Gold Mining Companies – Finding Diversification

Axel Merk and Peter Maletis from Merk Investments and the Closed-End Fund Association discuss the potential for gold mining companies to provide portfolio diversification at this point in the market cycle. The podcast audio can be heard here.

Axel Merk

Peter Maletis

CEFA: **Welcome to CEF Insights, your source for closed-end fund information and education, brought to you by the Closed-End Fund Association. My name is Diane Merritt.**

Before we start our discussion, I would like to note the Closed-End Fund Association is holding an educational conference for registered investment advisors on March 10th in Fort Lauderdale, Florida. For more information and registration, please go to www.cefadvisorsummit.com.

Today we are joined by Axel Merk, President and Chief Investment Officer and Peter Maletis, Portfolio Manager for Merk Investments. We're so glad you both can be with us today.

Axel: Good to be with you.

Peter: Good to be with you.

CEFA: **Axel, your firm regularly publishes economic research. Where do you see the U.S. economy in 2020?**

Axel: Had you asked me this question before the outbreak of the Coronavirus, I would have said that I'm more optimistic than many, that we seem to see a global turnaround on the production side. And importantly that there is a risk that's completely under-priced in the market of a hot economy, meaning that unemployment is at a record low. Not many people can be drawn from the sidelines of the labor market.

And then we have so-called accommodative monetary policy. And so what that basically means is that we could reach the point where we have workers demanding so much money that it will provide spillover inflation into other areas. Now we have this virus and all bets are off. We don't know exactly how this is going to play out. If we do have the hot economy scenario, I think we will have a very volatile environment because the Fed has all but promised not to do anything about it if inflation does go higher.

And then conversely, of course if we do have a global slow down because of this virus question of whether there is a short-term shock, which is the more likely scenario. But in any case, it is going to stay interesting. And one of the things that investors do when it's interesting, they look for diversification.

CEFA: **You have an investment focus on gold, precious metals and minerals. What is your outlook for this sector given your thoughts on the broader U.S. economy?**

Axel: Well, what we have seen, as I alluded to, people look for diversification and when "everything has gone up", gold is one of the areas that people like to use because historically it has had a near zero correlation to the S&P. Indeed, in every bear market since the early '70s, with the exception of when Paul Volcker in the early '80s raised real interest rates very high, gold did very well in a bear market.

And so that's on the gold side. On the gold mining side, in this cycle, companies finally appear to have the costs under control. In the last cycle, all the stakeholders, be that governments, employees, and then there were high commodity prices kind of didn't create that sort of leverage you might want to see in the gold mining side. And so people were rather disappointed and many of those investors are still on the sidelines. And so we think it's quite early in the cycle and people will trickle in over time. And so it's a very volatile space, but it is a space that I believe investors will increasingly look at as they look for ways to diversify.

CEFA: Thanks, Axel. Now Peter, can you discuss the key characteristics of companies in the precious metals and mineral sector as well as the benefits and risks they present to investors?

Peter: Yeah, I'm leveraging off of 15 years of looking at the natural resource sector and specifically the last eight to nine years at Franklin Templeton, as a gold equity analyst. Spent a lot of time traveling to sites throughout the world and visited over 30 countries during that period. What we're looking for at Merk is companies that have solid growth profiles with cost containment. Assets that are of high quality and companies that have strong management teams. I've met with all these companies over the years and so my relationships, going back a long time and I get comfortable with the groups that I believe do a good job of managing their businesses.

As Axel alluded, the mining companies over the last five to six years have really done a good job of bringing in the debt levels. So the balance sheets are in a good position as well as managing the cost structure. And they've gotten to a point where the companies have really done a good job of fine tuning the costs associated with producing an ounce of gold, over that period. So with this increase in gold over the last couple of years, we're seeing a lot of the dollars dropped to the bottom line and these companies are continuing to maintain their balance sheets as well as paying off the debt and doing a good job of being prepared for future investments in the sector.

CEFA: Peter, Merk Investments is an active investment manager. In the precious metal sector, what advantages do you see for an active manager with respect to managing risk and adding to performance?

Peter: Again, at Merk, we're of the opinion that the active manager has a chance to outperform the indices. In the past couple of years there's been a strong reliance on the indices for investment and they've gotten a little out of whack where they're heavily weighted towards some of the largest producers who have an inordinate size in the indices such as the GDX and the GDXJ as well as the FTSE Gold Index.

It is our opinion that as those companies have matured since companies like Barrick and Newmont, which are great companies and they've really done a good job of managing in this space, the companies farther down in the market cap, in the mid cap, smaller cap range that have better growth profiles, cost structures still improving and have the flexibility to improve their growth profile through acquisition. So we believe that these companies have a better chance of outperforming in an up gold tick.

Axel: If I can just add to that. So firstly we're not giving a specific recommendation on the other companies we mentioned here, but as we alluded to all this emphasis on cost, what is meant for the large companies is that they have under-invested and so the index investor will get a bigger chunk of those firms that have under-invested. Whereas we position the portfolio, to an extent anyway, more towards the companies that might be the acquisition targets to remedy that under-investment.

CEFA: Axel, in 2019 your firm took on the management of a traditional closed-end fund, ASA Gold and Precious Metals, symbol ASA. The fund was previously internally managed and Merk Investments was hired as the external manager for the fund. When we last spoke in May 2019 you mentioned your expectation that this change would have some positive impact on the corporate governance of the fund. Have these changes all been fully implemented and what is the benefit for these investors?

Axel: Well, the key benefit to investors is that best practices are being employed. And I'm not suggesting that things were "bad" before, but it is the Board's responsibility to oversee service providers. And we as an external investment advisor, we have a mandate. And it's the Board's responsibility obviously to oversee us and if they don't like us to do something about that and potentially switch, but it goes far beyond that. It goes also with different types of service providers to do all their limited things and everybody has really stepped up to the plate. And so we have, I believe, turned the ship around on those items and can leverage on that.

It frees everybody up, notably the Board as well do not to have to micromanage things. When you have an internal management and things don't go exactly the way you want to, it creates the risk that there is tension that ultimately doesn't benefit anybody. And so yes, we believe that we now have the things in place and just to tell a few things that we do, with that new found, to some degree, clearance is we can take new initiatives. We don't have to scramble to take the old things off.

So, one of the things we do, for example, we publish our holdings on a monthly basis now in our fact sheet on the website and so it's those little things that we can do because we don't have to kind of run after the little things that kept everybody busy and but we can focus on more important things that might actually ultimately add value to investors.

CEFA: Now, Axel, from an investment perspective, how does your investment philosophy differ from the way ASA was previously managed?

Axel: I would think they are two key differences. One is that the previous portfolio was rather defensive. Now, to an extent that may have been because for much of the period the market was not a favorable market for gold mining companies and so, Peter has really turned that around and made the portfolio far more assertive. The other side of that is that Peter is willing and able to be more proactive and rather than... In this industry mistakes will happen. And so the question is do you wait seven years, 10 years, until you make a decision or do you assess it and then make a decision right away?

And so we at Merk, I believe have a very good dialogue and Peter has been very effective and assertiveness to drive this fund. And you see it in the result. We've managed the fund for less than a year so bragging about returns might be a tad premature, but we do think that if you compare what ASA has done compared to other funds in this space and compared to the indices, I think that Peter's approach has paid off very well.

And then just one more thing. What Peter does much more so than the previous management and also different from some other managers in this space is we help support the growth of the small mining companies quite actively. So we are quite willing and able to participate when these junior companies are raising money. And unlike in other industries when capital is raised, the share price tends to fall down, well in this industry often, not always, but often share price might go up because these companies need the resources to continue the projects.

And if we typically line up with other strong managers, we are able to support that growth. And as a closed-end fund, we're uniquely positioned in doing that because we don't have the shareholder outflows that have really hamstrung some of the open-end funds that have tried to do the same thing in the past but are now too small to help the industry as they had in the past.

CEFA: Peter, we spoke about the U.S. economy earlier. How does this outlook impact the way you structure your portfolio?

Peter: So I leveraged my historic analysis of the sector on the company basis with the Merk team. So Axel and his team have been analyzing the economy for many years. And so we are constantly having discussions and meetings on almost a daily basis about what's going on in the global economy and how that would affect the gold price. And so I take that into consideration in how I'm looking at it and it gives me a kind of a foundation for what I think and how I think gold is going to act. And with that I invest in companies that I believe are going to be able to take advantage of a stronger gold price.

Axel: And to just maybe add to that, one thing you asked me what's different? Well, Peter has been very actively investing in Australia and I mentioned that in the geopolitical context because the Australian dollar has been reasonably weak and when a currency is weak then when you price the gold in that respect of currency, the profits go up. And that geographic diversification has also helped to support the portfolio in returns.

CEFA: So Peter, are valuations in the precious metal space in attractive levels?

Peter: It's our opinion that there is room to go in the gold equities. We've had a good run over the last 12 months, but we've seen the gold price increase pretty significantly and anytime you see a gold price increase as fast as it has, it takes some time for the market to really adjust their assumptions that the gold price is at a good level. So we're slowly seeing companies get comfortable and analysts, I should say, get comfortable with the gold price. And so I, it is my opinion that things are priced attractively at these levels and have room to go. Also, with the tailwind of what we believe is a gold price that has chance to continue to increase.

CEFA: And where do you see the best opportunities among precious metals companies?

Peter: Like I alluded to earlier, we're of the opinion that if you move down in market caps, in the mid to small cap, you have a better chance of increased return with an increasing gold price. Historically, what you'll see is when the gold price increases as quickly as it did, a lot of the larger investors will move initially into some of the larger names because of liquidity. And that's where the moves start initially.

But as you get comfort with the gold price, the general investor will start moving down in market cap because they see the opportunity is better there. So what we're doing is investing in the mid and small cap. We're also, as Axel says, helping and investing in smaller companies that are exploration and development plays that need capital. And once they get that capital they can move forward very quickly.

So we've been investing in some of these exploration and development names where we think have good jurisdiction, good management teams and solid projects. And when they have this capital there's a good chance that they will develop some of the better mines going forward or potentially getting taken out by some of the larger guys that are trying to supplement their growth profiles that they have not paid as close attention to as they usually had in past.

CEFA: **And how do you believe an allocation to equities of companies in the precious metal sector is best positioned in an investor's diversified portfolio?**

Peter: We would obviously never give portfolio advice to an investor, but it is our opinion that gold has a place in everyone's portfolio or should be in everyone's portfolio. But it should never be a significant portion. The standard allocation probably is right around 5% it could go up to maybe 15% but we think that it's a good hedge against a larger portfolio invested across all sectors.

So we would never want someone to have a large portion of their portfolios solely invested in the gold equities, but we believe that their investment in ASA could be a smaller portion of the portfolio and give better leverage on an increase in gold price. My opinion is that we're investing for people that want to invest in gold. So if your comfort level with gold is good, we believe that the ASA portfolio has a chance to outperform some of the other investment indices and funds because of the portfolio allocation that we have adhered to.

Axel: One of the ways you can think about the allocation to gold is about the risks you can afford to take. And so if you can't afford to lose money, then you probably want to stay away from the gold space. What we see in practice, in the current environment, people want to have their "cake and eat it" meaning the equity markets have been moving higher and higher and people want to diversify, but they don't want to diversify by going to cash.

And it's one of the reasons why they choose gold and notably gold mining, because gold mining is so volatile that by adding only a very small portion to a portfolio, you get a substantial amount of diversification. Well, that's not an investment recommendation it's just an observation that that's how many investors are using gold mining these days.

CEFA: **Axel and Peter, thank you so much for taking the time to join us today.**

Axel: My pleasure.

Peter: Thanks for having us.

CEFA: **And we want to thank you for tuning into another CEF Insights podcast. For more educational content, please visit our website at www.cefa.com.**

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