The Big Long

> "Bear markets make people a lot of money, they just don't know it at the time."
>
> -Shelby Davis

> "The return to monetary stability does not generate a crisis. It only brings to light the malinvestments and other mistakes that were made under the hallucination of the illusory prosperity created by the easy money."
>
> -Ludwig von Mises

The Big Short is a movie that is currently in theaters and is nominated for five Academy Awards, including best picture. Based on Michael Lewis' well written book about the actions, travails, agony, and eventual triumphs of a group of eccentric, independent and contrarian-minded investors who bet on the "inconceivable", yet, in reality, inevitable collapse of the mortgage market. In two hours and ten minutes, the picture does a decent job of portraying the pain that is inflicted upon investors who are too early. The collapse of the hugely overextended, and arguably corrupt, mortgage market took over three years to unfold. Once it did, Wall Street ignored it at first, and refused to reflect reality into the price of securities. It had to be excruciating for these maverick investors. As Howard Marks notes, "successful investing requires the ability to **look** wrong for a while." He mentions David Swensen's (of Yale) 'terrific phrase': "Uncomfortably idiosyncratic."

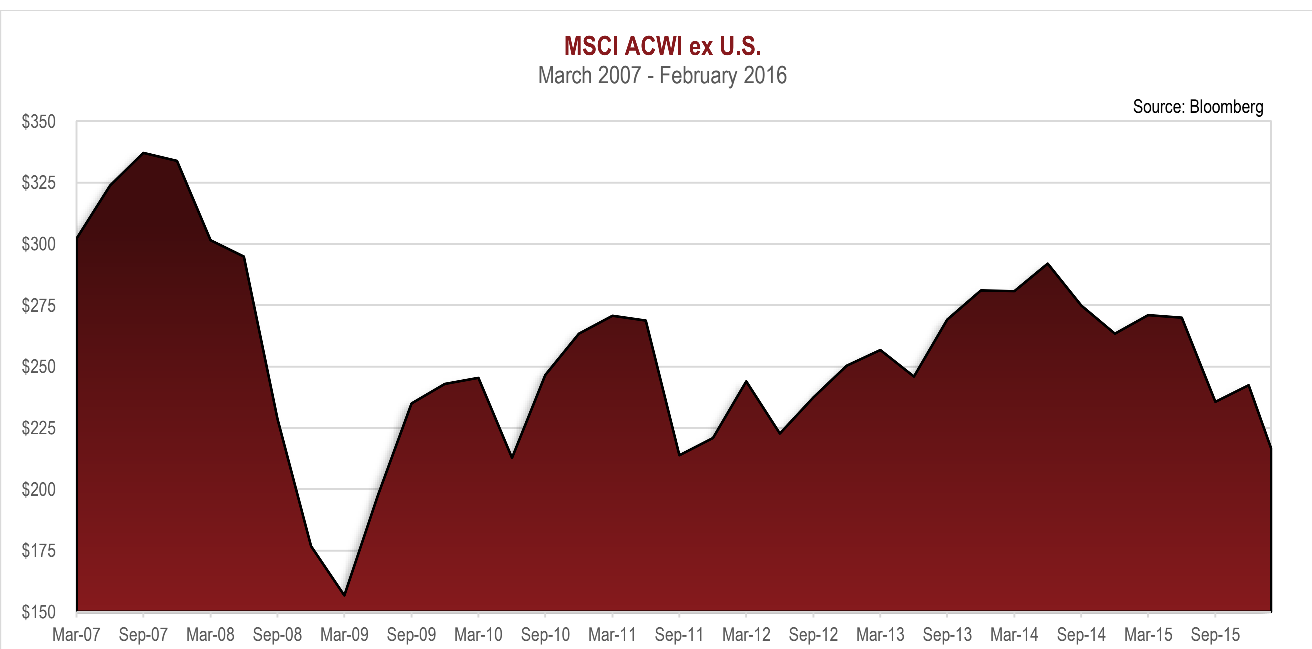
The movie begins in an era, roughly a decade ago, when, because mortgages in aggregate had been stable, arguably safe for decades, people ignored the principles of economics; didn't worry about oversupply; didn't worry about a borrower's ability to meet obligations. At the same time, investor aversion to negative cash flow, and to short-term loss, allowed astute investors to buy optionality (on the collapse of mortgage values) at extremely attractive prices. The result is legendary. Hence an Academy Award contending movie.

And here we are in early 2016, with much of the public fearful that, as we watch *The Big Short* in theaters, the real world is scripting the sequel. It is understood that the GFC (great financial crisis) in 2008 was the unintended, but inevitable, consequence of excessively easy monetary policy conducted by the Federal Reserve. This policy of profligacy was designed, perversely enough, to repair the damage caused by the collapse of the tech bubble seven years earlier; a bubble that, not surprisingly, was caused by excessive easing by the Federal Reserve. Slow learners, the Fed has spent much of the last decade trying to fix the problem by using a turbo-charged version of the very policy that caused the past two bubbles. Back then, people feared that the banks were "too big to fail." Now they are much bigger. People worried about excessive debt. It is now larger, both in absolute terms and, more importantly, in relation to the size of the economy. The 2007 bubble caused malinvestment in the housing and banking industries. Malinvestment is now prevalent in finance, energy, commodities, consumer discretionary goods, emerging markets and others. It's wreaking havoc. Investors feared that stock prices were unsustainably high in 2007, as the ensuing crash validated. Yet, eight years later, prices are even higher for many U.S. stocks, for high-end real estate, art, collectibles, tuition, healthcare and entertainment. Alarmingly, tens of trillions of bonds are priced at or near the highest prices (lowest yields) in the history of mankind. Clearly, we believe, the central banks messed up royally. For the third time in less than two decades 'the Piper' seems to be asking for payment: U.S. stocks struggle, post a 6 ½ year run; junk bonds are plunging from prior excessive values; and commodities have nosedived; etc. Many people are rightfully worried.

At this juncture, the tone of this Commentary changes. We hereby put forth the argument that **this is not the beginning of a bear market, but rather is the late stages of a bear market.**

Don't misconceive us; we won't quibble with the distinct possibility that we've just seen the end of the bull market for larger cap U.S. stocks or for "quality" growth stocks or for the U.S. dollar. And the end of the astonishing 35-year bull market in bonds is inevitable - it is just a matter of when. But, it is essential to notice that **the impressive performance of these select groups has obfuscated the existence of a deep, long-enduring bear market**. While the press tends to gravitate to simple definitions, such as, "a bear market is a decline of 20% or more" or "a decline of a year or more", we prefer to think about them as lasting years, often delivering torturous, deep losses, ultimately leading to panic and capitulation, and behavioral change. Let's delve into the current market further.

Facebook stock hit a new all-time high this month (February 2016). Netflix, Google (Alphabet, now) and Amazon hit new all-time high price levels in December 2015. All was right with the world. The NASDAQ composite index, though technically having peaked in July of 2015, was still plugging along quite nicely as recently as December. The S&P500 peaked two months earlier, but really meandered sideways from November 2014 through the end of 2015. The ACWI (MSCI All-Country World Index) peaked the same month. What was very different from the S&P was that it peaked at roughly the same level as it peaked in 2007. Eight years, same level. The S&P was a third higher. Leaving the U.S. aside for a moment, it becomes clear that things haven't been firing on all cylinders for many a moon. The ACWI ex-US peaked almost a full year earlier in July 2014. And that was a secondary peak that came nowhere close to the all-time peak established way back in 2007. To repeat, the index most investors use to represent the global market suggests that beyond U.S. borders, the bear for stocks may have started in September of 2007. How can this be? The table on the following page shows the details, country by country. Enlightening.



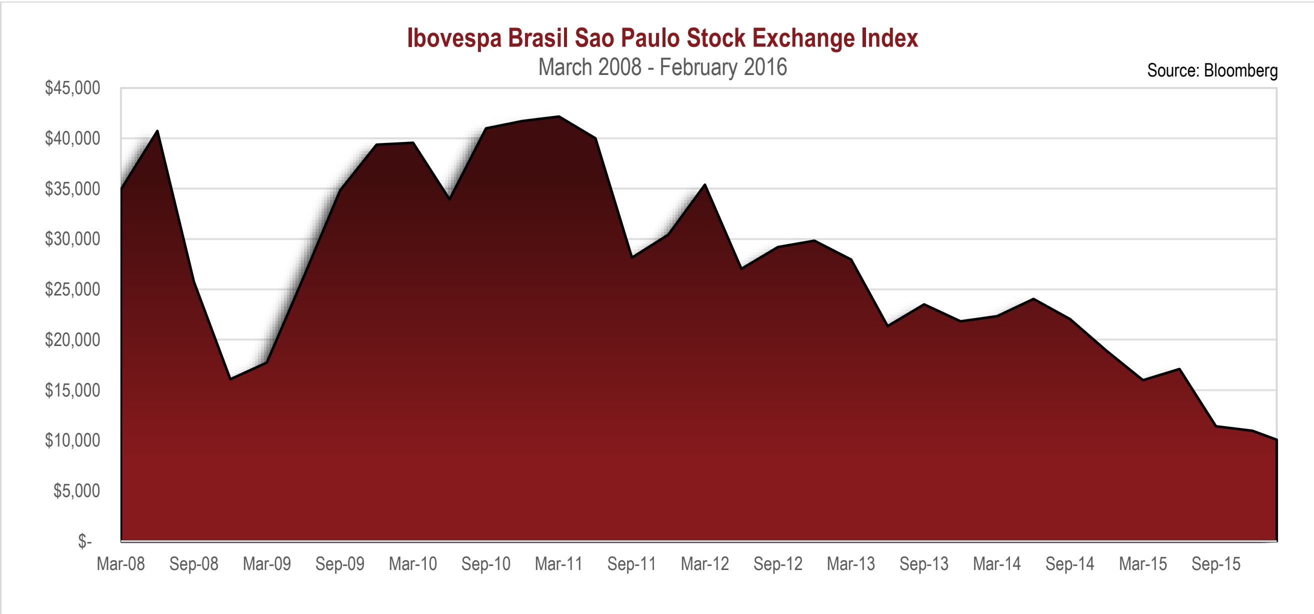
As of January 2016

Location	Index	Returns in USD 12 Month	3 Year	5 Year
Venezuela	Caracas Stock Market	269.01	1,932.99	14,918.92
Denmark	OMX Copenhagen 20	7.88	41.68	90.97
Ireland	Irish Stock Exchange Overall	12.42	50.09	78.36
United States	Nasdaq Comp	-3.32	42.94	62.00
United States	Russell 1000	-8.07	25.26	43.75
New Zealand	S&P/NZX All	-13.23	1.38	29.33
Belgium	BEL All-Share	-3.33	19.41	27.76
United States	Russell 2000	-15.95	10.77	22.46
Switzerland	Swiss Market	-11.48	3.94	19.73
Japan	NIKKEI 224	0.26	19.75	12.64
Germany	DAX Deutsche Boerse AG	-11.18	2.93	10.62
China	Shanghai Stock Exchange Comp	-8.72	22.67	9.20
Mexico	Mexico IPC	-1.51	-10.06	7.54
Thailand	SET	-25.97	-27.74	2.76
France	CAC All-Shares	-7.54	-0.64	-7.16
United Kingdom	FTSE All-Share	-14.47	-10.57	-7.62
Sweden	OMX Stockholm 30	-14.07	-10.22	-10.63
China	Shenzhen Stock Exchange Comp	-7.79	5.22	-12.85
Finland	OMX Helsinki 25	-5.46	8.94	-14.84
Indonesia	Jakarta Stock Exchange Comp	-20.37	-29.92	-16.92
South Korea	KOSPI	-11.24	-16.66	-17.55
Netherlands	AMX	-6.56	-3.83	-19.15

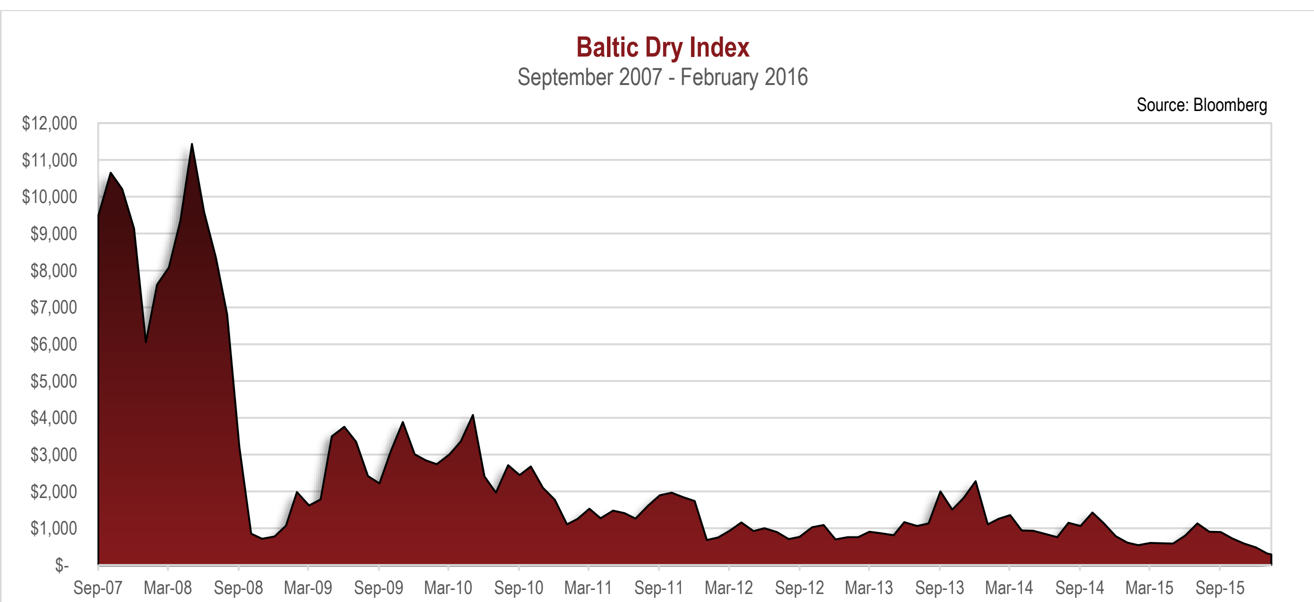
Location	Index	Returns in USD 12 Month	3 Year	5 Year
Hong Kong	Hang Seng	-17.94	-17.47	-19.98
Argentina	Argentina Merval	-27.14	13.07	-19.99
Norway	Oslo Stock Exchange All Share	-20.98	-28.42	-20.78
Taiwan	Taiwan Stock Exchange	-19.77	-12.39	-25.29
Italy	FTSE Italia All-Share	-6.37	-9.13	-25.59
Australia	S&P/ASX 300	-21.83	-32.48	-30.65
Spain	IBEX 35	-20.72	-18.43	-34.30
Nigeria	Nigerian Stock Exchange All Share	-29.12	-42.67	-36.94
Poland	Warsaw Stock Exchange WIG TR	-21.90	-31.41	-37.00
South Africa	FTSE/JSE Africa All Share	-32.43	-37.00	-38.50
Canada	S&P/TSX Comp	-31.40	-35.95	-39.14
Austria	Austrian Traded	-7.34	-29.44	-41.13
Turkey	BIST 30	-38.76	-52.60	-45.22
Peru	Bolsa de Valores de Lima	-5.30	-49.54	-46.40
Chile	IGPA	-18.88	-49.15	-49.44
Czech Republic	Prague Stock Exchange	-10.58	-34.80	-49.97
Portugal	PSI 20	-12.95	-38.63	-50.64
Russia	MICEX Stock Exchange	-13.87	-58.88	-64.63
Columbia	Colombia COLCAP	-43.37	-68.26	-65.50
Greece	Athex Comp Share Price	-35.27	-52.98	-69.98
Brazil	Ibovespa Brazil Exchange	-47.94	-68.93	-77.53
Ukraine	Ukrainian Equities	-59.51	-76.19	-92.08

Source: Bloomberg

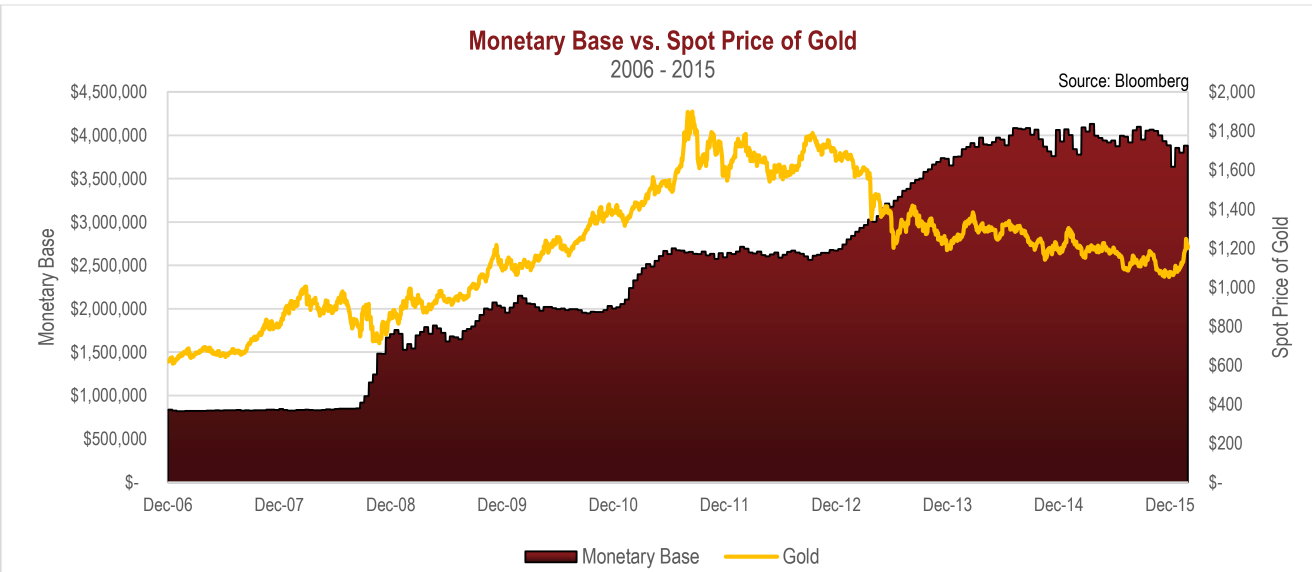
Countries that are down on a 1, 3, and 5 year basis (in US$) include France, the UK, South Korea, Netherlands, Hong Kong, Australia, and Canada, i.e. most of the large economies. China, the second largest economy, is down on a 5 year basis, but not three (Shenzhen Stock Exchange Index). Germany, Japan and the U.S. are among the few that have fared better. Australia and Canada are both down over 30% on a 3-year and 5-year basis. The formerly exulted BRICs (Brazil, Russia, India, China)? See below.



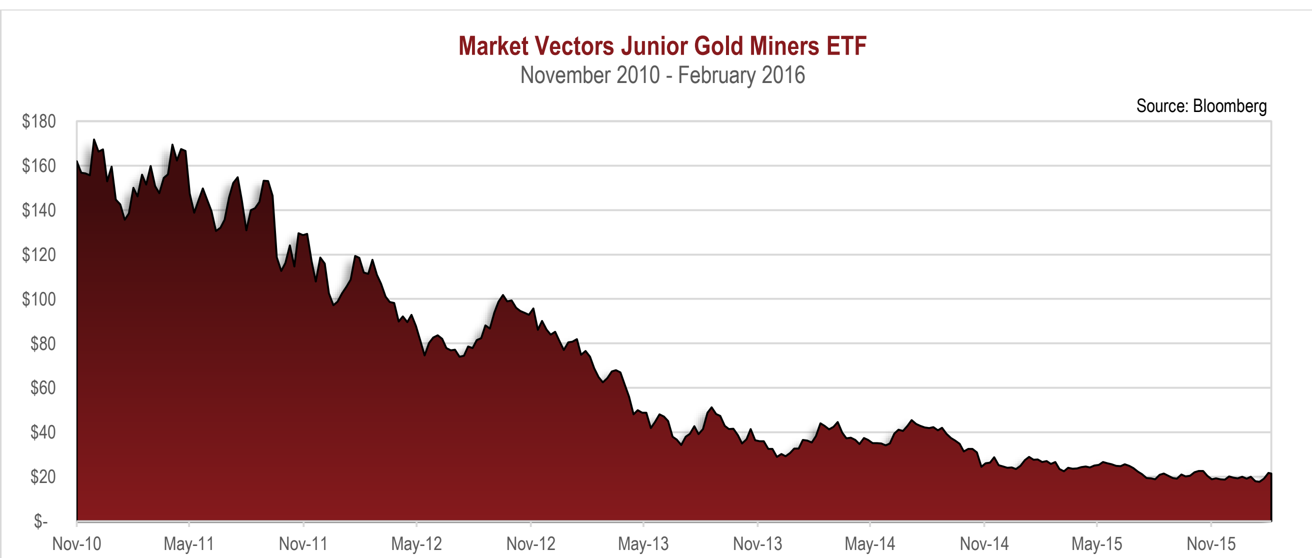
Human emotions are interesting. We all know to buy low and sell high. But things looks so damn good at the top, and so abysmal at the nadir. Oil, gas, coal, uranium, and hydroelectricity were not competitors at the top, they were all important parts of the solution to a very important question: How are we ever going to meet the insatiable energy needs of 7.3 BILLION people?! Now investors are grappling with how to unload the stigma and potential liability associated with owning archaic relics of a bygone era; so unappealing in the contemporary "post-hydrocarbon" world. People viewed China as a dynamo, a must-own economic juggernaut, destined to leave the United States in the dust. Russia, Brazil, and other economies that are well-endowed with natural resources were accorded royalty status. Along with India, the four were honored with the sobriquet – BRICs, and were must haves for any trendy portfolio. Now? Not so much. China, Russia, and Brazil are disdained as fraud-ridden, slow-growth, poorly governed producers of oversupplied dreck. Might the markets have moved from one outrageous extreme to the other? We're sure the truth is somewhere in the middle. At the height of the China hype, the price of ships leapt into the stratosphere only to fall to the lowest level in recorded history of the Baltic Dry index. We live in an era of Fed-induced extremes, and as a result, many valuable "things" can be purchased at all-time low prices.



And speaking of Fed-induced extremes, people seem to have forgotten that only a couple years back, the Fed was wrapping up the most audacious money-printing scheme since the 11-fold increase of "the Continental" in the 1700s (they became worthless within five years). Of course, money printing has been around for as long as currency has been around, so it's not the end of the world. As the quantity of one form of money increases relative to another form of money, the prices adjust accordingly. This makes sense. The chart shows that this has been the case with the U.S. Dollar relative to gold as well. The more dollars that are conjured into existence, the more dollars it takes to buy an ounce of gold. Pretty clear relationship, until 2011! This divergence is unprecedented and it is nothing if not extreme! The value of gold has skyrocketed while the market price of gold has plunged. So not only has there been a long bear market in gold, the stark plunge in the price of gold relative to the intrinsic value of gold may represent the "Granddaddy" of bear markets. **Extreme divergence of price from value is what we value-focused investors live for.**

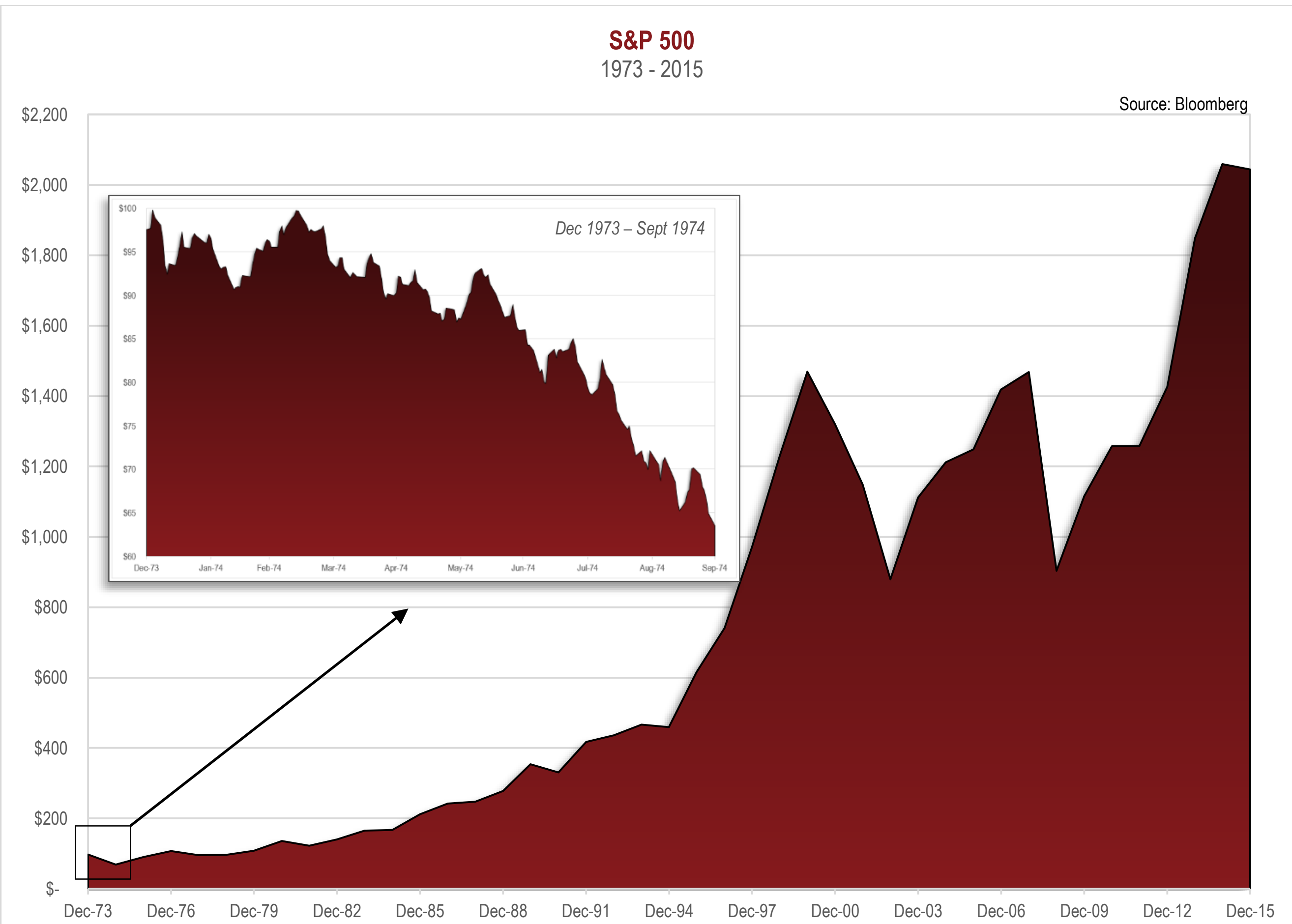


One last bear to observe. Gold versus dollars is down; gold versus the shadow price of gold is down hard; but the price required to own gold via the companies that own many of the world's remaining gold reserves/resources has been in a long pronounced bear market – down 90% from December 2010 through last month's low, as illustrated by the Market Vectors Junior Gold Miners ETF (GDXJ).



In conclusion, **it is time to be bullish!** Rather than trying to get out near the top, we believe that investors should be more concerned with getting in near the bottom. The bear market for many highly important assets/regions/sectors has run long and deep. The obvious question seems to be – when will it turn? This is the subject of the next Commentary, one that's been in the works for many months now. It should be out in the next month or so. But, in the meantime, a relevant flashback in time. In late 1968/early 1969, Warren Buffett deemed the stock market to be too expensive, shut down his investment partnership and sent back everyone's money (with the notable exception of Berkshire Hathaway, a small, struggling textile company at the time). The market, as if on cue, dropped for the next five years. This fact wouldn't be so obvious to anyone based on a quick perusal of historic stock charts. For the first three years, the index bounced around but generally remained at 1000 level (the Dow Jones Industrial Average; meanwhile the S&P 500 advanced from 90 to 115). This was a combination of most stocks falling meaningfully while many "quality growth" companies, which became commonly known as the "Nifty-Fifty", riding a wave of immense popularity, trudged relentlessly higher. Beginning immediately in 1973, the Nifty-Fifty joined their less-esteemed brethren plunging south. The result was that by late in the year stocks had become cheap. After almost five years of sitting on the sidelines, Mr. Buffett went on a buying spree. He famously told Forbes magazine that he felt, "Like an oversexed guy in a whorehouse. Now is the time to invest and get rich." This only added to his legendary status as the market, from the end of 1973 until the end of 2015, went up 6902%!! Annualized gains amounted to 10.6%.

Interestingly, what is not often mentioned, the market dropped 35% during the first three quarters of 1974!! In today's world of short attention spans, he would be questioned about performance and risk management techniques. Hindsight shows that he had come within a year's time of picking the perfect entry point for decades to come, but the immediate feedback was dismal. It is important to note that if he had timed it perfectly, his incremental annualized returns over the next 41 years would have been 0.91% (11.64% vs 10.73%). To repeat, attempted market timing would have added just over 1% annually if successful (VERY hard to do) or would have resulted in a huge opportunity cost if not successful (between 0 and 6901% over the long-term, depending on how bad the mistiming).



Kopernik has clearly been early. Whether the bear market in tangibles is over, is too early to call. What is clear, though, is that the bear isn't just starting – it started anywhere from 2 to 9 years ago, depending upon the particular asset. And it has been a deep, powerful, psychologically challenging bear market. From current depressed valuations, the upside potential is enormous. We estimate the intrinsic value of many of our portfolio companies to be more than five times the current market price. Given a choice of being too early, and possibly suffering short-term pain, or being too late and risk missing out on massive gains (the only two choices the real world offers given an unknown future), we'll make the first choice any day. We patiently await, what we believe to be, the inevitable return to rationality.

Cheers,

David B. Iben, CFA
Chief Investment Officer
Kopernik Global Investors
February 2016

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