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## Bonds and Gold: A Dangerous Hedge

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*Exclusive Marketers of  
The Contrarian Research Report*

PCS Research Services  
125 Maiden Lane, 6<sup>th</sup> Floor  
New York, NY 10038  
(212) 233-0100  
[www.pcsresearchservices.com](http://www.pcsresearchservices.com)



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Steven Bregman	Thérèse Byars	Peter Doyle
Michael Gallant	Matthew Houk	David Leibowitz
Eric Sites	Fredrik Tjernstrom	Steven Tuen
	Murray Stahl	

## *Facts & Figures*

### GOLD COMPARED WITH TRADABLE GOVERNMENT BONDS

The table below displays the size of the national bond markets of various countries and includes the size of the gold market. The data is as of March 31, 2013, when the price of gold was higher. Today's gold number would be much lower.

Table 5: Size of the Market in Tradable Gov't Bonds

	<i>(in billions of USD)</i>
Switzerland	\$134
Australia	460
Denmark	593
Canada	1,134
China	180
United Kingdom	1,524
Eurozone	9,314
United States*	10,521
Japan	12,143
Gold	3,437

\*Excludes agencies, central bank holdings, Soc. Security Trust, etc.

Source: *World Gold Council*

The table includes Switzerland, Australia, Denmark, Canada, the People's Republic of China, the U.K., the Eurozone—which are all the nations denominated in the euro—the United States, and Japan, measured by the market value of their tradable bonds. In this context, for the U.S., the term ‘tradable bonds’ excludes central bank holdings of Treasuries and Treasury holdings by institutions like the Social Security trust fund and others. It includes only the bonds that are tradable, so it is a lower number than the value of the U.S. debt.

Based on that metric, priced in dollars, Japan has the largest bond market in the world at \$12.1 trillion. In the United States, the bond market is \$10.5 trillion. One of the ironies of this statistic is that the Federal Reserve has been buying back United States government debt for some time now and the Japanese central bank has just begun to buy back its government debt. Given enough years, maybe Japan can pass the United States and have a smaller bond market than the U.S. It is possible, but at this point, it really is not a fair comparison at all.

At the time the Gold Council provided this data, the gold market was \$3.4 trillion; now it would be greater. Gold is a huge, very liquid asset class. The reason for citing these statistics is to illustrate the logical absurdity of the very idea that there could be asset classes this large that do not properly reflect inflation expectations that investors, as a generalization, can use as a hedge against the danger of inflation. Investors at large fear

inflation and they must have some expectation of what it is likely to be, and that expectation will be reflected in the price of the liquid asset. Therefore, by virtue of these figures, these asset classes cannot be an effective hedge against inflation. To be an effective hedge against inflation, an asset class must be one for which the world does not have inflation expectations.

## *Murray's Musings*

### BONDS AND GOLD, LIQUIDITY AND RISK

As I pointed out in previous Compendium Reports, the correlation of the annual performance of long-term Treasury bonds and gold in the last decade has an unusual history.<sup>1</sup> Ironically, gold has had its worst year-to-date performance in many a year, and long-term Treasury bonds have had their worst experience since 2009. It seems that the correlation is continuing.

Table 1 lists the performance of gold from 2006 to 2012 as represented by the iShares Gold Trust (IAU), and Table 2 presents the performance year by year of the iShares Barclays 20+ Year Treasury Bond Fund (TLT) representing Treasuries.

Table 1: Annual Performance of Gold based on  
iShares Gold Trust (IAU)

YTD as of 6/30/13	(28.43)%
2012	8.37%
2011	8.86%
2010	27.94%
2009	23.46%
2008	5.41%
2007	30.92%
2006	22.43%

*Source:*  
[http://us.ishares.com/product\\_info/fund/performance/IAU.htm](http://us.ishares.com/product_info/fund/performance/IAU.htm)

Table 2: Annual Performance of Long Term  
Treasury Bonds based on iShares 20+ Year  
Treasury Bond Fund (TLT)

YTD as of 6/30/13	(8.57)%
2012	3.25%
2011	33.60%
2010	9.26%
2009	(21.53)%
2008	33.77%
2007	10.14%
2006	0.85%
2005	8.46%
2004	8.87%
2003	1.76%

*Source:*  
[http://us.ishares.com/product\\_info/fund/performance/TLT.htm](http://us.ishares.com/product_info/fund/performance/TLT.htm)

The idea of having a portfolio position in long-term bonds and simultaneously having a position in gold is very reasonable. In principle, one is protected from the dangers of deflation, should that scenario occur, and one is simultaneously protected from the dangers of inflation should that occur.

The only problem with this risk-avoidance notion is that for many investors to simultaneously embrace these positions involves taking the greatest risk that anyone could

<sup>1</sup> *The Global Contrarian Compendium*, Musings, "Correlations in Investments."

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possibly take in the world of investments. The largest risk in economics and in business is the situation in which many other individuals engage in the same strategy as you are, except they might do it better.

There are many risks in the world. There is inflation risk and commodity price risk. There are businesses that make use of commodities, and within reason those risks, in principle, can be hedged. There are risks to commodity producers that make investments today to extract commodities from the ground in the future. Eventually, when the commodities are sold, the commodity price might be radically different. In principle, those future price risks can be hedged away.

There are those who borrow money and those who lend money; both sides of those transactions are dependent upon interest rates, which, in principle, can be hedged away. There are businesses that operate on a global basis and as a consequence they are paid in a variety of currencies. In principle, those risks can be hedged away, but the risk that someone else will produce the same product or service and do it better, or at least less expensively, is a risk that not only cannot be hedged, it cannot even be predicted.

Let us look deeper more into this question of gold to understand how people behave. To illustrate, we will not use the SPDR Gold Shares (GLD), the largest gold fund, but we will look at the second largest fund, which is the iShares Gold Trust (IAU). On March 31, 2013, IAU owned 6,820,000 ounces of gold. On August 13, 2013, it had 5,709,989 ounces.

The interesting point is not necessarily that over 16% of the ounces were liquidated by this fund because investors took their money from the fund; it is the idea of holding a certain amount of gold as a hedge. The hedge, viewed as insurance, is actually a better hedge because it is less expensive insurance when the gold price is low. If it really were a hedge, people should not be removing it. However, if it is an investment, that is a completely different situation.

It is not unlikely that some investors, having seen very large flows into bonds for many years and having seen very large flows into gold for many years, invested based on the argument that the weight of money into those asset classes will inflate their value simultaneously. Now that they see the outflow—and perhaps even as part of the outflow—they do the reverse.

That observation brings us right back to where we began, which is that owning positions in which the assets themselves are not inherently productive is a huge risk, because it is affected by human behavior. The Treasury bond clearly does not yield very much and gold yields nothing. Gold is not an inherently productive asset. In principle, it should appreciate with inflation, but there is no guarantee of that happening. It is not a business that generates a return on capital, and it costs something to store the gold.

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The result is that bond funds, according to TrimTabs Investment Research, have witnessed the record outflow for a given month since figures have been kept. TrimTabs shows , \$61.7 billion were withdrawn from bond funds by the third week in June 2013. The previous record was the withdrawal of \$41.8 billion in October 2008. That was during the worst financial crisis since the Great Depression when investors worried about defaults. Now people are not worried about defaults. They are not even worried about high interest rates. They are only worried about the Federal Reserve purchasing fewer bonds. According to statements made by the board of governors of the Federal Reserve, if they were to raise rates, it would be a long way in the future. However, this bond fund outflow is an example of what happens when people accept the greatest risk that they could ever take.

In the bond market, withdrawals and the rise in interest rates occurred despite the Federal Reserve's purchase of \$85 billion worth of bonds each month. One can only imagine what would have happened had the Fed ceased its bond purchases. One can only ask rhetorically whether it is not better to buy investments that are less liquid and that do not involve the competitive factors and complexifications in the analytical process that come with mass behavior rather than to accept the increased competition that is inherent in buying the most liquid asset classes in the world. It also entails accepting intrinsically low rates of return that can only be modified by mass action. That is, the return will only change when the masses buy enough to make it appreciate. Anyone who reads this report knows the position of these research analysts.

## *Industry Thoughts*

### GOLD

We will begin with a fact that I find interesting: at the end of April, Barrick Gold disclosed in one of its filings that analysts should assume that in the future the so-called ‘all-in sustaining cost’ of mining gold will be in the range of \$950 and \$1,050 an ounce.

Let us take the midpoint between those two numbers and say it will cost \$1,000 an ounce to replace reserves. That includes not merely the cash cost of extraction, but all the upfront capital investments that need to be made before extraction. If the gold price were to stabilize at \$1,200 an ounce, profits will be greatly reduced. The consequence for many gold miners would be that they would not be able to sell increasing amounts of common stock to the public to fund capital expenditures as they have over the last decade.

Table 3 shows the shares issued and outstanding for major gold miners since 2008.

Table 3: Shares Issued by Major Gold Miners Since 2008 (*in millions*)

	<u>Shares Issued</u>	<u>Shares Outstanding</u>
GoldCorp Inc. (G CN)	82	812.09
Barrick Gold Corp. (ABX)	128	1,001.15
Newmont Mining Corp (NEM)	50	492.32
Silver Wheaton Corp. (SLW CN)	103	354.77
Yamana Gold Inc. (YRI CN)	20	752.51
Kinross Gold Corp. (K CN)	481	1,141.77
Agnico Eagle Mines Ltd. (AEM CN)	18	172.87

*Source: Company reports*

Using Barrick as an example, the company has about one billion shares outstanding. Since the end of 2008, Barrick Gold issued 128 million shares, which is a lot. Kinross Gold, a smaller company, has a little more than a billion shares outstanding, and it has issued 481 million shares since 2008. Therefore, the \$1,200 an ounce price of gold is simply not going to happen.

There is another problem, and we will illustrate it by examining Newmont Mining (NEM). In 2012, with an average gold price of \$1,669 an ounce, Newmont Mining earned roughly \$2.1 billion. It produced 4.977 million ounces of gold on what they call an ‘attributable’ basis. That means the production volume that was attributable to the company after paying various partners their share of the gold production. If Newmont Mining maintains that production in future years, but the gold price is \$1,200 an ounce instead of \$1,669 an ounce, then by definition Newmont will forfeit \$469 per ounce sold. That is \$469 per ounce multiplied by production of 4.977 million ounces for a loss of over \$2.3 billion per year. The company will essentially lose more in operating income than its net income. Looking at it another way, Newmont Mining will lose 25% of its 2012 revenue. If gold

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remains around the \$1,200 per ounce price, Newmont Mining might operate not far above breakeven. At a minimum, the dividend is at risk.

Another factor in the case of Newmont Mining is the company's cash flow.

Table 4: Newmont Mining Corp (NEM)  
Available Cash Flow and Capital Expenditures  
(\$ in billions)

	<u>Available Cash Flow</u>	<u>Capital Expenditure</u>
2012	\$2.455	\$3.210
2011	1.514	2.787
2010	3.817	1.402

*Source: Company reports*

According to the company's 10-K filing, the last three years of available cash flow add up to \$7.8 billion as the company calculates it. The capital expenditures were about \$7.4 billion, and there was a dividend, of course. To maintain its production, Newmont Mining was reinvesting almost the entirety of its available cash flow, but it does not have that cash flow anymore. How is it going to maintain its reserve base in the fullness of time unless the gold price goes up? In the next three years, Newmont has \$3.866 billion of contractual expenditure obligations that range from \$1.64 billion of debt payments to royalty payments, equipment purchase obligations, land reclamation obligations, and assorted employee benefits. Since it is losing the lion's share of its available cash flow and the contractual obligations remain, it will either have to sell more shares to the public—if it can do so—or it will have to borrow more money.

Newmont Mining is one of the best-capitalized and leading companies in the gold mining space. In classical economics, in the long run, a declining gold price and the difficulty of replacing reserves is the mechanism by which the gold price will eventually stabilize and possibly even rise, but that could take a very long time. The irony of the whole situation is that one takes a position in the gold mining stocks as a hedge against inflation, but the only way Newmont could have protected itself against a fall in gold production would have been to hedge its production or to sell it forward. Of course, had Newmont sold the production forward and hedged its earnings, then the stock would not have been a good hedge against inflation and it would have been a poor investment, at least from the perspective of those investors wishing to own an inflation beneficiary.

The entire notion of hedging in this manner is very bizarre, with this level of competition and the number of companies that are effectively—though not practically—funded by rising asset levels in ETFs that permit the companies to get guaranteed bids for equity issuance. This kind of hedging involves all sorts of feedback effects that are not sustainable in the long run. It is one of the pitfalls that come from simply investing in the same manner that other people invest.

In the future, gold miners will probably trade much more like classical cyclicals. They will have very low multiples when the gold price is high and very high multiples when the gold price is low. This is because everyone will realize that they are not likely to hedge production when the gold price is high because the shareholder base is not interested in hedging production. The shareholder base believes that the price is rising. From the point of view of the shareholder base, it is a hedge, although one might argue with some degree of justification that it is actually a speculation, not a hedge. The gold miners, without access to capital, will find it much more difficult to replace reserves.

## CORRELATION OF GOLD WITH OTHER ASSETS

The data in Table 6 also comes from the World Gold Council. It shows the three-year correlation with gold for the period ending June 2011 of the following asset classes: Brent Crude, the Dow Jones UBS Commodity Index, the Barclays Capital Global Aggregate Bond Index, the Hang Seng Index, the MSCI Emerging Markets Index and MSCI U.S.

Table 6: Correlation of Gold with Other Assets,  
3 Year Correlation ending June 31, 2011

Brent Crude oil	0.43
DJ UBS Commodity Index	0.38
Barclays Capital Global Aggregate	0.16
Hang Seng Index	0.21
MSCI Emerging Markets	0.26
MSCI US	0.07

*Source: World Gold Council*

Perhaps if the calculation were done today, the numbers would be different. The reason for using that period of time is that those were the correlations at which investors were looking to justify the decision to have large positions in bonds and gold simultaneously. According to this calculation, the Barclays Capital Global Aggregate Index has a correlation coefficient of 0.16 with gold. However, recently gold has gone down and the Barclays Aggregate has gone down, no matter what the correlation may be. The idea was that one would rise when the other would fall, but that simply is not happening. As a matter of fact, the Barclays index fell, the gold price fell, the MSCI Emerging Markets Index fell, the Hang Seng index fell, the MSCI Japan fell, and the MSCI U.S. fell. While they are not all correlated, they all declined.

Why is the analysis based on correlation? Why is it not based on an estimate of what one thinks a more reasonable return might be? The reason is that most of these asset classes, such as Brent Crude, gold, or the UBS Commodity Index, do not involve productive assets. One cannot reasonably make a forecast, because one has nothing upon which to base it. The return could be anything, including negative.

## GOLD AND SILVER AS PRODUCTIVE ASSETS

In my opinion, if one wants to have a hedge position in gold or silver, a much better investment would be to buy the gold and silver royalty companies. The evidence for that can be seen in Table 7, which displays the last 9 or 10 years of the return on equity of Silver Wheaton (SLW), Franco-Nevada (FNV) and Royal Gold (RGLD).

Table 7: Returns on Equity of the Gold and Silver Royalty Companies

	<u>Silver Wheaton Corp. (SLW)</u>	<u>Franco-Nevada Corp. (FNV)</u>	<u>Royal Gold, Inc. (RGLD)</u>
2004	(0.6)%	NA	11.2%
2005	9.6%	NA	13.1%
2006	18.8%	NA	9.0%
2007	12.9%	(2.6)%	8.2%
2008	2.1%	3.0%	5.3%
2009	9.0%	4.8%	6.2%
2010	14.6%	3.7%	2.0%
2011	22.4%	(0.3)%	5.0%
2012	20.3%	3.4%	5.6%

At least these companies have positive returns on equity. The gold and silver royalty companies are inherently productive assets even though they have lower returns on equity than they had historically. This drop occurred for the simple reason that there are now more gold and silver royalty companies, and those that did exist are much larger and operate on a much larger plane than they did going back many years. Now they compete with each other for business, but that was not always the case.

One could argue that future the returns to the royalty companies might be somewhat better. It is unclear if that is going to be the case, but one could make that argument, because it is going to be very difficult for gold miners to raise capital and they might have to go to the royalty companies to raise capital for which the royalty companies might charge them a higher rate. Therefore, in principle, an argument can be made that royalty companies might end up having much more robust returns on equity for the next several years than they would otherwise have had without the decline in gold. We have no evidence to support this yet, but it is possible in theory.

One of the complicating factors is that now we have the emergence of smaller gold royalty companies. It is not clear how they might operate. It is not clear how competitive they are likely to be with the larger companies. It is not clear how much, if any, capital they are going to be able to raise.

An example of such is Sandstorm Gold, Ltd. (SSL C). This is not a recommendation; I raise Sandstorm Gold only to illustrate a point as part of the *Facts & Figures* discussion. Take note of the name, because it has relevance to its fundamentals. Sandstorm Gold has a \$546 million market capitalization. It derives much of its royalty income from gold mines

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in Mongolia, and the buy-in price to deliver the gold, which is the price at which the miners are pledged over the life of the mines, is \$220 an ounce for gold and \$5 an ounce for silver, until 8.6 million ounces of gold and 40.3 million ounces of silver have been mined. At that point, the strike prices rise to \$500 an ounce for gold and \$10 an ounce for silver, which are both still well below the market prices. Essentially, Sandstorm Gold is a long-term call option that is deep in the money. As a consequence, it is really a leveraged investment in gold. The stock price performance, if one observes it, would leave no doubt of that.

Interestingly enough, Sandstorm has the presence of mind to understand that competition is not necessarily a good thing, so in recent years it bought 59% of its primary small competitor, Premier Royalty Inc. (NSR CN). Premier Royalty is still unprofitable, but after adjusting for the fact that it pays various of its obligations in shares of its own common stock in lieu of cash, it is cash flow positive. It has a debt-free balance sheet and only has a \$62 million market capitalization. Should the price of gold rise, Premier Royalty would rise disproportionately. I do not think there is much doubt about that.

It may be taking a little bit of literary license, but one could therefore say that Sandstorm Gold and its partially-owned investment Premier Royalty are, in effect, the VIX<sup>2</sup> of the gold market with a much lower decay rate. They are small capitalization stocks that are incredibly volatile. For small capitalization investments, they are amazingly liquid. This is not a recommendation or endorsement of either company. However, it is worth noting the existence of these companies, not merely because of their volatility and their hedge attributes, but to show how efficient the gold market has become. Even companies like these have become amazingly liquid, because the gold aficionados have left no stone unturned—no pun intended—in their search for exposure to gold.

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<sup>2</sup> The Chicago Board Options Exchange Market Volatility Index (VIX) measures the implied volatility of the S&P 500 Index options.