October 14, 2022

Dear Investor,

The third quarter of 2022 ended with investors trying to find refuge in a year where nearly every asset class has fallen significantly. In past market selloffs, investors would typically flee stocks for the safety of the bond market. However, this year has seen the rare occurrence of sharp losses in stocks and bonds, not to mention real estate, commodities, and cryptocurrencies. Oil and gas are the only gainers in a difficult year for investors. Through the end of the third quarter the S&P 500 has had the fourth worst start to a year in history. Only the Great Depression, the 1974 market implosion, and the 1999 bursting of the tech bubble were worse. However, looking back at other years with negative first three quarters, all but two of the years had positive fourth quarters. There's something we can hang our hat on.

As you can see in your enclosed statement, we were not spared from losses in the third quarter. Our year-to-date performance is in line with our benchmarks, which I'm not too displeased with after having back-to-back years of huge outperformance. Our portfolios have significant exposure to commodity producing companies, and the selloff in commodity prices has created opportunity which we will discuss later in this letter.

One of the main reasons for the correction in commodity prices is the strength of the U.S. dollar. To combat inflation the Fed continues to raise the Federal funds rate and create tighter monetary conditions. The increase in interest rates results in a stronger dollar as the Fed has been more aggressive than the European Central Bank, Bank of Japan, Bank of England, and Bank of China. The others are following along but the Fed is leading the way. Commodities are traded around the world in U.S. dollars, so a strong dollar results in lower prices.

It's anybody's guess how far the Fed will go in raising rates to combat inflation. As we have all heard, the Fed has a dual mandate of maximum employment and stable prices. They are definitely failing on the stable prices mandate as inflation is the highest in forty years. The Fed has added a third mandate going back to Alan Greenspan, and that is using monetary policy to prevent recessions. Greenspan, Ben Bernanke, and Janet Yellen have all been guilty of manipulating monetary policy to prevent recessions. This ill-fated thinking was largely responsible for the financial crisis of 2008. It has been said that capitalism without bankruptcy is like religion without hell.

The Fed is truly in a self-induced difficult situation. They cannot let inflation continue in the 6 to 9% range. The least fortunate of us suffer the most with inflation and it has been described as the cruelest tax of all. Does the Fed have the backbone to bring down inflation even if it results in a severe recession?

For the past 25 years, the Fed has come to the rescue anytime the stock market sharply corrected, but they haven't had to deal with inflation since Jimmy Carter was president. What might cause the Fed to pivot is not a falling stock market, but rather a liquidity crisis in international markets. Most developing countries around the world hold debt denominated in U.S. dollars. A super strong dollar makes the servicing and repayment of these bonds difficult. The Fed's sharp rate hikes have driven the dollar up 17% year to date to a 20 year high. Market strategist, Mike Wilson, of Morgan Stanley recently said, "such dollar strength has historically led to some kind of financial or economic crisis."

The strong dollar begs the question, is the U.S. in that good of shape to have a burgeoning currency? The U.S. has a record $31 trillion of national debt and a government that has never met a spending bill they didn't like. Another budget expense on the rise is interest on our debt, which has grown 53% year-over-year due to the rapid rise in interest rates. This along with all other government spending, will plunge the U.S. deeper and deeper in debt and will ultimately lead to the dollar sharply correcting.

We're not quite sure how all of this plays out, but we do sense tremendous opportunity building. Our job is to protect and grow your money. We constantly vet and scrutinize the companies we own to be sure they are trading at a discount to their intrinsic value. With the recent selloff of many of our holdings, they range from inexpensive to extremely cheap and are fabulous long term investments. Thankfully we have a loyal and patient client base that will reap the benefits in the future.

Five years ago, our team focused on what looked like a once in a generation investing opportunity. The stock market was at a historic high and the commodity index (a basket of widely used commodities) was at an all time low. I've been around long enough to know that situations like that don't remain static, and there is eventually a reversion to the mean. This is partly what led to our investing in uranium producing companies selling at record low prices. Low prices for commodities over the past decade have led to a lack of investment in developing new supplies.

Copper and Filo Mining Corp. (FIL.CN, FLMMF)

I was recently stopped at a red light, and I noticed there were electric vehicles on all sides of me. I then realized there is no turning back from the movement to a carbon free environment. Of all the commodities required to build EVs, solar farms, windmills, solar panels, and all things electric, there is no mineral more essential than copper. Old West partner and portfolio manager Brian Laks writes the following:

We have been writing for years about how the push to clean energy will increase demand for many key metals and materials as governments around the world design policies and spend money to usher in a low-carbon future. One of the main ways to achieve this is the widespread shift to electrification, which will greatly increase the need to generate, transmit, store and use electricity. Many of the technologies proposed depend on raw materials that are either in short supply or controlled by a limited number of players and there is probably no metal more integral to electrification than copper, the primary means to conduct electricity.

Renewable energy generation, mostly solar and wind power, and electrification of the global vehicle fleet are two of the major initiatives driving this change. Both require vast amounts of copper, much more than is used in fossil fuel generation and internal combustion engine vehicles. Moving this electricity to where it is needed will also require an expansion and modernization of the electric grid, itself a large consumer of copper. Demand for copper is expected to double over the next 10-15 years driven mostly by these clean energy initiatives. Meeting this demand will be extremely difficult.

The supply challenges are numerous. Existing mines face resource depletion and far fewer meaningful discoveries are being made. Average copper grades have been declining for years making mines less productive and requiring more cost to produce the same amount of metal. Some of the largest producing countries have seen political shifts toward increased taxes and regulations that have hampered investment in new supply. Mining companies have also become more conservative after the last cycle preferring to return cash to shareholders via dividends and buybacks rather than pursue growth, and there is a shortage of skilled labor in the industry as many of the younger generation have pursued careers in finance and tech. Political will and public support can also present a challenge. Anti-mining sentiment is often seen due to environmental concerns even though many climate goals cannot be met without additional mining to provide these necessary metals.

In a world where average copper grades are declining and new discoveries are rare, a large high-grade discovery naturally caught our attention. This is what we saw last year when Filo Mining, a Canadian-listed developer with operations in South America, drilled one of the best copper intercepts the industry had seen in years. With our focus on people we of course looked to see who was involved and were pleased to see the Lundin family own roughly a third of the company. Adolf Lundin was a Swedish entrepreneur who built an oil and mining empire in the 1970s that has grown under the stewardship of his sons and grandsons. The Lundin Group made a name for themselves operating in far-flung regions of the world with incredible success. In an industry where many early-stage projects are run by cash-strapped promoters, being backed by a seasoned group of mining executives with deep pockets is very unique.

The family has a long history of operating in the region, where roughly 40% of the world's copper is produced. Three generations of Lundins have worked closely with a succession of presidents and other high level country ministers. They acquired the Bajo de la Alumbrera deposit in the early 1990s which became one of the largest copper and gold producing mines of its time. The same local team discovered the Veladero deposit, which is now a producing mine for Barrick Gold. They then picked up a large swath of land in between the region's two famous copper and gold belts, identifying three early-stage exploration prospects which in 2009 were put into a company called NGEx Resources. As the exploration work yielded discoveries, they eventually decided to spin the individual projects into their own companies. The first was Filo Mining in 2016 which held the Filo del Sol deposit in Argentina. The Filo property was what initially attracted them to the land package, with turquoise-colored rocks visible from space hinting at potential copper mineralization.

Filo was able to delineate a development project by 2019 and released a pre-feasibility study on the reserves that had been defined up to that point. They had also been doing exploratory drilling beneath the envisioned pit outline and a few months later announced the discovery of over 1,000 meters of copper mineralization. This suggested a much larger mineralized system lay beneath the project and opened up a pathway for future exploration. Follow-up drilling yielded additional kilometer-scale intercepts and in 2021 they released what many consider to be a generational discovery. In addition to high grade copper, the drill results indicated exceptional grades of gold and silver. Having ample quantities of byproduct metals can give companies more flexibility in ultimately financing a project, as it opens up the possibility of selling the byproduct revenue stream for an upfront capital contribution.

The combination of size and grade puts the asset in a rare class among the giants of history. The footprint is truly massive, with a strike length upwards of 5 kilometers, and the mineralization extends to such great depth that the company has had to order special drilling rigs to try and find the bottom of it. The company famously overlays the outline of their project with maps of large cities like New York and London to show its true scale. Their geologists now believe they have identified an entirely new mining district that will support the development of multiple projects. As early entrants to the area, the Lundin Group controls much of the land and recently consolidated that control with the acquisition of Josemaria Resources (another of the earlier spinouts) by Lundin Mining.

Many of the megaprojects in the region require billions of dollars of capital expenditures and are typically operated by joint venture between some of the largest mining companies in the world. Perhaps to that end the company welcomed BHP as a large investor earlier this year. BHP invested C$100 million for 5% of the project and agreed to form an advisory committee to help guide its development. Usually early-stage companies must offer a significant discount to attract large investors, but this transaction was notable in that it was done at a premium to the prevailing share price. It also provided the cash to expand their drill program, targeting a combination of infill drilling to better understand the high grade core of the deposit and step-out drilling to prove its extent. Given what they have discovered so far, we believe it could become one of the largest copper mines in the world.

The first quarter of this year saw copper prices hit decade-highs amid concerns about future supply. The last two quarters have seen an abrupt shift in price and sentiment as focus has shifted almost exclusively to demand. Investors worried about rising interest rates and recession risks have been selling commodity-related stocks even as their long term prospects have improved. Lead times for new mines are measured in years, and investments to fix future supply deficits must be made well in advance. In the current market environment, where prices are depressed due to short term fears, those investments are less likely to be made, further exacerbating the inevitable supply crunch.

In our view copper prices will likely have to at least double from here and stay elevated to give the proper signal for additional investment in new supply. We believe structural supply deficits in many commodities will lead to sharply higher prices in the coming years, even if current market conditions suggest otherwise. This disconnect between short term concerns and long term fundamentals presents a compelling opportunity for investors, and we have been actively raising capital to deploy into these areas.

As we enter the last quarter of the year, we are very confident the companies we are invested in have been oversold and have tremendous upside. We appreciate your loyalty and support, and we look forward to having a strong finish to the year.

Sincerely,

Joseph Boskovich, Sr.
Chairman and Chief Investment Officer

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