

THE FINAL COUNTDOWN!

By Adrian Douglas

The key to successful investing is "buy at the time of maximum pessimism and sell at the time of maximum optimism". This seems fairly straight-forward except that in practice it is difficult to gauge exactly what the "maximum" point is.

In the precious metals markets it has become in vogue to look at the famous Commitment of Traders report (COT) to see what the net positions of each category of trader are to decide if sentiment has reached an extreme or not. The futures market is a zero-sum market. For every buyer there is a seller. An analogy can be made with the housing market. You can not have a contract to buy a house unless you find someone to take the other side of the contract and sell you a house. The COT report states which major trading group holds which side of the contracts. There are three groups: The Commercials (Bullion banks), Non-Commercials (large investors such as trading funds) and small speculators. In general, the Non-Commercials and the small specs buy long gold contracts and the Commercials take the other side buy selling the contract to them (they commit to delivering the gold should the buyers hold the contract to maturity and "stand for delivery"). Most of these contracts are not held to maturity and are settled for cash when either the longs take profits on their gains on a price rise or they dump their contracts at a loss when they panic on price falls.

There has been a myth that has developed in market lore that says that one can use the total number of contracts held by the Non-commercials and specs (usually net long) as a measure of when optimism has reached an extreme. This is considered to be around 200,000 contracts. When the COT gets close to this level it is considered "overbought" and it is time to sell. This has absolutely no foundation in logic, and is clearly a convenient myth propagated by the Commercials. There are only 6 million ounces of gold in the Comex warehouse. This equates to 60,000 contracts. So if the Commercials have reached the point where they have promised to sell 20 million ozs of gold, a mere 14 million more than they have available, why on earth would this be an indication that it is time to sell and let the short sellers off the hook?

What is magical about 200,000 contracts or thereabouts? I can see why 60,000 contracts might hold some key significance. Once sellers are prepared to sell more ozs of gold than they have available then it seems to me the upper limit to their folly has no rational boundaries. This is what one day soon will be discovered by the ever more daring bulls, particular those bulls who want to take delivery of gold.

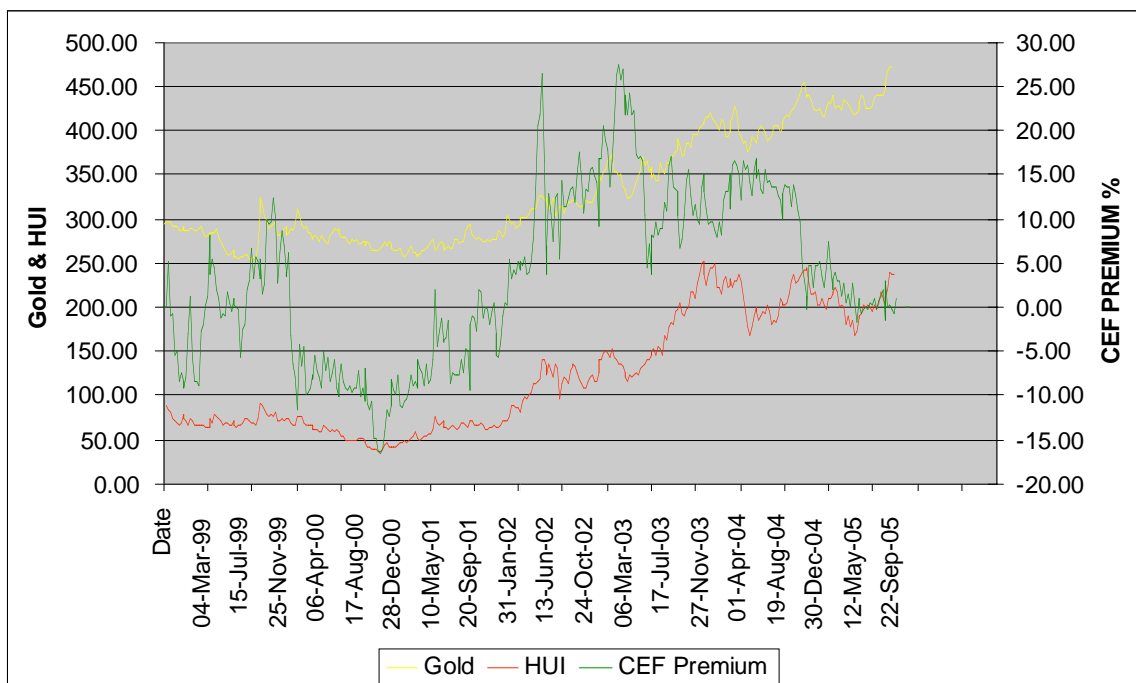
In looking for a measure of sentiment of precious-metal investors one really needs an indicator of sentiment that truly has bounded extremes that are logical and not arbitrary. In researching this topic I believe I have found just such an indicator.

The Central Fund of Canada is a closed end fund that holds a certain amount of gold and silver. As of today the holdings are 619,591 ozs of gold and 30,973,714 ozs of silver. They sell shares on the TSX and the AMEX in this fund under the ticker symbol CEF. Buying shares gives an investor a partial ownership of this hoard of precious metals. The value of the holding can be calculated by multiplying the ozs of silver and gold held by the respective spot prices (the net asset value NAV). The value that investors place on the holding, however, is given by the share price multiplied by the total shares issued (Market Capitalization). If the market cap is higher than the NAV then investors are prepared to pay a premium over the spot price to own their share of the holding; if market cap is less than the NAV then investors demand a discount to the spot price.

As the fund is closed end, the only way a new investor can obtain shares is to buy them from a current owner. If investors are pessimistic about the future spot price of bullion the shares will be sold at a very low premium or even a discount to spot to offload them. If investors are very optimistic about the future spot price of bullion then they will be prepared to pay a premium over the spot price to obtain a partial ownership of the CEF bullion holding. There are logical limits for the extremes of the premium and the discounts. If an investor is very bullish on bullion but doesn't want the inconvenience of buying and storing, and insuring the metal himself then he might, in an extreme case, be prepared to pay up to 25% more than the current spot price for this convenience. If he had to pay much more than this he would probably decide to buy bullion from a broker. If an investor feels pessimistic about bullion it would seem likely that he would not have to discount his holding in CEF by more than, say, 15% below spot to encourage another investor to buy his shares from him. While these are not absolute limits it is highly unlikely that premiums or discounts would go far outside this range. Imagine if you were selling your house, would you sell it to someone who offered a price that was 15% below valuation

even if you were really in a hurry to sell? Or if you were buying a house that you had really fallen in love with, would you pay more than 25% above valuation? So it would appear that the premium of discount of the CEF fund to its NAV would be a good sentiment indicator which has some realistic and logical bounds on its possible extremes of optimism and pessimism.

So let's take a look at the following graph. The graph shows the gold price in yellow, the HUI index in red and the CEF premium/discount to NAV in green from Jan 1999 to Oct 2005. I am extremely grateful to the CEF investor relations department for providing me with this data.



Gold made a 20 year bear market bottom of \$255/oz in April of 2001. At that time market analysts were predicting gold would drop to \$100/oz! Just before that bottom was reached the CEF premium dropped to a low of -16%. CEF investors were prepared to sell their share of the CEF holding with a discount of 16% to the spot price! This was an extreme of pessimism and turned out to be the perfect time to buy just as the current gold bull market was launched. As the bull market got under way optimism grew and investors were prepared to pay ever increasing premiums over the spot value of the

CEF holding to get in on the action. The first extreme level of optimism was seen as spot gold passed the psychological resistance of \$300/oz in March of 2002 when the premium shot up to 26.5%. The premium fell back but continued to trend upwards. The premium spiked again as the key psychological price of \$350/oz was surpassed in January of 2003 reaching 27.5%. This was the highest that the premium reached. It has gradually declined and showed no great excitement as gold has broken through \$400 and \$450 per oz! Today as gold stands at an 18 year high new investors in CEF are prepared to pay no premium whatsoever over spot bullion prices for a share of the CEF holding. It can be seen that since reaching gold \$350/oz the HUI and the premium on the NAV of the CEF have displayed apathy toward the gold price. It seems that investors in the CEF and the HUI are in disbelief that gold can go higher. The CEF premium indicates that investors have been more and more expectant of a major correction the higher gold has risen above \$350/oz! In the last few months, however, the premium on the CEF is displaying a bottoming formation around zero percent premium to NAV and is starting to tick upwards. This looks to be that an extreme of pessimism has been carved out. Despite the remarkable performance of gold and silver bullion prices there is no excitement amongst investors, no irrational exuberance in bidding up the premiums on the CEF NAV. It is possible that the CEF premiums could go lower into discounts but it would seem unlikely that sentiment could return to the same levels as it was at the end of a grinding 20 year bear market when prices are currently at an 18 year high!

From these indications, I firmly believe we are on the launch pad for phase 2 of this gold bull market when extraordinary gains will be made by investors who are well positioned. This is the FINAL COUNTDOWN!

In the coming weeks and months you will understand what I mean when I say:

"You haven't had a rush until you have had a gold rush!"

Adrian Douglas
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