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Gold Hedging: A Precious Lesson Learned

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Perceived Dovish Comments Support Small Gains for Gold and Gold Stocks

November was an uneventful month for gold. Since August, gold has been consolidating around the $1,200 per ounce level, and the rout in oil prices that sent WTI crude to 13-month lows of $50 per barrel did not impact gold prices. Gold began the month trending lower to $1,200 per ounce on November 13, then recovered to end the month at $1,222.50 per ounce for a $7.74 (0.6%) gain. Support late in the month came from U.S. Federal Reserve (Fed) comments that the market interpreted as somewhat dovish. Press articles only focused on a small portion of Chairman Jerome Powell's comments, while the entirety of his speech seemed to suggest that the Fed has not changed its outlook for three interest rate hikes in 2019.

Gold stocks trended sideways with gold in November. The NYSE Arca Gold Miners Index (GDM)[1] gained 1.2% and the MVIS Global Junior Gold Miners Index (MVGDXJ)[2] declined 2.3%, which indicates that the juniors and mid-tiers were slightly weaker than the senior companies.

2019 Could Be Interesting for Gold

Last month the International Monetary Fund (IMF) downgraded its forecast for growth in Europe and emerging markets and suggested conditions have worsened. Germany and Japan experienced negative third quarter GDP growth. As the Fed tightens monetary policies, it is doubtful that the U.S. can remain an island of prosperity. Conditions in housing and autos indicate economic weakness has begun to set in. We believe 2019 is shaping up to be an interesting year for gold as we continue to see signs that the U.S. economic expansion is on its final legs.

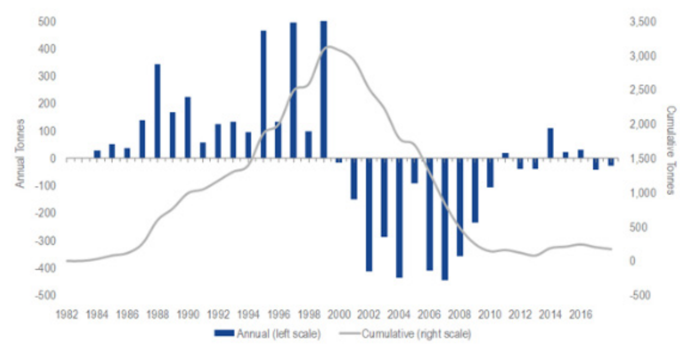
Once a Key Strategy, Gold Hedging Now Nearly Non-Existent

The age of hedging has long passed for gold companies. However, we still get questions about hedging from investors and clients. Many remember the scars from hedging strategies that went terribly wrong. Hedging is attractive because gold is almost always in contango, which means the futures and forward prices are almost always higher than the spot price. The forward curve rises as a function of interest rates.

The chart shows gold mining industry hedging activity since 1982. From 1987 to 1999, hedging strategies were a key financial component for most companies. Hedging was originally a way to manage risk. It enabled miners to secure credit and protect revenues from falling gold prices. However, hedging became excessive from 1995 to 1999 as companies increasingly used hedging as a way to speculate on the gold price. It was the answer to a secular bear market in the dotcom boom when gold was regarded as an ancient relic and European central banks were relentlessly selling their gold reserves. To demonstrate the scale of the super-sized hedging, in 1999, 3,091 tonnes (99.3 million ounces) were hedged, compared to global gold mine production of 2,602 tonnes (83.6 million ounces).

The Golden Age of Gold Hedging Has Passed

Net Producer Hedging 1982 through 2018



Source: Reuters GFMS, World Gold Council, VanEck. Data as of November 2018.

Lessons Learned from the Ashanti Crash

As usually happens when anything is taken to excess, a crash soon followed. In September 1999, European central banks announced an agreement to limit their gold sales to an average of 400 tonnes per year for five years. This announcement caused the price of gold to spike 41% from $255 to $360 per ounce in two weeks. Ashanti Goldfields was a major African producer with operations centered on Ghana. Ashanti held 23 million ounces of reserves and was producing 1.7 million ounces per year with plans to expand to 2 million. The company had built a gold hedge book totaling 11 million ounces. The book was complex because it used derivative arrangements with 17 counterparties or banks. A significant portion of the book was locked into prices below $325, as Ashanti failed to anticipate such a rise in gold prices. When the price rose, the value of the book fell to negative $570 million. This brought margin calls from the banks that totaled $270 million. However, the company did not have the liquidity to post margin. It was effectively bankrupt. Ashanti was ultimately able to work out an arrangement with the banks, but shareholder value was decimated in the process. It took several years for Ashanti to gets its finances in order, and in 2004 the company merged with South African major Anglogold (0% of net assets*).

The Ashanti crash scared the daylights out of every gold company CFO with a hedge book, resulting in the huge decline in hedging from 1999 to 2000. The secular bear market for gold ended in 2001, when a secular gold bull market was heralded in by the dotcom bust and subsequent decline in the U.S. dollar. As the gold price rose, more and more hedge positions that were struck at low gold prices in the 1990s fell underwater. We began avoiding hedged companies in the fund very early in the cycle. By 2007, gold had surpassed $600 per ounce, and some of the heavily hedged majors had books that were billions of dollars in the red. Fearing a continued rise in gold prices, by 2010 companies had bought back virtually all of their underwater hedges at great expense to shareholders.

The next prolonged fall in gold prices came in the cyclical bear market from 2011 to 2015, when the gold price fell from $1,920 to $1,050 per ounce. Through this downturn, hedging was never considered because the industry learned a painful lesson that has not been forgotten. The low levels of hedging shown on the chart since 2010 are again aimed at risk control. Many companies have anti-hedging policies, and those that hedge do so with limitations. There are several circumstances where companies sometimes find hedging a small portion of reserves useful:

- Secure near-term cash flow
- Insure revenues for short-life operations with high costs
- Secure financing

Lack of Hedging and Debt Reduction a Sign of Gold's Financial Health and Stability

Another area where companies have fundamentally changed their financial approach is with debt. As the gold price peaked between 2010 and 2012, the majors financed many of their new projects and expansions with debt. Low post-crisis rates proved irresistible. As the gold price fell to its 2015 lows, many companies were in danger of violating debt covenants. If the gold price had fallen further, some companies would have been in an Ashanti-like situation, lacking the liquidity to service their financial obligations. This close call has caused companies to pare down debt substantially, and most now target net debt of zero or less. Conservative debt policies are necessary in a business where there is no control over pricing and price swings can be volatile. We believe the gold industry is financially sound and stable now, positioned to possibly generate positive returns for shareholders in the next cycle.

IMPORTANT DISCLOSURE

[1]NYSE Arca Gold Miners Index (GDMNTR) is a modified market capitalization-weighted index comprised of publicly traded companies involved primarily in the mining for gold.

[2]MVIS Global Junior Gold Miners Index (MVGDXJTR) is a rules-based, modified market capitalization-weighted, float-adjusted index comprised of a global universe of publicly traded small- and medium-capitalization companies that generate at least 50% of their revenues from gold and/or silver mining, hold real property that has the potential to produce at least 50% of the company's revenue from gold or silver mining when developed, or primarily invest in gold or silver.

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