DEEP VALUE

WEALTH INSURANCE: THE CASE FOR OWNING GOLD

AN INTERVIEW WITH JOHN HATHAWAY

Gold is a unique asset: monetary but lacking counterparty risk, with its liquidity much more easily available than that in other high-value physical assets. John Hathaway, an elder statesman in the metals investment field, thinks that exposure to gold should be a part of everyone's portfolio, not because he predicts a coming monetary apocalypse, but for far more present reasons. In this interview, he explains his short- and long-term outlooks as well as the structural forces arguing for gold ownership.

John Hathaway

Octavian Report: What's your thesis on gold generally and what are your short- and long-term outlooks?

John Hathaway: The thesis is that throughout history gold has outperformed paper currency. You can go back thousands of years and prove that. Paper currency is just an instrument of public policy and is basically backed by political promises, which tend to be such that they're in excess of what can be supported by the value of the currency in any given moment, and so there's going to be debasement in some (usually sneaky) form over time.

So one should always have some exposure to gold. It's the only monetary asset or quasi-monetary asset that doesn't have counterparty risk, and it has liquidity that you can't get with Picassos and Rembrandts. If you wanted to dispose of any of these collectible, one-of-a-kind pieces of art or exotic cars and all that kind of thing it would be a huge bid-ask. And you can't mobilize the wealth that that represents in a short space of time. Gold is the one asset that's outside of the banking system that's a form of wealth that can be liquefied immediately, within 24 hours — no exceptions to that, for whatever reason.

If you have some percentage of your wealth in effect insured by a position in physical metal, you really shouldn't care about the day-to-day price fluctuations measured by one currency or another. What you know is you have a secure asset so that when some opportunity comes along — let's say the S&Ps are trading at three times earnings, for whatever reason — and you want to back up the truck, gold would be a way to do that, and there's probably nothing else that you can say that about. That's the real reason to own gold.

Too many investors think of it as a way to make money. I'm not saying that that's completely wrong, but it really isn't the fundamental reason for owning gold. The fundamental reason for owning gold is insuring financial wealth and having buying power for the kinds of events that we saw in 2008, events we may well see again once or twice within our lifetimes.

That's the big top-down point of view. What makes it particularly relevant in the current context is we've seen these radical monetary policies practiced by virtually every Western central bank and now in China and Japan. Nobody knows how they're going to turn out. You could have justified these policies maybe during the financial crisis of 2008. But the fact is that it's continued all these additional years: we're now into the seventh year of zero interest rates and QE. Nobody knows how this is going to turn out. It's such a departure from conventional historical monetary policies that nobody knows the consequences. I'd say, in this moment, gold is more relevant than it might have ever been in post-war history.

Out of the box in 2008 you had this terrific rally and the markets broadly thought that QE was going to result in high inflation and high interest rates. Gold had a tremendous run from 2008 on. It topped $1,900 an ounce for a few moments in 2011. But since then it's all been pretty much downhill. Gold is like a stock that went from $8 to $19, and now it's back at $12. That's within the range of a normal correction. But what we've had in addition is a four-year siege by the bearish camp, and of course during that period the competition for gold, which is basically financial assets, has done really well. Incrementally, the psychology has reached a point where people say, "Well, we don't need gold, because look how well stocks and bonds are doing." Of course, that's the design of monetary policy — to force people who would normally invest in safe assets into riskier assets. So far it's succeeded admirably.

What's needed to break that psychology is adversity in financial assets. That's a polite way of saying a bear market, which we've had in the past. There's one waiting somewhere out there — maybe around the corner, maybe not, but it's definitely there. I'm just finishing my second-quarter investor letter and I'm comparing what's going on today to the breakup of the London Gold Pool in the 1960s, when you had governments banding together to keep a lid on the gold price to disguise the underlying erosion of fundamentals for the U.S. dollar. It worked for a while; it basically scared investors out of being in gold. Then it fell apart. Fell apart in bits and pieces in the late 1960s, and then, finally, as we all know, Nixon closed the gold window.

I think we're in a period like that today. I think when gold got to $1,900 in 2011, there are a couple of things you could

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have said about it. One is that it may have been overcooked: too many people liked it, it was going too far too fast, all the momentum guys were on board. It deserved to have a correction, like anything that gets ahead of itself. That probably accounts for some percentage of the next four years' decline. And while I haven't been of this mind until the last couple of years, I do think that there is an invisible hand working against gold to keep it well-behaved. So that it won't give the lie to what many very thoughtful people believe are failed public policies, monetary and fiscal.

I'm sure that it was an omission on the part of the powers that be, the Fed, the Treasury, the Larry Summerses of the world, the Bob Rubins, not to have put this into place right away after the windup of the 2008 crisis. When gold behaved as it did, going, I think, from $800 to $1,900, that probably wasn't well-received in those quarters. And certainly the financial markets were saying: we're going to have a bad outcome with inflation. Yet inflation in the way we normally think of it hasn't arisen.

There's some evidence that what we have is the second coming of the London Gold Pool in the form of very sophisticated financial engineering. Let me just point out that most of the price-setting for gold is done on the COMEX, which is a well-known institution where billions and billions trade daily in gold (and a lot of other things). If you look at the COMEX trading in gold, almost none of it is explained by people who want to actually buy physical metal. You look at the deliveries out of COMEX on a monthly basis, and they're minuscule. It's really a paper game. The same is true in London. Those two markets, London and New York, are essentially synthetic gold markets. They don't really reflect supply and demand for the physical metal. It's not very difficult to dump billions and billions of dollars of gold on the market — even if you don't have it.

When you short something in the stock market, you've got to borrow it. You have to control what you're selling. That's not true on COMEX. You can short gold without having borrowed any. And that is what I think has happened over the last few years. First, gold went into a correction, so there was an established downtrend. Then it became more and more of a macro playpen for hedge funds, for high-frequency traders, commodity speculators, and a wide variety of other institutions. Then you began to see expectations that the Fed was going to raise interest rates — and of course they never have. Maybe they will, but I'm on the side that would be suspicious. Merely a few words from the Fed minutes, the FOMC, Yellen speaking, talking about raising rates, in a way has given people who are on the short side of the synthetic gold trade the fortitude to look at shorting gold as essentially a riskless trade.

The question whether there's government involvement I'll leave to the conspiracy theorists. But the fact is that you have a synthetic market where you can completely ignore supply and demand fundamentals and simply view gold as a way to position yourself according to your macro view of the world. Gold has provided a very cheap source of carry for these long positions — again, macro-oriented, but taken in complete disregard for fundamentals.

But take a look at the consumption of gold for the last several years running. Note that consumption measured by offtake in the parts of the world where they don't play in the derivative market — India and China being the big players there — is substantially more than the amount of gold that's being produced every year. And if you start looking at the migration of gold in vaults, you'll see it's all going to Asia and being refined in Swiss refineries. Not into 0.999 purity 400-ounce bars, which is London Good Delivery, but into 0.9999 purity kilo bars. This is well-documented. And in addition you've had substantial disappearance of gold from Western vaults — London being the least transparent because there are probably 50 vaults in London. Nobody really knows.

OR: What's the significance of the increase in refining into smaller increments?

Hathaway: Well, once it's refined into four-9's kilo bars instead of three-9's 400-ounce bars, you can't claim it with paper in the synthetic gold trade because it's not London Good Delivery. What it points to is that the underlying physical upon which this pyramid of credit for synthetic gold is built is getting smaller and smaller.

Now how does that play out? I don't think anybody can really know for sure, but at some point the market for gold will be influenced more by what is going on in Asia, which is the offtake. The Shanghai Gold Exchange numbers seem to be fairly accurate. Those numbers are fairly transparent.

Where I think I'm getting to on this is that there's substantial evidence that China is ramping up its exposure to gold. We know the Chinese government has been buying surreptitiously and not reporting what they have since 2009. They announced in mid-July a 57 percent increase in their holdings over the last reported figure in April of 2009. This looks a little on the low side to me. Three possible interpretations seem likely. One, they are still underweight and therefore have more to buy. Two, there is a gray area between official-sector and quasi-official institutions. It wouldn't surprise anyone if they had parked a good deal of physical away from the official PBOC balance sheet. Three, this could just be cosmetic — a part of their campaign to elevate the RMB to SDR status.

No matter the immediate motive for its accumulation, gold is still for them a hedge against the vast amount of U.S. low-yielding / non-yielding treasuries which they've accumulated because of balance of trade payments surpluses. The other is that they're forced to do that because they didn't have anything else to recycle those trade surpluses into. But with the arrival of the Shanghai Gold Exchange, there's a mechanism now for recycling some of those trade surpluses

they have with the rest of the world into something besides U.S. treasuries — and that's gold.

We know that Russia is selling its oil and natural gas to China — not for U.S. dollars, but for RMB and gold. We know that Saudi Arabia is selling oil to China, and to some degree the settlement is in gold. Gold is sneaking up on us and re-entering the international trade picture to the detriment of the dollar.

I'm not saying the dollar is going to go away. The dollar is still going to be a hugely important reserve currency, but there are some chinks in the armor and some erosion at the fringes. And this is being achieved basically because gold allows the recycling of large amounts of trade surpluses away from U.S. dollars. I think this is a space to watch and that's why there's some relevance and importance to the displacement of Western above-ground gold stocks to Asian markets.

Is this going to lead to an explosion in the gold price? I don't necessarily think so, but I do think that when something occurs which leads Western investors who have been shorting paper gold to turn around and want to own gold as they did from 2000 to 2011, there are underlying forces shaping up in the gold market that could result in an even more dynamic upside leg than what we had from 2000 to 2011.

OR: What do you think gold will generally tend to correlate with? And when the market finally corrects for gold, do you think we'll be in an inflationary environment?

Hathaway: Probably. I would say probably. There's been this debate for the last seven years: how does gold do in a deflationary environment versus an inflationary? The truth of the matter is that it does well in either environment. In the 1930s, the dollar was devalued against gold. A deflationary episode like we had in the 30s basically triggers inflationary public policies. Witness the aftermath of 2008.

But what hasn't happened, what we haven't seen so far, is CPI inflation. We've had inflation. I'm sure Jim Grant talked about this — we've had inflation of other assets, inflation of stocks, inflation of collectibles. Inflation of the kind that we think of in the 1970s we haven't seen so far. I'm beginning to think we're starting to see it, certainly in the labor indices. The Atlanta Fed has one which shows no significant uptick in wage rates, contrary to what Yellen says.

OR: You got into the gold business in 1998?

Hathaway: That's when we started our gold fund.

OR: Was it because the price was so absurdly low that you thought it was interesting?

Hathaway: Yes. Today is more like 1998, when you couldn't articulate any of the things that happened post-1998. All you could say is, "Boy, gold has just been trashed for a long time," and then we look around — we're a value shop — at what was going on then: dotcoms, telecoms, absurd overvaluation in the financial markets. We didn't have much more to go on than that. I would say, flat statement, nobody expected gold to do what it did, including me, over the next 10 years.

"To me a rerun of the 1970s would be just fine. The world didn't end."

—John Hathaway

We thought it was cheap. I wrote something in '02 that said it might get to $1,000. You couldn't say why it was going to happen. Then of course we had the perversions in financial assets with structured finance in the mid-Oughts, and then the public policy responses: zero interest rates or absurdly low interest rates, these eventually evolving into QE. None of that could have been anticipated in 1998 other than to say gold is being cast off in the dustbin.

Then you look on the other side of the equation and say, the financial markets are absurdly expensive. I think you could say that today.

OR: Is this the worst you've seen sentiment for gold stocks?

Hathaway: Yes.

OR: What are your favorite names? It looks like you own a lot of the royalty companies.

Hathaway: Yes, we've emphasized royalty stocks and it's certainly been helpful to us in terms of relative performance. Absolute performance has been difficult, to say the least. The royalty business model is: you don't get your hands dirty, basically you're a finance house with many more exposures geographically and participation in many, many more mining assets than somebody like Newmont or Barrick that actually operates the asset. It's a terrific business model within the gold universe.

OR: Is Franco-Nevada your favorite?

Hathaway: Two big holdings we have are Franco and Royal Gold. We also have Silver Wheaton, and then more recently Osisko, which has transformed itself into a royalty company. Those would be the four main exposures that we have. It's a small island within a small space, and there are a couple of other names out there, but those are the ones that you would probably own in an institutional account.

OR: Those you like because of the diversification? Or why?

Hathaway: That, and high returns on capital. At least that was the original thesis. Again, as the markets closed down for mining companies or financing became increasingly expensive on the back of adverse sentiment and the declining trend in the gold price, it became more and more difficult and expensive for mining companies to go the conventional route to raise money — the conventional route being deals underwritten by Canadian investment banks.

The royalty companies — their pipelines were always fairly good but they got even more robust over the last three or four years. What's interesting about the royalty space is that the royalty guys are starting to reach, just as everybody is. It's amazing. You see central banks buying S&P futures for yield. What's the reason? Because they can't get yield in safe assets. It's what they've done to themselves. And with the royalty companies, their success has made them

Gold has unique properties as an asset that allow it to insure financial wealth.

reach for yield. They're doing bigger deals at lower returns on capital than I can ever remember. It's like anything: success breeds ultimately these counterforces where you reach marginal returns. I worry that the royalty guys are there.

They're starting to do deals that are very big in size. Franco and Royal would be the main examples, but Silver Wheaton also did a huge deal that we questioned in terms of return on capital. They're doing it because they can raise the money and because everybody loves what they do for the reasons that I said. We still own them because we're bullish on gold and silver prices, but they're reaching, and it's something to take note of.

OR: Are the traditional miners, then, the cheapest in the universe?

Hathaway: Yes. I would say that if gold were to go up 10 percent, you might get a 15 percent or even 20 percent move in the royalty stocks. You might get 30 percent or 40 percent moves in the miners. Because they've been more heavily discounted and have performed, on a relative basis, so poorly that any signs of life in the gold price are going to get much more performance from the beaten-up mining names.

I would just want to say one other thing in terms of stock selection for what we do. Our list contains a number of names where there's value creation, which is difficult in the mining business. Value creation is accretive on a per-share basis: growth in reserves, cash flow, that sort of thing. That's why the big names like Barrick have had such a difficult time: because they lacked financial discipline and basically, in Barrick's case, destroyed their balance sheets.

We have a lot of names that are not the familiar big-cap mining names. We favor the mid-cap and smaller-cap names where there's value creation.

OR: Can you give us some examples?

Hathaway: Torex would be one. Another would be MAG Silver. Those would be two standout examples. We like B2Gold. Those are not household names, even for people who know the mining space. Primero would be another one that we've gotten to like a lot. These are run by good, entrepreneurial businesspeople. Very often in commentary on mining stocks, you see people speaking of the industry as if it were a monolithic, homogeneous industry, and yet within it there are companies that create value which is the kind that we try to own.

It may not be reflected in the share price today, but we think that when the sun starts shining again, we'll have a lot more joy than just a random gathering of gold-mining stocks could provide.

OR: Do you think there'll be more M&A in the sector?

Hathaway: There's been a huge amount, which to me is a very positive sign in a couple of ways. One is that companies that take advantage of this huge, heavily discounted sector are buying, so to speak, straw hats in the winter. If they know what they're doing, and we think there are a few of them that do, they deserve to be commended. That's another way to add shareholder value.

What you really have is divestiture of assets from forced sellers. That's advantageous to the buyer. The other thing that I think is that this M&A, and it's been quite significant, represents a give-up phase in psychology by the seller who's being forced to deal because they've given up hope that the gold price is ever going to do anything. Companies give up, in many cases, very, very good assets. Anglo, for example, just gave up ownership of Cripple Creek, which is the only mine in Colorado of any size. Newmont was the buyer. I can't remember if there was somebody else on the buy side. I think it was just Newmont. That's a class asset bought in a very attractive environment. The people who are on the buy side of this are taking advantage of this very weak environment — that's my idea of how you create value.

OR: Obviously, equities being this far

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down limits financing opportunities.

Hathaway: Certainly.

OR: But there's the fact that mining costs have come down.

Hathaway: There's that, too. Mining costs are quite stable. In some cases they're going down. Most people think about inputs like energy. Of course energy is down. Many of the other inputs are down. Backlogs for mining equipment are nonexistent. All of that is positive. Labor was very scarce when things were great. Now you see good mining engineers lining up for jobs.

OR: Do you agree that there should be a premium on assets in safe jurisdictions?

Hathaway: Absolutely. Just look at what goes on in some of these countries. Your predictability of cash flows has to be haircut. Every country is different. Mexico used to be a great mining jurisdiction. On a relative basis it's still one of the better ones, but it's not as good as it used to be.

OR: What are the jurisdictions, do you think, that should get a premium? The U.S., Canada, and Australia?

Hathaway: That would be it. It's a short list for sure. There are some no-go areas for us, but we're crowded pretty heavily into North America, as is the rest of the space.

OR: Do you have a view on NovaGold?

Hathaway: Yes, we do. I enjoyed Tom's comments on that in your last issue. It's a great out-of-the-money call on the gold price. It would be a 15-to-20 bagger when things turn around.

OR: It sounds like you're also bullish on silver. Is that correct?

Hathaway: Yes. Silver is part of the mix and we have plenty of exposure to it. In some cases it's not as identifiable as just looking at a name in the portfolio because a lot of companies produce silver in conjunction with gold. We've done a drilldown into the portfolio to figure out how much silver there is. It's probably 30 percent to 35 percent in terms of revenue flows. Silver is going to benefit from all the macro reasons that gold will.

Silver is a small-cap precious metal, so probably you get bigger percentage moves in silver during an upcycle than you do in gold itself. The thing to remember about silver, and again, I think silver's great, is that if you have a million dollars of gold, it would fit within one wine bottle or maybe one-and-a-half wine bottles. You have a million dollars in silver, it might be three or four cases of wine. It's heavy and bulky in comparison to gold. That's more for people who think in terms of physical as opposed to what we just talked about, which is a percentage upside in the metals.

Did you know, by the way, that bitcoin has gone up during the Greek crisis while gold is going down? That really burns me up.

OR: Some investors like gold opportunistically — they're reacting to what's going on. Some, however, own gold because they have a view that the entire system is going to collapse in on itself. What camp are you in?

Hathaway: I don't like the end-of-the-world stuff. It makes you sound loopy and foaming at the mouth. I think if you have gold out of the financial system, and you don't have to have a lot of it relative to your financial assets, you're protected. One percent or two percent is all it takes. Some people say five percent. Numbers like that for those fat-tailed events. If you look at the macro picture, with central banks buying stocks and valuations being so inflated, I think that's all you need. To me a rerun of the 1970s would be just fine. The world didn't end. We went through some major changes. What gold needs is for people to lose confidence in central banking — which I think is long overdue.

When that happens, you'll have essentially a rerun of the 1970s. It's not going to be exactly the same, but there will be tough markets for financial assets and gold should do, on a relative basis, really well.

OR: Where do you see gold a year from now? Do you think we'll see a change in sentiment by then?

Hathaway: It seems to me that gold is in a very intense low these last six months. You would think that from that you would get a pretty respectable rally that might break a number of these downtrend lines that have been well-established and get people to think that maybe this short gold trade, long whatever, is yesterday's game.

I can see that happening. I can see gold rating maybe a couple hundred dollars higher over the next 12 months. It wouldn't surprise me at all. I think that would break the spell that we've been in. I remember that back in 1999, when gold went from $250 to $300, I thought that was fantastic. I'm saying the same thing now: basically you want to break the negative psychology.

Who knows where the witches' brew that has been simmering for the last seven years takes us? I think that there's a lot of stuff that's going to happen that is not in stocks at record valuations or government bonds at zero interest rates or negative rates. I think that the pendulum will start to swing the other way and all kinds of gremlins and goblins are going to pop up that nobody is talking about today.

I don't want to be the one to say the world is going to end, because it's not going to. We'll manage our way through it just as we did in the seventies. People who have owned gold for all the right reasons have been castigated by their clients because it's led to underperformance. That's just thinking about superficials: is gold going up or down? The other thing is, in the longer context of preserving wealth, a wealthy family should have gold. They should have it just like they have insurance on their house and insurance on their lives and their health. Then you don't look at it. That rationale for holding it — that you don't hold gold's feet to the fire because it caused you to underperform some benchmark — well, nobody in the U.S. has that view of gold now. And I think that view of gold will resurface when we go through a bear market. Maybe a decade-long bear market like we had in the 1970s.

OR: Fantastic. Thanks, John.

John Hathaway co-manages the Tocqueville Gold Fund and is widely considered to be a leading voice on the subject of gold and precious metals.

John Hathaway
Tocqueville Asset Management L.P.
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Average Annual Rates of Return	
1 Year	-33.32%
3 Year	-21.00%
5 Year	-13.43%
10 Year	3.42%
Expense Ratio	1.38%

Top Ten Holdings	
Physical Gold	12.51%
Detour Gold Corp.	5.80%
Royal Gold, Inc.	5.60%
Agnico Eagle Mines Ltd.	5.11%
Franco-Nevada Corp.	4.85%
Goldcorp, Inc.	4.13%
Randgold Resources Ltd. - ADR	4.09%
Eldorado Gold Corp.	3.76%
Osisko Gold Royalties Ltd.	3.50%
Silver Wheaton Corp.	2.91%
Total	**52.26%**

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