

## JUNIOR MINING STOCKS AN INVESTMENT OR SPECULATION (GAMBLE)?

Many of you who read my first article on why I believe Gold is fundamentally undervalued in terms of Australian dollars have emailed me requesting a follow up article on Gold/Silver share investing. This is a logical progression in that once you have determined an asset class is undervalued the next step is to ascertain what is the best way of capitalizing on this re-valuation process. There can be no dispute Gold has started its journey of catching up to its monetary inflation adjusted fair value in "all" currencies. Gold in Australian dollar terms as at the end of November 2005 still trades at just under 30% of its monetary inflation adjusted price. Hence the precious metals sector still seems like a pretty smart place to be. As I write this the Australian Gold price is AUD\$745 an ounce. Many Gold/Silver shares have recently benefited from these increases.

### Australian Theoretical Price of Gold Update

Date	10 Year BB Interest Rates	Official CPI	M3 Aggregate Money Supply	Rate of Australian M3 Change	Gold Production Av Annual Increase (1.73%)	Australian Theoretical Gold Price	Actual Australian Gold Price	Actual as a % of Theoretical
Jul-05	5.13		636.36	0.01%	0.14%	2,086.66	562.00	26.93%
Aug-05	5.06		639.30	0.46%	0.14%	2,093.65	580.05	27.71%
Sep-05	5.36	3.00	649.70	1.63%	0.14%	2,124.67	623.20	29.33%
Oct-05	5.48		646.70	-0.46%	0.14%	2,111.80	624.20	29.56%
Nov-05	5.38		652.40	0.88%	0.14%	2,127.37	625.20	29.39%

Like many I believe history has shown junior Gold/Silver mining companies to be one of the best ways of playing this bull market in Precious metals. At this point I want to re-iterate that I have only been involved in precious metals for just over three years and while I have learnt a lot in this time, I am still relatively wet behind the ears. In arriving at the best way to trade Gold/Silver mining stocks my brother (Who is my business partner) and I have done extensive work using both technical analysis and financial modeling. We like using technical analysis predominantly for indicators in determining when the Gold market is overbought and hence risky and subsequently when the market is soft and downside risk is minimal. Fundamental analysis is used in choosing individual stocks to buy taking into account the myriad of important factors one needs to consider before buying into a junior resource company. Before I get into details I want to briefly touch on what speculating in mining stocks entails.

### Investing versus Speculating

Firstly I believe it is important to make the distinction between investing and speculating. I used to believe the difference was a function of timeframe. If you bought for the long term based on sound fundamentals you were making an investment. If you bought a stock for a quick fire 30% profit in two weeks you were speculating. I have recently discovered this view was wrong. When you purchase a stock or anything for that matter predominantly for dividend and cash flow you are investing. If you make a purchase primarily for anticipated price appreciation you are speculating,

regardless of timeframe and fundamentals. It is my belief speculation is just a sophisticated word for gambling. The point I am trying to make is that when you buy junior mining stocks you are in effect gambling not investing. It may be reasonable at some point in the future to expect a handful of these precious metals companies to pay healthy dividends and become sound investments but for now there are not many that do.

Now there is a lot of negative connotation with the word "gambling". Images come to mind of destitute casino junkies losing the family home in a poker game etc. In the three years I have been speculating for a living I have had many people tell me I am gambling and to be honest with you I used to take exception to this. The word gambling in today's society implies recklessness and most of the speculation we have undertaken has been anything but with what I consider to be a lot of homework and some good sound reasoning.

There are a lot of hard working people out there that wouldn't dream of going into a Casino with 5 to 10 thousand dollars, and mindlessly blow it all on games that they knew they had no statistical chance of winning over the long term (Some do but they are an exception to the rule). However this is precisely what a lot of people do when it comes to speculating in shares. With little homework or a stock broker's advice some even blow more than this but simply justify it as an investment gone wrong which can be written off for tax purposes. The point I want to make here is there is reckless gambling and there is educated gambling. The two are mutually exclusive. Having since learned that speculation was a form of gambling, I decided for research purposes to take up the increasingly popular game of Texas Hold 'Em poker and endeavor to learn how a professional gambler approaches the game. After a lot of fun and reading my findings were that playing educated and smart poker requires essentially the same disciplines that speculating in mining shares involves. In order to be successful in poker you must adhere to the following:

- 1. You must play hands which are statistically long term winners requiring a great deal of patience (You generally play just 20-25% of hands dealt which isn't many!!).***
- 2. You have to consider your position on the table when you play these hands as some hands have more value from different positions.***
- 3. Finally and most importantly you must consider your opposition and whether they play at a better or worse standard than what you do (Simple way of doing this is by observation, looking at how many hands they play and from what position. You are not going to win money in the long term by playing against smarter opposition.***

All these factors if applied consistently put the odds in your favor for winning money over the "long" term. Now, before you all quit your day jobs and start hitting the Casinos I must stress that my above assessment of the game is grossly oversimplified. My apologies go out to you professional Texas Hold 'Em players out there. The game is obviously much more complicated than this but for the purposes of what I am writing it is essentially adequate.

## Speculating in Mining Shares

Speculation on mining shares, like Poker is a game and you need to know what to look for in order to put the odds in your favor over the long term. The following three sections are the areas based on my experience that you need to concentrate on in order to be profitable:

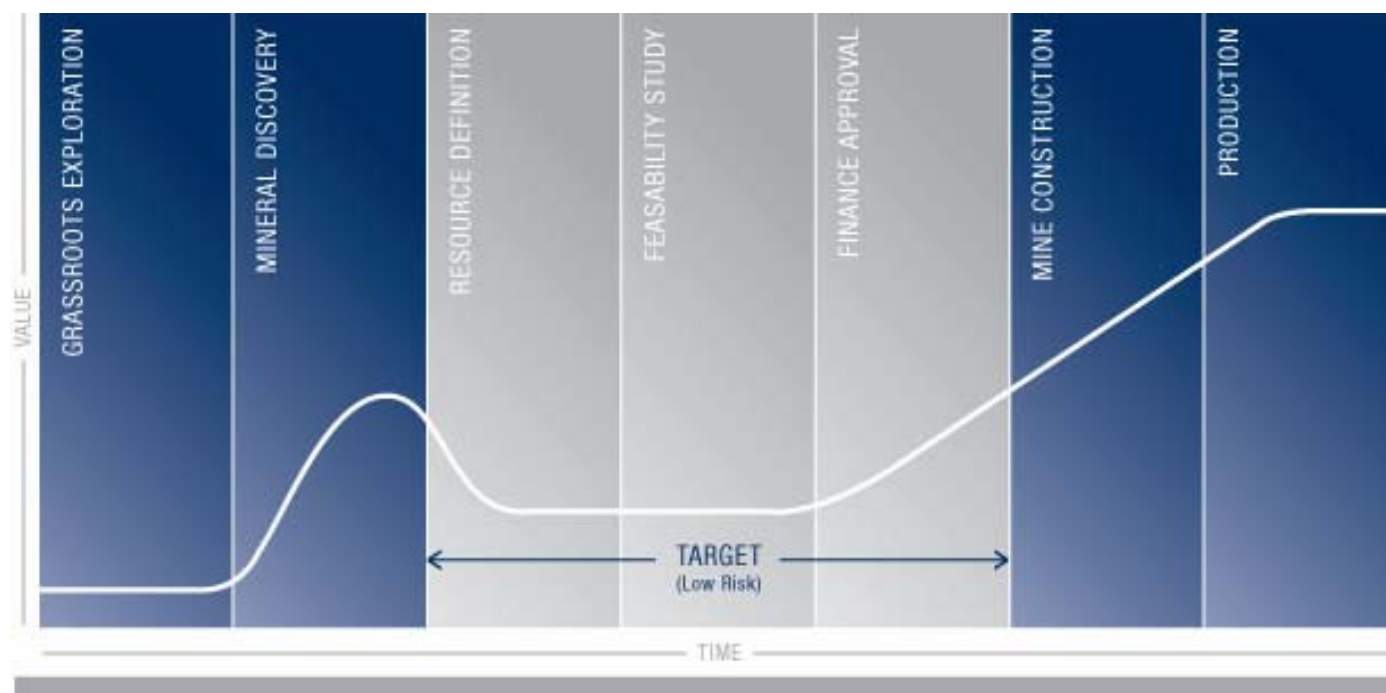
- 1. Companies that have advanced deposits (Preferably many) and are moving them towards development decisions or production.**

The odds of bringing a raw prospect into production have been estimated at 1 in 5,000 to 1 in 10,000. When I first read these odds I was stunned. Many of the mining companies I see everyday investors buying are these very same grassroots exploration companies. It is no coincidence in my opinion that most of these stocks have

been recommended by Stock Brokers whose respective firms underwrite a lot of the small capital raisings associated with these companies. Whilst I am not disputing that fortunes can be made by successfully holding a junior that makes a discovery, the odds of being successful are not that great. This is why we prefer buying juniors that have already made a discovery and are ideally in at least the Resource Definition stage or working towards feasibility and production (See Diagram below). Choosing grass roots exploration juniors is a very specialized field and I believe you really need a geologist to be able to interpret the available data or prospective ground. For the most part these companies are bottomless money pits where shareholder value gets diluted to next to nothing. I hasten to add many juniors that have advanced projects also have green field exploration programs so you still get that blue sky potential without as much risk.

Most of you are aware that mining companies have a cycle. Below is a diagram that effectively summarizes this process. It is this process that adds value to a mining company regardless of what metal prices are doing (assuming we are in a secular bull market and sentiment in the sector remains strong). Metal in the ground becomes more valuable as the transition towards a production stage progresses. When you speculate with this in mind, any rise in metal prices becomes a bonus or a safety net depending on how successful the company is in its developments. If the company has successfully advanced its projects the share price should already be rising. If this happens in conjunction with higher metal prices the company's assets should be worth even more and theoretically this should be reflected in the share price. On the flip side if the company encounters problems in advancing its assets, the share price will usually fall but a lot of this decline can be negated if metal prices are increasing at the same time. So investing in these shares in an environment of rising prices (Such as now) can in effect give you terrific upside with a nice margin for error if things don't go your way.

## The Mining Life Cycle



There are literally thousands of stocks all over the world that fall into the category we are targeting and steps need to be taken to short list them. The following is a list of quantifiable factors that my brother and I take into account when deciding on a junior mining company to speculate in. We have recently incorporated these into a financial model we have developed for ranking and assessment purposes:

- Significant Insider Ownership of shares
- Options/Warrants issued
- Cash position
- Debt to Equity
- Enterprise value per unit of primary metal
- Mineral diversity
- Project diversity
- Gross Metal Value per Ton
- Gross Metal Value as a multiple of Market Capitalization
- Share Valuation using NPV and a Metals Valuation Matrix
- Political Risk
- Hedging Commitments

Management experience is an intangible factor that is arguably more important than any of the above factors which must also be taken into account when deciding on a junior to invest in. I will be discussing each of these factors in more detail in my next column which will be titled **Mining Company Fundamentals 101**.

## 2. Timing your entry

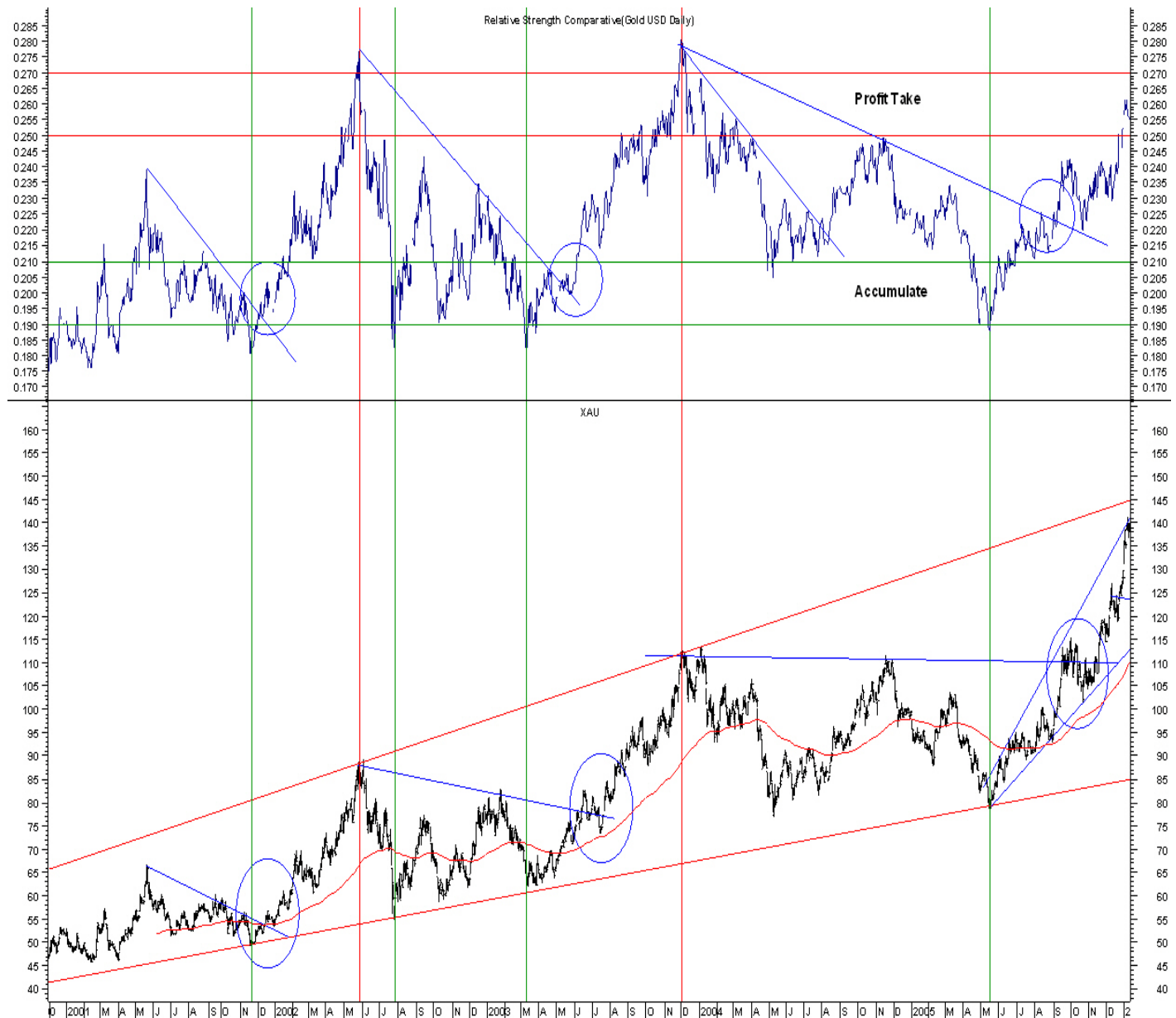
Once you have established the stocks you like, you need to time your entry. I liken this to playing the right hands from the correct position in poker. One of the fundamental mistakes you can make is playing a hand out of position. The risk is after waiting for what sometimes seems an eternity for a good hand to play, you find yourself out of position and rather than fold (like you should), you play it out of mere frustration.

Most of the money we have made in mining shares has not so much been a function of “what” we have bought (although this is obviously important) but “when” we have bought. I made mention in my last article that the best time to invest in an asset class was when it was out of favor and consequently the risk reward was to your advantage. This same principle applies to mining shares. Even though we have been in a bull market in precious metals now for at least 4-5 years, there have still been extensive periods when Gold shares have fallen out of favor. These periods have invariably followed exhaustive rallies which have seen precious metals shares get way ahead of themselves.

As mentioned previously we like to use technical analysis in assessing market conditions. A favorite of ours that I am sure many of you North American readers are familiar with is the XAU Gold ratio or the Gold XAU ratio depending on your preferred use of it. It has been a reliable barometer in the bull market thus far. We use it to assess risk when making purchase decisions and as a profit taking signal when the market gets ahead of itself. For Australian and New Zealand readers we keep a similar index using an Australian Gold stock index versus the Australian Gold price.

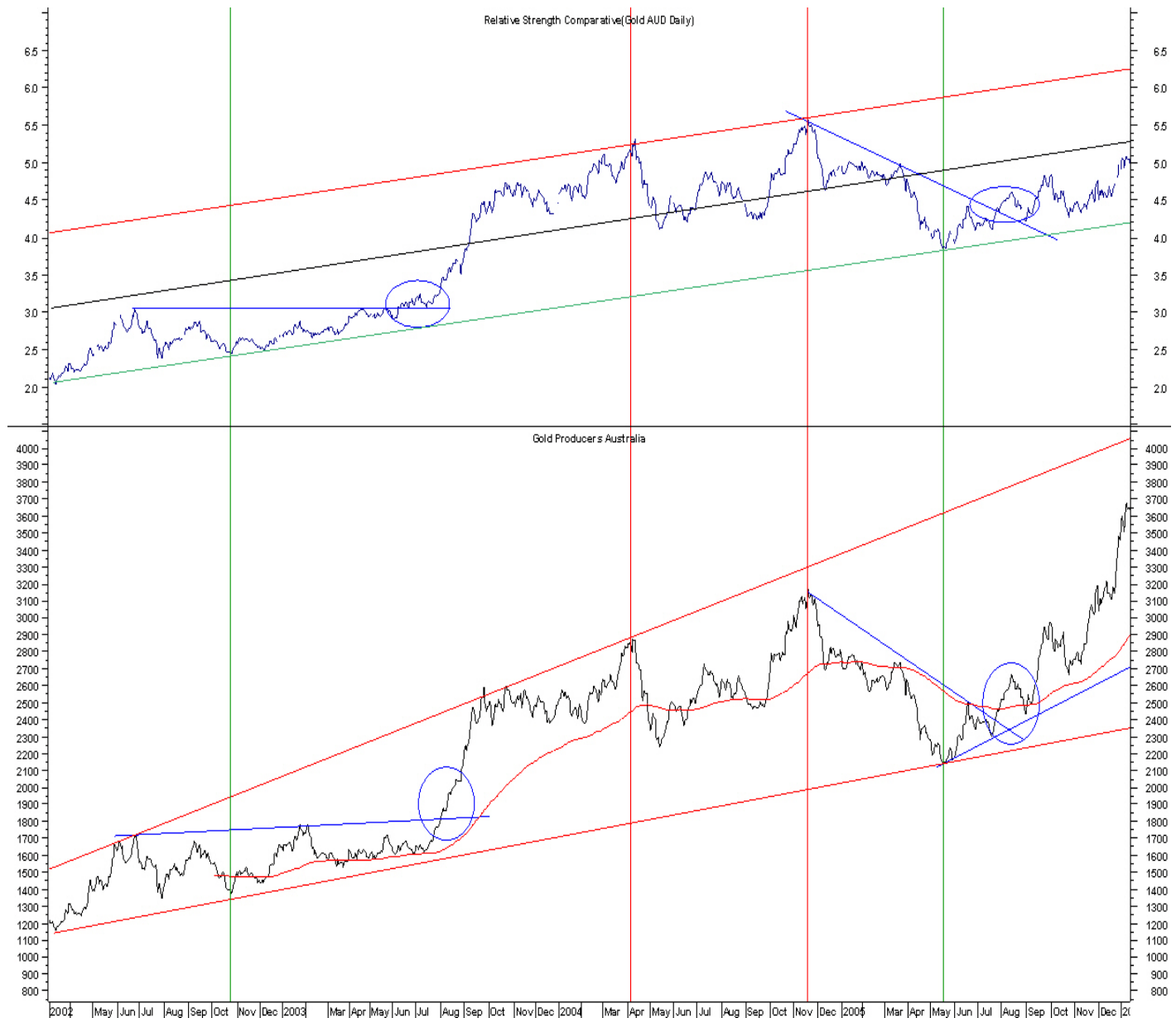
It is best to do most of your buying when these indicators hit the oversold buying levels. This invariably occurs when the market has temporarily turned its back on the Gold sector. To comfortably buy in these stages takes discipline and you need to train yourself as it goes against the grain of how most people like buying and selling shares which is essentially in the comfort of crowds. The following is a brief introduction to the two of the charts we use.

## XAU Index



*This is simply a chart of the XAU with the XAU Gold ratio in the top section. Note the red horizontal column in the top section indicates Gold shares are overbought relative to the Gold price and the horizontal green column indicates Gold shares are oversold. Doing most of your buying when Gold shares are oversold (Green vertical lines) and some significant profit taking when the gold shares are overbought (Red vertical lines) has been a pretty lucrative strategy to this point. As you can see we are getting into overbought levels again. I want to stress at this point that technical analysis while useful should just be a guide. While we are in a precious metals bull market I think it is prudent to leave at least 50 percent of your Precious metals portfolio in the market at all times as at some point these indicators will break down and precious metals shares will more than likely go well and beyond what most of us would consider remotely reasonable.*

## Australian Mid-Tier Gold Producers Index



*This is a chart of the Australian Mid-Tier Gold producers Index with a ratio to the Australian Gold price in the top section and the index itself below. Like with the XAU index the buying points are clearly marked in green and the selling points in red. The red line charted with the Gold index is the 150 day moving average and you can see with the first leg of the bull market (2002 – 2004), the best times to add to your positions on the way up were on pull backs to the moving average. When the index gets away from the moving average (like it is now) this has historically not been a good time to add shares and for those traders out there some profit taking may be prudent. Another thing of note is the seasonality with precious metals shares. May to July has generally been a good time to buy with the ideal selling time being a little harder to assess in a general range from December to March.*

### 3. Being smarter than your opposition

In Poker gaining a perspective on your direct opposition is critical and in the game of mining stock speculation first and foremost your opponent is the market. I would argue your ability to make consistent long term returns comes from knowledge and understanding of how this market works. I think what appealed to me the most about the precious metals market when I started out was the fact that by main stream standards it was and still very much is misunderstood. This is not surprising given that up until 5 years ago the sector has effectively been lost in the wilderness. I read an article in one of the Australian newspapers recently that suggested some brokerage houses have been struggling with a flood of inquiries about precious metal stocks because they lacked the qualified analysts to handle them. Most precious metals analysts were made redundant 5 years ago!! I stress your competitive advantage in this game is having a better working knowledge than the majority. Because most of the stocks we are talking about are too small for institutions to become interested, they remain poorly researched and this creates opportunities. As these stocks start to attract larger market capitalizations over the coming years this window of opportunity will at some point close.

## Conclusion

In concluding I want to reiterate that websites such as Gold-Eagle, Kitco and 321gold have been invaluable in building up my knowledge base. Over the coming months I hope to share my experiences and findings with anyone that is interested. I value and welcome any feedback from readers no matter what their level of experience. It has been my intention with this article to make readers think carefully before plowing hard earned money into the precious metals sector. You need to know what you are doing or find someone else that does. I strongly encourage people to do their own analysis. I believe Stock brokers for the most part are a poor guide when it comes to precious metals. I also want to caution readers in relation to the countless newsletter writers and stock promoters out there. We have subscribed to our fair share and the better ones are the people that have been involved in the industry through thick and thin (15-20 years plus) and have a proven track record. There are many that have been involved for just a short time (Under 5 years) claiming fantastic returns and charging people to look at their portfolios and what have you. I believe there is a saying on Wall Street "Don't mistake brains for a bull market" and I think it rings true today. In poker anyone can get lucky in the short term, hence the attraction. While these players come and go, the players that do the correct things consistently remain in the game.

Troy Schwensen

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