discussion on this. I have spent time in prior commentaries on the fact that US margins are near all-time high, which is masking the overvaluation. That combined with the shell game of having investors focus on non-gaap profits hides, to some extent, that the US is actually more expensive than it looks, so we don't need to cover that in much detail again. That said, below are a couple charts showing that global tax rates and interest rates are down big, which is no small part of the reason that profit margins are up big. Is this sustainable? You can decide.



Source: Bridgewater

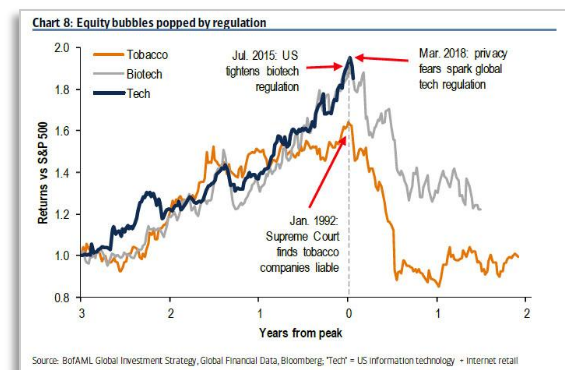


While it doesn't seem like a big deal, recently the US Business Roundtable switched their stated objective of business from its 1990 statement "generating economic returns to its shareholders" to include all stakeholders including employees and society. While this may or may not be the right move it is hard to see how it isn't the pendulum swinging back towards labor getting a bigger piece of the revenue – i.e., profit margins will go down.

Source: Bridgewater

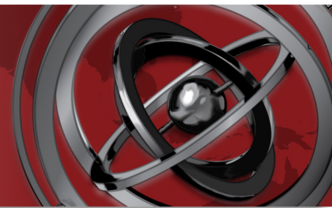
Lastly on this topic, see the chart on the right. The US Dollar matters in the context of US stocks outperforming. How about the fact that the trade weighted US Dollar, at its broadest against all of its world trading partners, has never, since Bretton Woods, been stronger than it is today? It could certainly go higher, but if you believe in reversion to the mean, do you want to bet on that?

Let's shift our attention to technology stocks. Here is an interesting chart on the right. It gives a couple examples showing that frequently it is regulation that ultimately breaks a sector's strength. Politicians on both sides of the US aisle have intensified their focus on antitrust issues with the big US tech companies. To add to this concern/risk, according to Goldman Sachs, the S&P500 Info Tech sector is trading two standard deviations above its 10-year average valuation across a range of metrics. Want more? US tech represents 28% of ALL US profits. It is the least regulated sector according to an analysis done by BofAMerrill. Tech companies are, by far, the most active in share buybacks, and have been the market leaders for past ten years. And yet, hanging out there are discussions of:



Source: BofA Merrill

- Anti-trust investigations.
- Anti-buyback sentiment.
- Questions about Section 230, which gives immunity for anything published to the "content neutral platforms" which they are clearly not.
- European-led digital services revenue taxes. (You mean when you shell game your income to low tax countries the higher tax countries will at some point try to get their share of taxes back? Weird)
- Privacy concerns including the "always on" nature of the location tracking and microphones on smartphones and Alexa-like devices.
- A bill in California, which is frequently the starting point for other states, to essentially ensure that all "gig" economy workers (Uber, Lyft, Grubhub, etc.) are not classified as "Independent contractors" but rather are treated, and the companies are taxed, as if they are employees. This means significantly higher employee costs.
- Continued/increasing recognition of depression / mental health issues associated with social media, especially for teens.
- Broader discussion of income inequality and concentrated power and wealth, etc.



Translation: as the world becomes even more populist, which it clearly is, the public's anger will inevitably fall on one sector - the one which has performed the best since the last recession - **technology.** P.S., it is also the sector with the most profit from which the politicians can take in order to redistribute income in order to buy votes, I mean to allocate to the most deserving areas.

From my previous commentaries I'm sure it's obvious that I enjoy going to the movies. In addition to entertainment (and quotes), they are an interesting source of getting a pulse on how we think about different issues as a society. Yes, it is probably specific to the point of view of the producers/filmmakers, but it isn't far off from the U.S. point of view at large. For the last 10-plus years the evil country/antagonist of the US was always Russia. I will bet that over the next ten years it starts changing to China and the evil tech corporation. In the current movie, Hobbs and Shaw, the Fast and Furious spin-off, the source of evil is a big tech company. Just sayin'.

In the movie, The Big Short, the Deutsche Bank salesperson, Mr. Bennett, played by Ryan Gosling, says "I guess you don't realize how clueless the system is...it is fueled by stupidity…No one is paying attention." The stupidity he is referring to is more specifically people assuming the trend will continue and refusing to look at the risks. I could argue the same goes for technology today. Many of them are great businesses, but people are not fully considering the risks.

Side note, if you were around in early 1992 a presidential candidate, Bill Clinton, was talking about health care and specifically high drug prices and how he would "fix" this problem as president. This morphed into what was referred to as "HillaryCare" after his wife, Hillary Clinton, championed the reform effort. The point is that this fear of a governmental/regulatory attack on drug prices caused the share price of Pfizer, Merck and Lilly to fall between 40%-50% between January 1992 and August of 1993. As was the case with many candidates/elected government officials it proved far more difficult to regulate the drug prices than hoped, so the drug prices didn't fall and instead continued their ascent, which continues to this day. Once it became clear that this impact was a non-issue, the stocks rallied between 30-40% within four months and continued thereafter. Today, it would seem a non-material risk that the US elects a "Democratic Socialist" president next year and the democrats have control of both the House and Senate in which case they can easily ram through their health care agenda. You may like or not like that as it relates to societal benefit, but the OVERT target is basically the entire medical industry's profit pool (insurance companies – gone, drug companies, device companies – regulated prices way down, etc.) and yet these stocks don't seem to show much of this risk in their prices.

Earlier we saw the Top ten stocks by decade. How about if we look very broadly in the world since the start of this decade? Today the US and tech globally have had huge runs while much of the world has lagged, especially emerging markets. When you look at stock returns around the world in US$s, it would be safe to say that we will probably find fewer names that look cheap to us in the markets that are up big, like the US. Conversely the markets that are down will likely have better opportunities. I'm sure based on this table you can guess where we are looking for cheap stocks and where we are not.

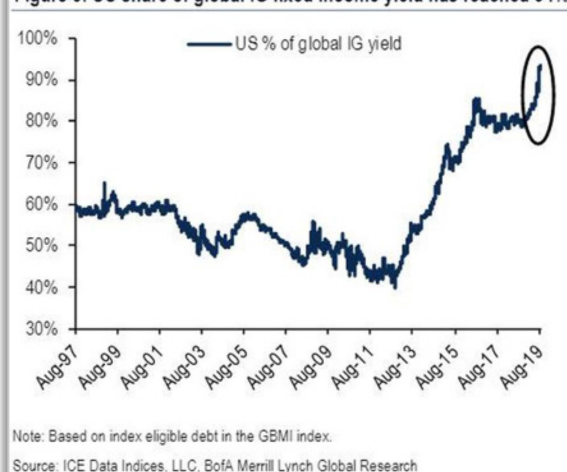
Index/Area	Returns Since 10/09/07
S&P500	158.70%
Nasdaq 100	247.00%
MSCI All Country World Index	69.30%
MSCI European Index	10.40%
MSCI Emerging Market Index	-1.20%
US Dollar	26.70%

Source: Bloomberg

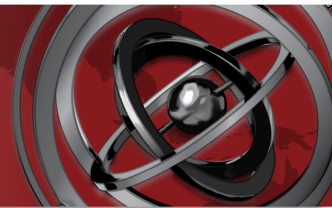
Bonds

As Jim Grant has said, bonds are "return free risk." The easy retort is "Of course." Here are a few examples of the extreme things happening in the world of bonds that maybe you haven't seen.

Most of us know of the European Central Bank and the Bank of Japan induced mania in European and Japanese bonds, which combined are now over $17 trillion dollars in negative yields, with roughly half of all European investment grade corporate bonds having negative yields and a few handfuls of European junk bonds having negative yields. While this is truly astounding, according to BofAMerrill 95% of all worldwide corporate investment grade yield (income) is based in the US. Think about that for a minute. (And even that income is shrinking fast as well.)



Source: ICE Data Indices, LLC, BofA Merrill Lynch Global Research



Below to the left is a chart of the price of the 2.1% coupon 2117 Austrian, Euro pay, bond (yep, 98 years out). The chart on the bottom right is the same bond but showing the yield to maturity. Can it be true that people think that there is virtually no possibility of anything but deflation for the next 98 years in Austria? Or is this purely a greater fool theory investment where anybody investing in it is convinced they can get out when they see it reversing before everyone else? By the way, Belgium and Ireland also have 100-year maturity bonds that yield roughly 0.75% and 0.85% respectively to maturity.

Source: Bloomberg

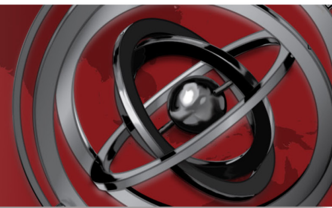
Source: Bloomberg

How about the Argentina 7.125% coupon US dollar pay 100-year bond? The chart below and to the left is the price. Below and to the right is the yield to maturity. Until August of this year it traded with a yield to maturity of roughly 9%. Argentina has defaulted on its sovereign debt eight times since its independence in 1816 and most recently in 2014. Yes, just three years prior to this oversubscribed offering of 100 years. Their current stated inflation rate is over 50% with the spike in yields in the right chart attributable to the prospect of newly elected far-left politicians becoming President and wreaking more havoc on their economy. Since 2000 the Argentina currency has gone from one peso to the dollar to 57.25 pesos to the dollar (at the time of the century bond offering the Argentinian Peso was at 16.6.) That is, the currency has lost virtually all its value, and anything valued in dollars has become completely unaffordable (ie, unable to be paid back)– this includes the bond and it is thus inevitable that it will not be repaid and defaulted on.

Source: Bloomberg

Source: Bloomberg

Here is another example of this. I remember earlier in my career when convertible bonds essentially had the stock conversion premium ratio roughly equal to 3-5 years of the coupon. In other words, if the bond had a coupon of 5%, the premium of the conversion ratio to today's stock price was 15-25%. Another of today's ridiculous Unicorn public companies is Wayfair. It started as a hodgepodge of furniture retail sites but has now been all put together under Wayfair.com. Somehow being able to shop for big, bulky furniture online without being able to touch or feel the fabric, then have HUGE diseconomies of scale in shipping 1 couch at a time makes sense to somebody, but enough about that. They recently issued $825mm of convertible bonds. The coupon was 1% and the conversion premium is 40%. If you like the stock, why buy a bond paying 1% interest annually and give up the next 40% of upside in the stock? If you like the bond, well, I don't have enough time here to describe that insanity. Buying a bond in a company that has lost $1.25bb in net income in the last seven years, with seemingly no ability to ever generate positive net income all the while getting 1% a year for your investment takes a special kind of investor.



The obvious question is, unless you are a specialized convertible bond fund AND you have so much AUM that you have to buy any convert you can (in which case you should return some of your assets) then who is buying this? By the way, it was upsized from the announced $750mm size so demand was robust. Given terms like the Wayfair bond, why is any company offering equity as opposed to convertible bonds?

I will conclude the discussion on bonds with the fact that you can now get a 30-yr amortizing mortgage with rates fixed for 20 years at a negative rate in Denmark. A full-30yr mortgage has a marginally positive interest rate. While there are many factors that go into property prices worldwide, certainly the mortgage rate is one of the key determinants of price. For comparison a $1mm mortgage with a 5% rate equates to a payment of roughly $65,000 annually. A 2.5% rate equates to roughly $47,775 annually. A 0.0% rate equates to roughly $33,000 annual payment. While this is great for existing real estate owners, it spells risk to property prices, banks, etc. going forward, unless you think interest rates will stay at 0% or negative forever.

Emerging Markets (EMs) are too risky

In my last commentary, *These go to Eleven,* I showed a bunch of graphs showing how global and especially EM stocks were cheaper than US stocks, hence more interesting. While it is price that always drives our investment decisions, let's dive a little deeper into why qualitatively Emerging Markets may not be as risky/scary as people seem to think.

The narrative is that EMs are SUPER risky and must be limited to a small percentage of a portfolio. As much focus as the developed world garners due to its collective history and size, the fact is that Emerging Markets today are the world's primary drivers of global growth and wealth accumulation. They cover a majority share of the world's population and probably more importantly for future growth their population skews very young. Further, EMs also have a dominant share of the world's natural resources and their government finances are on more stable ground, on average. Despite these incredibly attractive features, investors' perception of these markets generally remains mired in the perceived risks of the small size, lack of financial market depth, governmental/regulatory risk, currency risk, etc. While risks are everywhere and need to be carefully considered, we would argue the EM risks are lower than the market assumes (i.e., prices in), while conversely the risks are higher in the developed markets. It is this gap in perceived versus actual risk which we believe creates the opportunity to invest in Emerging Market equities at excellent valuations from time to time.

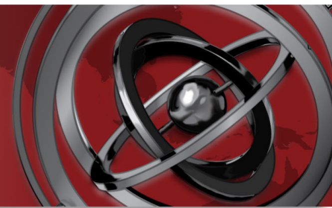
What are Emerging Markets?

According to the International Monetary Fund (IMF), of the nearly 200 countries in the world, more than 160, or 80%, are classified as 'emerging.' The primary tool for such classification is a measurement of wealth, most frequently expressed as Gross Domestic Product (GDP) per capita. The second key factor is the degree of development of the financial markets in these countries. It is not always the case that GDP per capita goes hand-in-hand with financial depth or sophistication. A number of countries with relatively high GDP per capita but relatively underdeveloped financial markets are frequently classified as Emerging Markets, including several of the oil-based Middle Eastern countries. There are certainly other quirks in which countries are considered EM. As an example, I can't imagine anyone who has visited South Korea wouldn't say that it is a developed country, and yet it is tagged as EM.

Just like the US was until probably the late 1800s, the current EM countries are in a transition phase, both economic and structural, as their financial and regulatory systems mature. Call them what you want but the classic definition of Emerging Markets focuses largely on data that only partially reflects the rapid development of this large universe of countries.

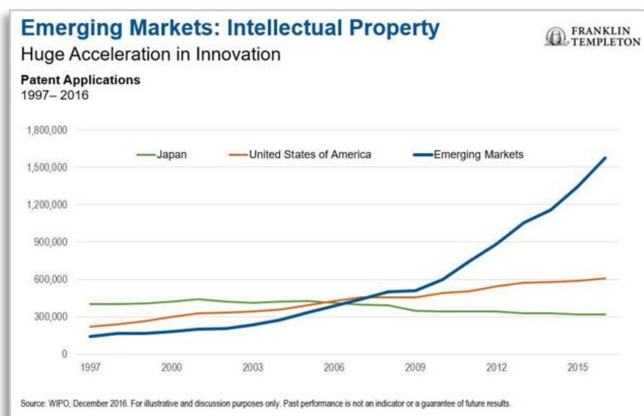
Benefits of Emerging Markets (in no particular order)

- The 20-year historic average real GDP growth for emerging markets is 5.5% versus 2% for developed markets.
- The 20-year historic average real income per capita growth for EM is 7.2% versus 3.2% for DM.
- Because of previous crises, EM countries are more fiscally conservative, on average.
    - Many/most EMs have low levels of government debt. Many of these countries run trade surpluses and depending on their commitment to grow infrastructure they are probably roughly budget neutral as well.
        - EM government debt averages 47% of GDP compared to 98% of DM debt, according to the Bank for International Settlements (BIS).



- Consumer EM debt averages 39% of GDP compared to 73% in developed markets, according to the BIS. While this is likely in part due to a lack of financial development of the country and access to credit is poor, the fact remains that these countries don't suffer from having so much consumer debt that it is hard to see a way out (think the US with credit card and student loan debt)

- 76% of all central bank reserves are held by Emerging Market countries, according to the BIS.
- The population of EM is over 6bb, and growing, versus 1.25bb, and shrinking for DMs, so positive relative growth in EM matters more for the world. Further the EM population skews far younger than DM which means more productive years ahead for their population. Having a young, working population is better for economic growth, let alone government finances, than a much older workforce where retirees exceed the number of new workers.
  - 90% of the global under 30 population live in an EM.
  - Asia (ex-Japan, Singapore and HK) is all considered an emerging market. Asia has 60% of the world's population. It has 10x the population of Europe and 12x that of the North America.
  - Asia is roughly 60% of the global population but only 40% of global GDP, and 2/3rds of the economic growth, and increasing. Maybe more importantly it is only 25% of the world's equity market cap. EM debt only represents 20% of the global fixed income universe. These gaps highlights the extent of underfinancing in EM (and over-financing in developed markets) and provides significant support to the opportunity for upside in the EM universe.
  - 8 of theTop 10 largest cities in the world and 16 of the top 20 are in EMs.
- Their history of being relatively poor has given them the advantage of a lower wage level to compete against the world. While this might make the country a low skill factory for worldwide production of whatever, it is a start. This labor advantage gives the country an export advantage over higher wage countries. It wasn't that long ago that this is how the world thought of China. Now they are moving quickly up the charts of value-add, high skill manufacturing and research and development. (This is also how Japan started as did South Korea and currently Vietnam.)
- As the countries grow, wages rise and households become spenders on items outside of purely survival products (shelter, food, etc). The inflection point when a country develops a middle class is very powerful for domestic purchases, let alone travel, entertainment, etc.
- EMs have a disproportionate share of natural resource wealth. While this might lead to boom and busts depending on the commodity price, the world NEEDS natural resources and they tend to be extracted in EMs driving economic development.
- The chart to the right is interesting showing the growth of patents (intellectual property development) in Emerging Markets compared to the US and Japan. Granted this is heavily China weighted, but I bet it still surprises you.

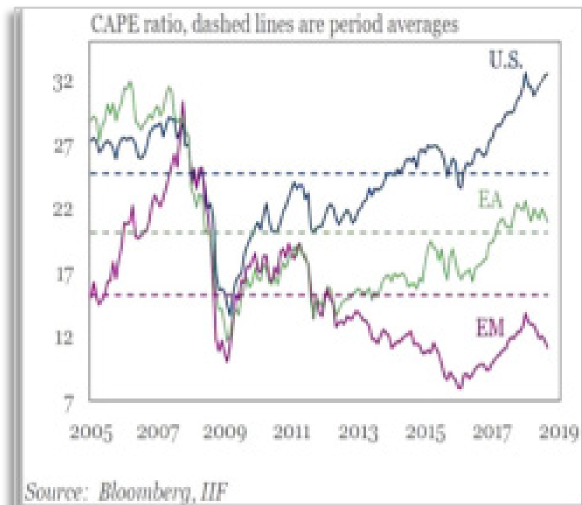


Source: WIPO

- Middle class growth. The number of people in the global "middle class" will be 3.2 billion by 2020 according to Kishore Mahbubani from the book "Has the West Lost It." By 2030 that number will hit 4.9 billion, which is more than half of the world. This is virtually all coming from the EM world.
- The Organization of Economic Cooperation and Development (OECD) estimates that middle class spending in Emerging Markets will increase from 25% of global consumption in 2009 to nearly 70% by the year 2030, a mere 11 years away.

- Developed markets are characterized as having transparent, less corrupt governments, where there is free trade and free flow of capital (i.e., prices are primarily determined by supply and demand). Is this true when central banks have forced negative interest rates on the world?

All of the above is fair support, but as said earlier, it is all about the valuation. To the right is a chart of the CAPE (cyclically adjusted P/E, ie, normalized margins over the long term) for the US, Europe and Africa and EM. If rates stay at 0 forever and margins stay elevated forever then maybe the US stocks will not be expensive, but we are concerned. You can see where the value is. Lastly on this point, the US CAPE is at the second most expensive it has been in 150 years. Caveat emptor.



Source: Bloomberg, IIF

Risks in EM

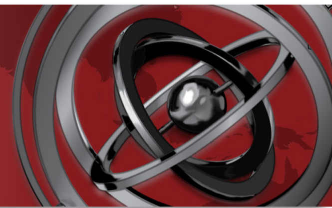
While there are many risks in any region, country or company, let's hit a few of the risks that people always point to with emerging markets.

- Political risk: these are government policies that are unfavorable, such as taxation, trade barriers and tariffs, and worst-case nationalization. There can also be expropriation through new taxation laws. Weak legal framework and copyright laws are also sources of risk. All are possible, but in today's world, don't the US, Europe, Japan, Korea, etc. share many of these? Expropriation is always feared, but realistically it has been very isolated other than a couple entire country examples like Venezuela. Further, there are many people that would say the US has never been less stable and others that are very concerned for the US if a "Democratic Socialist" is elected president in a mere 15 months.
- Weak currencies/volatility: Historically somewhat true depending on the country, but it is not clear that will always be the case. Further, if you primarily export products your revenue is probably in US dollars. This might be a big positive, especially if your debt is local currency, not US$. If you are a domestic only company, a weaker currency can hurt if you are big importers, but again the past has moved many countries to develop their own supply chains, which begins to lessen this risk. As a US$ investor the translation back to dollars is a risk, but is the risk higher or lower after the dollar has had a massive upward move over the past decade plus?
- Poor governance: shareholder protection is reputed to be weak in EMs as are the objectives of company CEOs, which are considered not as aligned with those of the shareholders. Here is an interesting table for you according to data from Bernstein showing it is the US and Canada that have the public shareholder unfriendly corporations, based on uneven voting rights for public shareholders, as opposed to EM countries. Make no mistake, we don't fault the US or Canadian founders for wanting to keep control via super voting rights. We fault the shareholders for buying those companies and tacitly saying that it is no big deal.

Country/Region	% of companies with uneven voting rights
US	11.0%
Canada	5.0%
Rest of World	0.0%

Source: Bernstein

  - As an example, Polyus, a Russian gold company, recently said that it will use the extra cash from the rise in gold prices to pay off the relatively low levels of debt instead of paying dividends or buying back stock, at least until there is clarity with their next big mining project. Name a situation like this in the US where the company didn't keep paying a dividend or buying back stock in the face of shareholder pressure.
- Poor disclosures: getting access to good quality information may also be difficult due to weaker accounting standards and disclosure requirements. This is sometimes true, but, again, is this unique to EMs? Most accounting is now IFRS so fairly tightly regulated with minimal EM fraud reported. Access, or lack thereof, to as much information is certainly true in certain countries, but is that always bad? I could easily argue that many small cap US companies have great investor relation efforts which leads to them spinning a story that may or may not be completely accurate.
  - Relatedly, it continues to amaze us that the US and much of the developed world seem to not care at all about the growing gaap/non-gaap differential in financial reporting.

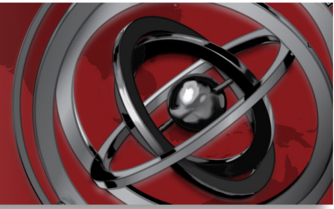


- Did you know that the small-cap Russell 2000 index in the US excludes all money losing companies in their overall reported valuation metrics? While the stated P/E is 17x, it excludes over 1/3 of its constituent companies. If you include them the P/E goes to 75x. Let's also keep in mind this is non-gaap P/E and the spread between non-GAAP and GAAP numbers is far greater in small cap companies.
- With the exception of China tech, most of the EM investing world shows 1 set of numbers: IFRS or their local derivative of IFRS. There is no mention of "pro-forma" numbers. Granted, historically most EM countries had very little access to venture capital / private capital. It is this dynamic that seems to lead to greater gaap/non-gaap differential, which effectively boils down to 'other people's money.' When it is primarily your money backing the company you want to know that you are making money sooner rather than later. There is also no reason to try to make the numbers look better than they are. You are the primary shareholder. When it is somebody else's money, AND most of your compensation as management is in the form of stock options, the dynamic changes where you have to look like you are doing great. This is what leads companies like WeWork to coin the most egregious financial term ever in "Community Adjusted EBITDA" to show their true profitability. You can look it up but it is essentially gross margin. If your gross margin can be considered your actual recurring profit or cash flow, soon enough somebody will coin an alternate phrase for revenue and make that sound like profit. There are some winner take all software/platform companies where the need to get big fast, no matter the losses, is worth it (maybe Facebook, Amazon, etc?) BUT.. this isn't the average business.

- Liquidity risk: This includes stock liquidity and currency liquidity in the form of currency controls in some markets. Currency hedging can also be costly due to lack of trading. Diversification solves some of this, unless you think the US$ will rise against all other currencies forever. Similarly, the buying and selling of stocks may incur relatively higher transaction costs as market accessibility may be poor. Sometimes true, but if the stock is cheap enough you can overcome this, let alone if you are a buy and hold investor this is much less of an issue over time versus an active trader.
- Financial conditions/financial markets. It is true that many EMs have much less developed capital markets, including debt and equity. That said, as discussed earlier, the pace of change here is very positive.
  - I believe Sir Winston Churchill was the first to say, "never let a crisis go to waste" and we have seen many emerging markets take advantage of their historical problems since the Asian currency crisis in 1997 and the 2008/2009 global financial crisis and become more self-sustaining. A big part of this is realizing that relying on the US$ for funding was not ideal and thus improving their underdeveloped internal capital markets. You can see this throughout the EM world. It is not overnight but the ability to get a mortgage, borrow money domestically at a fixed rate for a few years, etc., has increased dramatically. This is a big deal. Further, exactly like any relative you had that lived through the Great Depression in the US during the 1930s, their behavior changed afterward to be more conservative, especially as it relates to debt and savings. You can see this in most EM countries (not all, since basket cases like Argentina remain that can't seem to get their act together). This lowers one of the main EM risks of years past, which was an over reliance on US$ debt that crushes you when the dollar is strong (see Argentina 100 yr bond example earlier).
- Many EM stock markets show higher volatility. This one isn't even true. According to Bloomberg each of the last 2 decades and the 30 yr moving average of volatility shows the S&P500 is more volatile than the MSCI All Country World Index. (30-yr moving avg for ACWI is 11.6% vs 15.6% for S&P500.) This statistic is just proof that diversification reduces risk. The MSCI ACWI has many individual countries blended together so while any one EM stock market may be more volatile, when you combine them together they are less volatile than the US.

In summary, EM countries have stronger balance sheets and less debt, and their companies have faster growth coupled with cheaper valuations. That doesn't sound like a recipe for disaster to us. We strongly agree with the Warren Buffett quote "Be fearful when others are greedy and greedy when others are fearful." This is a different way of saying what Ben Graham originally said, "The intelligent investor is a realist who sells to optimists and buys from pessimists."

Thus, we have been underweight (fearful) with the euphoria (greed) in developed market stocks (especially the U.S.) and we have been overweight (greedy) and becoming more so (greedier) as emerging markets continue to falter, as others have gotten more fearful in EM. As is common with many value managers, we were, and will remain, early with some of our stock picks, but over the long run we are confident that the corporate fundamentals and lower valuations will pay off. In the end, I'm not sure any of these risks make EM stocks look so scary that you should limit yourself to a small percentage of your portfolio if you have done the research and can diversify away much of the specific risk.



Before I end I have to give a special shout out to my favorite cult, I mean company, which has now filed to go public; The We Company (ex, “WeWork”). In their IPO document it shows their losses have been roughly equal to their revenue in each of the last three years, which is impressive. (I’m 100% sure I could grow any company at a massive rate if I were allowed to lose as much money as I had in revenue.) In one of the opening lines of the IPO document it says, “We dedicate this to the energy of We – greater than any one of us, but inside each of us.” It also states the company’s goal to “elevate the world’s consciousness” and constantly reminds of their “extensive technology.” Technology? It is a community-space landlord. This is 2000 era tech stuff. It also reminds me of when Google went public and we learned the phrase it used in its code of conduct, “Don’t be evil.” By the way, they changed that phrase in 2015 to “Do the right thing,”, which is interesting. The We founder, Adam Neumann, has historically sold shares, bought buildings then leased them to the company and most recently sold shares and borrowed against others to take out $750mm just prior to the filing, so that is all somewhat less than inspiring. While there are many other things that could be said, let’s leave it at, this is the guy people are comfortable giving 20x voting rights per share? Side note; if WeWork is the poster child for the greater fool market we live in, does that make Softbank the greatest fool for investing so much in all this, and other companies in such scale? Sam Zell recently said that “every other time in history when you create long-term liabilities and short-term assets, results are predictable. Why is this any different?” Lastly, to quote Scott Galloway, a Professor of Marketing at NYU, about the We IPO, he has two nice quotes: “There is a thin line between vision, bull**** and fraud.” and “The bankers stand to register $122m in fees flinging feces at retail investors visiting the unicorn zoo.”

To come back to the title of this piece, ‘*The Subtle Art’* means Kopernik won’t influenced by career risk, or what scares people over the short term, and will remain singularly focused on achieving great investment returns over the long run.

To end, I will quote the 2018 movie Jurassic Park: Fallen Kingdom. At the very end of the movie, Dr. Malcolm, played by Jeff Goldblum, was speaking to a congressional subcommittee about dinosaurs, but in our case let’s assume he was speaking about our global monetary experiments, when he said this, “This change was inevitable… We convince ourselves that sudden change is something that happens outside of the normal order of things like a car crash or that’s beyond our control, like a fatal illness. We don’t conceive of sudden, radical irrational change as woven into the very fabric of existence. Yet I can assure you it most certainly is. And it’s happening now… We’re going to have to adjust to new threats that we can’t imagine.” Well said.

Thanks again for your support.

Mark McKinney
Co-Portfolio Manager – Kopernik International Fund/Analyst
Kopernik Global Investors, LLC
September 2019

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