

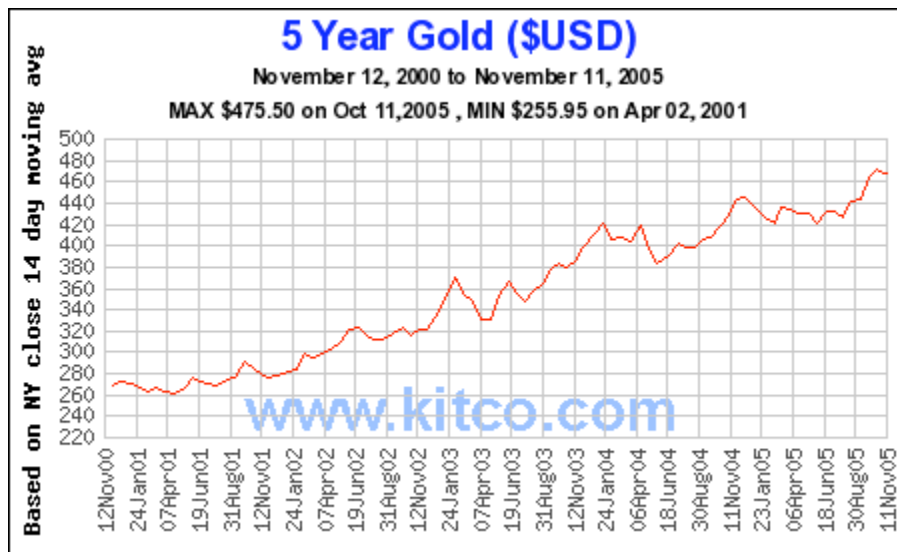
Doctor, Why Am I So Depressed About My Gold Mining Share Investments?

by Adrian Douglas

How many of you mining share investors are contemplating visiting your psychiatrist to ask why you are so depressed about your gold mining share investments?

I can save you the expense of the consultation with your shrink. It's because they have been going nowhere or even worse have been going down for the last two years. It is even more depressing because gold has gone up over the same time frame. The key to controlling your emotions and not throwing in the towel, or jumping out of a window is to understand what drives the performance of your investment. You can then rationalize the past performance and make informed predictions of future performance. Once you do this you will feel a lot better about your investment and I guarantee if you read on you will be feeling a lot better about the outlook for the future of your investments.

For many reasons explained time and time again in the Café gold is an undervalued asset. This means that to become fairly valued its price must rise. Let's take a look at the story so far:



What a beauty of a chart! Since April 2001 gold has demonstrated a classic bull market performance. Gold is in a very well established powerful bull market. Period. There is no discussion.

Anyone who had taken note of the Café commentary 4 ½ years ago could have played the gold bull market in its purest and simplest form by just buying some

gold coins at \$260/oz. You would be very happy because gold is \$210 per oz higher than it was 4 ½ years ago, yielding a gain of 80%. Even if you had joined the party late and bought gold two years ago in November 2003 at \$380/oz you would still be looking at a gain of almost \$90/oz today yielding a gain of 24%.

Now many investors did not make a pure speculation on gold bullion but an indirect speculation on mining shares. Typically mining share performance is leveraged to the price of gold. When gold was \$260/oz in 2001, imagine a mining company had mining costs of \$240/oz. They would have made \$20 profit on each oz of gold they produced. Now imagine that the price of gold were to rise to today's price of \$470/oz and the mining company had no significant rise in its costs of mining. The mining company would now net \$230/oz in profits. An increase of 1050%!! If the p/e ratio of the mining stock were to stay constant then one could reasonably expect the price of the mining stock to multiply ten fold!!

But now you are no longer speculating purely on the price of gold rising as you are with a purchase of gold coins. **You are now speculating that the price of gold will rise faster than the cost of mining will increase.** You have to be perfectly clear in your own mind that this is your speculation.

Let's have a look at the story so far with respect to gold mining shares as portrayed by the HUI index.



Anyone who had invested in the HUI at the start of the gold bull market in April 2001 could have purchased the HUI index for \$50. Today it is \$234. A gain of 468%. So anyone who bought the HUI in April 2001 has no reason to be depressed. But if you had bought the HUI in November 2003 at around 250 then today you would be nursing a loss of 6% despite gold having gone up 24%. This is much better than the portfolio performance of many Café members because

some junior miners that have been widely held by Café members have performed very poorly compared to the average of the companies that make up the HUI index. Some stocks are not down 6% from their highs but 50%, 60% or more. This is why you are depressed.

So should you throw in the towel and go and buy Google shares? I strongly recommend that you don't. We need to understand why our speculation failed over the last two years. Any decision to sell or hold, however, should be based on the outlook for the immediate future, not on the past performance.

The profits of a mining company are the difference between the price of gold and the cost of mining each ounce. The costs of mining are essentially driven by two big costs. Labor and energy. Mining is very labor intensive and a lot of energy is consumed in extracting and processing ore to convert it to pure gold. There are other costs but for a simplistic view of the profit drivers these are the principle factors. While there have been increased wages paid to miners in many countries this has been dwarfed by the increases due to higher energy costs.

As a simple world view we can say that if the price of gold does not rise faster than the cost of energy then mining company profits will be squeezed and conversely if the price of gold rises faster than the cost of energy mining company profits will expand.

Let's take the price of crude oil as a proxy for energy costs. The following graph is the ratio of the price of gold divided by the price of oil.



When the ratio is declining as it has been since Nov 2003 this means that the price of oil is rising faster than the price of gold. This implies that the mining company profits are being squeezed. This corresponds exactly with end of the first major upleg of the HUI and the period of side ways ranging of the HUI.

The Gold-oil ratio has broken up out of the down trend channel and it closed at 8.0 on November 11, 2005. Also today gold made the headline achievement of closing above 400 euros. Gold is poised to break above the headline grabbing level of \$500/oz in the US. Breaking through these enormously important levels will create immense excitement and attract large inflows of investment funds that will drive gold prices much higher. The scene looks set for gold to rise significantly faster than the price of oil. This will expand mining company profits. If this occurs then the HUI should outperform gold. This is already starting to happen as some smart investors have already noted the likely coming change in the fortunes of the mining companies. Look at the Gold to HUI ratio graph.



When this ratio is falling then the HUI is outperforming gold. When it is rising gold is outperforming the HUI. We can see that up until Nov 2003 the HUI was a superior speculation than a pure gold play. From Nov 2003 until recently gold has been a superior speculation because the gold/hui ratio has been in an uptrend channel. The ratio has formed a classic head and shoulders and the ratio broke downwards out of the channel in September, it came back to test the lower support line and then fell away. On a technical analysis basis it looks likely we have just started a new era in which the HUI will be a superior speculation than a pure gold speculation.

You must not lose sight of the fact that the monetary fundamentals and the clandestine “management” of the supply of precious metals by bullion banks and the Central banks have created a huge undervaluation of precious metals. It is this that should be the primary objective of your speculation. For this reason you should have bullion in your portfolio. If you have a portfolio of mining shares, in addition to company specific issues, your speculation is driven by whether the gold price will rise faster than the cost of mining. For the last two years that has not been the case and as a result your portfolio has suffered. I would suggest that you don’t throw in the towel, or jump out a window, or buy Google shares instead. You probably don’t need to visit your shrink either because by now you

should not feel so depressed. What I would prescribe is a dose of a little more patience and to keep an eye on the gold/oil ratio.

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