Value Investor INSIGHT
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Good as Gold

Long-time Tocqueville Gold Fund manager John Hathaway describes why investing in gold is the best antidote to the toxic combination he sees today of reckless monetary policies and mass delusion on the part of investors. He also details why he finds Detour Gold, Torex Gold and Silver Wheaton stocks of choice for the coming storm. By Ted Crawford

INVESTOR INSIGHT

John Hathaway
Tocqueville Gold Fund

For someone who considers himself a consummate contrarian, John Hathaway found his calling in the midst of the technology craze in 1998, starting the Tocqueville Gold Fund to invest in a sector that had languished for nearly two decades. "Let's just say things were quiet for the first couple of years," he says.

Focusing on gold miners that operate in business-friendly locales and have disciplined management, his fund since inception has earned a net 12.1% annualized return, vs. 3.8% for the Philadelphia Gold/Silver Index. Expecting continued increases in the price of gold, he sees particular opportunity today in early-stage miners and more-diversified precious-metal "streaming" companies.

Describe your formative investing experience and when and why you started to specialize on gold?

John Hathaway: I had no real experience investing in gold when we launched the Tocqueville Gold Fund in 1998. It suited me well personally because I had always been more of a macro thinker and a contrarian by nature since starting in the investment business in the 1970s. The late 1990s was a very frustrating time to be a value investor, which I very much was. Growth investors were running circles around us investing in high-tech companies whose value we had a hard time understanding. When I suggested to my Tocqueville colleagues that we launch a gold fund, their initial laughter gave way to a realization that gold represented real value. So rather than emanating from some grand design, the launch of the fund was simply a recognition that gold was the ultimate contrarian investment during the dot-com craze.

The fund didn't do anything for a couple of years after we launched, but when the tech bubble popped, gold held its value, generating a lot of investor interest as a result. The cycles obviously can be long and sometimes painful. The most-recent bear market in gold, for example, led to somewhat of a shakeout of gold funds. We're one of the last funds standing with our outlook and mission.

Let's talk in more detail about that outlook and mission, starting with what you consider the primary basis for the investment case for gold?

JH: The reason to own gold and gold-related stocks is as a store of value in the event of what I'll call monetary disorder, which I believe we have in spades today. When we started out 18 years ago I couldn't have foreseen the policy responses of central bankers, which not only were partly responsible for the credit crisis, but also in the aftermath I believe have created more problems than they've solved. You can see that most notably in the fact that $11 trillion of sovereign debt around the world currently has negative nominal yields. People always used to complain about gold paying no return while you held it, but getting nothing is better than what you get on huge swaths of supposedly safe-money government debt.

To my mind it is simply not possible to conclude that these monetary policies have led to a robust economy. I'd argue that the economy is, at best, at stall speed, and maybe sinking into recessionary territory. Given the strength of equity markets, that is certainly not what most investors think. We see rot beneath the surface, covered up by monetary policies that are simply not sustainable. Anyone who wants wealth-insurance protection against worst-case outcomes from monetary extremism has to think about gold.

How do you describe your opportunity set for investing in gold?

JH: For pure capital protection, investors don't have to go much further than owning the physical metal. It is true that gold doesn't provide a return, but it is a liquid store of value that should provide buying power if worst-case outcomes ever come. People ask me what they should do with their money in today's environment of uncharted monetary stimulus, and I tell them first to consider owning physical metals because they can offer protection against the risks they see that caused them to ask the question in the first place. As one astute investor remarked to me recently, it's like owning a 2,000-acre farm or some other physical asset that exists outside the mix of day-to-day investment that is highly liquid. That's the mentality one should have for owning physical gold. In our portfolio today, roughly 10% is in physical gold.

We do not invest at all in gold exchange-traded funds or futures contracts. Essentially, ETFs are securities captured within the financial system, and if worst-case outcomes materialize I think there's a non-negligible risk that ETFs don't function as investors expect them to. The same is true for futures. In our fund we take physical delivery and store the metal with Brink's. We used to store our gold at a major bank, and I made a big deal to our fund trustees to have that changed because I was personally very uncomfortable storing gold at any financial institution, even if it wasn't co-mingled with the bank's other assets. Certain other gold funds get exposure to physical gold via structured notes with banks, which has counterparty risk. I'm not comfortable with that either.

Investing in gold miners is a completely different proposition because you do so on the idea that the gold price will go up within a reasonable period of time. You don't need to believe that to invest in physical gold – you just want to have liquid assets stashed away that can be accessed when needed. The reason the vast majority of our fund is in gold miners is because we see much more value there given our expectation for rising gold prices.

How do you assess future prospects for the price of gold – in general, and specifically today?

JH: In 1998 the inherent distrust of a monetary system based on paper currency was more of a theoretical construct than it is today. But since 2008 the dramatic expansion of central-bank balance sheets and the manipulation of markets through monetary intervention makes that distrust more acute and tangible. The Bank of Japan is a top-five shareholder in about a third of the Nikkei 225. The Swiss National Bank has a portfolio of stocks that looks like a hedge fund. If interest rates return even close to normal, given the level of sovereign indebtedness, solvency of government debt becomes a real issue. This all wasn't the case in 1998, or even 2007. We expect such an environment to be a significant driver of increased gold demand for as long as the environment persists.

ON MINERS:

Finding those whose management meets our standards around capital allocation are the exception, not the rule.

Constrained supply of gold is another important part of the equation. For historical context, gold production doubled from 1980 to 2000, despite bear-market gold prices. The major cause of that increase was the development of heap leaching, a process that increases the efficiency of producing low-grade stockpiles of ore. During the current cycle there have been no major technological improvements in gold production and no step-change in the economics of the mining process. One result has been that in the latest gold bull market from 2000 to 2011, annual aggregate gold production worldwide increased only 10%, despite all the capital that was attracted by a seven-fold increase in the price of gold.

The correction in the price of gold since the 2011 peak hasn't been severe enough to trigger widespread mine shut-ins, so total production has not declined. But development capital spending has been slashed. Gold miners are not spending what they need to as an industry to prevent a decline in the production of gold five years out. There is very low risk of the gold price being hit by a material increase in global mine production.

The price of gold over the last 15 years has risen roughly in line with the increase in the cost to produce it. Won't there need to be a significant shift in how investors view gold in order for the price to break free of that production-cost anchor?

JH: Our view is that we're in the early innings of a paradigm shift in terms of gold's importance in the global financial system. The dollar-centric banking system at the center of world commerce is in peril. Europeans are coming to terms with negative rates on sovereign debt. Asians have a long history of bad banks and crooked politicians, so gold has been a part of their DNA for centuries. If you look at the Treasury International Capital report, foreigners have been dumping U.S. Treasuries like crazy for over a year. As risks build, increasing numbers of people and institutions are likely to want the type of alternative that gold provides.

The gold price is currently around $1,320 per ounce. What is a reasonable expectation for where it goes from here?

JH: From 2008 through 2014 – the latest numbers available – global debt increased by $57 trillion, while global GDP increased by only $20 trillion. That the global economy's balance sheet is even more stretched suggests that systemic risk is higher than ever. The relationship between debt, GDP and the gold price cannot be explained by linear progressions. The dynamics are geometric because of systemic risk. On that basis, I believe that another financial crisis, which almost certainly lies ahead, will produce a gold price well in excess of the prior $1,900 peak.

How do you square the view that financial-market adversity is good for gold with the fact that gold wasn't a great hedge during the financial crisis?

JH: It's important here to make a distinction between gold bullion and gold miners. Gold bullion has, in fact, been a good hedge. It decreased less than equities during the financial crisis, and over the last 15 or 20 years has outperformed just about every asset class during a period of reckless monetary policy.

In contrast, gold miners have not been a good hedge. The temptation of many gold miners to extend their balance sheets when capital is flowing into the industry is exposed by periodic price corrections in the metal. That had an impact, as many miners just didn't have the financial wherewithal to withstand the downturn. That's much less of an issue today after a period of capital flowing out of the industry.

Describe where you focus your research once you've identified a potential gold miner of interest.

JH: A company can have great gold deposits with robust grades and low costs of extraction, but that's not enough. It can be completely screwed up by a management team that lacks discipline with the company's capital. It can be devastated by a toxic political atmosphere.

We put considerable emphasis on identifying high-quality management teams. Because ore grades have declined significantly over the years, mines require far more capital to develop. Bad decisions regarding the financing of mine construction can be disastrous. The risks have increased because of the increased capital intensity, so getting comfortable with management's skill and discipline around capital allocation is paramount. Finding teams that meet our standards are the exception, not the rule.

The politics of the countries where mines are located is also extremely important. The new ore bodies being discovered today – and there aren't that many of them – are disproportionately located in places where companies and investors are hesitant to put capital. The number of safe host countries has declined dramatically in the 18 years I've been doing this, but the importance of focusing on them has only increased. As a general rule, we're unlikely to invest in countries with a weak rule of law, such as Russia.

We do a lot of traveling to see mines. When we're on-site, we get to talk to levels of management that we would never meet at big mining conferences. That access gives us much more color into the day-to-day operation and makes us more cognizant of the risks, especially around regulatory and social issues.

To give an example, we were very aware of the headline risk around bandits impacting a key Torex Gold [TXG:CN] mine in Mexico. But by visiting the site many times we got comfortable that the mine was well protected and that the company was working well with the government to keep it so. That's different from what we've seen on the ground in Guatemala, say, where there may be good deposits, but there isn't a similar level of commitment from the government to support mining. The government is unstable and desperate for revenue, and there is constant pressure to raise royalty rates on mine properties. At the local level there is crime and communities are empowered by the Catholic Church to resist the expansion of the mine perimeter. These issues in aggregate make investment difficult – you're more likely to miss them if you haven't been on-site.

Your focus has been more on riskier early-stage miners, so it's a bit surprising you've outperformed your benchmark through periods of strength and weakness for gold. To what do you attribute that?

JH: Owning physical gold has certainly helped. But what it really comes down to is investing with the right management teams. The biggest source of capital destruction in the mining industry is excessive share issuance. Since the XAU gold and silver index was launched in 1979, the gold price has increased nearly six-fold, while the index is up by only 6%. That's 37 years of capital destruction. We look closely at management's judiciousness regarding financing, as well as the extent to which they have skin in the game through stock ownership.

We have low portfolio turnover because when we find a strong management team, we stick with them. We know the gold price will be all over the place. We know there will be adversity along the way, probably something political in nature. The last thing we need is a company that does gratuitous financings because Toronto's investment bankers want them to. Companies that raise money when they don't need it end up wasting capital on bad acquisitions or mine development when they should keep the share count and debt levels in check. Those are the things that make a real difference, so our sensitivity to them may allow us to protect capital a bit better than others.

Turning to some specific ideas, describe your investment case for Toronto-based Detour Gold [DGC:CN].

JH: The company has the classic characteristics we look for. Its huge Detour mine can produce 650,000 ounces annually with all-in costs of $750 per ounce, which is below average. The mine is in Canada, which is an excellent jurisdiction. Its reserve life of 23 years is twice the industry average. The development of the mine was very capital-intensive, but management had the discipline to just stick with it and not get swayed by the siren song of diversifying into different mines. That's uncharacteristic of what we typically see, especially given that they started development when gold prices were rising. The mine now generates free cash flow, and management is making good on its promise to use that cash flow to buy back debt.

Would you consider a company like this a good acquisition candidate?

JH: It's one of the best ones I can think of. Large companies like Newmont Mining and Barrick Gold have had to shed assets to slim down their balance sheets. But eventually they'll come to a point where they're running out of reserves. The gold price will be higher, and these large companies that were forced to sell low will be buying high to replenish reserves. Given

INVESTMENT SNAPSHOT

Detour Gold
(Toronto: DGC:CN)

Business: Owner and operator of the Detour Lake mine, an open-pit gold mine located in Ontario, Canada with an estimated annual production capacity of 650,000 ounces.

Share Information
(@8/30/16, Exchange Rate: $1 = C1.31):

Price	C$29.61
52-Week Range	C$12.13 – C$35.93
Dividend Yield	0.0%
Market Cap	C$5.15 billion

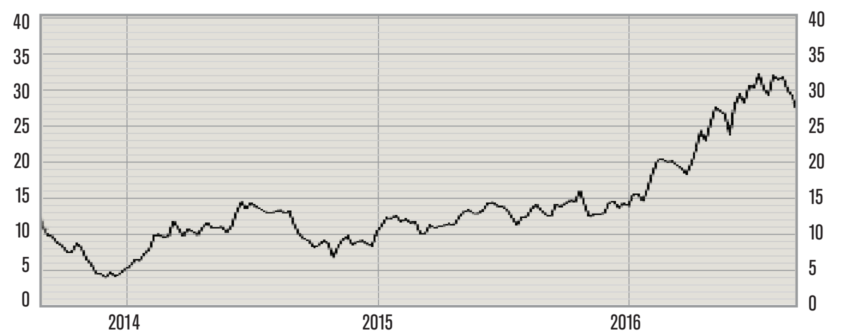
Financials (TTM):

Revenue	$617.8 million
Operating Profit Margin	5.9%
Net Profit Margin	(-14.3%)

Valuation Metrics
(@8/30/16):

	DGC:CN	S&P 500
P/E (TTM)	n/a	24.7
Forward P/E (Est.)	21.6	18.6

DGC:CN PRICE HISTORY



THE BOTTOM LINE

Having only recently completed the costly and arduous development of its large long-lived Canadian mine, the company is particularly well-positioned to benefit from the gold-price rise John Hathaway expects. On cash flow he says would double with a 50% increase in the price of gold, at today's multiple the shares would trade for about C$60.

Sources: Company reports, other publicly available information

its reserve base, profitability and financial strength, Detour will probably be one of the crown jewels in which large miners will be interested. I wish we owned 15 companies like it, but only a few exist.

Detour's stock, at C$29.60, has more than doubled this year, compared to a 25% increase for bullion. Are you concerned the stock has gotten ahead of itself?

JH: Mining stocks do from time to time get ahead of themselves relative to the bullion price, and we may be in one of those zones now. But given that we believe the gold price can go much higher, miners like this are still very attractive.

The company doesn't have to commit any more capital to mine development and generates cash at a $1,300 gold price. If gold returns to its previous high of $1,900 per ounce – which as I said, I expect – the free cash flow the company generates would double. If that happens, it's likely investors will expect more of the same and at least pay the current 16x cash-flow multiple, resulting in a share price of C$60.

Are there similarities to the investment story for Torex Gold?

JH: Many attributes are similar. Torex just completed its only mine, in Mexico, building it in a tremendously difficult period for gold. It's also a low-cost operator – operating costs are a bit lower than even Detour's – and the mine is now generating cash. Management also kept the share count in check during development.

Where the story is somewhat different is the fact that Torex can now turn its attention to another adjacent prospect it owns in Mexico that could double its current production to roughly 700,000 gold-equivalent ounces per year. That type of growth potential is fairly unique today in the industry.

A cynic might warn against management in this industry that is touting adjacent prospects.

JH: That is certainly true, but Torex management is not promotional. We've been to the site five times and the side-by-side property to our conservative eyes looks very much to be a realistic opportunity.

So this is a low-cost producer, with the riskiest phase of development behind it and great growth prospects. But the stock trades for just 10x consensus 2017 cash flow. What is the market missing?

JH: In the world of mining, Mexico isn't an A+ jurisdiction, but probably more of a B+. For good reason, the market rarely gives a gold miner the benefit of the doubt until about a year after production begins and people can see that the mine is delivering on production levels and on costs as advertised. Analysts are starting to come around, but there's still a wait-and-see approach here – especially when it comes to recognition of the company's ability to double the size of the complex.

Crime is also a worry, but as I mentioned, we believe that affects perception far more than it will actual cash flow. But honestly, you have to hold your breath with these things. We believe Mexico is an acceptable place for miners to do business. If that ever changes, that would dramatically downgrade the valuation of Torex.

INVESTMENT SNAPSHOT

Torex Gold
(Toronto: TXG:CN)

Business: Owner and operator of Mexico's El Limon-Guajes gold mine, which recently began production, as well as the adjacent exploratory mine, called Media Luna.

Share Information
(@8/30/16, Exchange Rate: $1 = C1.31):

Price	C$30.71
52-Week Range	C$10.70 - C$33.75
Dividend Yield	0.0%
Market Cap	C$2.42 billion

Financials (TTM):

Revenue	$102.1 million
Operating Profit Margin	(-1.6%)
Net Profit Margin	(-35.0%)

Valuation Metrics
(@8/30/16):

	TXG:CN	S&P 500
P/E (TTM)	n/a	24.7
Forward P/E (Est.)	19.6	18.6

TXG:CN PRICE HISTORY

THE BOTTOM LINE

John Hathaway believes that security concerns over the company's Mexican mine complex will not ultimately affect cash flow to anywhere near the extent the market seems to be pricing in. He's more focused on incremental upside from development of an adjacent mine, which he thinks can fuel a doubling of the share price over the next three years.

Sources: Company reports, other publicly available information

What upside do you see in the shares, now around C$30.70?

JH: As you said, the stock trades at only 10x 2017 cash-flow estimates, which assume current gold prices. Given the profitability and production capacity as the adjacent mine in developed, there's no reason the multiple can't at least approach Detour's 16x. If on top of that you assume gold prices increase, again, we see this as a stock that could at least double over the next three years.

The acquisition potential here is high as well. There are just very few large deposits like this held by non-major producers. That has to be attractive to the majors if the gold price continues to rise.

Your next idea, Silver Wheaton [SLW], is a so-called "streaming" company, which provides capital to development-stage mines in exchange for the right to purchase a set percentage of the mine's production at a low fixed price. Why are you high on its prospects?

JH: The streaming companies are like merchant bankers who don't get their hands dirty. While mining is very capital intensive, Silver Wheaton has no hard assets, has just 35 employees, and generates more than $750 million in annual revenue. The model allows it to diversify its portfolio through slices of mines all over the world, and that minimizes the risk of any one mine getting into difficulty. During the period when the industry needed money but the market wouldn't provide it, streaming companies like this provided capital that helped miners weather the storm.

We think Silver Wheaton is the cheapest of the three primary streaming companies – the others are Franco-Nevada [FNV:CN] and Royal Gold [RGLD] – for two primary reasons. First, there is an unresolved tax issue with the Canadian government. The company is incorporated in the Cayman Islands but domiciled in Canada, and the Canadian tax authority is trying to claim back taxes. We don't have to believe this to own the stock, but we think the odds are good that Silver Wheaton prevails in the case.

The second issue relates to a mine in Chile called Pascua-Lama, which is dealing with environmental-management issues and cost overruns. Barrick Gold, the mine operator, is working through these issues and the rising gold price is helping to breathe life back into the project. This was a huge capital commitment for Silver Wheaton that could add 17% to the annual volume of production it purchases.

While the start date for construction is uncertain and may even be a few years away, we believe Barrick will complete the project. Chile has always been a good mining locale. The federal government wants the tax revenues so it tries to work through issues that often arise with local environmental groups. This project is a sunk cost; the cash has already been spent so there will be no cash impact to the balance sheet if the project fails. On the other hand, if Barrick is able to commence production, that will eventually remove a significant overhang on the stock.

How cheap do you consider the shares at today's $25.60 price?

JH: Royalty companies typically trade for higher multiples than mining companies because of the inherent operating leverage in their model and the diversity of cash-flow streams. Marginal increases in the gold price drop directly to the bottom line because the company's cost structure remains the same. What they are contrac-

INVESTMENT SNAPSHOT

Silver Wheaton
(NYSE: SLW)

Business: "Streaming" company that owns long-term, fixed-price agreements to purchase production from 30 gold and silver mines in politically stable regions around the world.

Share Information (@8/30/16):

Price	**25.60**
52-Week Range	10.04 – 31.25
Dividend Yield	0.7%
Market Cap	$11.27 billion

Financials (TTM):

Revenue	$753.6 million
Operating Profit Margin	3.2%
Net Profit Margin	(-21.8%)

Valuation Metrics
(@8/30/16):

	SLW	S&P 500
P/E (TTM)	n/a	24.7
Forward P/E (Est.)	25.6	18.6

Largest Institutional Owners
(@6/30/16):

Company	% Owned
Van Eck Assoc	4.7%
Franklin Templeton	3.6%
Fidelity Mgmt & Research	3.0%
Carmignac Gestion	2.5%
Vanguard Group	2.0%

Short Interest (as of 8/15/16):

Shares Short/Float	2.2%

SLW PRICE HISTORY

THE BOTTOM LINE

John Hathaway believes two overhangs on the stock – a Canadian tax issue and concerns about the viability of a key production "stream" – won't prove as negative as expected. As gold prices rise, he expects ample profit growth and multiple expansion to drive the share price to at least twice its current level over the next two to three years.

Sources: Company reports, other publicly available information

tually obligated to pay for gold per their streaming agreements doesn't change based on the spot price for gold.

Silver Wheaton shares today trade for around 16x 2017 consensus cash-flow estimates. Franco-Nevada trades for twice that multiple, and that's on current gold prices. We expect the stock to close some of that valuation gap as the tax issue is resolved, and more still if Pascua-Lama progresses. In addition, it will benefit more relative to miners from a rising gold price because of the fixed nature of its cost structure. I may sound like a bit of a broken record, but this is another stock we believe could at least double over the next couple of years.

Some smart people advocate a return to the gold standard, but a case could be made that that's a fringe view that will never come to pass. What's your take?

JH: If there were a credible commitment to back paper currency with gold, the gold price would have to go much higher. But I don't believe we'll return to the gold standard and I wouldn't even advocate that given the complexities involved. It's so politically unpalatable that it won't happen. I'm not arguing that's the right outcome, or that the current system is sustainable, but the reality is I can't imagine the major powers getting together to tie fiat currency back to gold.

What risks keep you up at night?

JH: Gold is a bet on significant disruption to the financial system. If in a way I honestly can't imagine short-term interest rates normalize at 3% to 4%, without increasing inflation or causing big debt-servicing problems, that would likely be a big headwind for gold. Another headwind is the ongoing perception by the majority of investors that the stock market is an okay place to be invested. Were that to change – and I'll readily admit I've been wrong in predicting it will – that could be what kicks the next cycle in gold into high gear.

Why would you say investing in gold fits your personality?

JH: I've always been somewhat anti-authority and can't stand the BS you typically see on TV from the financial media. I've seen many times the damage done when mass delusion takes over financial markets and think it's important to try to set the record straight. Investing in gold is a great outlet for my contrarian instincts. VII

Tocqueville Asset Management L.P.

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Mutual Fund investing involves risk. Principal loss is possible. ***Past performance is not a guarantee of future results****. The Fund invests in gold and other precious metals, which involves additional and special risks, such as the possibility for substantial price fluctuations over a short period of time; the market for gold/precious metals is relatively limited; the sources of gold/precious metals are concentrated in countries that have the potential for instability; and the market for gold/precious metals is unregulated. The Fund may also invest in foreign securities, which are subject to special risks including: differences in accounting methods; the value of foreign currencies may decline relative to the US dollar; a foreign government may expropriate the Fund's assets; and political, social or economic instability in a foreign country in which the Fund invests may cause the value of the Fund's investments to decline. The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund.*

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The average annual total returns and top ten holdings for The Tocqueville Gold Fund ending December 31, 2016 are as follows:

Average Annual Rates of Return	
1 Year	40.42%
3 Year	0.87%
5 Year	-13.48%
10 Year	-1.57%
Expense Ratio	1.44%

Top Ten Holdings	
Physical Gold	12.21%
Detour Gold Corp.	5.12%
Franco-Nevada Corp.	4.87%
Agnico Eagle Mines Ltd.	4.86%
Pan American Silver Corp.	4.34%
Newmont Mining Corp.	3.84%
Alamos Gold, Inc. - Class A	3.72%
Torex Gold Resources, Inc.	3.24%
OceanaGold Corp.	3.05%
Fresnillo PLC	2.96%
Total	**48.21%**

Performance data quoted represents past performance and does not guarantee future results. *The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. The performance assumes reinvestment of capital gains and dividends and does not reflect the redemption fee. If deducted, the redemption fee would reduce the performance quoted. Fund performance current to the most recent month-end may be lower or higher than the performance quoted and can be obtained by calling 1-800-697-3863 or visiting www.tocqueville.com/mutual-funds.*