Eschler Recovery Fund (ERF)
Q3 2017 Update

	Q3'17	Year-to-date
A share class	-1.37%	-0.37%
B share class	-1.12%	+0.37%

"*What can a market analyst say about the state of optimism among investors here in October 2017? The short answer is: not enough. No matter how hard one tries, one lacks the vocabulary to communicate the extent of the mood-induced, emotion-laden, thoughtless, careless, cavalier, arrogant, rationalized optimism that exists among stock and bond market participants in the U.S. today*."
(Robert Prechter, Elliott Wave Theorist, 23 October 2017)

Against the current speculative backdrop, getting stock selection right may be temporarily subordinate to broader portfolio considerations. This juncture demands an integration of macro risk management into a bottom up investor's toolkit. As a matter of fact my modus operandi for the past five years (as this mania metastasized) has been to build a novel portfolio with a fighting chance of getting through a bear market in stocks. In 2009 we heard value investors swear they would never ignore the big picture again. Today is hardly the time to give up on that learning. Two must-reads:

"Volatility and the Alchemy of Risk", Christopher Cole, Artemis Capital Management, October 2017
"*Historic Optimism Among Investors Fits The Case For A Major Top In Stocks, Part VII of a Multi-Part Series*", Robert Prechter, Elliott Wave Theorist, 23 October 2017

Strategy

Here is what I wrote in 2014 as a preamble to discussing the multi-year commitment to precious metals stocks in the fund:

"*Portfolio construction is a key differentiator for ERF, the most unique aspect of the strategy for the foreseeable future. Think of ERF as a high-conviction portfolio deploying a value-oriented investment program, but also invested in a massive unconventional insurance policy. There are four hedging tools at my disposal: 1) holding cash; 2) shorting; 3) buying put options, or 4) finding an investment whose prospective return may negatively correlate with the rest of the portfolio."*

For various reasons I argued at the time that options 1-3 above were inferior to option 4--investing in an uncorrelated area. The optimal manifestation of the latter was a large commitment to precious metals (gold and silver) shares near the bottom of their bear market. Three years later this holding has played the role I anticipated, having produced a portfolio return stream with little correlation to the S&P 500. This holding remains 32% of ERF NAV. But, I hear you say, who cares if ERF's return ultimately somewhat lagged the S&P 500 in that time? My answer is that passive investors can be right, but for the wrong reasons:

"*The very idea that one can make a lot of money without learning, studying, thinking, working, choosing and deciding is a pipe dream. Yet countless advisors—even investors considered gurus of the age—counsel that passive investing is a wise course. Don't bother investigating companies; don't bother picking stocks; and above all, don't try to time the market. Just put all your money—at any time at all—into an index fund. Then forget about it, sit back, and make plans for a pleasant, fully funded retirement.*" (Prechter commenting on the craze for passive investing)

Allocators committing to passive investment in today's broad stock market fit this description. It sounds quaint, but there is no free lunch, at least over time horizons less than a decade. Investing is hard work. Being wrong at times, for the right reasons, is part of the game. Some investors will be schooled in this reality, and possibly soon.

My views on the utility of holding cash and shorting have evolved over the past three years in response to the S&P 500 rising another 30% without earnings growth. The option value of cash, now 16% of NAV, has risen. I also anticipate ERF's short position gradually increasing toward 25-30% of NAV again (from zero today). In the meantime, I have found a tail hedge with great risk-reward, available as a result of the extreme speculative distortions manifesting in this market. During the next market "air pocket" it is at least plausible (no guarantees!) that ERF's NAV might even rise. If on the other hand the current backdrop persists, NAV may struggle to participate on the upside.

The Indispensable Element

Over an 80-year human lifespan, the typical investor has perhaps six chances to get the major tops and bottoms right. Initiating a substantial investment in silver equities (now the largest holding in ERF comprising 10% of NAV across several securities) is to capitalise on just such an infrequent opportunity. While the NASDAQ now trades over 100% *above* its 200-month moving average, at $17/oz silver is only just above its 200-month moving average having *fallen 72%* from a peak of $49/oz in April 2011 to a trough of $13.60/oz in late 2015. My thesis is that the probabilities favour silver recouping a good portion of its bear market losses for fundamental and technical reasons. If past cycles are anything to go by, the implications for currently moribund silver equities could be downright sublime.

Supply: Less than one-third of global silver supply comes from primary silver producers (two-thirds of global silver supply is as a by-product of mining other metals like gold, copper, zinc and lead). Why? Since silver is so much less valuable than gold (on a production basis gold is 9x rarer but 75x more valuable) mining silver is a tough business. Consider two mid-sized producers of similar operational scale, a 10 million ounce silver miner and a 300,000 ounce gold miner. The gold miner produces over twice as much revenue and cash flow off a similar cost base. For this reason silver miners have been justifiably diversifying into gold. The result is that global mined silver supply has declined each of the past three years.

Demand: Total silver demand has exceeded supply for each of the past 10 years. It is hard to plot a different course in coming years, implying continued inventory draws. Unlike gold, silver gets used up in industry (due primarily to its superb conductivity). Where above ground gold supply is 60-70x annual mined supply, silver inventory globally covers a mere 2 ½ years of demand. But even this is misleading. Only 60% of this inventory (1.6bn oz. out of a total of 2.6bn oz.) is in custodian vaults and readily available. Of this, over 60% is held in (and unlikely to leave) China. This leaves a much tighter market than generally perceived, just as silver demand from photovoltaics is taking off. The buildout of solar is following an exponential curve now that grid parity has been reached in major markets. Analysts suggest solar capacity could rise by a factor of 20x over the next 25 years. Current silver demand from the solar industry is 100 million ounces per annum, 10% of global demand, growing at 30%. I estimate that the solar buildout to 2040 could require over half of known silver resources globally.

Market dynamics:

"*I bought silver early and sold early. Silver was my fault. Speculation is wildest at the end.*"
(Warren Buffett, 2006 Berkshire shareholders meeting).

Buffett bought 129 million ounces of silver in 1998, 37% of annual mined supply. By my estimates he paid $5/oz. and sold eight years later in 2006 at $7.5/oz. Had he waited another 5 years he could have further quadrupled the investment as silver traded above $30 in 2011 and 2012. So the silver market is volatile and goes to extremes because it is so small. The $812bn market cap of Apple is 50x the $17bn of the physical silver market (at $17/oz). The physical gold market is 10x larger. All else equal, a dollar invested in silver has 10x the impact of a dollar invested in gold. In gold bull markets silver tends to thus rise faster than gold. Unusually, this year silver is flat while gold is up 8%, and is likely due a catch up. It is plausible that the mania in bitcoin (not to mention the broader stock market) has temporarily taken the spotlight away from more classic alternatives such as silver. Make no mistake, though: The online pop-ups advertising bitcoin investments for my SIPP (self-invested personal pension) are about as sure a signpost for the future of bitcoin returns as there can be. The catalyst for a revaluation of silver is thus likely to be the popping of the bitcoin bubble and the return of volatility to the stock market.

In a similar vein, the total combined market value of the 24 investable silver equities is only $26bn, which is to say that the majority of S&P 500 companies *each* have a market cap larger than the entire silver equity universe (Apple's market cap 31x larger!). But high fixed cost leverage means the silver equity universe could easily double if silver rose to $25/oz. and triple with silver at $35/oz. When a bad business becomes less bad the stock price can enjoy extraordinary gains.

Valuation: How can one justify silver at $25 or $35? One useful measure is the gold/silver ratio, currently at 75 (One ounce of gold at $1275 is worth 75x more than one ounce of silver at $16.90). Over the very long-term this ratio averaged 15, primarily when silver was money, reflecting its relative abundance in the earth's crust compared to gold. Since 1970 the gold/silver ratio has averaged 56; in 1997/98 when Warren Buffett bought silver the ratio averaged 62; and in April 2011 at the recent silver peak it reached 31. *Over the past century it has averaged 40.* Using a 40 gold/silver ratio (and assuming no change in the price of gold) yields a $32 fair value for silver +90%. More generously, assuming an average gold price of $1669/oz. (the average 2012 price before the market distortions of QE infinity) and a 40 gold/silver ratio, yields a $42 fair value for silver +150%. If the silver bull market peaked at $42 the entire bull market would be +210% from the $13.60/oz. trough in December 2015. This would be consistent with the last three silver markets from 2005-2011 which rose, on average, +227% peak-to-trough. As for the silver stocks, we can leave that to our imagination.

The principle risk to the price of silver is gold itself. If gold fell silver would likely fall a bit further, though the high gold/silver ratio could dampen the fall at this point. To the extent that bitcoin continues its vertiginous rise silver could easily languish. Ultimately, it is my belief that the behaviour of the stock market itself is now the catalyst for gold (and silver). A shift of the current market narrative will, in my view, send investors scurrying for alternatives.

Theron de Ris
24 October 2017