

## Gold Equities - Thoughts About Perception

By Markus Bachmann | 14<sup>th</sup> February 2012

'Why buy good luggage? You only use it when you travel'

*Yogi Berra*

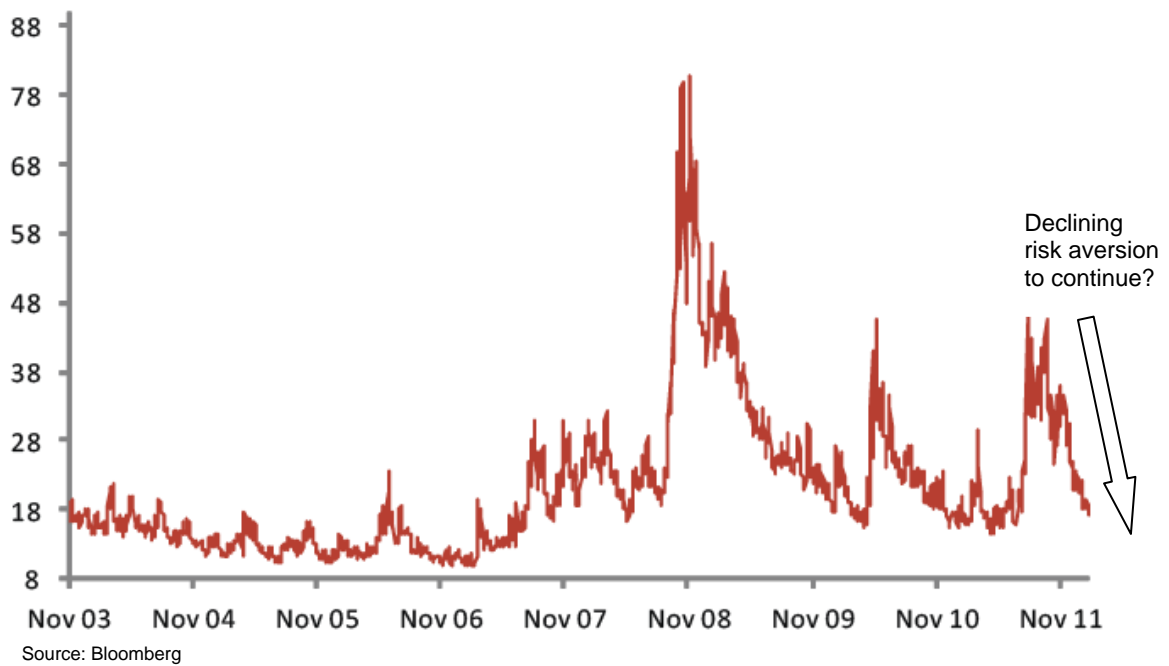
The Washington Post conducted a social experiment a few years ago with world class musician Joshua Bell\*. He was performing incognito at a Washington subway station playing Bach on a violin worth US\$ 3.5mio - hardly anyone took notice. At the end Mr. Bell was able to collect a meagre \$ 32 for his efforts. A few days earlier he had sold out a concert in Boston where tickets went for \$ 100 or more.

One can draw parallels between real life and behaviour in financial markets. There are times where real value doesn't get the deserved recognition and there are times where everyone desperately rushes into the music hall, preparing to pay top dollar for a spot.

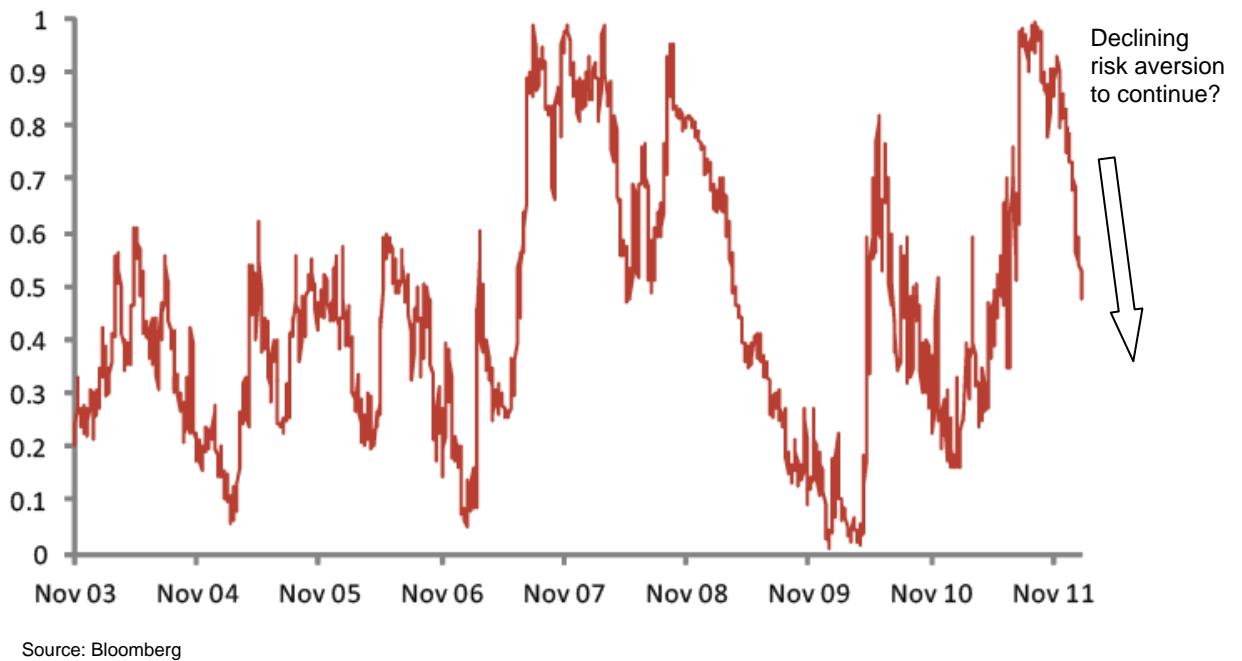
The headwind in financial markets including credit markets resulted in a strong decline of risk appetite from investors with mounting concerns about steadily increasing government debt in developed economies and the exceptionally poor quality of the balance sheet of many banks in Europe and elsewhere. Looking back, 2011 may be remembered as the year where investment risk had to be redefined. Events unfolding over the past couple of years have clearly shown that various concepts of determining value or measuring risk, such as the Capital Asset Pricing Model ("CAPM") or Value At Risk ('VAR'), are seen to be fundamentally flawed with dire consequences for the so called risk free part of a well balanced portfolio. In simple terms: triple A rated debt instruments were not nearly as risk free as they were assessed by various rating agencies and investment committees of large institutional accounts. Perhaps they should have taken heed of a comment made by an analyst of a rating agency who stated that they would rate every deal, even if the instrument had been structured by cows. One suspects that Nassim Taleb's "Black Swan" was purchased mainly for decorative purposes instead of being read and understood. We must assume that this epic shift in truly understanding and defining what real investment risk is, has still has to settle in many minds. A collective belief of a generation of MBA's and CFA's is hard to change overnight, case in point is the collapse of the CAPM. Perhaps a back to basics approach might be a starting point to understand the health of the financial state of a company or an instrument.

In respect of gold equities, the discrepancy between the gold price and the valuation of the companies has widened over the past year. Whilst the gold price increased by some 10 % year on year, the performance of gold equities was mostly negative. Why is that? A closer look at some risk indices might provide a clue. Both the VIX and the MRI (Citi Macro Risk Index) increased substantially in 2011, in particular in the second half of the year. Investors' risk appetite has been significantly dampened by economic woes but even more so by the unresolved Euro crisis which has scared investors away from what is perceived as a 'risk asset'. Yet what is becoming more and more apparent is the outstanding financial health of many gold producers. The longer the gold price remains at current levels, the better the economics.

**Chart 1: Risk Aversion - VIX Index**



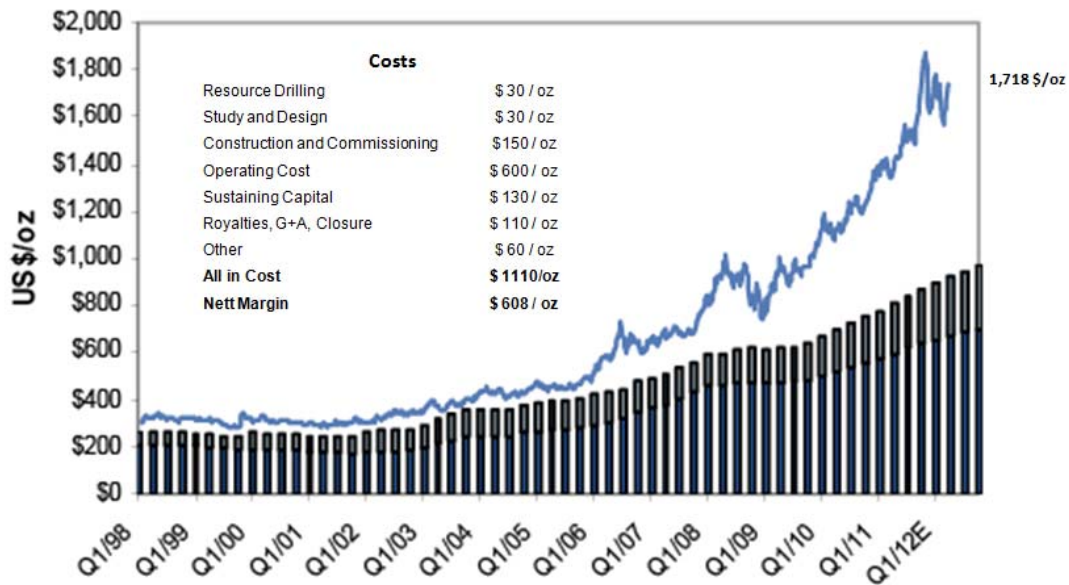
**Chart 2: Risk Aversion - Citi Macro Risk Index**



Let's try to illustrate that in very simple terms: the life cycle of a gold company is structured in various phases. To start, there is the discovery and the development of a resource. Then a mine needs to be constructed and commissioned. The ore is produced at a certain cost per ounce and for the operation to run smoothly, a reasonable amount of maintenance capex will need to be spent. In all likelihood the company is looking for more ounces of gold on their properties as they would like to increase their reserves and their life of mine. Then, once an ore body is exhausted,

the property needs to be rehabilitated. These steps all come at a price and our analysts calculated the total costs for mines in operation in the Craton Capital Precious Metal Fund at \$ 1,110 per ounce of gold. The current price of gold is quoted on Bloomberg at \$ 1,718 per ounce. That leaves an average net margin of \$ 608 on the table. This means that with every ounce of gold produced the company is currently pocketing a net profit of over \$ 600. In short, a gold producer has all the attributes of a very sound business model.

**Chart 3: Gold Net Margin**



Source: GFMS, RBC Capital Markets estimates, Craton Capital

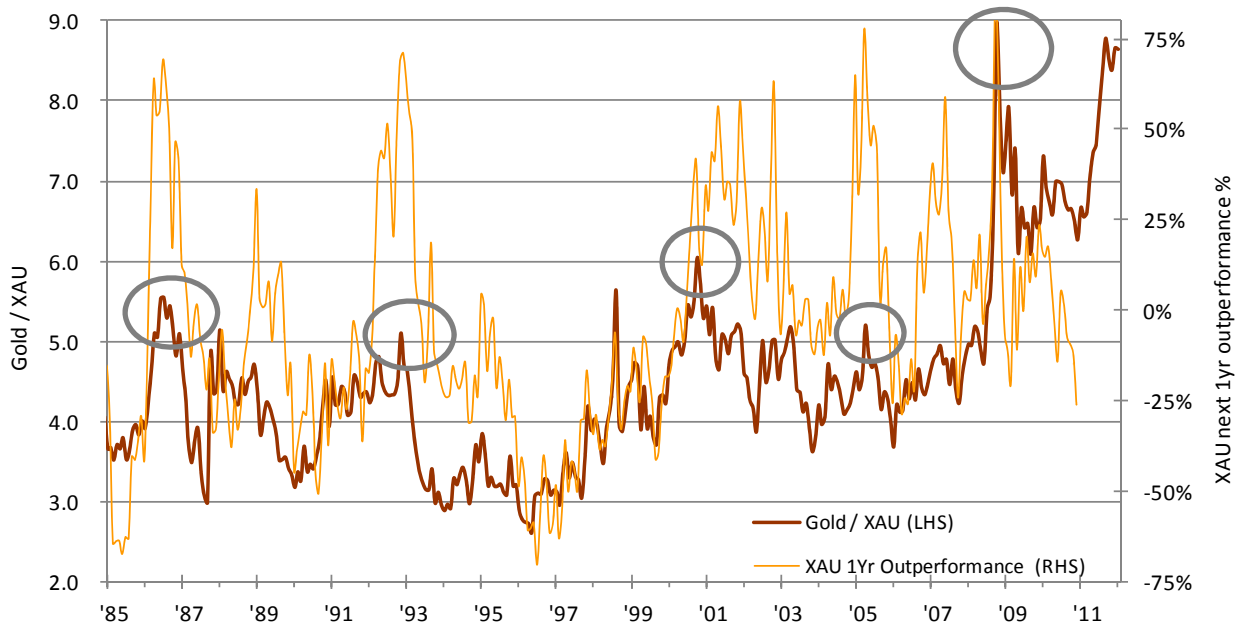
Whilst investors still need to come to terms with the strongly improved economics, some governments are a few steps ahead. Strong cash flows by companies are attracting increased royalties, taxes, free carries etc. Resource nationalism comes in various formats but it is definitely a risk investors have to be aware of. Hence it is imperative to invest in companies in politically secure domiciles, preferably with unhedged resources in the ground and a well established legal system that rules the jurisdiction. It is a policy that the Craton funds follow strictly. But the overall verdict remains and it is illustrated in the chart below: Gold companies compared to the gold price continue to trade at significantly oversold levels, in territory that we have not seen in 25 years. So “something has got to give” over time. Either the equities will close the valuation gap or the gold price will see a significant downward correction. Our conviction remains firm with the first scenario. The timing of the re-valuation of the sector remains open but one senses a change of tide. Equities started to outperform the physical and risk indicators are on the decline since the latter part of last year. Risk aversion measured by the MRI was at very elevated levels in the last two quarters of 2011, but has halved since its peak.

**Chart 4: Sr/Int. Historical P/NAV – From Premium to Discount**



Source: Canaccord Genuity

**Chart 5: Gold/XAU – Equities Oversold**



Source: Bloomberg

We remain relatively positive on the gold price outlook. “It is tough to make a prediction, especially about the future”, legendary baseball player Yogi Berra was once quoted. So we elect not to pull a number out of the hat. The stage has however been set by the two most important central banks in the world by maintaining ultra-low interest rates for years to come. In its recent statement the Fed committed itself to keep the rates unchanged until 2014, possibly even longer. But it is of great importance to note the shift in policy by the ECB with the change of guard from Jean-

Claude Trichet to Mario Draghi. Since its emergence in 1988, the European Monetary Union followed a strict and Bundesbank-like mandate of price stability. This policy remained the ultimate *sine qua non* with the newly formed ECB in 1998. But the ECB under Mr. Draghi might abandon this strategy altogether and follow a very similar stance as the Fed does by keeping interest rates ultra low and providing markets with chunks of liquidity. A clue about the future relative prospects of the US dollar and the Euro lies in what in essence defines the value of a currency: It is a reflection of the basic economic and fiscal health of a nation. If this is a concern to you, then one should not dismiss the distinct possibility of gold performing very well.

The Craton Capital Precious Metal Fund had a good start into the year. All things considered, the 16.5 % return in January was only a small step to closing the valuation gap that still exists between gold price and equities. The robust decline of risk indicators and an increased investment appetite leads us to conclude that financial markets are starting to look through the existing mess in the Euro zone. It is early days though but other financial indicators, in particular in the US, point in the direction of a constructive environment in equity markets and if that materializes over the next few months, then precious metals and commodity equities will lead the charge. This may create a window of opportunity where the favourable consequences exceed the unfavourable ones. As 2011 bore a litany of negative surprises and angst, this year could take a turn in the opposite direction.

---

\* Washington DC, January 12<sup>th</sup>, subway platform

*“On that cold winter morning, a man sat a metro station and started to play the violin. He played six Bach pieces for about 45 minutes. During that time, it was rush hour, it was calculated that thousands of people went through the station, most of them on their way to work.*

*Three minutes went by and a middle aged man noticed that there was a musician playing. He slowed his pace and stopped for a few seconds and then hurried to meet his schedule. A minute later, the violinist received his first dollar tip; a woman threw the money in the till and without stopping continued to walk. A few minutes later, someone leaned against the wall to listen to him, but the man looked at his watch and started to walk again. Clearly he was late for work.*

*The one who paid most attention was a three year old boy. His mother tagged him along, hurried but the kid stopped to look at the violinist. Finally the mother pushed hard and the child continued to walk turning his head all the time. This action was repeated by several other children. All parents, without exception, forced them to move on.*

*In the 45 minutes the musician played, only 6 people stopped and stayed for a while. About 20 gave him money but continued their normal pace. He collected 32 dollars. When he finalized playing and silence took over, no one noticed it. No one applauded, nor was there any recognition.*

*No one knew this but the violinist was Joshua Bell, one of the most esteemed and finest musicians in the world. He played one of the most intricate pieces ever written with a violin worth 3.5 million dollars. Two days before his playing in the subway, Joshua Bell sold out a theatre in Boston and the seats averaged 100 dollars”.*