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It glitters, too

It turns out that President Vladimir Putin is no Napoleon and the Swiss franc is no gold bullion. A pop-up war lifts many veils.

Following is a bullish analysis of gold, which will make up in content what it lacks in the element of surprise. In preview, the mining shares are commandingly cheap, just as the gold miners are very profitable.

To acknowledge an interest, your editor is no neutral observer. Personally long, he believes that gold is the answer to many, if not most, of today's timely investment questions, including:

· Which monetary asset makes up just one 500,000,000th of Earth's crust?

· Which is liquid, tangible, storied, unhackable and unprintable?

· Which entails no counterparty risk?

· Which can perversely depreciate against paper money just when you know—you *really* know—that it ought to appreciate, as in the immediate wake of the Lehman failure?

Gold is all these things, not forgetting the last.

Long-term readers, who can recite the essential bull case for gold in their sleep, will pass quickly by the seemingly constructive supply-demand arguments, not because they're not true (new discoveries are indeed rare, and the degree of difficulty in getting a new mine into production is great and growing), but because they are beside the point. A year's production, on the order of 3,500 metric tons, hardly registers in above-ground stocks, on the order of 205,000 metric tons, which are not consumed but augmented. Almost twice as dense as lead, gold is certainly a thing, but it is also a concept. Its price can be said to be the reciprocal of the market's trust in paper money (and now, too, we suppose, in digital monetary interlopers like bitcoin).

The bull case for gold miners begins with valuation, and a comparison of the Philadelphia Gold and Silver Index with the gold price shows how relatively subdued is the speculative mood. At the close of 1999, when the Bank of England dumped its gold near a generational low in prices, the XAU-to-gold price ratio weighed in at 0.236. At year-end 2008, after the Lehman Brothers bankruptcy filing, which prompted a fast 29% swoon in the gold price, the ratio fell to 0.14. It stands today at 0.08.

"Of course," observes colleague Evan Lorenz on the industry's well-deserved reputation for poor governance, "an ounce of gold has never paid itself a lavish salary while destroying shareholder value through overpriced acquisitions and poor capital allocation, as gold miners did at start of the 2010s. However, a decade-long slump in share prices appears to have invested the surviving managements with prudence if not virtue."

It's the investor's cross to bear that the gods buried so much treasure in the dominions of grasping governments. Last year, Papua New Guinea unilaterally boosted its ownership stake in the Porgera gold mine to 51% from 5% at the expense of Barrick Gold Corp. and Zijin Mining Group Ltd., which had

No speculation here

source: The Bloomberg

been under the impression that they were the majority owners.

In January, First Quantum Minerals Ltd., the nominal owner of the Cobre gold mine, submitted to the demand of the government of Panama that it begin to pay a minimum of $375 million per year in royalties as well as a 25% corporate tax rate (the miner had understood that no such tax was payable until it had recouped the capital cost of its mine). Newly elected leftist leaders of the formerly welcoming nations of Peru and Chile have begun to lick their chops in anticipation of higher levies on gold mining.

"Resource nationalism" is rampant, observes John Hathaway, managing director of Sprott, Inc.—as the market is well aware. Only compare, for instance, the valuations of Newmont Corp., at 27.4 times trailing net income, with that of Barrick, at 20.8 times. Each company sources about half of its production in North America, but Barrick has greater exposure to places where the rule of law runs at the discretion of the host government.

A monetary asset first and last, gold competes with other kinds of money as well as with credit, the promise to pay money. Notably, then, since the start of the year, the Swiss franc has declined by 4.3% against the greenback while the Japanese yen has been basically flat. Actively working to discourage the appreciation of the franc, Swiss authorities have set a minus 75 basis-point discount rate. Gold issues no press releases, conducts no independent monetary policy and yields nothing, and is, in that respect, a relative bargain. Worldwide even now, as Bloomberg reports, $5.742 trillion's worth of debt securities are priced to yield less than nothing in nominal (let alone real) terms.

Barrick's fourth-quarter results, released on Feb. 16, showed earnings per share rising 46% year over year to $0.35 versus expectations of $0.29. Rather than pouring those profits into the search for new gold deposits, the mining giant announced a $1 billion share-repurchase program. "We believe that the shares are trading in a price range that does not reflect the value of the Company's mining and financial assets and future prospects," CEO Mark Bristow told readers of the accompanying press release.

As a result of a decade of belt tightening, today miners are solidly profitable. "[P]roductive gold miners began the year 2020 with average operating margins of 20%," James Rasteh, founding partner of Coast Capital Management, L.P., advises his clients. "Since then, margins have more than doubled due to an increase in the price of gold, but also, and more importantly, a decline in production costs—which consist mainly of energy, raw materials, and labor in local currencies. The average gold miner is currently four times more profitable than the average company in the [S&P 500], yet trades at only 1/3 of the valuation of the S&P."

Assuming you agree with the aforementioned rationale for buying gold miners, the next question is, Which ones? With gold discoveries lagging, one might think the shares of junior miners are an attractive opportunity, it being cheaper to acquire reserves on Wall Street than under ground.

"I've come to the point of view that companies that are in production and have a reasonable mine life are the best place to be," John Hathaway, also co-portfolio manager of the Sprott Gold Equity Fund, tells Lorenz. "Companies that are in the development stage find that their timelines keep getting stretched out, even in Canada, which is one of the best places to be. What you thought was the date of first production gets pushed out by a year or two and sometimes more. To me, the obvious and best place to put money to work are the ones that are demonstrably cheap based on earnings and cash flow."

Within the universe of producing miners, smaller companies offer better value than larger ones, Rasteh contends. "A big part of that is that, because the industry is so complicated, investors tend to invest through ETFs," he tells Lorenz. "When you invest through ETFs, the ETFs are geared towards larger companies, so, by default, the larger companies will trade at a slight premium."

As an example of the value on offer, Chad Tappendorf, Rasteh's partner, highlights Regis Resources Ltd. (RRL on the Australian Securities Exchange). With an A$1.4 billion ($1 billion) market cap, Regis is a minnow compared to the big fish in the United States like Barrick ($41.1 billion market cap) and to Australian gold miners like Northern Star Resources Ltd. ($8.5 billion). The stock is also cheap at 12.5 times trailing earnings and 5.4 times price to trailing cash flows. For comparison, Barrick trades at the aforementioned 20.8 times earnings and at 8.4 times cash flow.

Regis operates three assets: the Duketon Gold Project, situated in the North Eastern Goldfields of Western Australia; the McPhillamys Gold Project in New South Wales; and a joint venture (Regis owns 30%, and AngloGold Ashanti Ltd. the remainder) in the Tropicana Gold Project in Western Australia. In the half-year ended Dec. 31, 2021, Regis generated a 40% Ebitda margin by selling 216,651 ounces of gold. It estimates that its all-in costs of extraction are between $1,039 and $1,094 per ounce versus the current spot price of $1,944. With net debt amounting to 0.5 times trailing Ebitda, the Regis balance sheet is lightly leveraged.

"The company has really good assets: Low-cost production in a Tier 1 jurisdiction, and it is sitting in a gold belt in Australia that is largely unexplored at this moment," Tappendorf says. "The gold belt in which it sits has about only 10 million ounces [i.e., reserves that have been discovered], but it is largely unexplored and largely near the surface and sits right next door to one of the largest gold belts ever discovered, with 160 million ounces."

For investors looking for diversified exposure to miners without, necessarily, overpaying for the biggest producers, there is the Sprott Gold Equity Fund (SGDLX), which came into the world as the Tocqueville Gold Fund in 1998. From inception to date, the Sprott fund generated a 9.5% compound annual return versus a 4.25% annual gain in the Philadelphia Gold and Silver Index and a 7.9% yearly return from the S&P 500. This is despite fees and expenses that sum to 1.4% of assets under management.

At year end, Sprott held 12.9% of assets in the form of gold bullion itself. Top mining positions included Corvus Gold, Inc. (6.9% of AUM; the company was acquired by AngloGold on Jan. 20), MAG Silver Corp. (4.8%), Osisko Mining, Inc. (4.6%) and i-80 Gold Corp. (3.9%).

"Our largest holdings show up as established producers," says Hathaway. "It is cheaper to buy a mine on the market than to build a new one, especially things that are within a reasonable time frame of actually producing. That's the rationale for holding something like Osisko Mining, which will be producing in two years. There will be a few other names like that."

Lorenz finally put the big question to Hathaway: "What's the best way to play the gold bull market? Should investors look at the majors? The juniors? A diversified fund like Sprott?"

Hathaway stopped him right there. "Go no further," he said.

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