SIA

Strategic Investment Advisors Group

Long Term Investment Fund

Newsletter

of March 2022

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Figure 1: LTIF Classic EUR
vs. MSCI Daily TR Net World Index EUR

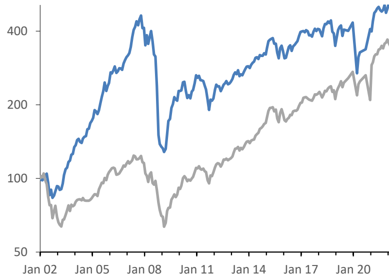

Figure 2: LTIF Natural Resources EUR
vs. S&P Global Nat. Res. Net TR Index EUR

"The one thing you can be quite sure of is if we went into some very major war, the value of money would go down — that's happened in virtually every war that I'm aware of. The last thing you'd want to do is hold money during a war... Investors would frankly be a lot better owning productive assets over the next 50 years".

Warren Buffet

Overview of our funds

Table 1: Net Asset Value - Net assets under management of our funds

March 31, 2022	NAV	Δ 3m	Δ 12m	Annualized return (s.i.)	AUM *(in mio)*
LTIF Classic [EUR]	546.93	10.7%	15.1%	8.8%	83
LTIF Natural Resources [EUR]	138.67	13.2%	33.4%	1.9%	78

Source: SIA Group

The long-term investor, in a basket of good businesses, is immune to crisis

A large part of the investment community is not fully aware of the **value of long-term investing in a basket of solid businesses (equities), which**, as we can see in the graph below, **is practically immune to any crisis.**

In the chart (which we use in uncertain times), we see that over the course of 70 years, there have been a huge number of geopolitical events (wars, crisis, invasions, blockades, etc..). Nevertheless, the stock market has uninterruptedly continued paying (increasing) dividends.

The still-raging Covid-19 pandemic and the invasion of Ukraine are the latest events generating strong market uncertainty, but the long-term trend is clear: **overall, the stock market has (and will) yield, on average, a 6-7% return per year, whatever happens.**

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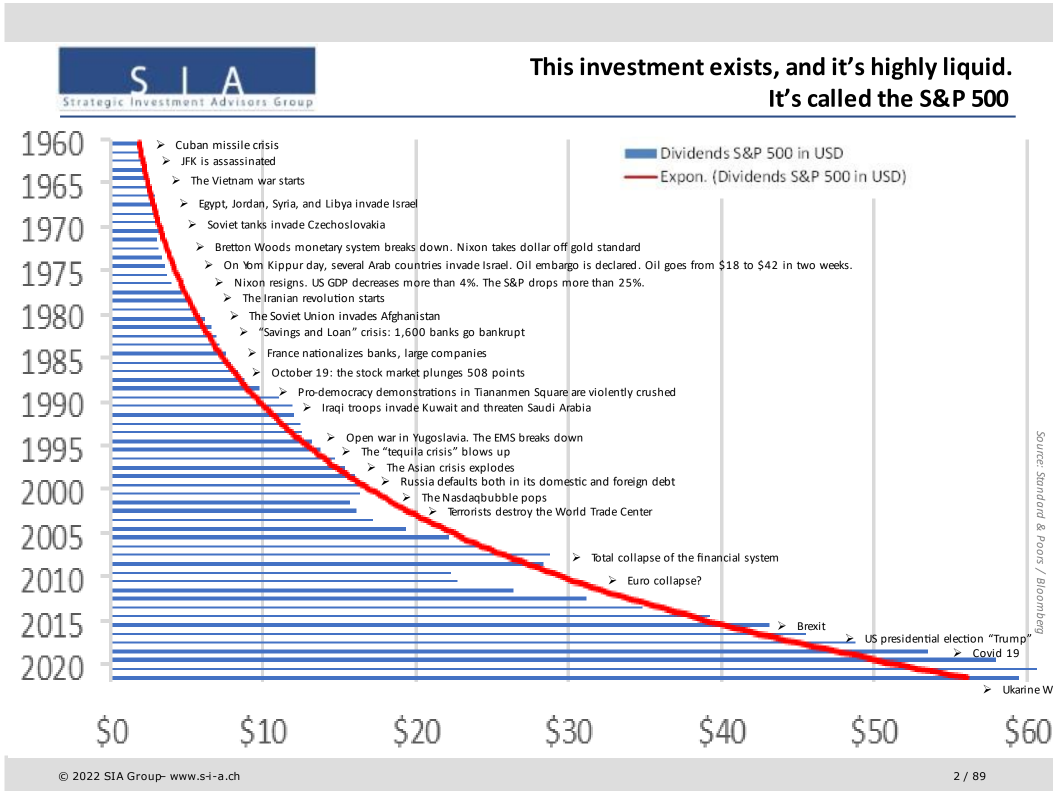

During these times of great uncertainty, it is very hard to digest negative news, high volatility, and the "*extrapolating consensus*" but we must not let ourselves be carried away by fear, the short term, and the negativity. Ultimately, **investing in quality companies at a discount is a strategy that will pay off.**

Warren Buffett, always a reference for SIA Funds, mentions that **in a war context, the best strategy for the next 50 years is not to be in cash, but to be invested in productive assets**. We go as far as saying that this is not only true in times of war, but also in respect of almost all geopolitical events. At SIA, we try to add a quality bias and some discount that make the long-term performance somewhat better.

The Classic (+14% to mid-April) and Natural Resources (+21%) started well in 2022, a year in which the four horsemen of the apocalypse (war, death, famine, and conquest) seem to be accelerating their pace.

Two black swans in the last 3 years and our Classic and NR Funds are doing just fine

We are beginning to think that the *black swans* we are experiencing might be business as usual given that the global pandemic that has been ravaging us since 2019/20 is still ongoing when an unexpected war emerges in the heart of Europe.

We deeply regret the loss of human life (**death**) and the horror and disaster that **war** brings. With this humble *Newsletter* we wish to express our opposition to war of any kind. We have, after all, enough problems due to climate change and feeding the world's population (**hunger**), without needing to become involved in geopolitical conflicts (**conquest**) - the fourth horseman.

We are not geopolitical or military advisors, but our base scenario is for a short-lived war, followed by a cease-fire and negotiations. We will not elaborate on what we think will happen as this is irrelevant, but we do highlight two structural changes of an economic nature that could be long-lasting:

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1. The **strategic repositioning of many countries (and corporates)** with respect to their dependence on non-democratic countries such as Russia and China.

2. A **review of the world's energy strategy,** especially that of Europe, which will have global implications and will have an impact on the planned energy transition.

These two structural changes will define many of the economic and business decisions in the coming years. However, from an investment point of view, we, investors, could perhaps take advantage of their impacts. We see some structural changes emerging:

1. An increase in **defense spending which will be long lasting.**
2. **The tectonic movement in respect of energy** and the resultant multitude of impacts, which we describe later.
3. **The reorganization of supply chains**.
4. **Reduced FDI in risky countries.**
5. Greater **financial caution** (currencies, payments, reserves, investments, etc.).

These changes will be slow, gradual, long-term, but need to be considered in the management of our investments.

From a fundamental point of view, the Classic's exposure to the Russian invasion's impact is very marginal. We do not hold any Russian companies and the fund's revenue exposure to Russia is very low: ING (<5% of the loan book, with a coverage of over 50%), BuzziUnicem (<9% of revenues), HeidelbergCement (<4% of revenues), MetsoOutotec (<10% of revenues) are noticeable. In our view, all 4 companies are extremely solid, and the impact will be marginal.

On the positive side, we are already exposed to 2 of the mentioned emerging trends: aerospace and defense (we are invested in Thales and Raytheon), and energy (with 20-25% of the Classic fund and 45-50% of the Natural Resources Fund).

Covid-19 is on its last legs. China is managing Omicron. The world is still growing above trend

The war has made us forget a bit about Covid-19, but **the virus (and its new variants) is circulating widely in most countries.** As discussed in the previous newsletter, it seems that Omicron and the BA.2 variant (and 3 other sub-variants) only affect people mildly, with the exception of those with underlying illnesses and the elderly.

The problem has shifted toward China, which, with its zero-virus policy, is finding controlling Omicron more difficult than the rest of the world. The country's large cities and/or geographic areas have recently experienced temporary lockdowns again.

Our base scenario remains optimistic, because China has started to strengthen its economy in order to compensate for the temporary lockdowns and the expected economic slowdown as a result of the many important measures: 1) accommodative monetary policy 2) housing reactivation policies 3) industrial acceleration (heavy industry, metals) 4) infrastructures, and 5) energy transition, renewables, etc. We believe that even if the country does not achieve its GDP22E growth target of 5.5%, it will not be far behind. China can also substitute some of the heavy industrial production that Russia will lose.

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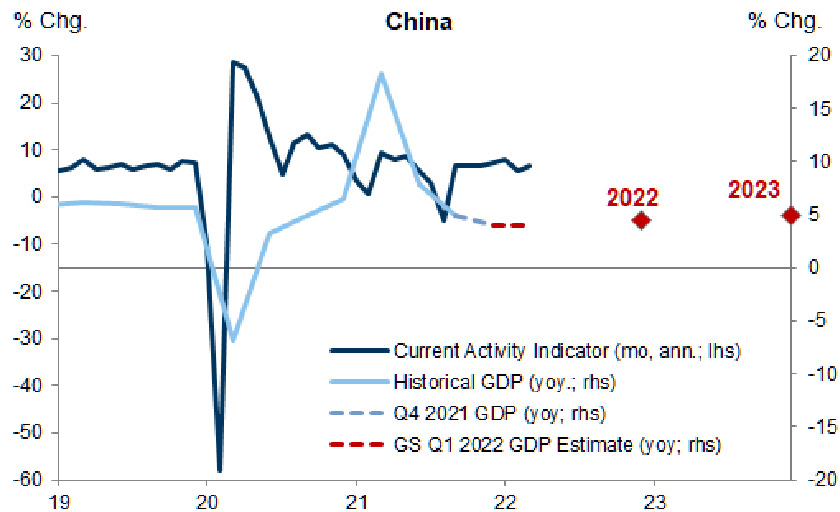

Despite the flare-ups in China and despite the risk of a more damaging variant emerging, **we maintain our view that the pandemic is behind us, and the world is heading for an economic recovery,** which Russian invasion's impact will nevertheless temper somewhat.

Our figures point to a **GDP growth in the region of 3% in the US, 2.5% in Europe, and 5% in China, with a global GDP growth of around 3% in 2022, still above trend.** These numbers are easily forgotten within all negative comments about the war, the Chinese slowdown and inflation but the truth is that GDP growth is above trend in most countries.

Inflation and interest rates rise as the output gap closes. Nothing new really

High inflation and rising interest rates are currently in everybody's mind. Despite the noise surrounding them, this is nothing new: **both are challenges that tend to appear in the final part of the economic cycle**, when the output gap gets tighter.

It is true that inflation has strongly jumped in early 2022 to levels not seen in decades, and will possibly remain high in 2022, but it is also true that this spike is being fueled by factors that should fade: the pandemic impact over global supply chains and the invasion of Ukraine. Both will take some time to manage but should be softer in 2023.

On our numbers, **US inflation is likely to be around 3-4% in 2023 and European inflation 2-3%, which are manageable levels, with plenty of stabilizers currently on steam: Chinese slowdown, tighter monetary policies, weaker consumer confidence, impact of the invasion in Europe, higher energy prices, higher electricity prices etc.… these economic stabilizers are already impacting economic growth and will also help to control price inflation.**

We are a bit more concerned about the US and UK, where the output gap is narrower. However, we understand that the FED and BoE will manage the relevant monetary policy in such a way that it will control the current inflationary spiral.

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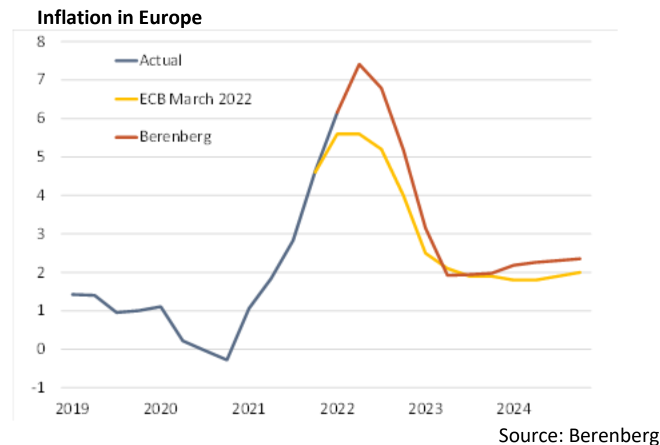

Source: Berenberg

That said, our two funds, Classic and Natural Resources, offer good protection against higher inflation, which normally appears in times of maturing economic growth. In the Classic, we invest in quality companies with a strong strategic positioning, pricing power, higher margins, and therefore better protected against inflation. Commodities, with an important weighting in both funds, have a strong historical positive correlation with inflation and this time this is also backed by fundamentals: supply deficits in most commodities and energy transition fit perfectly with higher prices.

In conclusion, we believe that within a few months, we will have returned to our initial 2022 scenario of economic recovery with *highish* inflation, back to the last part of the upward cycle which started in 2009. In this context, we remain convinced that it is time for value and commodities, which are currently the focus of our investments. It is also clear to us that we are closer to a slowdown/recession than a few years ago but as we said a quality portfolio will be able to navigate rough waters in its long-term journey.

At 31/03/2022, the Classic stood at EUR 547 p.a., +11% ytd.

LTIF Classic started 2022 well with +11% to the end of March, ahead of the main stock indices. That's good, but doesn't mean much, since the performance of a listed company's mutual fund can only be viewed over the long term - 10 years, in our opinion. Nevertheless, we are delighted to have started 2022 on a firm footing.

Why is the Classic doing well? As always, we have quality companies at very low prices that are unlocking their value (salmon and aerospace/defense, for example); we also have a strong exposure to energy and commodities, which has more than offset the falls that the Russian invasion caused. **In this context, the Classic has taken a firm step toward the 2022 target of EUR 575 per share (+16%), which we maintain for the time being.**

The sectors that performed well in Q122 were energy (+40%), mining (+25%), salmon (+30%), and aerospace/defense (+25%). The sectors that performed worse as a result of the invasion, were industrials (-10%), consumer discretionary (-6%), financials (-12%), and cement (-7%).

We highlight 4 companies that have gained nearly 50% (Thales, aerospace; First Quantum, copper; Hess Corporation, oil; and Grieg Seafood, salmon) and 4 that have declined significantly: Pandora (affordable luxury -20%), ING (bank, -20%), Metso Outotec (mining equipment, -16%), and ASML (semi's equipment, -11%).

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In our Classic deep reviews, we have not identified any companies with "structural" challenges. We are averaging-down whenever we have the opportunity, despite the saying that the graveyard is full of "*average-down guys".*

The Classic's current IRR is 14%. Intrinsic value: €815 per share

The LTIF Classic is currently trading with an expected IRR on investment of 14% and a medium-term intrinsic value of EUR 815 per share. The current IRR is not far from the historical average IRR (14-15%) which fluctuates between highs of 12% and lows of 17%, so the fund is neither too expensive nor too cheap.

Looking at the long term, we see no reason why the Classic should not be able to make 9-10% per annum as it has done for 20 years. We are sorry to repeat this, but it is extremely relevant, since it shows the **magic of compounding: 10% per annum means doubling the investment every 7 years** (x4 in 14) which in turn means that by the end of the decade, our shares should be over EUR 1,000.

As stated many times before, **long term compounding is the investor's best friend,** although we are becoming increasingly aware of some of its more negative side-effects, such as some hair loss or the deterioration of some youth attributes. We are, however, happy to have compounding savings compensating for the passage of time.

The LTIF Classic. Capital preservation and decent return

As usual, ten companies make up 50% of the Classic. Through these 10 companies, we can observe 4 of the characteristics we look for in our investments: **good businesses, good managers, healthy balance sheets, and attractive valuations.**

Two further characteristics are also present: the **Fund's strong business diversification** (in these 10 names we have exposure to energy, aerospace, defense, plasma, salmon, cleaning, cement, banking and catering businesses), and its **only large concentration factor, namely energy/oil**, where we have 20-25% of our assets.

LTIF Classic Top10 Holdings	
Cenovus Energy Inc.	6,6%
Thales SA	6,2%
Grifols SA	5,7%
Grieg Seafood ASA	5,4%
Suncor Energy Inc.	4,4%
ISS A/S	4,1%
Heidelberg Cement AG	4,1%
Harbour Energy plc	4,1%
ING Groep NV	4,0%
Compass Group plc	3,9%
TOTAL	**48,9%**

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Quarterly Investment Case: Buzzi Unicem

We have chosen Buzzi Unicem as our investment case of the quarter, because it is a good example of the value that many of our investments harbor.

Buzzi Unicem is an Italian company founded in 1907 by the Buzzi family, who are still its main shareholders and managers. Historically, Buzzi Unicem is no exception: over the decades it has pursued a strategy of mergers and acquisitions, including the Buzzi-Unicem merger, expansion in the USA, and acquisitions in Germany (Dyckerhoff), Brazil (Companhia Nacional de Cemento), and Mexico (Corporación Moctezuma).

Buzzi is currently present in 14 countries with more than 10,000 employees and around 60 million tons of production capacity. The main countries are the USA, Italy, Germany, Mexico, and Brazil, although the share in the latter two is 50%.

Buzzi Unicem also has assets in Russia (4 million tonnes) and Ukraine (3 million tonnes). The company has recently estimated that its profits in Russia will fall by 50% and that those in Ukraine will go straight to losses. The war has led the management team to estimate a drop of around 10% in its 2021 EBITDA (EUR 800 million) to around EUR 725 million in 2022. Owing to the invasion, the share fell by 12% at the start of 2022. This is very much in line with the lowering of estimates, but in no case do we think that the company will be worth 12% less than in January.

If we assume that the company will return to some normality in 2023, it is relatively simple to assume a return to an EBITDA21 of EUR 800 million. Should we keep our calculations simple and apply the average EV/EBITDA of the last 10 years (8x, source Bloomberg) we arrive at 6.4 billion EV. Without adding the December net cash (EUR 236 million) or adjusting the debt and EV for minority interests in order to maintain simplicity, **we obtain a value per share of EUR 33 at the current price of EUR 17.**

We also estimate that the free cash flow generation could, on average, reach around EUR 350 million per year for the next 2-3 years, which implies a **free cash flow yield of 11%** compared to an average of 6% over the last 10 years.

What do we like about Buzzi Unicem?

1. Cement is a good business, multi-local, oligopolistic, with strong cash generation.
2. The good management team focused on the long term and aligned with their shareholders.
3. The good margins (consolidated EBITDA of 23%) and group returns (ROCE of 11% in 2021) for a geographically well diversified group.
4. 60% of EBITDA is generated in the US where growth, margins, and returns are high, and 25% in Central Europe where the business is also high quality.
5. The good balance sheet with a net cash position of 236 million in December 2021.
6. The emission reduction efforts and ESG that are not far behind those of the world leaders.
7. The valuation: 0.65x price/book value vs. a RoE of 13.6% in 2021.

What are our concerns?

1. Cement is a cyclical sector, and we are in the second part of the bullish cycle that started in 2009.
2. Buzzi is a cyclical company, specifically dependent on the US cycle.
3. The CO_2 emissions' impact on the margins and investments, although we understand that they will be passed into prices.
4. The management team could decide to make acquisitions instead of distributing free cash flow to shareholders, with the resulting increase in risk.

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We have positions in Classic and Natural Resources with an Intrinsic Value of EUR 30 per share and an expected IRR of 17%.

LTIF Natural Resources. Good start to 2022 and a very long cycle ahead

The LTIF NR fund closed 2021 up +41% and ended the first quarter of 2022 up +13% at EUR 140 per share, a positive performance fueled by the Russian invasion of Ukraine and its consequences for energy and commodities.

The Ukraine invasion has also negatively impacted the NR Fund as we had investments in three russian companies (*more comment below).*

After valuing our Russian stocks at zero, the fund's **Intrinsic Value does not change much and remains at EUR 185 p.s., with an IRR of 13% at current prices,** using mid-cycle DCF models. Part of the loss of the held Russian companies might be recovered in the future but prefer a conservative approach.

We never believed that Russia would invade Ukraine

We are somewhat disappointed by having been invested in Russia (around 6-7% of the NR fund in recent years; 5-6% adjusted for dividends) through 3 companies: Gazprom, Surgutneftegas and Norilsk Nickel in which we have had weights of between 1% and 3%. We often discussed the weight and risk of our investments in Russia in recent years, believing that it was under control. With hindsight, the risk was too high.

At the March closing NAV, we conservatively valued these stocks at zero (the shares are still suspended), **which roughly subtracted 7 points from our performance in the first quarter**. In other words, the NR Fund would have been +20% to March if there had been no conflict, although we imagine that commodities would not have risen as much either.

There is a possibility of recovering some of the assumed loss once the conflict has been resolved, especially as all 3 companies are listed on the Russian market with declines of around 40-50% since the start of the invasion. This would add about 3-4 pp to the NAV, but today the visibility is too low to count on it.

We were aware of the risks of investing in Russia, but perhaps we should have dug deeper following the annexation of Crimea in 2014 and should have further limited our exposure. Our investment committee discussed this issue a great deal during the last 3-4 years, as we still remember the 1998 Russian crisis, during which old friends lost a good part of their savings.

Fundamentally, we have decided to sell all Russian stocks whenever possible. The decision to sell is a structural one, but we will execute it as best we can when the markets reopen. Could we have done better? Possibly. We probably should have reduced our exposure to Russia to below 5% to avoid unnecessary risk. In our defense, we need to mention that commodities have an extra geopolitical risk, as most reserves are concentrated in non-democratic (Russia, Congo, Zambia, Saudi Arabia, etc.) and high(er)-risk countries (Brazil, Peru, Chile, Mongolia, Indonesia etc.).

Applying our maxim of capital preservation, we try to control this type of risk, although unforeseen events sometimes arise, such as the invasion of Ukraine. In the following chart we can see the extraordinary concentration of commodities production in a small number of countries.

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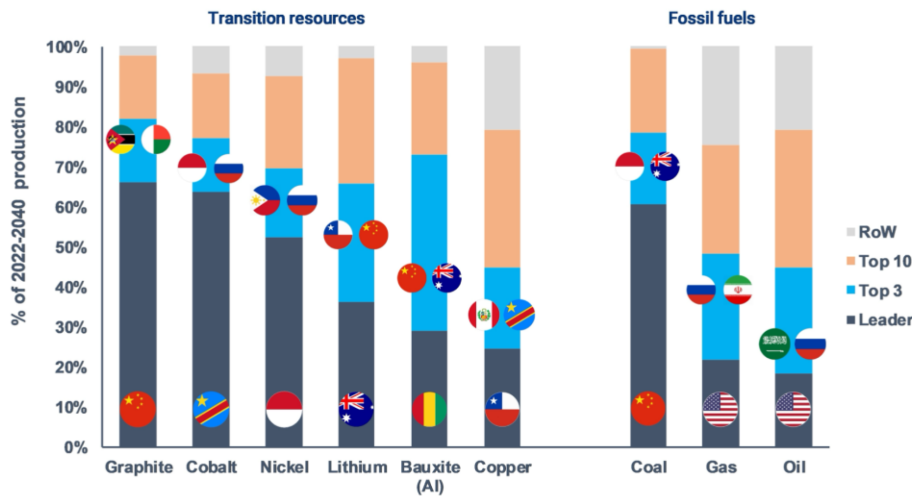

The invasion has made the problem of the supply of commodities obvious

The Russian invasion of Ukraine and the ensuing war are having a significant economic impact, while also highlighting the structural global undersupply of commodities.

With regard to fossil fuels, the blockage (whether temporary, structurally…we shall see) **of Russian flows** (11% of world oil production and 16% of gas according to our figures) **aggravates the existing structural deficit in oil, gas, and coal** due to almost 10 years of reduced investments (currently worsened by ESG and financial discipline). Sanctions are starting to disrupt normal trading patterns and we expect lower capex in Russia in the medium and long term.

Something similar is happening with metals, as Russia and - to a lesser extent - Ukraine are major players in the production of copper, nickel, aluminum, and precious metals. The same applies to these countries' steel and some other metals, which have a 5-10% share of the world's production.

We are thus facing short-term disruptions (sanctions, logistics, supply chains, market dislocations…) and long-term challenges (lower capex) in, broadly speaking, one of the world's largest producers of fossil fuels, metals, and commodities overall. In the case of green commodities (nickel, copper, cobalt, and aluminum), which are at the core of the energy transition, strong growth in demand had already led to a deficit problem, now worsened by the invasion.

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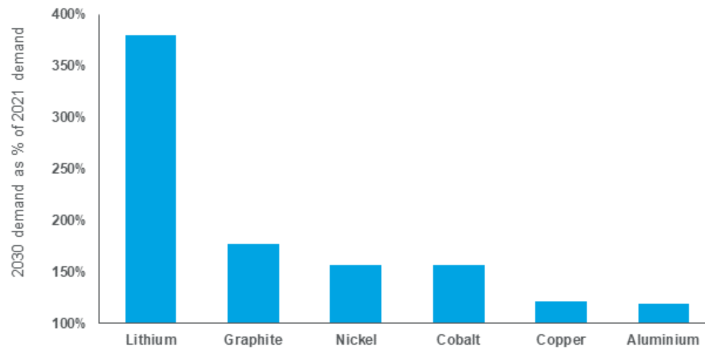
Increased Demand for Green Metals 2021-30



Source: Wood Mackenzie Q4 2021 outlook reports; based on our energy transition outlook scenario (+2.5-2.7°C in 2050)

As stated in previous newsletters, the world faces an overlap of two long-term cycles: 1) the usual commodity boom/bust cycle, starting in 2021 after 10 years of underinvestment, and 2) the energy transition, with a jump in demand for green metals/commodities. **Now we must add a third unexpected factor:** 3) the urgent need to reduce exposure to Russia, one of the world's largest commodity producers, which will be difficult, to say the least.

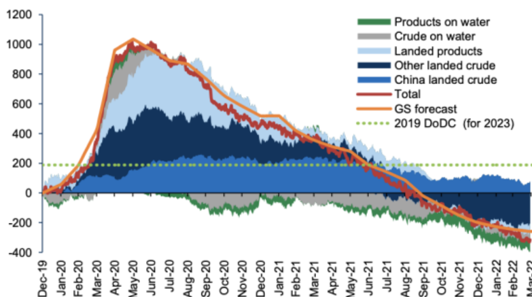
Brent above $100 bbl. (45% of LTIF NR invested in energy, oil & gas)

The Russian invasion of Ukraine complicates the structural oil deficit problem that we have been anticipating. On the one hand, we have the sanctions' impact on Russia, which is currently "blocking" between 1m b/d and 2m b/d of Russian crude oil exports. On the other hand, we expect a structural reduction in investments in Russian energy and oil projects in the medium and long term. This is extremely relevant, given that **Russia produces about 11% of global oil and 16% of global gas.**

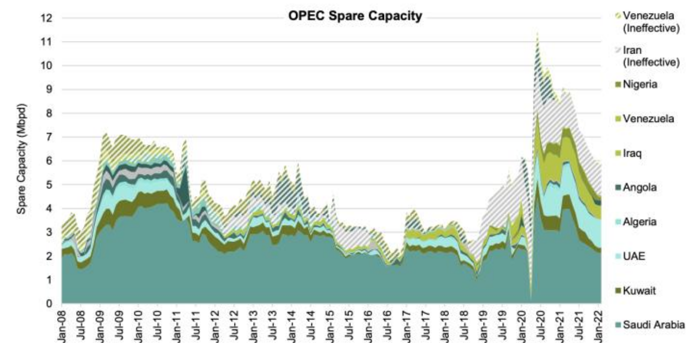
Looking at 2022, we believe that the oil market has not changed too much: the release of strategic reserves (mainly from the US, but also from other developed countries), the gradual increase in OPEC+ production (targeting 400,000 b/d monthly), and a possible agreement with Iran that will release around 1-1.5m b/d will cover the lost Russian exports.

The real problem lies more in 2023 and the following years, when we will enter with minimum spare capacity (less than 2% of the world production), combined with the lack of new projects/supply due to the underinvestment cycle, which started in 2013.

Global high frequency inventory tracking vs Dec-19 vs implied by GS supply-demand balances (mb)



Source: Kpler, IEA, JODI, EIA, PAJ, PJK ARA, Oilchem, Fujairah, IE Singapore, Goldman Sachs Global Investment Research



Source: IEA, Bernstein analysis

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The current geopolitical situation has brought forward the expected super-cycle in oil, which we fear will keep oil prices at levels above $100 per bbl. for the next few years, with spectacular spikes each time there is a minor supply issue somewhere.

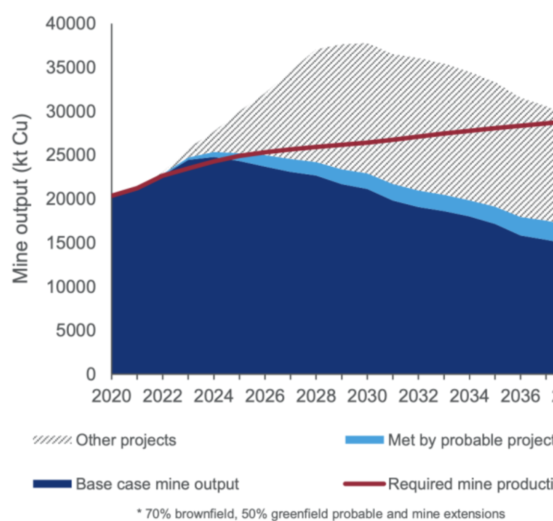
Copper and Nickel trading well above incentive levels (25% of LTIF NR). No inventories. Gone

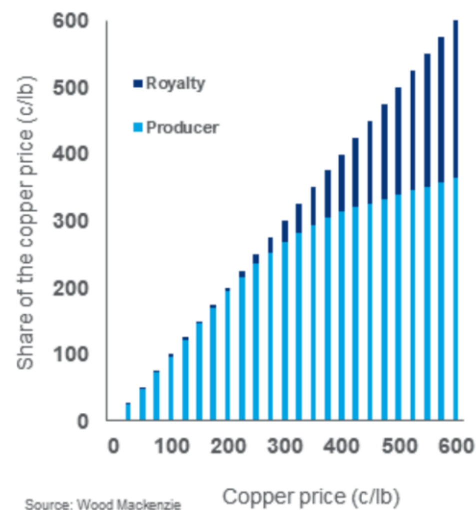
Copper and nickel prices are soaring, trading well above the incentive levels. We maintain our investments in both commodities, totaling around 25% of the fund, despite the sector's strong outperformance in 2021 and 2022, as we are convinced that the cycle has only just begun.

As already mentioned, we are witnessing two long-term cycles in conjunction: the normal "boom-bust" commodity cycle, which usually lasts a decade, and the energy transition, which will accelerate demand for green metals to unanticipated levels. To these two cycles, we now add the *Russian effect*, which will have serious implications for many commodities' supply.

Against this backdrop, we would expect countries and governments to incentivize the production of copper, nickel, and other green metals, but the reality is quite different. Chile and Peru, for instance, are toughening their respective mining codes, raising taxes, and even threatening other measures such as nationalization of assets. Not good for attracting capex.

In the next chart, we can see this paradox. On the left-hand side, the expected massive deficit in the copper market in the next decade, and on the right-hand side, the Chilean tax proposal, capping the profits from high commodity prices. Is this the right way to incentivize capex? **The sector is a boom/bust sector, with mediocre mid-cycle returns, as we have commented many times; however, governments tend to forget the bad times when prices rise.**





Not much new regarding the nickel market situation. Just look at the inventory level. Gone. Nada. This just before the biggest jump in demand ever due to the trend toward electrification/batteries.

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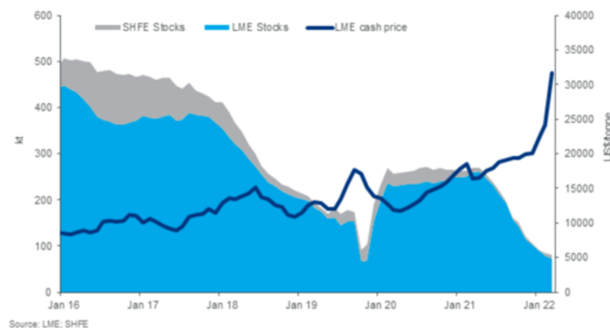

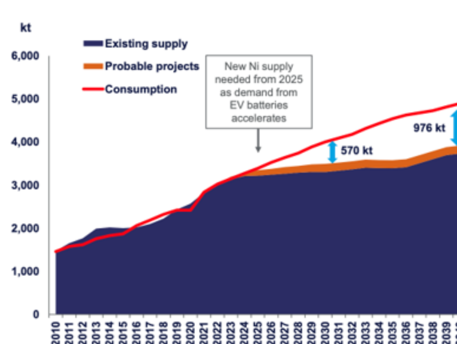

Salmon prices continue to rise (10% of LTIF NR)

Salmon producers started the year very well with a strong market performance following salmon prices, which have reached 90-100 NOK per kg and rising. This is not much of a surprise, because supply is extremely tight (no growth in Norway and Chile, the main producing countries in the world with 75% of the total) and demand is recovering after the pandemic (*Hotels, Restaurants and Catering* demand still depressed and will move up).

We do not only envisage short term supply issues, but also in the years to come. **We therefore expect high prices and very good earnings from salmon farmers in the mid-term, a trend that will complete the sector regime change (from low return cyclical to high return) with a full re-rating.**

Let us pose an interesting question: **who dares calculate the current electricity/energy's and food prices' impact (and the inflation on capital expenditures) on onshore fish farms, which were meant to offer substantial capacity in the mid-term?** To make these projects profitable, salmon prices should certainly be far higher than the current spot prices; and under the current circumstances, we understand that there is very little risk of substantial new capacity.

The infrastructure cycle has just started (10% of LTIF NR)

Infrastructure is a segment where we foresee a very promising future after massive underinvestment and the energy transition's impact. Both issues are triggering a new infrastructure investment cycle. By definition, infrastructure cycles are long term.

There is also some overlap with the commodities cycle, since these must be extracted, processed, and transported, which require large infrastructures. A mine with huge reserves but no infrastructures (rail, road, electricity generation, port, etc.) could be largely worthless. The electrification of the global economy will also require heavy investment in infrastructures.

We currently have three investment axes in infrastructures: cement (5%), electrical cables (3%), and mining equipment (2%). We will reinforce investments when we find new interesting companies, or when our own companies lower their prices.

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Cement and mining equipment have done badly to March this year, with falls of 10% - mainly due to exposure to Russia (between 5 and 10% for Heidelberg Cement, Buzzi Unicem, and Metso Outotec) - but we believe that all three will be a source of outperformance in the not-too-distant future.

The three cycles of industrial commodities

Industrial commodities (oil, natural gas, coal, base metals, etc.) show very volatile prices over the long term (say, five years) and over the short term. The last few years have seen the oil price go from $120 per barrel to minus $37, only to shoot to $80, then $130, then $90, achieving the last three prices within two weeks. Simultaneously, we have seen the nickel price go from $10,000 / tn to $48,000; coal from $50 / tn to $400, and, of course, natural gas for European delivery (TTF) from €37 to €225, then to €98, and then to €120 again. All the changes occurred within just a few months.

It's not surprising, then, that many investors (most?) consider the sector uninvestable, little better than a casino. Nevertheless, we believe that commodity prices are among the most predictable in financial markets, although subject to some qualification. In the following, we explain why.

1. The investment cycles

The best way to understand a given commodity's price movements is to visualize it as the result of three simultaneous cycles that are completely independent of one another and simply "add up" to determine the final price.

Investment determines the first cycle. Broadly speaking, this comprises overcapacity in the industry at some point. Since both supply and demand are pretty fixed (inelastic, i.e., they don't react too much to price variations) prices drop significantly. Nobody is going to buy copper at any price if they don't need it. Companies therefore keep producing, even at a loss, since it's better to lose some money than to lose a lot by closing down completely. The price keeps dropping until some companies can no longer cover their immediate cash costs with the low prices. In this case, it's better to close the mine. Those mines with the highest costs close first, until the supply and demand reach equilibrium again. From an accounting point of view (i.e., including full costs), almost everybody loses money before this stage, and the industry faces a crisis, with bankruptcies, debt restructurings, etc. But there are two unavoidable mechanisms that slowly correct this situation: depletion and economic growth.

"Depletion" simply means that mines are eventually exhausted. The amount of minerals in even the best mines is limited. Eventually, there is none left. This is, of course, an ongoing phenomenon. There are always mines closing somewhere. This closing refers to roughly about 5% of annual production disappearing. In other words, if we stopped investing in new mines, supply would decrease quickly, with the oldest mines being depleted first. This is exactly what happens when companies are in a "money losing" cycle: nobody invests in new mines. Since new mines take a long time to develop, ongoing projects keep coming to market, even when the price is low, because they had been launched some time before. This means the excess supply persists for years. However, ultimately, there are no more projects in the pipeline, and the industry continues closing the oldest depleted mines.

The second mechanism that eventually balances the market is the world economy's growth, which ensures that there is a steady increase in demand for industrial commodities. Despite all the headlines, this growth is consistent, ranging between 2% and 5% per year with very few exceptions. This economic growth-induced increase in demand and the depletion mechanism ensure that, sooner or later (normally, later, since this takes time), supply and demand are again balanced.

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But remember, during the bad years, nobody invested in new mines, which means there are no new mines in the pipeline despite the inexorable depletion and economic growth. After a few "magical quarters" of balance, the market will – once again - find itself out of kilter, this time due to the lack of supply.

As in the previous stage, the price will move a great deal, because demand is also inelastic when prices go up. A company making electrical appliances is going to buy copper - literally at any price - or go out of business. Prices will then start climbing again.

With the increase in prices, interest in the industry (which had been probably left for dead) revives and, after one or two years of hesitation, companies once again start investing some of the huge cash flows being generated in new projects. These take many years to complete, so the scarcity situation lasts a long time. Eventually, all the new projects come into production, there is a supply surplus, and the cycle restarts.

How long is this cycle? This depends on a few variables: how fast is the depletion (the faster it is, the shorter the cycle), how quickly companies react, and, above all, how long it takes to add capacity. The latter varies per commodity and even in respect of specific projects, but ranges between 5 and 15 years. The net result is the period between to peaks of cycles is about 20 years. The last cycle in metals went from 2002 (bottom) to 2011 (peak) to 2019 (bottom). In oil it went from 2002 to 2014 to 2019.

This cycle is immutable, no recession (2008), pandemic (2020), or war (2022) can alter it. If there is no oil, there is no oil; and if there is too much, the price can fall to zero or even a negative sum. The previous 10 years of investment determines the amount, so nothing can be done about it in the short term, hard as this might be for politicians to accept. This cycle is relatively easy to analyze and predict, since the total productive capacity of most commodities, the total demand, and the pipeline of new projects are well known. Consequently, it's not difficult to calculate whether there is going to be too much or too little supply over the next 2 to 5 years. At SIA, for instance, we have a database of all the relevant oil, copper, and nickel projects.

2. The economic cycle

If the world were a very stable place, that would be it. Since it isn't, when we are not experiencing recession, we're overheating, or fighting a war, or being hit by pandemics, tsunamis, revolutions, etc. Although we said that the world economy does grow regularly, that constancy still faces quarter to quarter or even year to year variations. These variations create their own cycles.

A recession means the commodity consumption is slightly less. An overheating economy increases demand above the long-term trend. A revolution in an oil producing country will lower supply, etc. These are cycles that last anything from a few months to slightly less than two years. The demand (or supply) curve superimposes itself on the "investment cycle" analyzed before, making it less smooth than it would otherwise be, and introducing shorter-term price variations. However, these changes resolve themselves within a few quarters, and the underlying long investment cycle imposes itself.

3. The financial cycle

The commodity prices we see on our screens every day are not really purely the result of supply and demand. Financial players determine them. For instance, the "Brent oil price" we see is not the price that somebody purchasing oil is paying today, instead it's the price of next month's contract, traded in an electronic market. In fact, there is a price, called "dated Brent", which is the real price that a trader buying physical oil is paying today. This price may or may not be very different from the one we see, depending on the situation.

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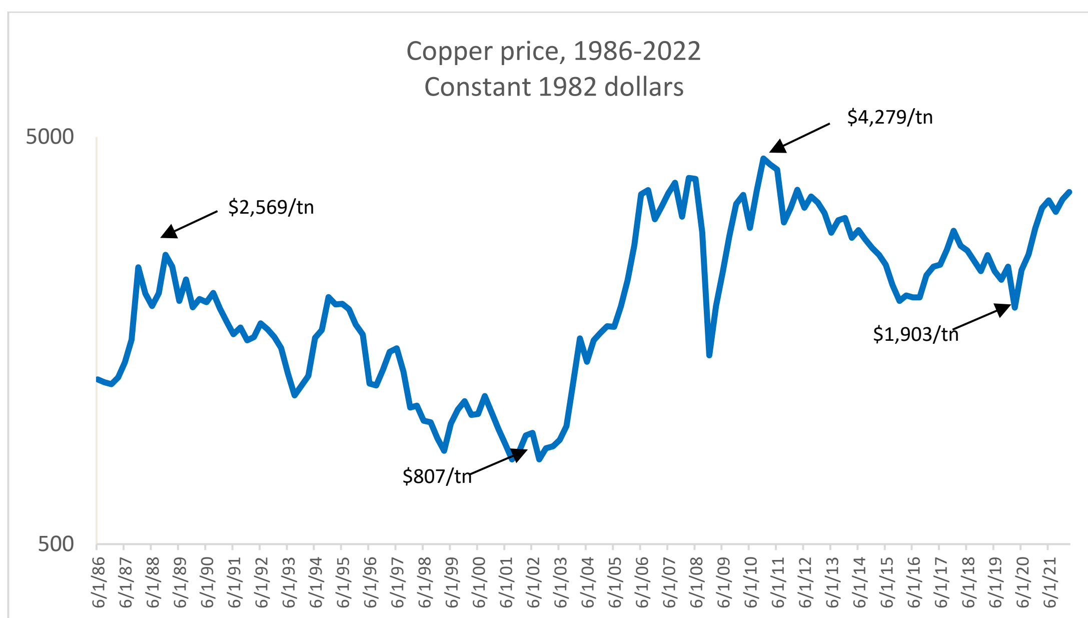
Financial actors' main characteristic is their ability to anticipate. The war in Ukraine might lead them to think that there will not be enough oil in the near future due to sanctions. They therefore increase the price of oil by 30%. Nevertheless, nobody is currently buying oil at that price, since it's just financial players' anticipation of what the real price could be in a few weeks' time. If the sanctions don't materialize (or there is just a rumor that they won't), the price will fall immediately.

In addition, many other players try to earn money from this volatility by buying and selling futures, options, and derivatives. These tend to exaggerate the underlying movements, since many players buy whatever is going up and sell whatever is going down.

These movements create a third cycle of very short duration that should be added to the two previous ones. Once we add the three curves, we have the final, observed price.

The charts below show the prices of copper and oil adjusted for inflation. The underlying investment cycles are very clear see. The bottoms and peaks coincide with the shortage or excess of supply, and the price differentials are enormous, creating the huge crises and booms that natural resources companies experience.



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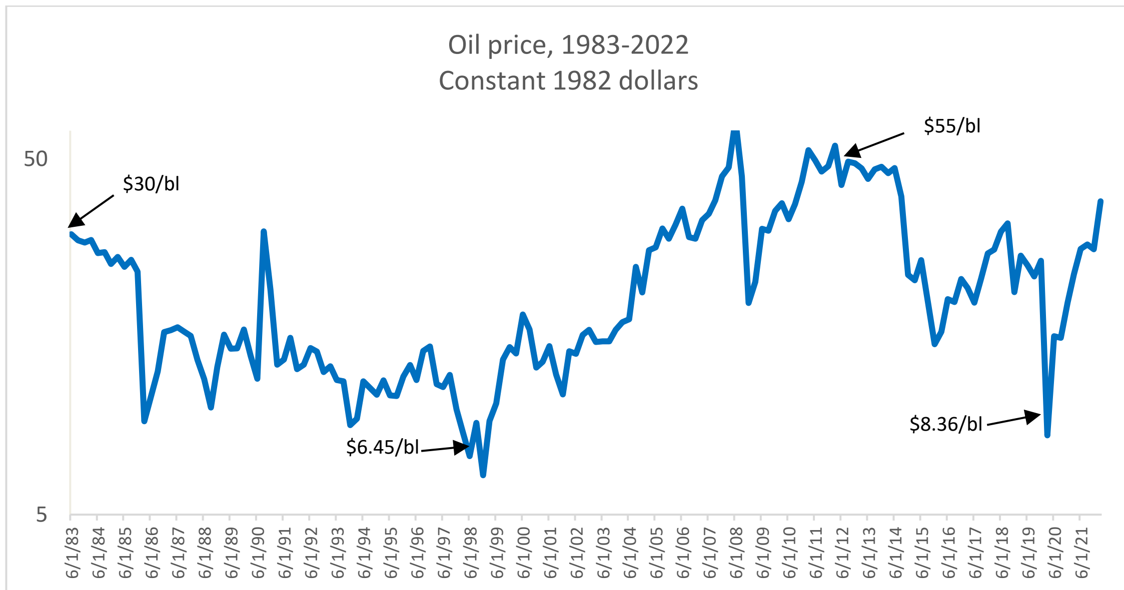

How to invest

This analysis indicates how one should go about investing in the industry. The long "investment cycle" is all that matters for a long-term investor, since it overpowers the other two over the years. One needs to understand the industry's supply and demand dynamics to be successful, and the discipline to follow this cycle, regardless of the shorter-term variations that the other two cycles induce. When the "macro" investor tries guessing what the economy is going to do over the next two quarters, the key is to anticipate those movements correctly. Short-term investors need to be great traders, able to buy or sell on an almost daily basis with a correct understanding of the market psychology.

At SIA we position ourselves in the first group, of course. That's why we are so confident about our investments in natural resources, even in the middle of high volatility events. Once we understand each commodity's supply and demand dynamics, we have a solid view of where things are heading in the next five years, which is far more than can be said of many markets.

Furthermore, share prices reflect the cycles in hindsight. At the bottom of a cycle (i.e., after 10 years of losing money), the shares are extremely cheap, which creates the perfect conditions for outstanding outperformance - a very low entry point and several years of above-expectation profits.

All of the above doesn't really apply to most agricultural commodities, since their shortages or surpluses are random due to unexpected extreme weather. Their supply conditions are normally rectified within a year. If wheat, say, is very expensive due to a poor harvest, farmers will plant more seeds for the next season. Moreover, agricultural commodities' demand elasticity is much higher than that of industrial commodities, since, up to a point, a range of such commodities can be used to substitute others and their use declines naturally when prices increase due to less demand or substitution (coffee, sugar, etc.).

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Where are we in respect of the three cycles currently?

The most important is the investment cycle, in which respect we are at the very bottom - or even lower, for there are as yet no big investment plans to counter the current supply shortages. This is due to ESG concerns and a decade's accumulated loses. Managers do not want to commit to new investments until it's very clear that they will be profitable many years down the road. As yet, very few people see this clearly.

Consequently, we will have to live with increasing prices for quite a few years. For environmental reasons, governments are not yet granting licenses to build new mines, even for those commodities whose future demand is undisputed, such as copper. Stocks are becoming critically low, and will decrease even more, until there is no more metal left. Only at this point do prices act as a mechanism that controls demand.

Currently, the mid-term cycle is particularly confusing. We have a war, inflation, the pandemic acting as a stimulus, interest rate increases to control inflation, Covid-related lockdowns in China, and huge political pressure to lower gasoline prices, all of which lead to releases from strategic reserves. The uncertainty about the possible lifting of sanctions against Iran is a point that one could add to the previous ones. The oil price's very high volatility is therefore no surprise. It often moves up or down by more than 5%, with the market trying to guess how this second cycle is going to play out for the next few quarters.

In addition, the financial cycle reflects large moves in respect of derivatives, drains liquidity, etc. We have also seen the nickel price double within a couple of days and its market closed for more than a week.

By the way, all this volatility does nothing but reinforce the bullish situation of the long-term cycle - the more chaos there is in commodity markets, the less attractive new investments become.

Nonetheless, for the long-term investor, the opportunity is outstanding. We are at the bottom of a very long upward trend, while the shares of commodity producing companies do not reflect this at all - largely due to the shorter-term cycles generating confusion. However, these cycles are irrelevant in the medium term since the USA's total strategic petroleum reserve is, for instance, good for about a month of consumption. The plan to release 1 million barrels per day for six months represents less than 1% of the market and is not sustainable. China will come out of lockdowns at some point; the war in Ukraine will end; recoveries will follow recessions; and many industrial commodities will be woefully undersupplied. Nothing, absolutely nothing can change this fact over the next few (or perhaps not so few) years.

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Copper price, inflation adjusted

Oil price, inflation adjusted

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Investment Case. Atalaya Mining. Site visit: Rio Tinto Cerro Colorado
"*Be greedy when others are fearful",* is a famous Warren Buffet quote. "*Buy when there is blood in the streets, even if the blood is your own",* is one by Baron Rothschild. Both can be applied to various aspects of life, not only to investing.

Given the fear of Covid, the empty planes, cheap flights, and very good hotel deals, we took the opportunity to make a site visit to one of our NR fund holdings.

Atalaya owns 100% of Riotinto in Andalusia, Spain.
It is an open pit copper mine located an hour's drive north of Seville and Huelva that was reopened at the beginning of 2016. It produces more than 50,000 tons of copper. The grade is below 0.5%, the total sustainable costs are around USD 2.50 per pound, while the mine's life is estimated at 12 years, but could be extended.

Robust cash generation has led to a net cash position, and the company announced its first dividend in October 2021. 30-50% of the FCF has been earmarked as dividends for the shareholders. The company trades around 3 times the EV/EBITDA of the spot copper prices.

The mines have been delved since Phoenician and Roman times and were leased to a British syndicate in 1872. They were returned to Spanish control in 1954 and were among the world's most valuable copper mines for many decades.

An old pit that has been mined

Spain received the astronomic sum of 93 million pesetas (EUR 559,000) when it sold the mines, which immediately cleared its large deficit. The British company was called "Rio Tinto Company Limited," and this transaction gave birth to the current mining giant Rio Tinto.

The Spanish love for football (a game, although first played by the British, is consistently won by the Spanish) has its origin at the Riotinto mine. British expat workers founded the first football club on Spanish soil here. The Spanish passion for the game persists to this day. Nevertheless, the miners support Real Betis rather than FC Sevilla, maintaining that although this club has less money, it has more passion.

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A railway line was even built to Huelva, which is currently home to one of the largest copper smelters in Europe. Freeport (a former owner of the mine) owns it and processes concentrate arriving from as far as its gigantic Grasberg mine in Indonesia.

Drilling, blasting, loading, and hauling in the main pit

Atalaya is a good example of SIA's strategy to invest close/at cash flow.
Bringing this old asset back into production was a huge task associated with many risks and challenges. When production finally started, the big cash flows (helped by the prices) reduced the debt quickly, allowing the company to already pay dividends). There are also good expansion projects in nearby areas, such as the San Dinonisio and San Antonio deposits, as well as the Masa Valverde project 30 km from the RioTinto Cerro Colorado main mine.

Running a mine in such a region has its pros and cons. There are ridiculous bureaucratic hurdles, like the old steel scrap falling under heritage protection. The company also needs to employ three archaeologists to comply with regulations. On the other hand, there is very good infrastructure: a power supply, workers, housing, health, schools, etc. The skillful experienced and local management team was key to successfully bringing this project into production.

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Atalaya Mining. The tailings dam

Working with large contractors/consultants would have led to a massive cost-overrun.
These companies apply simple standardized designs, etc. for projects, which works rather well when setting up new mines from scratch. However, this would not have worked in respect of Atalaya.

Instead of scrapping and replacing all the existing hardware, a different approach was taken. Most of the existing hardware was repaired and fitted with the most modern IT/steering technology. This was done by means of the local crafting/engineering companies/skills in the rather populated area with a long history of running such industries.

Ball mills (the entire operation has spare capacity)

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Atalaya Mining is a long-term investment in our NR Fund, with an expected IRR of 15%, an IV of 500 GBp, and some exploration upside. Although Atalaya is not a TIER 1 asset, it is a good mine, with high profitability at incentive prices, and an excellent management team. We have known them for years and our only comment on their performance is: *hats off!* For instance, until recently, the management committee had to approve all expenses of more than 500 euros. Value in mining.

Marcos Hernández
Carlos Jarillo
Urs Marti
SIA Team

April 2022

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