CAPITAL MANAGEMENT 101

RECAP

In recent articles we have touched on what a fair value for Gold might be. We have arrived at the conclusion that Gold is still cheap relative to its monetary inflation adjusted value. We have determined that the mining juniors are a pretty good way to leverage off future increases in the Gold price. We have looked at when are the best times to buy into these juniors. We have also considered some of the important things to look for when choosing a mining company to speculate in. Once you have decided on a junior company that deserves your hard earned cash, the last piece of the puzzle is ***Capital Management***.

There are a countless number of ways to manage a trade and many books telling you the best ways to go about it. The fact of the matter is, most of these techniques work and are effective. It is my belief most people that trade in mining shares do not go wrong with the choice of trading strategy they employ but more so because they **don't** have a strategy at all! They have no idea how much they want to make out of the trade and more importantly they have no idea how much they are prepared to lose. The strategy we employ and are going to share with you today is by no means the Holy Grail in capital management plans but it is one that has worked for us and is certainly better than not having a plan at all.

In demonstrating Capital management to you I am going to use a hypothetical example where we have found a stock called XYZ we would like to buy with the following details:

Company:	XYZ
Current Price:	$0.10
Stage of Development:	Completing a Bankable Feasibility Study and the share price is depressed due to a lack of patience regarding its completion
Long term price target:	$0.44 (Based on some solid and sound analysis)

FORWARD PLANNING

1. Long Term Price

Value is an important factor in arriving at a purchase decision. We used some financial modeling to determine a conservative estimate for what XYZ could realistically trade at. XYZ is trading at $0.10 at the current time and we have arrived at a long term potential valuation of close to $0.44. In a trading plan this number would become our aggressive long term price target. It is also a moving target based on what metal prices do and how comparable companies that we used in our calculations trade.

2. 50% rule

At this point I want to emphasis that mining companies are extremely risky to trade, hence the fantastic returns and severe loses we endure from time to time. There are many things that can go wrong at any level in their development process.

Here is a list which is by no means exhaustive:

- Further drilling fails to delineate a resource for a deposit at the economic Measured and Indicated category deeming the discovery unviable.
- Having successfully proven up a deposit and completed a Bankable Feasibility, environmental permitting is denied.
- Having delineated a deposit the company's title to the deposit is challenged by another opportunistic miner who claims the company used confidential data in acquiring the property.
- Having completed a feasibility study on a project, the current government is over thrown and a new government takes its place which is corrupt and fails to renew or acknowledge the company's existing business license.
- Having developed a project to the production phase, metal prices plummet leaving the project un-economic and putting the company's financial viability under serious threat.
- Once a project is carried through to production it fails to operate up to the economics of the Bankable Feasibility study and is consequently uneconomic to run.
- The company having progressed successfully through to a producing mine is hit by a derivatives scandal in their treasury department, where a member of the finance team had partaken in some rogue trading on metals prices. The result is massive trading losses which the company can not endure.
- Having successfully operated at a production stage for several years some seismic activity causes the main mine shaft to collapse rendering the mine useless and un-economic to repair.

Having looked at this list many of you may be asking why would anyone in their right minds want to get involved in mining companies at all? The answer is the big returns!! With this risk comes big rewards and if you can successfully manage this risk by employing strategies that ensure a large component of your capital is protected, I strongly believe you can make consistent returns over the long term. This brings me to what I call the 50% rule (Widely employed by many analysts). That is when you make a double on a mining share, take your original capital out and ride the profits to your longer term target. So getting back to our example with XYZ, we would have an interim target of $0.20 (2 x $0.10 which is our purchase price) at which point we would sell half our position, thereby protecting our original capital.

3. How much are we prepared to lose?

The amount we are prepared to lose should be determined by our total trading capital. I like to employ a formula of 2% of total trading capital. Therefore if you are trading with a $25,000 portfolio your stop loss on any individual trade would be $500 (2% of $25,000). I would also suggest not having any more than 10% of your original capital in any one company (For reasons that should be quite apparent by now!!). Therefore in our example we may invest $2,500 in XYZ (25,000 shares) and place a stop loss at approximately $0.08c (Which constitutes the $500 loss or 500/25000 which equals $0.02 in the share price). This gives us a 20% margin for error on our entry price which might sound like a lot but given the volatility of mining juniors is necessary.

4. How does the risk reward stack up?

Once you have determined what you stand to make and what you stand to loose you need to weigh this up against the chances of the trade being successful. There is an excellent quote I would like to share with you at this point by **Henry T Ford** which sums up beautifully what speculating in mining companies is all about:

"The best we can do is size up the chances, calculate the risks involved, estimate our ability to deal with them, and make our plans with confidence".

BREAK EVEN CONFIDENCE LEVEL (BECL)

There is a simple formula that I recently discovered in the process of researching the game of Texas Hold 'Em poker, which I think is applicable in assessing the risk in any speculative situation. It is a simple expectations equation which I like to call a **Break Even Confidence Level (BECL)**. It's calculated by taking:

What you stand to loose from a trade which in this example is $500 if the share price drops to our stop loss level of $0.08.

Divided by:

The profit you stand to make assuming both profit targets are hit which is $1,250 on the first half of the position and approximately $4,250 on the second, plus what you stand to lose which is the $500 we calculated before.

In summary you get:

$500 / ($1,250 + $4,250 + $500) = 8.33%

Put another way you would calculate your Break Even expected return from the trade as follows:

Expected return = (% chance of success x Expected Profit) – (% chance of loss x Expected Loss)

Break Even Expected Return = (8.33% x $5,500) – ((100% - 8.33%) x $500)

= $458.15 - $458.15

= $0.00

What this means is for this trade to be worth while from a risk/return point of view, you need to be better than 8.33% confident that it will work out favorably. That is based on the research we have done we are confident that there is a better than 8.33% chance that XYZ will successfully complete its Bankable Feasibility study and the market will recognize this and re-rate the stock accordingly.

If we can say we are more than 8.33% confident given the information available, the risk versus the return will be worth our while and we can go ahead with the trade. If not, we pass it up for something that is more favorable. Most people that enter into a trade wouldn't do so unless they felt there was at least a better than 50/50 chance that the trade will come off. Therefore a Break Even confidence level of 50% or lower (The lower the better) would be a trade you would consider. I would like to stress that the validity of a technique like this is solely dependent on how accurate your research and consequently your judgment is.

SUMMARY:

It was my intention from these recent articles to share with you the readers some of the key concepts I feel are important when buying into junior mining companies. I firmly believe a logical process should be employed. Some of the concepts I have covered I understand will be foreign to many of you and a little confusing at first. However if you are genuinely interested in employing a fundamental approach to your mining speculation, I strongly encourage you to sign up to our **free** monthly newsletter **The Global Speculator**. In this newsletter we will be revisiting all of the areas we have covered in the articles with some real some life case studies. I want to close by sharing with you a comment I received via email from a gentleman whose attitude to investing/speculating is quite simple: ***"I refuse to put my hard***

earned money into anything I don't fully understand". I can't emphasis enough how pertinent this is to the game of mining speculation. Very few mining speculators employ this approach to their detriment.

Troy Schwensen

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