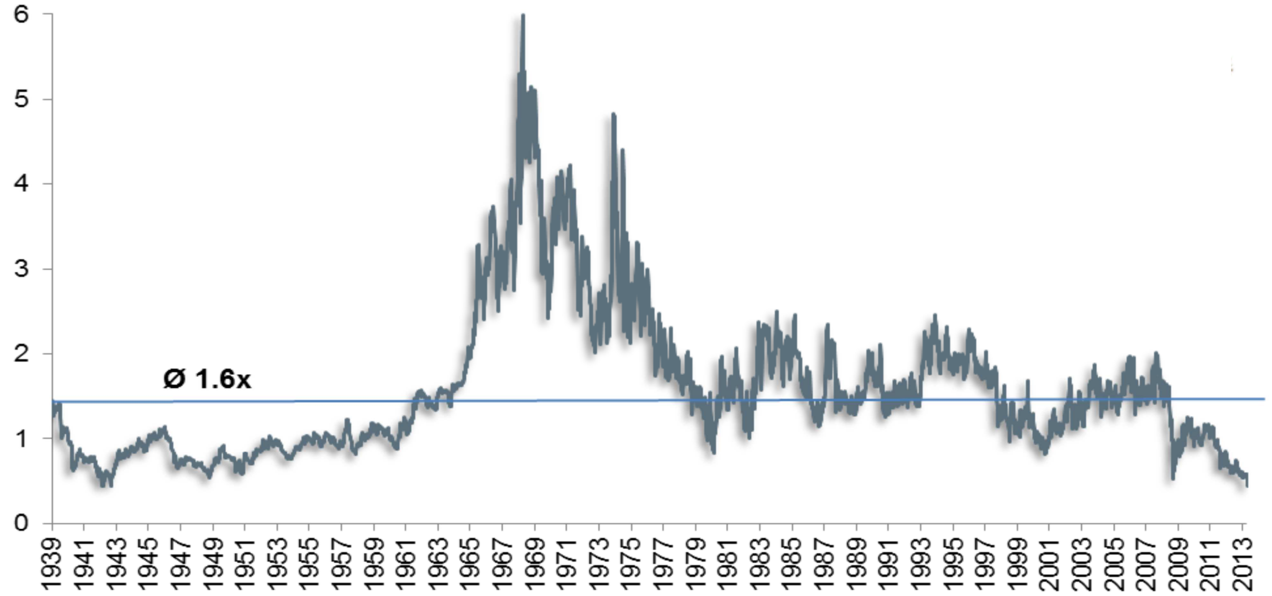
The Ultimate Contrarian Investment

"...At a bear market low those investors who have money are thanking their lucky stars that they avoided the bear market disaster, and the last thing they are tempted to do is to buy stocks. The retail public, who have been wiped out, swear that they never want to hear the words "Wall Street" or "stocks" again. In this kind of atmosphere, you have to plop down your hard-earned money and buy stocks. Very few people have the stomach or the nerve to do it. But those few who buy here will be the eventual winners...Believe me, it's not easy, even if you've waited a decade for exactly this situation." Richard Russell, Dow Theory Letters, June 2013

From atop the current late-stage bull market in stocks, the context described above is hard to fathom. I was just two years old at the bear market bottom in December 1974 when investors (apparently) held a similar level of disdain for general stocks.

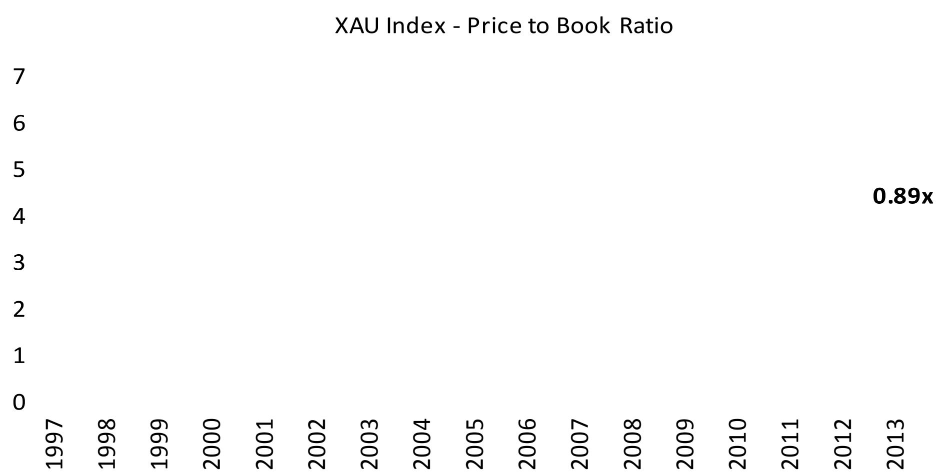
Believe it or not, though, the above quote appears to describe the current situation in junior gold mining stocks. This obscure group of securities are ~70% off their three-year highs (~3x the fall in the price of gold) having erased a decade of returns in the past two years. The last time the sector traded at this level, gold was 1/3 its current price.

Barron's Gold Mining Index Relative to Gold: Lowest in 70 years (since 1943)



Source: In Gold We Trust, Incrementum AG, June 2013

Absolute valuation for the overall gold mining sector matches, or is lower than the period of profound secular distress culminating in 1999-2001 when gold traded between $250-300/oz:



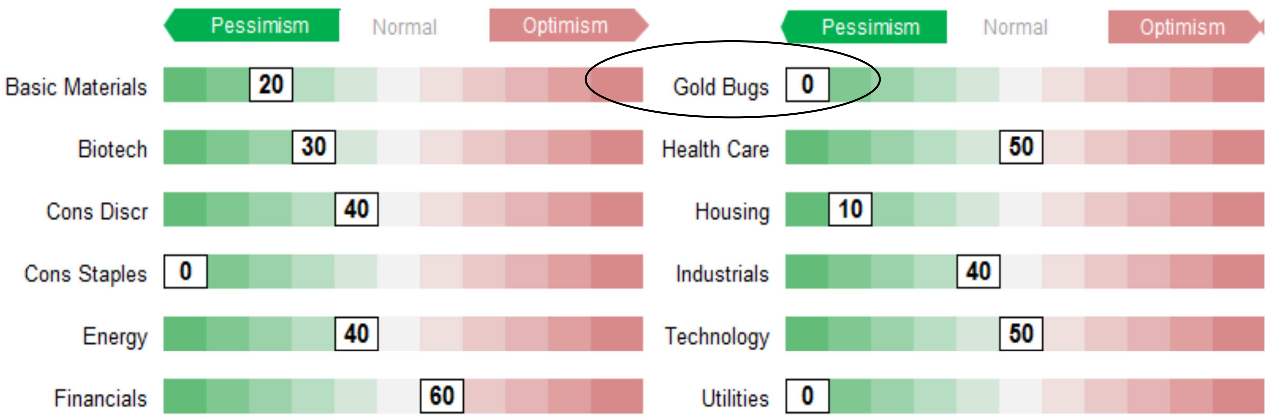
"We went back as far as 1997 and *could not find one episode where gold producers as a group traded below book value – and the late '90s was known as the 'nuclear winter' for the gold mining industry!"*

Jeff Clark
Casey Research,
July 1, 2013

Source: Bloomberg, as of July 14th 2013

The fall in gold in Q2’13 has also catalyzed climactic panic selling of the miners, and It may not be over.

Gold Miner Sentiment: Contrarian Bearish



Source: www.sentimentrader.com

Summary

We had been intrigued by this industry for years but never bothered to understand it and rarely noticed any real value. But during Q2'13 Eschler Recovery Fund finally accumulated a position, roughly comprised of ¾ producers and ¼ explorers, now worth 25% of NAV. Buying into this downdraft, initially in March and April, impacted NAV during the past few months (the fund is now up +5.55% since inception on 8 October 2012). But if we are correct in our assessment of gold, and in the price paid for the collection of miners in which we have invested, this holding could ultimately generate large excess returns independent of the broader stockmarket. This would be very beneficial to the overall portfolio at a time when general stocks in the US appear to be mostly fully-valued and offer low expected returns.

We are not gold bugs and we recognize that gold mining is a tough industry perhaps unsuited to true long-term investment. We certainly do not possess differentiated geological knowledge. But we feel we can rely on certain analysts and investors who do know a lot about individual managements and deposits. And we are very confident that the industry now qualifies as a value investment with potentially high, though volatile, expected returns.

Implementation

We have chosen to invest in a *basket* of junior gold stocks. Why a basket? While we prefer to invest in concentrated holdings of individual securities, this is not the first time we have invested in a broader basket of fundamentally attractive securities in an overlooked part of the market. From time to time, the undervaluation of entire groups of stocks is such that we believe a basket approach can diversify risks without relinquishing return (the diversification benefits of this basket approach in the junior gold sector are arguably greater given the high risk attached to individual projects). In 2010 we invested in a basket of small cap Japanese “net nets”, stocks trading at least 30% below liquidation value, and made a positive return through the end of 2011 in a weak market. In January 2011, we invested in a group of micro-cap US thrifts and earned annualized 20-30% returns on capital by the time we exited the positions in late 2012 / early 2013. The big mistake we made in both cases was not to make the basket position a much larger percentage of the portfolio. Another added attraction of the junior gold mining segment is that panic selling has created ripe near-term conditions for achieving single stock alpha in addition to high mean-reverting returns at the sector level. For example, one of the junior explorers we acquired only a few weeks ago, Esperanza Resources, just received an offer at a ~35% premium to our cost. The acquirer, mid-tier producer Alamos Gold (another holding in the fund) has stolen the company at a steep discount to Esperanza's average enterprise vale over the past year, paying away only 5% of its own market cap to greatly accelerate potential future production growth.

Our basket of junior gold miners currently has the following characteristics:

Our junior and mid-tier producers are all growing production and operate primarily in the favourable jurisdictions of North America and Mexico. They average cash costs of ~$600/oz allowing for ample cash generation at current spot gold prices that can be used to cover all or most of the other considerable indirect costs, and to fund growth. They have strong balance sheets with cash on hand averaging ~1/3 of market cap. These shares are on average ~60% off their highs and trade at just over half their 52-week highs.

Our junior explorers are active in Ontario, British Columbia, Nevada, Mexico, Columbia and Burkina Faso, all currently favourable jurisdictions for building and operating gold mines. Most are near production, or have cash on hand to move along a well-defined development plan. Average market cap is ~$65m but average enterprise value is ~$38m on account of cash balances averaging ~40% of market cap. They are not the cheapest in terms of cash to market cap, but more importantly all appear to have compelling resource potential. These shares are on average ~80% off their highs and 60% off their 52-week highs.

Catalyst: Gold

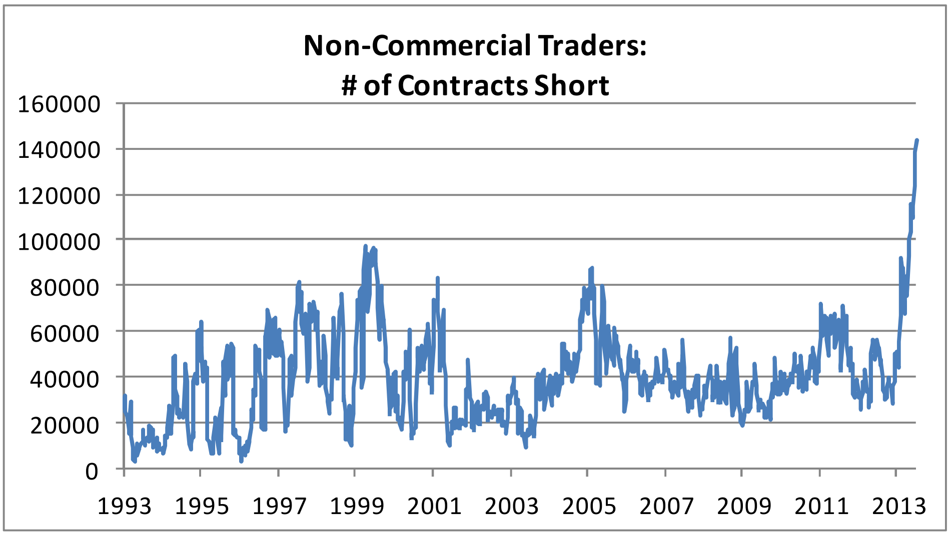
Gold mining shares will always remain tethered to the price of gold. Sure, increased cost transparency and a focus on capital efficiency at the micro level are important. But we feel we can deemphasize this aspect in our overall thesis. The bottom line is that valuation reversion to the mean will not happen in the absence of a recovery in the price of gold. We are the first to admit that gold might fall further in the short term. But we feel strongly that gold's emotional sell-off over the past several months was at odds with improving fundamentals that will ultimately win out. We base our view on robust underlying supply and demand trends; gold's valuation relative to alternative financial assets; and technicals. We are not smart enough to know what gold is worth other than to note that its rise over the past decade has been much smaller than during the 1970s when similar money-printing experiments were in force. It is in this context of an emotional sell-off set against strong fundamentals that we remain quite constructive on the outlook for gold.

Supply and Demand: Throughout history, citizens have viewed gold as a currency that cannot be debased. While this view is no longer universal, there still appears to be a majority of citizens worldwide who maintain this belief. Further, non-Western central banks who understand the history of money-printing continue to be heavy buyers. The flow of physical gold from West to East is evidence that citizens and leaders in many parts of the globe understand the historical role of gold, and are acting to protect their wealth. After all, the Federal Reserve's current "QE3" will still double in cumulative size over the next 12 months even in the very best case scenario where the Fed's targets for unemployment and inflation are met. The Bank of Japan's large experiment in monetization can only be interpreted as positive for gold as well. While booming stockmarkets have turned "paper gold" markets into a temporary source of supply as momentum investors in the West sell gold to buy risk assets, much of the damage from gold ETF liquidation now appears behind us. In fact, China just launched its first two gold ETFs to a robust reception. The weakening Yen has helped gold ETF holdings in Japan buck the trend in the US and rise substantially this year. We also wonder whether money coming out of bonds might not leak into gold if stocks roll over.

Valuation: Since gold does not provide any yield and the supply curve is price inelastic, the key is to understand the relative demand, or lack thereof, for the existing stock. Sure, if gold stays where it is now some marginal, high cost mined supply will disappear. Perhaps one can thus argue for a supply-driven floor in the $1000-$1200 area (representing the all-in cost of producing an ounce of gold). But the more important factors are whether demand for physical gold can catch up with and surpass the selling of ETF "paper gold" (we think it can) and how long will real interest rates remain negative thereby perpetuating the minimal opportunity cost of owning gold (for some time). Indeed, it can be shown that the expected returns for gold are actually inversely related to the expected returns for financial assets. With the latter particularly low at this time, against a backdrop of gold having suffered its worst quarterly decline in 90 years, gold's expected return may now be quite high. For a cogent discussion of this premise that seems to stand the test of time, investors should refer to, "*Gold 2002: Can Investment Consensus Be Wrong? The Summers Barsky Gold Thesis, Sun Valley Gold LLC.*

Technicals: The technical situation in gold is fascinating. Non-commercial (otherwise known as large speculator) short future positions on the Comex have exploded to a record 143,657 contracts equating to 407 tonnes. Large speculators, unlike commercials (producers), do not take delivery. These non-commercial shorts will ultimately have to be covered, most likely at much higher prices. Non-commercials are always positioned wrong at extreme turning points, and exacerbate trend change as their extreme leverage and inability to take delivery, or deliver the physical, forces them to close positions. One key thing to watch will be the pace of gold ETF liquidation: if it reverses or at least slows to a near-halt that will be an important bullish signal as ETF and futures selling are intertwined due to ETF market maker hedging.

CFTC CEI Gold Non-Commercial Short Contracts/Futures Only



The non-commercial short position in gold equates to 407 tonnes, 3.6x the 20-year average of 113 tonnes. This equates to nearly 11% of global net demand for gold from all sources (Q1'13 annualized).

Source: World Gold Council: Gold Demand Trends, Q1 2013, p13

Source: Bloomberg, CFTC, as of July 9th 2013

Roadmap

What will we be looking for to confirm or disprove our thesis? At a macro level, we want to see stabilization and, in time, recovery in the price of gold. At the industry level, we want to see signs confirming that we are not alone in observing value in the industry, specifically purchases of high-quality junior explorers by larger gold producers. The purchase of Esperanza Resources by Alamos Gold and the purchase of Rainy River Resources by New Gold, are confirmatory examples. At the micro level, we will be watching corporate SG&A closely, in expectation that it begins to fall on a trend basis. We would like to see the cost of mining equipment and services begin to fall as well, disproving the consensus that mining costs will only keep rising. We are not assuming any dramatic exploration success beyond the immediate roadmap these companies have already clearly defined. Overall, we would like to see our basket earn a higher return than the gold miner indices.

Risks

As always with a contrarian investment, the risks are self-evident but priced into the market to a large extent. If gold continues to cascade down, these shares will fall more on a percentage basis. If corporate M&A does not pick up due to the large miners' new mantra of capital discipline at the cost of future growth, our thesis might not play out as we expect. Some of our junior explorers could simply run out of money, or go into hibernation thereby delaying or even impairing the realization of corporate value. This latter scenario is a material risk for our basket of companies. However, we feel our realistic worst case is that certain of our smaller exploration-focused holdings might get away with suffering dilution to secure funds, or selling out cheap, as opposed to actually going under. We estimate that if only a handful of our junior explorers survive as independent going concerns in a future rising gold environment, this will more than offset other picks gone wrong.

Theron de Ris
14 July, 2013