HindeSight

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More risks in the world of gold equity funds than meets the eye

We wrote some months ago about the risks of investing in Gold ETFs, and urged people to consider a better claim on the physical gold than merely a paper promise. In addition to ETFs, we believe other gold funds may not be the most secure and most stable way to invest in gold.

Gold equity funds prior to the evolution of pure gold ETFs, were primarily the only vehicle for those seeking an investment in the precious metals sector. Most investors see "gold" in the title of a fund and invest believing they are aligned more or less with the gold price without realising there is inherently more risks associated with such funds relative to funds that align themselves to the bullion price.

We have been long term supporters of one of the largest and most successful precious metals funds. We viewed their stellar performance as a measure of accurate stock picks by an astute investment manager. However, we recently analysed the returns of this well-known gold fund. The graph below illustrates what we found.

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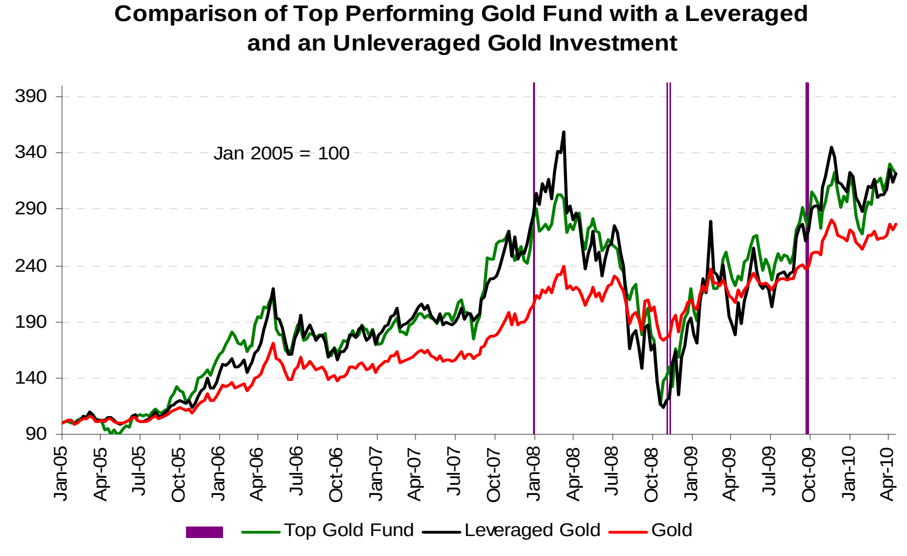


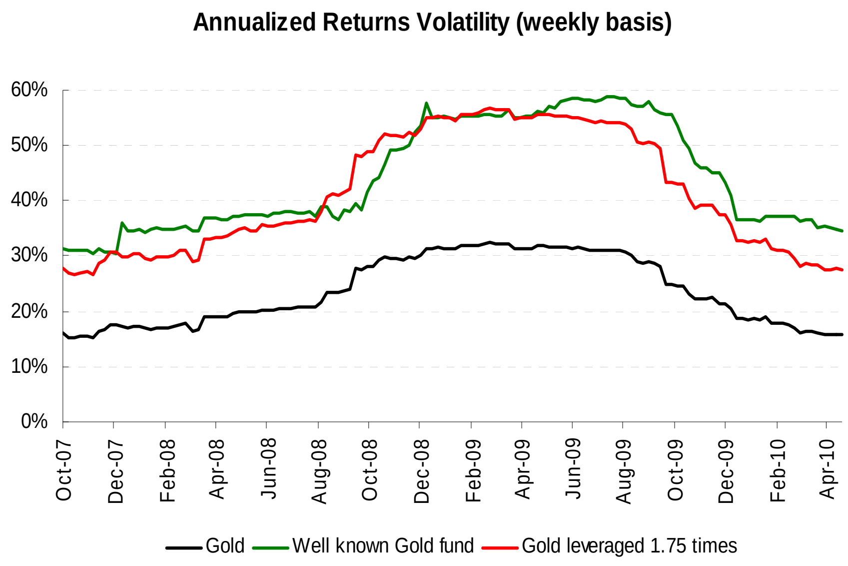
As can be seen, the fund does not follow a simple gold investment. If that was the case the green line – showing the performance of the fund – would closely follow the red line, which is the performance of spot gold. Instead, we linked the returns of the gold fund to gold by splitting the chart into 4 sections, marked by the vertical purple lines:

1) Jan 2005 - Dec 2007	Fund ~ 1.5 times spot gold
2) Jan 2008 - Oct 2008	Fund ~ 2.4 times spot gold on **down** moves (weekly numbers)
	Fund ~ 1.75 times spot gold on **up** moves
3) Nov 2008 - Oct 2009	Fund ~ 3.2 times spot gold
4) Nov 2009 - Present	Fund ~ 1.6 times spot gold

The correlation at over 97% is very high, and as you can see the performance mirrors that of the gold fund, on a week by week basis, very closely. What is clearly observable from this example is that by investing in this fund you have effectively 2x leverage to the gold price, which at times has accelerated on the down periods to 2.4x

Where does this leverage come from? The gold fund is marketed as a gold equity fund, and that is what primarily creates the leverage to the gold price. For how gold equities generate leverage to gold, we highly recommend you read the short appendix at the end of this report.

Another aspect to consider when analyzing the gold fund with respect to the performance of gold is the volatility. It is clear from the chart below that the well known gold fund has a volatility consistent with a leveraged exposure (approximately 1.75 times) to the gold price:



It is clear that increased exposure to the gold price comes at the cost of heightened volatility. While this is no amazing revelation to anyone in the gold arena, it is an area we consistently have to cover with potential investors who are looking to allocate money in the gold sector.

A typical investor will tell us that they have some gold exposure. Say, investor A has $500k in gold ETF and $500k in top gold fund. Investor A often looks shocked when we tell him he has gold price risk of approx $1,500k and that if gold loses 10% he will most probably lose closer to 15%.

We are of course writing this from the desks of Hinde Gold Fund so allow us some bias, but the strategy of HGF is simple. **Own *real gold* stored in a secure vault - not paper gold - and target a return well in excess of the spot gold price, net of fees, and with volatility close to the (unleveraged) gold price.**

Hinde Gold Fund, for its first year, had a benchmark of 50% mining stocks and 50% gold. Despite beating that benchmark, we ran into the problems associated with leverage as outlined above, as well as the 2008 end-of-world scenarios when the financial system virtually ceased to function.

Hence, after Oct 2008 HGF moved to a gold bullion benchmark, since when it has outperformed the gold price by over 25%. This has been achieved by small allocation shifts to the gold bullion price – while always maintaining a long-bias – and also an average holding of 10-15% of junior mining equities that have very low beta to the gold price.

We know we have the best strategy for a gold investment, and we believe we can maintain this outperformance for the long term.

Appendix - Gold equity valuations and leverage: a quick explanation

Gold mining companies offer leverage to the underlying commodity. In this case let's assume to gold. The most basic explanation for the implied leverage in gold equities is the margin expansion when the gold price increases. A typical gold company without any hidden cap-ex figures will report a cash flow based on selling the gold at the spot price allowing for its cost of production.

The only reasonable way to evaluate a gold mining company is to look at the net present value (NPV) of the potential future cash flow, discounted at an "appropriate" discount rate. Why an NPV? because gold mining companies have a finite gross mine life, i.e. the resource is fully extracted and the mine becomes obsolete. This is unlike a manufacturing company that could keep producing widgets indefinitely *ceteris paribus*, and thus will have a continuous cash flow stream. Even allowing for the capital costs needed to sustain production, development and exploration, to value the company the future cash flow derived from the mining company, over its lifetime, must be discounted at a rate that represents the geopolitical, geological, and even social risks that could impede the maximum cash flow return. An investor would clearly assign more risk to a mine in Afghanistan than say Canada, and so would want to be compensated for this risk by buying the stock at a lower price. A higher discount rate will produce a lower NPV and thus the stock based on let's say a 1 to 1 value to this NPV will be cheaper than the mine with a lower discount rate (discounted over same time period).

Rationally speaking investor should not pay more than this NPV (or net asset value) for the mining company, because how would you expect to make money if you keep paying over the odds for what they are intrinsically worth. But they do. As we mentioned earlier at the beginning of this section, gold companies provide leverage to the commodity – gold.

Example - If the gold price is $1000/oz and the production is $500/oz, the profit is $500. If gold rises by 10% to $1100 with cost of production still at $500 the profit is $600/oz, an increase of 20%. The NPV of the company would be calculated based on this $100 or 20% margin. The gold company would rise 2x the 10% gold rise. We have analysed since 2005, that as a rule of thumb gold mining companies perform 1.75x to gold price. The peculiar thing to note here is that the worse the sales to cost of production margin is, the higher the leverage and the more the potential return is with a higher gold price. Unfortunately this works the other way around too; as the gold price decreases margins decrease at the leveraged rate as well.