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listening**in**

Contrarian Value Is Just The Start

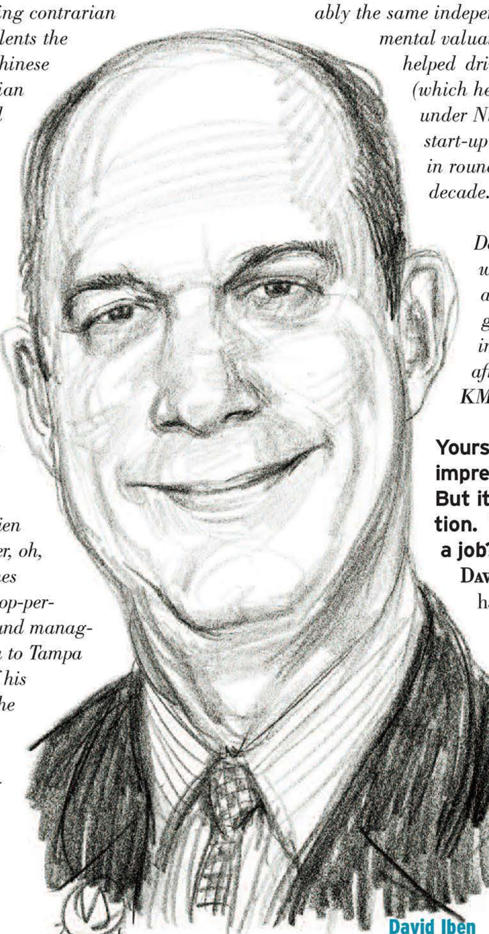
Kopernik, Named for the Scientist, Trusts Own Analysis, Scorns Convention

It's tempting to write that David Iben's Kopernik Global Investors takes value investing to extremes. After all, it's literally true, with the year-old fund group (which already boasts some billion dollars under management), taking contrarian positions in investor-repellents the likes of Russian banks, Chinese railroads, hulking Brazilian utilities — even gold and uranium mines.

Thing is, when you talk to Dave, he makes the value investor's credo of searching out intrinsic worth where the investment herd fears to tread sound incredibly, well, "normal" and "reasonable." Given the patience of Job. And painstaking research. Not to mention luck.

Dave's name and jovial mien don't ring bells? Remember, oh, two years ago, the headlines about Jeff Vinik luring a top-performing Nuveen mutual fund manager to move from California to Tampa to run a $3 billion slice of his hedge fund? Remember the headlines not nine months later about Vinik deciding to get out of running O-P-M "to focus his energy on other pursuits," and so cutting his PMs loose? Yes, Dave is that money manager, now with a new employee-owned firm (Vinik was an early investor). What hasn't changed, Dave says, is that he still employs the same rigorous analytical and portfolio management practices — and unquestionably the same independently minded fundamental valuation principles — that helped drive Tradewinds (which he essentially co-founded under Nuveen's aegis) from a start-up to AUM of $38 billion, in round numbers, in roughly a decade.

Dave and I chatted about what he's been up to — and why he says this is a great market for value investors — on Tuesday afternoon. Listen in.
KMW


David Iben

Yours is a long and impressive resume, Dave. But it does raise a question. Why can't you keep a job?

David Iben. [Laughing] I hadn't really thought of it that way. After getting my MBA at USC, I began my career at Farmer's Group where, over 14 years, I went from senior analyst, to lead portfolio manager, to director of research for both

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equity and fixed income strategies, to ultimately acting as CIO with responsibility for $16 billion of investable assets. But that business was being readied for sale, so in 1996 I went to Cramblit & Carney as a senior PM.

I remember interviewing Cramblit & Carney, way back at *Barron's*, probably long before you joined. They were young and so was I.
Well, two years after I joined, Cramblit & Carney in turn was being acquired, so I became a founding member, CEO and lead PM at Palladian Capital Management — but that "flight of independence" ended in just another couple of years when Palladian teamed up with a Nuveen affiliate, NWQ Investment Management. More recently, I was co-founder, CIO, co-president and lead PM, of Tradewinds Global Investors, another Nuveen affiliate, where I also directly managed $20 billion in three of its strategies. But the Tradewinds platform had evolved out of the six years I spent at NWQ before we spun it out, so that whole time felt pretty much like one job, from 1998 or 2000 until I left in mid-2012.

Tradewinds was also a pretty dramatic success for you, wasn't it?
It was small wonder your leave-taking made waves — to which your, umm, low-profile destination only contributed.
That move, of course, was to come out to Florida to join Jeff Vinik in his hedge fund, Vinik Asset Management. Then Jeff changed his mind about wanting to continue managing other people's money anymore — only nine months after my team and I started there.

"Now you have now — when the market is really bifurcated. The markets love some things way, way, way too much. Yet at the same time, they're giving away stuff. This is really the best time to be a value investor, I think — yeah."

Talk about a rocky transition. News stories pointed to disappointing performance and organizational woes.
What I tell everyone is that Jeff was very busy with his NHL team —and a lot of other things. So we just decided, "All right, I guess the key to stability in this business is to own the company." So now we own the company!

Gee, that's pretty much what I decided, albeit after only two companies.
Yes, very, very similar.

Not quite. I didn't run the others — well, I ran *Barron's* under Alan Abelson, but that's another story.
Yes, it seemed like you were the heir-apparent there —

Let's just say I was the managing editor for a long time, and Alan and I thought so, but Dow Jones had other ideas.
Okay. I always enjoyed reading your stuff and I always enjoyed reading Alan's, but not a whole lot of the rest.

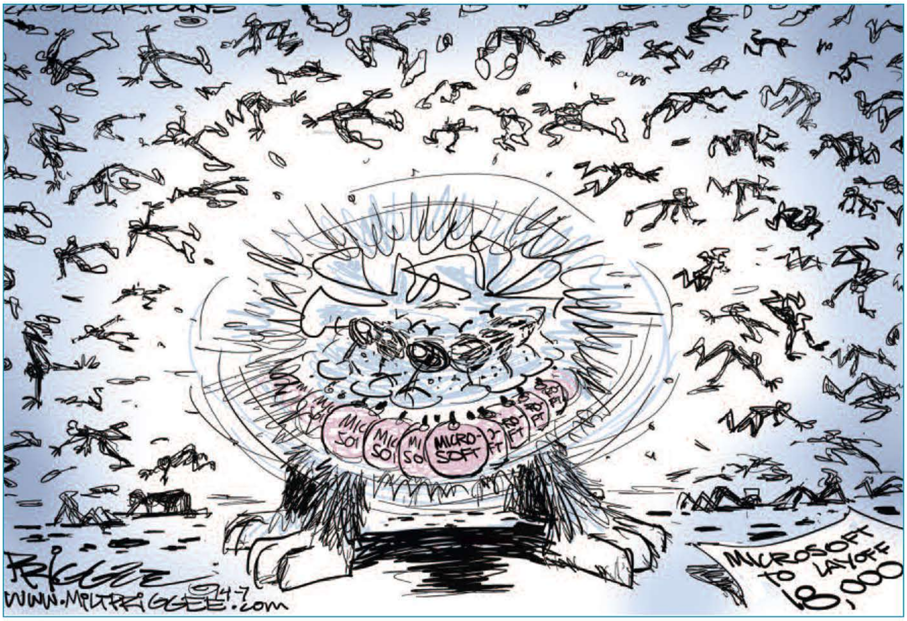
Thanks, but now I'm quite happy not to work for Rupert Murdoch. Even happier to be working for myself. If there's an editorial dispute, I win every time!
There's a certain beauty to that.

Absolutely. So Kopernik has been up and running how long now?
Just over a year actually.

And you seem to be focusing on institutional business?
Institutional accounts and a mutual fund.

But your mutual fund isn't exactly aimed at retail, is it, with a million-dollar initial investment threshold?
Yes, almost all that we're selling is in the institutional arena for now, the mutual's I-shares, separate accounts and private funds.

Well, you sure picked a great time to get into the business as, essentially, a value investor. Everyone I know is complaining about nosebleed valuations.
Actually, I think we did.



Really? Why?
Our job is to appraise businesses, and the market — it appraises businesses, too. You've got times like 1982, when I was lucky enough to come into the business, when you could throw darts and make money. Everybody was going to do well. And you have times like 2007, when everybody was going to do poorly. And then you had 1972 and you had 1999/2000 — and now you have *now* — when the market is really *bifurcated*. The markets love some things way, way, way too much. Yet at the same time, they're giving away stuff. This is really the best time to be a value investor, I think — yeah.

In 1972, you had the Nifty-Fifty —

And then you had everything else –
Right. Everybody decided, "If it is a good company it must be a good investment." I guess they then got to learn first-hand that a high price does not a good investment make. The companies flourished for 10 years and the stocks dropped for 10 years and became value stocks by 1982.

Then in 1999, the bifurcation resulted from the tech and telecom bubble.
Of course. 1999 was when people decided that roughly, say, *infinity* was the right price to pay for anything in tech, media and telecom; yet at the same time, they just had such disdain for "bricks and mortar," as they called it. —

That was "the old economy" where everybody who "just didn't get it" lived.
The old economy was bad; small was bad for the most part — especially, small value was death — and big companies became mid-cap companies. The market was going to pay way more for an internet idea than it was for franchises that took decades to build — whether it was the Boeings or the John Deeres or the Raytheons or the Union Pacific Railroads.

All of those stocks were just being given away at mid-cap valuations in 1999-2000, and at fractions of book and at low P/Es. It was really a wonderful time to be investing. But it was a tough time to convince your clients that it was a wonderful time to be investing. Yet most of our clients, if you told them the story back in those days, stayed — and it worked out very well.

And now, you're saying, you see a similar bifurcation?
Yes, right now you've got a similar bifurcated market. You've got various things going on. You've got bonds that are openly being bid by central bankers so the price of bonds are higher than they normally would be — who knows the right price? But we all know there'd be a lower price/higher yield if there was not this whole government intervention.

Bonds are overpriced, so people rotate into stocks. But they're rotating into the most bond-like of stocks, the ones that have the most stable cash flows. And they're paying *very* high prices for them. I think, very much like with the Nifty Fifty of 1972, people are going to find out that *really* good companies can be *really* bad investments if you pay too high of a price for them.

And yet because people seem to accept the idea that volatility is risk, stocks that don't boast stable cash flows — the unpredictable cash flows — they will *give* to you. So we are buying companies at huge, huge discounts to liquidation value and replacement value and book value and you name it. Really good assets. Because people fear volatility, well, we're getting them very cheap. I'm very much in the camp of Howard Marks and others who believe, oddly enough, that while volatility may be a risk to some people, it's not a risk to long-term investors. If other people are willing to sell a stock to you at a cheap price, that actually makes it *less risky,* not more risky. So the volatile cash flow stocks are probably less-risky. And the stable cash flow ones are being priced like bonds, i.e. they're probably going to be very risky stocks. So it's actually, I believe, a great time to be in this business.

***If* you've got the stomach to be contrarian.**
That's the whole key, I guess. Having the willingness to look very different from the crowd.

Behaviorists say it takes a sociopath —
That's right!

So you've gathered a team of sociopaths in Tampa?
No — Put it this way: We value very highly the willingness to think independently and the willingness to look different. Even, in the short-term, to look wrong. That is often required to be right in the long-term. So, we've gone out of our way to bring in independent thinkers.

Still, at bottom, value investing is your style. How are you finding stocks to buy when so many noted practitioners of the discipline are throwing up their hands in disgust with an "overvalued market?"
Lots of value investors are finding nothing to buy here, for reasons you can break into different categories. For starters, if I were a U.S.-only investor, I'd agree this would be a very, very challenging time. The U.S. in general is pretty overpriced. There are some values out there, but not a lot. So being a global investor is a *huge* advantage right now.

What's another difference?
This gets into the whole concept of value. We've always viewed value not as a philosophy, we view it as a prerequisite. And there's more difference there than it might sound like —

Expand, please.
If value simply means picking cheap stocks, then you can see why a lot of value investors got in trouble in '07, '08, '09. Because the cheap stocks back then actually were not value investments. They were companies with unsustainable business models. They turned out to be home builders and banks and mortgage companies and things with clearly unsustainable margins. So they turned out to all be value traps, if not worse.

How do you avoid falling for them?
To us it's important to think about what you're buying and to value an asset-light business differently than you value an asset-heavy business, for one thing. When it comes to asset-heavy businesses, we have a lot of different ways we look at them. But I think the market as a whole often makes a mistake in valuing them. You hear lots of value investors say things like, "Value is merely the present value of future cash flows."

The problem is, that leads them to saying that if a company doesn't currently have a clear stream of cash flow, then it has no intrinsic value. I've had people tell me that gold has no intrinsic value because it generates no cash flow —

You can't argue that a lump of metal does. Glitter doesn't equal cash.
Well, we can come back to that — But what I say is that there are a lot of things that have intrinsic value, but no cash flow. Art is not my field, but the Mona Lisa, I'm pretty sure, has intrinsic value.

I suppose you could argue it could be valued on the cash flow it generates via admission charges to The Louvre.
Maybe. But I also believe that The Louvre, anytime they wanted, could turn the Mona Lisa into lots of cash. Because it has intrinsic value, they could turn it into cash. So I think the world has it backwards: Intrinsic value does not come from future cash flow; I think future cash flow can be derived from intrinsic value. So show me a business right now with stable cash flow, and investors will torture themselves, using too-high assumptions for profit margins and too-high assumptions for growth rates — and too-low of a discount rate — to come up with a really high present value. Yet, if you show me a business that does not have a stable cash flow, people don't want to touch it. They think it has no value.

But how do you determine that it won't just get cheaper?

Well, we have been buying lots of assets. My view is that if you have an asset that is valuable, it eventually will earn a decent — if not superior — return on assets.

How do you determine if it has "value?"
It would be something that meets basic needs — needs that will still be here five years and 10 years from now. It will be something with a sustainable advantage or barrier to entry, something that has scarcity or monopoly power; those sorts of things.

If you have a good asset with a competitive advantage, it should eventually yield a return. So we'll look at things like buildings, farmland, hydroelectric dams, nuclear power plants, mobile telephone systems, gold mines and coal mines, and you name it. Things where we'll say, "Yeah, there are assets here."

Even it's just a hole in the ground with sunk costs attached?
There are assets that people have used for hundreds of years and assets that people are going to need 5, 10, 20 years from now — and that can't be replicated. If they're not cash flowing now, that's probably a cyclical phenomenon, not a permanent one.

So if we can buy these assets for half of what they're worth — and right now the market is willing to give us things at 10% of what they're worth really — then we just need to be patient. We buy things that are going to go up five or ten times. So whether that's going to happen next month or next year or two-to-three — or even farther out — or whether we're wrong on a few of them, if we do that 50 times in a portfolio, it works out very, very well.

Sounds like a lot of work, though. Analyzing companies with big, real assets that rust in the rain and depreciate and require upkeep is a lot more complicated than dreaming about "eyeballs" or some such social media metric.
That's where we come back to our original premise: Value to us is not a philosophy, it's a prerequisite. Philosophically, we believe that we're appraisers of businesses in an *inefficient* market.

Your west coast education is showing. You reject the Chicago school?
We do not believe the market is efficient; we think it's quite clear that the market quite often makes mistakes. Not because investors are dumb. There are lots of really, really smart people in our business. The market makes mistakes because people are emotional creatures. They don't like uncertainty. They don't like unpopular things. They don't like, in some cases, hard work. They don't like things that are off the beaten path.

So many of the values that we're finding exist because it takes extra work to find them. You do have to go and appraise a bunch of assets, or you do have to deal with foreign accounting or foreign regulatory filings. Or you do have to own things that are really, really unpopular — have the stomach to hold them. But those are the sorts of things that the market will give us at way too cheap of price. It's seldom just a case of we did our model, you did your model, and we came up with a different values.

How about some current examples?
Right now, we find that people maybe don't want to look at what a hydroelectric dam is worth. Likewise, people don't want to buy a nuclear power plant after Fukushima. Nor do people want to buy anything in Russia right now. In other instances, they don't want to buy a gold mine here, after a tremendous three-year bear market in gold mining stocks. So we're on the other side of market psychology there, as opposed to just applying different math.

Very much so. Clearly, you don't mind waiting a long time for "value to out." So you're not on broker call lists for crazy options baskets designed to turn short-term gains into long-term ones for the tax man?
What's that?

I was making a snide reference to the recent stories about Renaissance, SAC and some others buying specially packaged options to avoid paying taxes at short-term capital gains rates.
Oh. Well, we try very hard not to focus on the short-term. That's a game everybody is playing and I don't know who's that good at it. People will say, "Oh, the short run is all that matters," or, "If you have a bunch of good short terms, you do well in the long term." And, of course, we often hear, "In the long run, we're all dead." But what I say is, "The short term is just a guessing game," and, "If we can buy things for way less than they're worth, we will do well in the long term." If you're doing well in the long-term — which we've been fortunate enough to do — that generally means you're going to have a lot of good short-terms, too. But if you have to look for that catalyst and try to beat the crowd in figuring out *when* things are going to be good — that's a tough game.

Funny, isn't it? The investors drawn to that excitement find it intolerable to buy something the crowd doesn't covet.
Yeah, we'd much rather buy things that look so bad that people — and even we — can't imagine when things are going to get better. Those are the stocks that make us the most money, and quite often they're the ones that we don't have to wait long for. They're just so cheap — and that often gets recognized sooner rather than later.

Yet your selection process doesn't include any requirement that you see some sort of catalyst in the offing?
No, not at all. Like I say, some of our best ideas are the ones *where we can't even image the catalyst*. We've found out that value turns out to be its own catalyst.

Let's back up. I should ask how much you have under management at this point.
Well, we opened our funds with very little at the beginning of November, and we are now over a billion dollars. So we're feeling very good.

I covet your marketing team! Are they even free to show prospective clients your performance records from your previous incarnations?
What we're able to do is point out to people that they can look at the mutual funds that I ran as sole manager to see my track record over those periods. Those are public records. That is what most everybody is doing. Then, for people who want to go back further, get a sense of my longer track record, we've been able to point to some old magazine articles and other things that have published about how we've done. But we're not allowed to go back and recreate those track records.

I thought those regulations might challenge your marketing folks. But that ancient history implies you're not kidding when you call yourself a patient investor.
Yes, it does.

So Kopernik now employs 12 or 18 professionals?
Actually, we've got 34 people at the company now. Ten are full-time research people and 4 are traders — we are trading 24 hours a day. It takes a lot of people to get a lot done.

Making traders work around the clock is one sign that the "global" aspect of your business isn't just for show.
They are very helpful. Especially given our attention to the prices we pay, having traders who understand us and can get the best prices — and who know the markets, because some of the foreign markets are more challenging to trade in than others — we think our traders add a lot of value to the portfolio.

International news has been dicey, to say the least, lately. And you own stocks in out of the way little places like Russia. Are you getting clients calling up and asking if you're out of your mind?
You know, we go out of our way to point out the kinds of things we're doing to prospective clients. Our goal is not to simply say, "Come on in, look at our numbers and give us money." We *accentuate* the fact that we have a lot of money in places like Russia and in gold mining companies and in uranium companies. We try to make sure anybody coming in understands what we have and why. What we want is to attract investors that 1), conceptually are on the same page, and 2), can stick it out.

Because if not, they could be hammered?
If you look at the portfolios of people who sold in 2008, that was unfortunate for them. I feel the key is to let people know what we're doing and so attract the people who can ride out a downdraft, because those ultimately will do well.

Not to mention it's awfully inconvenient for a value fund to see redemptions just when it probably sees lots to buy. But it takes a special mindset to ride out downturns in a contrarian fund.
I think so. John Templeton was one of the guys I admired most when he was around. He left us with many wonderful quotes, but there's one I like in particular: "Everybody keeps asking me, 'Where do things look best?' That's the wrong question. The right question is 'Where do things look the *worst*?'" I think he was exactly right. So we go out and tell people, "Look at Russia and Ukraine — and here is why we are buying there."

You simply disregard political risks?
Trying to predict politics — I don't know if anybody is good at it — I know we're not. But I think the way to go is to buy in a market when most people are afraid of it. Years ago, when people were afraid of Lula [Luiz Inácio Lula da Silva, Brazil's left-leaning president from 2003-'11], that was the time to buy Brazil. And when they got scared of Obamacare, that was the time to buy U.S. health companies. Now there's this extreme hatred of Russia, so they're just giving away some incredible

franchises that could never be replicated. How the politics work out — I'll let other people worry about that.

There's plenty to worry about —
I wrote a piece a few months ago, trying to compare investing in Russia now with investing in Japan, back when Templeton was buying there. Of course, hindsight helps a lot. But with hindsight, why wouldn't you buy a growing market at four times earnings, versus a more mature market at 19 times earnings? Well, here we are with the same proposition. You can buy the mature U.S. market at pretty high valuations or buy Russia. It's not a fast-growing market but it *is* a growing market — an emerging market — with incredible resources and a growing economy. It has very little debt, trade surpluses, a roughly balanced budget, educated people — and huge monopolies control all these resources and other businesses. Yet people want to give them away at 20 cents on the dollar. So like I said, I'll let other people try to guess the politics.

I see your point. Except this is a case in which you can't even rely on the most basic rules of law.
Yes. It's all very difficult. I mean, it's probably even dangerous to go there. But being overly concerned about the rule of law might have kept you from investing in the U.S. in 2008-'09 — when *we* were breaking the rule of law about whether mortgages had to be repaid and all sorts of other things. But that was the wrong time to back away from the U.S. I didn't approve of what the U.S. was doing then, but it still was a good time to invest in the U.S. You know, politicians do things, and you can agree with some of them, and not agree with others. My point is that you don't have to like what the Russians are doing to like buying some really good companies at amazing prices.

Then you're happy to buy from billionaire Russian kleptocrats desperate to get money out of the country any as fast as they can?
Sure. If you had *all* your money in Russia, this would probably be a decent time to try to diversify and get out. I don't think people should have all their money in *any* place, even in the U.S. or Europe, in a world like this. People should be diversified in as many countries and regions and currencies as they can. We certainly wouldn't suggest anybody have all their money in Russia. But as part of a diversified portfolio, if the market is giving things away in Russia now, and in China, or in the Ukraine, then we're happy to buy some of that stuff.

Let's talk about the macro risks. Your outlook evidently isn't too grim, even if you've clearly indicated displeasure with central bankers.
We spend *zero time* on macroeconomic forecasts. We do pay attention to what is happening, so certainly we're aware that the U.S. central bank has quintupled the money supply. That, by definition, is inflation, though right now the symptoms are all in the asset markets, which makes people happy. When inflation rolls into other markets, though — We don't know when and how, but we know that it's an extreme possibility.

So if somebody is looking at buying a Treasury bond, we're not going to make a prediction. But in the face of massive, massive money printing, we would want *way higher than normal* interest rates to take that risk. Yet right now investors are willing to accept *repressed interest rates* — and we'll let other people do that.

If it works out for them, they can make their 3% or 4%. But if rates go back to where they were when I came in the business, they'll lose 85% of their money.

Not a very appealing risk/reward.
Contrast that to buying gold. We don't have to make a prediction on the price of gold. We can just observe that there used to be, in 1980, $400 in currency float for every ounce of gold out there, and now there's $15,000 out there in circulation for every ounce of gold. I'm not predicting that gold goes to $15,000 or to $2,000. Who knows? But if it's going anywhere from $1,000 up to multiple thousands, I like the risk/reward of owning gold *a lot*. While the risk/reward of owning a Treasury bond is something I'd rather avoid. But we're not going to make predictions on either. It's simply that if the market wants to give us a free option on gold, which it does, we'll take it. Since the market wants to give us nothing but downside on the Treasury bond, we'll leave that to others.

But none of that requires making macro forecasts. Now, when people get emotional and assume the end of the world, we're always willing to assume the world will still be here. Conversely, when people are assuming all sorts of wonderful things, we're willing to assume ahhh, they might be okay, but let others get excited and pay high valuations for things we don't own.

Do you make a point of keeping a stash of cash to deploy when the market serves up sudden bargains?

To us, cash to us is just a residual of the process. We don't have a crystal ball that says stocks are going to go down so let's raise cash. What we do is constantly look at the 50, 60, 70 stocks in our portfolios. Some of them, if they're getting cheaper, we're buying more. But others are going up, and those, we're trimming. This means we'll trim 50 basis points here and add 50 basis points there, and the cash balance generally stays low.

Still, when you have a market where everything is going up, like in early 2007, then lots of trims happen and not many buys happen, so the cash balances tend to go up. But in the markets where something is getting cheaper, the cash balance gets thin.

What's thin?

In our global portfolios. the cash balance is generally been between zero and 10%. Back in the days when we had U.S.-only portfolios, the cash would go higher. But today cash is generally nothing but a residual. Cash certainly is not an investment, yielding zero in nominal terms and less than zero in real terms, and with a central bank is committed to having drops in prices. It's not something that we should want to own. But that comes down to what the whole concept of risk is again. If you believe that volatility is risk, then cash is good and emerging market stocks are bad.

If I believe that — No.

Well, if you belive paying too high of a price, getting too little value for something is risky, then cash is bad. Over the last 100 years, cash has lost 99% of its purchasing power. There haven't been a lot of worse investments than that. Yet if somebody owned the Dow Jones Industrial Average over that span, they (or their offspring) have experienced tremendous volatility. They lost 90% of their money from '29 to '33; they lost half their money from '72 to '74; they got beat up in a couple days' time in 1987 and they lost a third of their money. There was the 2000 problem. There was the 2007-2008 problem. And yet that family not only maintained its purchasing power, it made a whole lot more. The Index is up 360 times or something.

In emerging markets, we don't have the data as far back, and they have been much more volatile, but they have actually performed much better. So, if people are worried about volatility, they can stay out of stocks and go with cash. But if they're interested in preserving and increasing their wealth, well-priced stocks in the growing parts of the world will serve them well and cash will serve them poorly.

Most likely, but we both know those long-term index returns are something of an illusion; they don't reflect the costs of the wholesale turnover in index components over that span, much less the demise of many. And there weren't any low-cost tracker funds available 100 years ago to attempt at least eliminate the heavy lifting from the roller coaster ride.

That is true — and index funds have plenty of problems of their own. But if you'd owned a wide selection of stocks, the index probably gives you an idea of how you would have done. Plus, you can see in what the Warren Buffetts of the world have done that good active management can do a lot better than the averages.

I've always thought Buffett's achievements pretty singular.

What I mean is that you don't have to buy "the market." As Buffett has demonstrated, investing in stocks is an opportunity to buy the businesses you want to buy — and not buy, or sell, the businesses that you don't want to buy. And it's amazing the good businesses we can get at huge, huge discounts here. So we like the stock market, even though we don't particularly like the S&P 500.

Because?

The market right now seems to paying really high prices for biotech and health care, for consumer discretionary and for some regular technologies. In country after country, you can look and ask, "Wow, why are they paying so much for that?"

Does anything put you off a sector like consumer discretionary stocks — other than the prices?

The whole concept of what a consumer stock is fascinates to me. If you look at our portfolios right now we own zero shares of companies in what are considered consumer discretionary categories. Yet I can easily make the case that almost our entire portfolio is geared to the consumer. Not to the U.S. consumer because — yeah, we own right now zero of what is considered consumer discretionary stocks, but I will make the case that we have almost our whole portfolio geared to the consumer. We don't have it geared to the U.S. consumer; we don't have it geared to that top 1% consumer. Instead, we have our portfolio geared to the consumers investors were actually excited about three-and-a-half years ago.

Emerging market consumers, in other words?

Right. Back then, people were saying, "Wow, it's a big world and you've got hundreds of millions of people that are just being exposed to capitalism and are living in growing economies." Meanwhile. all of these people in India and China and Indonesia and Brazil and all of Latin America — these people have gone from subsistence living to making $4,000, $5,000, $6,000 a year. What are they going to do with that income? They're going to buy cell phone service and they're going to buy electricity for their apartments and they're going to buy fuel for their motor scooters and they're going to buy protein to add to their diets. Investors were actually *excited* about all this stuff not that many years ago.

The past tense is telling us something there.

Sure, so *today* — if you want to buy Chipotle, people are asking for something like 40 times earnings *for a burrito stand*. And Under Armor, a few months ago, traded at 100-something times earnings — These are good companies, but come on!

By contrast, we can buy companies selling to that growing base of consumers in the developing world without having to pay 100 times earnings. We can pay 8 times earnings, we can pay a quarter of book value. Yet we are buying companies selling into a growth market, meeting sustainable needs, in a growing part of the world at *really* cheap prices.

So you're hinting at something by mentioning sustainable needs?

Yeah, we own a lot of what I consider consumer stocks in emerging markets. They're just categorized as utilities and energy companies and mining companies, that sort of thing.

Is your global asset allocation simply a residual of where you find values, or also driven by other considerations?

It is 100% bottom up but we do factor it a margin of safety. We like the idea of a margin of safety as much as any other value investors. But if someone says, "We want a 30% margin of safety," our reaction is, "Why 30%?"

You treat it as a sliding scale?

Right. If we did a really conservative valuation of Johnson & Johnson and found we were able to buy their stock 10% too cheap — which we can't — but if we could, we'd accept a 10% margin of safety to own Johnson & Johnson. But if they brought in a management team we didn't trust, maybe we'd want 25%, 30%, 35%. If they moved their office to Southern Europe, maybe we'd want our 30%. If Johnson & Johnson shocked us by moving their headquarters to Moscow, we would not say, "Wow, this is a crappy company — we will not buy it at any price." We'd say, "We have much less certainty. We want a bigger margin of safety. We want at 50% discount," and we would insist on it.

How do you go about doing your research and valuations?

We start with an industry. What do we like about the industry, who are the winners, what are the key attributes we're looking for? We'll value it six or seven different ways, but we'll focus on DCF or on liquidation value, replacement value. Then we look across the globe for a discount to the industry's metrics. And of course we want bigger discounts for things like geopolitical risk, management risk, inappropriate balance sheets, product obsolescence, etc. So we definitely want bigger discounts for Russia or China or Ukraine than we want for other places.

It's funny, the markets have created this bifurcation in valuations. Yet for many investors, investment decisions are only binary. I've talked to a lot of people who just say, "Invest in Russia?? No!" I'll ask, "What does 'No' mean? There's *no* price at which you would buy?" It's amazing how many people say, "Yes., there is no price at which we would buy Russia." That's crazy.

It reminds me of the late-'90s when I would go to clients and say, "People really don't like sin stocks now, so we can get bargains in casinos, alcohol, tobacco and hand guns." What surprised me was how many clients liked the basic idea, but would say something like, "Go ahead. But no tobacco." And add "at any price," if pressed. Well guess what? That turned out to be a beautiful time to buy Phillip Morris. So when people get binary about things, that's too rigid, and we risk-adjust everything.

You've mentioned gold a few times. I'm guessing investors have gone too binary in their rejection of the barbaric relic, in your view?

We have 25% of the portfolio in precious metals/minerals right now, which is the most we've ever had. We never can go above 25%. There have been only three times in my 33-year career when I've taken a position to 25% of my portfolios. In technology in '02 and in gold in '08 and in gold again now. It was just so cheap.

Investors hung up on dividends aren't particularly attracted to cash drains —

Once again, people like stable cash flows. And

The term "margin of safety" refers to a principle in value investing and is the difference between a stock's price and its intrinsic value as determined by an investment analyst. Margin of safety does not guarantee a successful investment and does not guarantee any portion of a fund's holdings against a loss of capital.

you don't have stable cash flows in an industry where the price in dollar terms fluctuates all over the map and in which costs keep going up — and probably will keep going up. Then too, many of the mining company managements have earned reputations as value destroyers. Plus, it's a tough business, and margins fly all around. But like a lot of things cyclical, gold stocks were a great buy in '03 and in '08, when the companies had no margins. By contrast, when margins were very high three years ago, it was a great time to be selling gold miners. But people bought, instead. Now margins have been crushed again and people are dumping them at unbelievably low prices.

It sounds like you're buying, but how do you value gold?
Well, I can show you cash flow models saying that these things are worthless and I can show you cash flow models that say they are worth 10 times what they're selling it at or more — it's all about the assumptions you put in — so we'll see.

Gosh, you don't say?
[Laughter] Sure, so DCF models, we love them. We love to do scenario analysis and whatnot. But to pull in some numbers and then look at a model's output and say, "It must be right," is a tough way to make a living.

So I ask again, how do you decide gold is value-priced?
What we do is ask, What does the market say an ounce of gold is worth? Today, that's roughly $1,300. Then we ask, Suppose we dig a hole in the ground and bury that ounce of gold, now what's it worth? The market here is saying, "We'll sell it to you for $1,000." So I say, "Done." The way that $1,000 cost breaks down is that they're selling the actual gold for $200, and it'll cost me $800 to dig it up, but I'll take that. So in buying mining stocks, we're buying something that does have value at a discount to the current liquidation value. We don't pay for our top-down views, but boy, do we like when we can get a free call option — which we've got on the price of gold. If the price of gold goes up, the amount of property these companies own that becomes economic to mine starts soaring. These companies don't have very big profit margins now, but with higher gold prices, their margins really swell — as people saw four years ago.

So you're clearly convinced gold stocks are too cheap?
Look, gold has been valued throughout all recorded history. Yes, at current prices for the metal, there aren't going to be new mines built. Barrick even stopped building a mine they'd already poured billions into. At current costs, you probably need a gold price of $2,000-$2,400 an ounce just to make it economic to build new ones. So buying something way below the incentive price is attractive, and buying something that, on a monetary basis could go way, way higher is attractive. But even if I'm wrong on all of that, we're still likely to make good money buying mining stocks below the current liquidation price.

The bull case on gold is true. It's a valuable, very scarce commodity that they're not making anymore of —

But that also is scarcely consumed —
It fundamentally could be worth a lot more, so we like it. But the bears are also right. Like I said earlier, the cost of production is high, managements tend to make mistakes and geopolitical risk is high. Some countries are demanding a bigger piece of the pie and probably will keep doing that. But we want something of value and we like risks that can be diversified, so we've diversified.

Did I hear you have a gold mining stake in Romania, of all places?
We have the big miners, with big reserves. There are not many mines in the history of the world that have more than 20 million ounces . So we own a lot of them. But we've also diversified by buying some in Romania and some in Mongolia and in Papua New Guinea and all over South America. We have a couple of good ones in Alaska and in Canada. They are all over the place. Some will disappoint us and some will make a lot of money for us. That is what happened in '08. A couple didn't work out and others worked really well. These reserves won't get developed next year or the year after, or the one after that. The mining industry has it tough. Even in Alaska, people don't want them permitted, so it will take a while.

Doesn't you risk sitting with dead money, or worse?
Look, if you assume the gold price never goes up and use a 10% discount rate to value these mines, lo and behold, they're not worth much. But if you're interested in buying a bunch of gold for its option value while the central banks print lots of money, you actually should prefer the miners with the longer-lived reserves. The mines that aren't going to produce fast have more optionality.

We have, like I say, some mines that are mining now and have good DCFs and we also have some in Alaska and Romania that won't be mined for a few years, and we have way more option value on those. So we have a diversified portfolio of cash flow and options and it's all what we think is a good discount to liquidation value.

Little gold mining prospects in far flung places have a — too well deserved — reputation for often being holes in the ground, with liars at the top. How do you try to protect yourselves?

I use that line a lot. People don't expect it from me, when I'm talking about the miners we own. But it is often true. So, for instance, if Nestle is the right price, we're happy to buy it without flying to Switzerland to visit management. While in turnaround situations, we often do like to talk with the folks running the company. And when it comes to buying miners, we'll travel the world. We've been to most of these places — like to see that the holes in the ground have hundreds of millions of dollars worth of But you know in turnaround situations we do like to talk to management, and mines, we've traveled around the world — we've been to most of these places — we like to see that hole in the ground has hundreds of millions of dollars worth of bulk mills and slag mills and autoclaves and power infrastructure and whole communities of people who know how to get the stuff out of the ground. We pay a lot of attention to that.

Why uranium? Fukushima still overhangs the industry, not to mention Japan.

The uranium story is incredible. We like it when you can see that the people on the other side of an issue are probably just quite wrong. Yes, Fukushima was horrible — I happened to be in Tokyo when it happened — and nuclear accidents are terrible. It's also terrible when people die in coal mines or building hydroelectric plants. It's terrible when they die on oil platforms. Maybe in some ways, we'd all be better off if we just stopped using energy. But I don't see any of us willingly making that sacrifice. We'll keep using energy, and all its different sources have advantages and disadvantages.

But nuclear is feared the most; probably because of its association with the bomb.

Nuclear power, however, creates no pollution (barring accidents) and no CO2. It has very low variable costs. It hasn't caused that many deaths — nothing compared to coal. I'm not saying it's either good or bad. It's both. But after Fukushima, the Japanese shut down their plants, the Germans very publically said they will shut down theirs, and others have looked likely to follow. The conventional wisdom is that it was the end of the industry.

You must disagree. I see uranium producer Cameco (CCI) in your portfolios.

Well, we went to visit them to ask how they'd survive, with no one building nuclear plants — and discovered we were misinformed. Cameco says nuclear is a growth industry, with more than 80 new power plants slated to be built, globally, over the next decade. Even if you subtract from that all 20 that the Germans had been planning, before Fukushima, that's still 60 more plants.

Which is pretty interesting, but the story gets way better than just the growth business — they are going to run out of uranium. For a dozen years now we've been using more uranium than we've mined. that's a lot of years.

But that's because we had a lot of Russian bombs to convert to peaceful use.

Right, the "megatons to megawatt program" provided a decent percentage of our electricity for 20 years. But that program ended in November, after making some big final deliveries. Those deliveries, plus the disappearance of Japanese demand, meant that stockpiles of uranium are very high. But the Japanese are trying to slowing come back on line and there are no more Russian bombs to decommission, so every month uranium inventories go lower. Even the bears agree. They just don't see tight supplies for two to four years.

You see it sooner? Nuclear power plants aren't built, or rebuilt, in a day.

Well, it seems that it's not economic to build new uranium mines unless yellowcake is selling for $75 or so a pound. Its price has dropped over the last 7 or 8 years from $137 a pound to $28. And uranium mines aren't built in a day, either. Even the bears will agree with that. The bears just say, "But that's two, three, four years off in the future." Well, if the price is going to bounce back from $28 to $75 — whether that takes one or four years, I'm not going to quibble. I'm just going to buy it now. It's not everyday you can buy something that people need. You're not going to spend billions on a nuclear reactor and then not buy the uranium. So the fundamentals are just incredible.

You're not in a hurry, but can Cameco afford to wait?

Actually, at current prices they're about the only uranium company on earth not losing money.

Where else are you finding scorned and

neglected values to buy?
How about a Chinese railroad, for starters? When I bought a lot of U.S. rails 10 years ago, people groused that 100 years of history showed they never earned their cost of capital. But they were so cheap that they didn't have to, for us to make a lot of money. Now it turns out they have the best economics for long haul transportation, better technologies and huge competitive advantages — and they were very good investments for 10 years. Then, after Fukushima, Japanese rails, which were always expensive, suddenly were available at big discounts. So we bought Japanese rails last year and then sold most of them when they started flying after the election.

So now, what do people hate? China, as unbelieveable as that would have been just three years ago. But all of the sudden we can buy Chinese railroads for a single-digit P/Es and at discounts to book.

They're not buying that many cars—
Exactly. We've bought Guangshen Rail (525 HK), which operates passenger trains in the super-densely populated corridor between Guangzhou and Shenzhen in Guangdong, and also has a hand in the Guangdong Through Train service from Hong Kong. Those runs are too short for airline competition, and lots of people need those trains to get to work. Yet it's selling now at less than two-thirds of book and 13 times earnings — with the book value growing nicely.

Increasing book value, by the way, is a common characteristic of our holdings — another place where we're leaning against the popular trend. When you look at as many financials as we do, it's interesting to see how many companies — particularly in the U.S. and Europe are finding different ways to move book value *into* the earnings statement, instead of having the earnings statement flow into book value.

Flowing in reverse, to follow the incentives, naturally! Do you care to elaborate?
Sure, many companies will show good earnings, but when you look at book value, it's gone down, not up. For a lot of reasons. It's easy to manipulate earnings and it's also easy to convince people they shouldn't count one-time write-offs — even if the one-time write-offs happen every single year.

"Serially recurring non-recurring events."
Yes, it's like, "Okay, we bought something, paid a bunch of money for it and we all agree it's better to capitalize it." But the next year, they write it off and shrug, "This is a non-cash charge." Well, yes, but last year it was a cash outlay and we didn't write that off, either. Then there various currency this and thats which don't need to hit the income statement. And of course the very popular move now is to buy your stock back, even at massively inflated prices. After all, if you're just looking at ROE, you can make it go up with higher earnings, but that can be difficult. But you can also get it up by getting the E to go down — the company's equity to go down — so why not drive down your equity; write off some of your book value?

Then, if you take cash out of the bank and buy your stock at, say, 33 times earnings — well, all right, so assuming no growth, you're buying your stock back at a 3% return. Now, history and logic will suggest that if you buy a mundane company at 33 times earnings, you're destroying wealth. Eventually, that stock will find its way back to 10 or 15 times earnings, and so you've just pissed away wealth in the long run. But in the short-term, if your cash is earning zero in the bank and you invest it instead in your own shares at 3%, your earnings go up. Now, your book value drops, but no one complains; they're too happy watching ROE "explode." Everybody is happy.

Especially executives with fat packages of incentive options, as Andrew Smithers tirelessly points out.
Absolutely. They are incentivized too get the short-term goose, cash-in their options and let others worry about the long-term.

We're contrary. We *like* companies that actually grow wealth that you can see accrue on the balance sheet but nowadays those are easier to find in emerging markets than in developed markets.

This year we're seeing lots of deals, deals, deals, as my old friend Mario Gabelli likes to enthuse. Is at least some of that tied to what we've been chatting about — companies getting creative to make their numbers?
I think so. If you buy something at too high of a price, based on long term fundamentals, but the return is greater than zero in this environment — and you can take your cash out of the bank to that — you've just inflated your earnings. Or if you can buy something that's even returning 5%, while you can go borrow money at 3%, again, you've added to short-term earnings. Let somebody else down the road deal with the consequences of the wealth you probably destroyed by buying whatever it was at too

high a price.

Not to mention that repressed interest rates have been a great gift to all sorts of private equity firms with deals that never would have made it in a higher-rate environment.

ZIRP has bailed out a lot of people. I have no idea how long the central banks can keep them at zero, but I know for sure that they can't keep them there forever. What can't last, won't last. They can control interest rates or they can sustain their currencies but they can't do both. You can't just keep printing money out of thin air and buying bonds with them and using those bonds to buy goods and services and have that game going forever. If I'm wrong, then this is Nirvana and none of us will ever have to work again. Why don't we all just quit our jobs now and the Fed can print everything we need?

Maybe that's the ultimate irony: This is Nirvana but we don't realize it. But before we get carried away, you mentioned Brazil and hydro power. Does that mean you own something as big and ugly as Electrobras (ELET6 BZ)?

Yes, and there the investment question comes down to cash flow. If you have an asset, however tremendous, that's only allowed to earn zero, maybe it's only worth zero. On the other hand, if it's allowed to act as a monopolist, controlling something people need, the best, cheapest and least polluting power source in the world, it has a huge competitive advantage and really should trade above replacement value. It should produce excess returns.

So which will it be?

I just know that a bunch of hydroelectric dams are worth somewhere between zero and a big premium to the cost of replicate them. Let's just say it's worth somewhere between zero and $3,000 per kilowatt hour of production. Now which is more sustainable? The value of hydroelectric dams or the notion that politicians will keep rates at zero forever—while the public endures blackouts and brownouts? My bet is that regulation is a cyclical thing. Still, you'd want to take big discounts because Brazil is and emerging market, and because of uncertainty about its government. So insist on getting it for half price. Say we wouldn't pay more than $1,500 a kilowatt for it, or even $1,000. Well, the market is selling it for only $300-$400.

Right now Brazil seems very risky. But when you can buy a monopoly at one-seventh of the replacement value and you've got staying power, it's probably not all that risky at these prices. Besides, our risk in something like Electrobras can also be diversified out. We have a similar holding in Russia, where we're also paying $300-$400 per kilowatt. A year ago, we could buy nuclear power in France for less than $1,000 per kilowatt; it's replacement value is probably $6,000-$8,000 per. Besides, if we can buy good, productive, monopolistic basic-needs assets for huge discounts, we can be wrong on a few of them and still make a lot of money.

You don't think in terms of batting 1,000?

Ha. It's all a numbers thing. We have 60-70 names and some of them are going to go up five or ten times. So we don't have to be right on every one of them. Our job is to appraise businesses and look for big differences from the market's opinion. We'd have to be stupid and arrogant to think we're going to be right every time. So we try to be right two-thirds of the time and accept being wrong a third of the time. that works out very well. Then, if we can make way more money when we're right than we lose when we're wrong, it gets even better.

It should — if nothing else, to compensate for the loneliness of the contrarian life! Thanks, Dave.

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Gazprom OAO	Russia	4.2%
Japan Steel Works Ltd	Japan	4.1%
Cameco Corp	Canada	3.7%
Newmont Mining Corp	United States	3.5%
Sberbank of Russia	Russia	3.2%
Federal Grid Co.	Russia	3.1%
RusHydro JSC	Russia	3.0%
Barrick Gold Corp	Canada	3.0%
Peabody Energy Corp	United States	3.0%
Total Percent in Top 10 Holdings		35.2%

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