August 31, 2012

"Gold was not selected arbitrarily by governments to be the monetary standard. Gold had developed for many centuries on the free market as the best money; as the commodity providing the most stable and desirable monetary medium."
-MURRAY ROTHBARD, ECONOMIST AND PROMINENT PROPONENT OF THE AUSTRIAN SCHOOL OF ECONOMICS.

There's gold in them thar mines! Have you ever noticed how investment "experts" develop a convenient case of amnesia when it comes to their bad calls? Truly great investors are exceptions to this tendency, however. They are often the first to bring up their whiffs, with Warren Buffett being a classic case in point. His now legendary annual letter to Berkshire shareholders typically contains admissions of his errors of omission and commission over the past year.

Consequently, the investment team at Evergreen strives to follow Warren's way, which brings me to the subject of this week's EVA: one of our worst investment decisions of the last two years. In the spirit of coming clean, there is some competition for this designation. Our anti-REIT (real estate investment trust) stance certainly is right up at the top of our "what were we thinking?" list. However, we did play our anti-REIT security quite effectively for most of last year, so it's a bit early to be too self-critical on that score.

Gold mining stocks, on the other hand, have been a drag on our portfolios for almost two years, with the results in 2012 being particularly disappointing. While the S&P 500 is presently up 15% this year—most remarkable given the myriad slings and arrows of outrageous misfortune zipping around—the "Big Two" of the gold mining world, Newmont and Barrick, are down 18%.

Given that gold itself continues to levitate at a price that ensures abundant profits for this sector, such punk performance is somewhat mystifying. Even more perplexing is the huge lag stocks like Newmont have seen during the great gold run over the last five years. (Fortunately, the gold miners ran up nicely early on, allowing us to book some lush profits for clients before they hit the wall.)

As always, there are plausible reasons for this disparity. Prominent among them have been rapidly rising costs, due to both wages and other inputs such as energy. Similarly, a number of the largest mines under development around the world have been plagued by cost overruns, in some cases of a massive nature. The industry has also been legitimately criticized for a "growth at any cost" mentality that has led to a tendency to destroy, rather than build, shareholder value.

The good news is that this is changing. Newmont's decision to link its dividend to the price of gold was the seminal step toward a more disciplined and shareholder-focused mind-set. Then, this month, Barrick announced its intent to sell its troubled African mining unit to a Chinese entity.

The foregoing is meant to be a lead-in to this week's guest EVA. It is written by Grant Williams, with whom I became familiar thanks to my friend and newsletter all-star, John Mauldin. Frankly, until earlier this year, when John began publishing Grant, I had never heard of him or had the pleasure of reading his essays. However, as you will soon read, Grant is blessed with exceptional writing and analytical skills.

Proving that Walt Disney was right—that it really is a small world after all—despite being based in Singapore, Grant is also close friends with our newest team member, Mark Nicoletti (who will be representing Evergreen GaveKal in Northern California). This sheer coincidence is fortuitous for Evergreen as Grant has graciously given us permission to share his impressive research and musings with EVA readers.

This is a longer missive than we usually publish, but I think you will find his defense of gold and gold miners to be worth the time investment. His discussion of the stellar performance of gold stocks during the deflationary 1930s is particularly interesting. (Although Grant only touches on it, gold mining shares also excelled during the inflationary 1970s.)

Consequently, you might want to print this out (hey, HP and Lexmark desperately need the business!) and read it at your leisure over the Labor Day weekend. I think you'll learn why Warren Buffett may need to write another mea culpa to his shareholders in the next year or two—and perhaps why Evergreen might be able to take our gold mining holdings out of the loss column in the not too distant future.

David Hay | Chief Investment Officer

THINGS THAT MAKE YOU GO HMMM...
By Grant Williams

In the middle of South Dakota's Black Hills, near the Wyoming state line, lies the tiny town of Deadwood (population – according to the 2010 census, 1,270). Despite its evocative name, it's probably fair to say that, without the recent eponymous HBO TV series, few people would have even heard of a settlement that, in the 1870s took its name from the dead trees found in its gulch (yes, 'gulch'). Amazingly enough, despite its size, Deadwood is the county seat of Lawrence County which is described thus by the US Census Bureau:

"…the county has a total area of 800 square miles, of which 800 square miles is land and 0 square miles is water". Dead wood indeed.

A little more than two miles south-west of Deadwood lies another town of which few will have heard; Lead (that's 'Lead' as in 'feed' not 'Lead' as in 'dead'), and Lead has a claim to fame all of its own.

Lead was founded on July 10, 1876, after four men; Fred and Moses Manuel, Alex Engh and Hank Harney discovered a gold deposit that they would sell the following year for $70,000 to a trio of mining entrepreneurs which included George Hearst, future father of William Randolph Hearst the publishing magnate and James Ben Ali Haggin, for whom the prestigious Ben Ali Stakes horse race is named.

That $70,000 payment - which in today's inflation-decimated dollars, would be worth roughly $1,500,000 - secured the Homestake Deposit which would turn out to be the largest and deepest gold mine in North America, producing more than 40 million ounces of gold over its life until it was finally closed in 2002.

A year after acquiring the mine, Hearst and his partners sold shares in the Homestake Mining Company and listed it on the New York Stock Exchange. Homestake would go on to become the longest continuously-listed NYSE stock in history until it finally merged with Barrick Gold in 2001.

The story of Homestake Mining has been on my mind a lot lately as I have watched precious metal mining stocks get decimated over the past 6 months - reaching levels that they haven't witnessed since the very depths of 2008 - when gold was trading a little below $800. It's hard to get away from gold these days as the bears rejoice in gold's 'demise' whilst the bulls rationalize a healthy correction in an ongoing bull market, but the one thing everybody who follows gold is confused about is the performance of the mining stocks.

A look at the NYSE Arca Gold BUGS (HUI) index (anecdotally, the BUGS in the name of this particular index, for those who aren't familiar with it, stands for Basket of Unhedged Gold Stocks) as a proxy for the mining sector shows just how extraordinary the collapse in the mining sector has been. The senior gold miners, as a group, lost over 40% from their September peak when gold hit $1900 to their recent trough against a comparative fall of only 15% in the underlying commodity which, even by the standards previously set by this particularly skittish group, is quite something.

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If we overlay the gold price and add the junior miners we find that, not only have the juniors (perhaps understandably) underperformed further still, but that, as a group, they managed to lose over half of their value in the same period.

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Now, for many latecomers to the world of gold mining stocks, these moves have been enough to send buyers scurrying for cover, vowing never to touch these stocks again. As gold hit $1,900 last year, hot money that wanted nothing to do with gold at $800, thought it was expensive at $1,200 and were convinced that the gold 'bubble' had burst at $1,500, flocked to the yellow metal in sure and certain hope of a bonanza. But a funny thing happened on the way to the ore... um...the price of gold corrected. Fast.

I have spoken at length previously in these pages about the dangers of listening to the wrong voices when seeking commentary on gold but for the benefit of anyone who missed that, here are the do's and don'ts of the gold space:

DO listen to:

Eric Sprott, Richard Russell, Jim Sinclair, Bill Murphy, James Turk, Harvey Organ, John Embry, Pierre Lassonde, Ben Davies, Egon von Greyerz, Rick Rule, Marc Faber, John Hatthaway and Bill Fleckenstein (amongst others).

Do NOT listen to:

Warren Buffett, Charlie Munger, Bill Gates, Jim Cramer, Jon Nadler, anyone speaking on CNBC about gold whose name does not appear on the list above, your broker (unless he has heard of AT LEAST 50% of the names on the list of 'Dos'), the FT, the Wall Street Journal and (sorry Dennis) Dennis Gartman.

There are many commentators who have been right about gold for 12 straight years and there are many who have arrived at the party late and proceeded to apply the wrong metrics to gold when attempting to predict its future movements. My advice? Listen to the former and ignore the latter. But I digress...

Let's get back to Homestake Mining, shall we? Specifically, its performance during The Great Depression.

By 1930, Homestake Mining had been paying continuous dividends for 50 years but during the period 1929-1935, when the US stock market was in a tailspin as Depression gripped the world, Homestake's performance was nothing short of staggering—its share price (particularly in 1930, 1931 and 1932—before Roosevelt's Executive Order 6102 confiscated gold from US citizens) soaring as the Dow Jones nosedived. In that six-year period, as the price of Homestake's shares leapt almost 600%, it was accompanied by similar performance in both earnings AND the company's dividend payout—the former going from $4.16 in 1929 to $32.43 in 1935 (that's compound EPS growth of 41% annually) while the latter, by the time 1935 rolled around, had jumped from $7 in 1920 to $56 by 1935 as the company continued to pay out 8-10% of its earnings as a dividend.

Now, when this discussion arises, many people like to point out the fact that the official price of gold in US dollars at that time was fixed, and that surely this helped drive investment dollars into gold mining shares as it limited the downside in the price of the metal and there is a lot of merit in that argument —after all, who WOULDN'T feel happy investing in mining shares if they knew for certain that the price of gold would not go down? Unfortunately, where the price of anything is 'fixed' by certain parties, that 'fixing' can go in both directions and that is exactly what happened in the late-1920s/early-1930s.

Between 1924 and 1930, with the US on a gold standard, the price of gold traded in an incredibly narrow range between $20.69 and $20.63 and it was this stability which surely drove many into the welcoming arms of gold mining shares as the world around them began to implode. But then came 1931 and, with deleveraging and deflation the order of the day, the gold ‘price’ fell from an average of $20.65 in 1930 to an average of $17.05 in 1931—a decline of almost 20% in a year.

As you can see from the chart below, during that time the price of Homestake Mining almost doubled as the Dow Jones Industrial Average lost around 90% of its value and it kept on rising the following year as gold recovered all its losses and added a few extra pennies for good measure— averaging $20.69 in 1932 while the Dow continued to languish.

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As 1932 turned into 1933, there was a whiff of panic in the air and so it was, on April 5th, 1933, that President Roosevelt issued Executive Order 6102 *"forbidding the Hoarding of Gold Coin, Gold Bullion, and Gold Certificates* within the continental United States" and forcing holders to sell their gold to the government at the mandated price of $20.67 ($371 in today’s dollars):

(Wikipedia): Executive Order 6102 required all persons to deliver on or before May 1, 1933, all but a small amount of gold coin, gold bullion, and gold certificates owned by them to the Federal Reserve, in exchange for $20.67 per troy ounce. Under the Trading With the Enemy Act of 1917, as amended by the recently passed Emergency Banking Act of March 9, 1933, violation of the order was punishable by fine up to $10,000 ($167,700 if adjusted for inflation as of 2010) or up to ten years in prison, or both. Most citizens who owned large amounts of gold had it transferred to countries such as Switzerland.

Order 6102 specifically exempted "customary use in industry, profession or art"—a provision that covered artists, jewellers, dentists, and sign makers among others. The order further permitted any person to own up to $100 in gold coins (a face value equivalent to 5 troy ounces (160 g) of Gold valued at about $7800 as of 2011). The same paragraph also exempted "gold coins having recognized special value to collectors of rare and unusual coins." This protected gold coin collections from legal seizure and likely melting.

And that’s how these things tend to go, folks. The twist, however, came immediately after the enactment of Executive Order 6102:

The price of gold from the Treasury for international transactions was thereafter raised to $35 an ounce ($587 in 2010 dollars). The resulting profit that the government realized funded the

Exchange Stabilization Fund established by the Gold Reserve Act in 1934.

The *'resulting profit that the government realized'* could have been worded in another way, so let's run it through Google Translate and convert it from Officialese into Realitish:

'the resultant 40% overnight devaluation of the dollar'

So what did this 40% devaluation in the price of the dollar do to gold mining shares? Well, using Homestake Mining as our proxy again, we can see from the chart on the previous page that , at the time of the confiscation, it was up roughly 400% in value over the previous five years, but from there it climbed relentlessly higher as the price of gold was revalued upwards, increasing its profits by around 50% almost overnight— peaking around 600% higher mid-1938 than it had been ten years prior, with the Dow Jones still floundering 50% below its 1928 level.

So, gold miners proved to be an acutely smart investment through the Great Depression, completely disavowing the notion that owning such stocks in a deflationary environment was a foolish way to invest one's money.

The performance of gold and the mining stocks during the inflationary vortex of the 1970s is far fresher in the collective memory and, seemingly, far easier for the average investor to get their head around—likely because a rising tide floats all boats so people have a far easier time getting their heads around rising prices being good for this particular corner of the investment universe.

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So now let's fast-forward to 2012 and take a look at the current state of the world and, in particular, gold and gold-mining stocks.

Since its ‘peak’ at $1,900 in September of 2011, gold has undergone a correction of perfectly healthy proportions—roughly 18% to the recent low print of $1,539—and is in the process of building a base before it makes another move higher. *(NB I began writing this piece on Thursday BEFORE gold’s stunning breakout performance on Friday after the disappointing US data.)*

Why the certainty? Let’s recap just a couple of the factors that affect the price of gold (and by extension the mining stocks) and try to make an assessment of the situation.

Any attempt to figure out the likely movement of the gold price should begin with the actions of the world’s central banks as they are both the biggest holders of gold and tend to move largely in lockstep in long, trending motions. Some would say that they also have both the most to lose by a strengthening gold price as well as the means with which to drive the price lower but that is a discussion for another day. What IS certain, is that central banks are, generally speaking, all buyers or all sellers at the same time and, once they set a course in one direction, they tend to stay that course for decades.

September 1999 saw the signing of the Washington Agreement on Gold which was intended to set limits on the amount of central bank gold that could be sold into the market in a given 5-year period. It was precipitated by the extraordinary decision by Britain’s then-Chancellor of the Exchequer, Gordon Brown, to announce to the market that he would be selling roughly 60% of Great Britain’s gold holdings through a series of public auctions as well as simultaneous sales by the SNB (Swiss National Bank), The Netherlands, Austria and proposed sales by the IMF (International Monetary Fund). Central bank selling pressure had overwhelmed the market and drove gold to its low of $252. The Washington Agreement stipulated that signatories could sell a maximum of 400 tonnes between them over the next 5 years. It was re-signed again in 2004 and again in 2009.

In fact, central bank gold holdings slid continuously from around 1974 through the tail end of 2009 (see chart on left, below) as the need for gold diminished (at least in the eyes of the stewards of global finances whose judgement is being shown to be less than prudent in many cases). Coincidentally, the selling of gold holdings accelerated right around the time the gold price hit its nadir in 1999. Against every seller, however, there stands a buyer so the gold being disposed of by the central banks was simply finding its way into private hands—smart money, if you will— as ETF and private bullion holdings climbed aggressively (see chart on right, below).

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It will hardly cause the sharpest collective intake of breath amongst readers when I point out that, by the time the Chinese central bank announced in late 2009 that their gold holdings (which had remained unpublished for several years) had doubled to 1,054 tons, the juggernaut had turned and central banks had become net buyers of gold for the first time in almost 40 years. That pattern has continued—despite plenty of rhetoric to the contrary from these August institutions—and it WILL continue for many years to come while the world unravels the Gordian Knot of debt with which it has bound itself over the last thirty years—as the latest report from the World Gold Council highlighted this month:

(Sharps Pixley): Mexico, Kazakhstan and Ukraine added about 204,000 ounces in April. The Philippines added a whopping 1.033 million ounces in March with gold now at 13.6% of its total reserves. UBS highlighted the Philippines' gold purchase is significant as this is the second largest monthly Central Bank's purchase after Mexico's purchase of 2.5 million ounces in March 2011. World Gold Council (WGC) reported that central bank purchases were 80.8 tonnes in Q1 2012 or around 7% of global gold demand. What is more interesting is that WGC is now confident that central banks will continue to buy gold and has added official sector purchases as a new element of gold demand while eliminating official sector sales as a negative supply factor.

The other key driving factor is investment demand and, as we highlighted above, traditionally this source of demand has been the other side of the equation to central bank selling—now the two are aligned and that spells higher gold prices

(WGC): The value measure of gold demand was 16% higher year-on-year at US$59.7bln, 11% below the record from Q3 2011 of US$67.1bln. The average gold price of US$1,690.57 was 22% higher than the average of Q1 2011. In value terms, virtually all sectors of gold demand posted year-on-year increases, with the exception of physical bar demand, which was broadly flat, and the official sector, where purchasing activity was below Q1 2011's exceptional levels.

Investment demand was the only sector of the gold market to register year-on-year growth in the first quarter, which was led by solid demand for ETFs and similar products.

So, with that as a background, let's take a look at gold mining shares and the extraordinary value they appear to offer at these levels after six months of fear and loathing.

Whilst I was writing this piece, the chart below hit my inbox from Wesley Legrand in Australia and it highlights beautifully just how oversold the gold mining shares have become.

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Originally culled from a piece by James Turk, it seems only fair to let James do the talking:

(James Turk): "I want readers to take a look at the following 30 year chart (see above), which I believe is the most important and extraordinary chart for 2012. It presents the XAU Gold Mining Index measured in terms of gold, not dollars. We're making history here. Gold stocks have never been this undervalued before. We've had a 12 year bull market in gold, but we've also had a 15 year bear market in the mining shares that began with the Bre-X collapse. It's very rare in market history to see an outlier like this. This is an extraordinary event. Years from now we are going to look back and shake our heads in disbelief at how undervalued gold stocks were in 2012."

This chart below shows that, despite rebounding after 2008's decimation, mining shares, when priced in ounces of gold have hit new and unprecedented lows.

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But in case you think I'm cherrypicking, a matter of a couple of hours later, Nick Laird of the wonderful Sharelynx website (one of THE best resources for gold and silver charts on the web), sent me this chart (bottom of previous page) of the Barron's Gold Mining Index vs gold and the similarity is eerie:

To illustrate the point further, I am going to use a specific stock, Newmont Mining (NEM) as an example along with the ETFs that follow the senior and junior miners *(and, at this point, I should disclose that the Vulpes Testudo Fund has a long position in NEM).*

Newmont Mining currently trades near a 52-week low and has a dividend of just over 3%. Newmont's dividend is indexed each quarter to the average price of the gold it sells in that quarter with step-up provisions of a further 7.5c if the average gold price exceeds $1,700 in a given quarter and a further 2.5c should those sales average in excess of $2,000. The company has a cash cost of gold mined of around $650/oz and is working hard to lower that figure. Analysts figure that earnings will hit an all-time high this year of close to $5 per share. The P/E ratio? That would be 11x. The same metric in 2008? 30x.

Newmont Mining is currently trading roughly $20, or 40% below the average analyst target price of $67.23 with a yield 50% higher than that of the S&P500 and a P/E ratio 30% lower, while its price-to-book ratio, at 1.8x, is also extremely close to the 2008 lows If we revisit the performance of NEM, GDX and GDXJ when priced in ounces of gold, it becomes apparent just how beaten up this particular sector has become. NEM and GDX are at levels comparable to the very depths of 2008 and, when comparing the state of the world now versus then, it is incredibly difficult to understand just why that would be.

Remember, in the Autumn of 2008, panic was at its zenith and good stocks were being thrown out along with bad as deleveraging took hold of the world.

Since then, a number of key metrics that directly affect the price of gold and gold miners have changed so it makes sense to see where we stand:

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Now, with that as a backdrop, and with the understanding that, as we approach the endgame for Europe, the choice facing those empowered to make decisions about how it ultimately plays out is actually a fairly simple one—allow massive, widespread sovereign defaults and a continent-wide bank-run or print unlimited amounts of Euros—is anyone still confused about how this will all play out?

Europe's 'leaders' will NOT arbitrarily choose to inflict the pain necessary to deal with the current debt crisis when they have the means to print free money at their disposal and the only impediment to doing so is an as-yet undetermined percentage of 81 million German citizens. If Germany has to leave the EU in order for the moneyprinting to happen, then mark my words, they will leave—either because they choose to or because the 'Latin-bloc' (which now includes France) force them to. Either way, the end will come in a shower of confetti paper money.

There may well be a period of deflation or deleveraging prior to inflation taking hold, but with inflation the central bankers' firehose of choice, we can be fairly certain that inflation is in our future and inflationary environments are good for gold. As for the period of deflation/deleveraging which we are seeing now, using the greatest de-flationary period in history as our example would seem to suggest that gold stocks will perform extremely well under those conditions also.

The fact that gold stocks are behaving so poorly seems to be as a result of both misunderstanding and inadequate knowledge of history on the part of the vast majority of investors and, as we have seen with subprime, Greece, Spain, Italy and, one day, Japan, the UK and the US, nothing matters to anybody until it matters to everybody.

When the need for gold as protection dawns on everybody, they will realise that owning it through gold mining stocks will provide tremendous upside gearing—particularly from these bombed-out levels—and, with gold making up such a tiny percentage of global financial assets (the bulk of the increase over the last ten years has been due to price appreciation), it will become a race to own ounces of gold in the ground.

The recent (April) Thomson Reuters GFMS survey laid things out perfectly:

(UK Daily Telegraph): Rising fears about [Spain] will send a fresh flood of investment towards the "safe haven" metal, according to the annual report from Thomson Reuters GFMS.

Philip Klapwijk, global head of metals analytics at the consultancy, said: "We could easily see last September's record high [a closing high of $1,900.23 on September 5] being taken out.

"A push on towards $2,000 is definitely on the cards before the year is out, although a clear breach of that mark is arguably a more likely event for the first half of next year."

Demand for gold often sees a boost when fears about the situation in Europe intensify. The metal can likewise benefit from the prospect of more quantitative easing (QE), as investors seek to protect their wealth from the inflationary effects of central bankers' actions.

The potential pitfalls? Well, they lay them out too:

In the shorter term, GFMS thinks the apparent abatement of the eurozone crisis and reduced expectations for a third round of quantitative easing or "QE3" in the US could drive the gold price lower, perhaps below $1,550 in the next couple of months.

Anybody see an abatement in the Eurozone crisis? Less chance of QE3 after this week's GDP revision and the weakening jobs market in the USA?

Me neither.

Gold stocks offer tremendous value and, while it is perfectly possible that they could get even cheaper in the next few months if fear leads to panic which in turn leads to indiscriminate selling, at some point they will be appreciated for the value they offer and, if like everything else in the last few years, that realization dawns on everybody at the same time..... look out!

Now, as I explained earlier, I began writing this piece earlier this week in between shifts driving a taxi for my daughters and, last night, in the wake of appalling US payroll data, gold finally busted loose - taking the gold stocks with it as the NYSE Gold BUGS Index added 7%.

This may or may not be the dawning of a collective realization (we have seen many false examples), but, if the deteriorating data leads to the inevitable appearance of QE3 (and it's hard to see how the Fed, in an election year, could take any action AFTER June's meeting) the price of gold (and with it, the price of mining shares) will head for new highs once again.

Count on it.

But I will leave you this week with the words of a gentleman for whom I have a tremendous amount of admiration, Raoul Pal.

In a recent presentation entitled The End Game, Mr. Pal had the following to say about the next stage of the crisis:

We don't know exactly what is to come, but we can all join the very few dots from where we are now, to the collapse of the first major bank…

With very limited room for government bailouts, we can very easily join the next dots from the first bank closure to the collapse of the whole European banking system, and then to the bankruptcy of the governments themselves.

There are almost no brakes in the system to stop this, and almost no-one realises the seriousness of the situation.

Got Gold (miners)?

IMPORTANT DISCLOSURES