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Keep the Faith—Higher Gold Price Will Come

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On the global stage of currency devaluation and debasement, the reasons for owning gold seem obvious. But have you ever stopped to consider the derivative market? According to Charles Oliver and Jamie Horvat, both senior portfolio managers at Sprott Asset Management, "The impact of the derivatives has yet to express itself." In this exclusive interview with The Gold Report, Charles and Jamie explain how gold will react in the New Financial (dis)Order. Both foresee $2,000 gold in the next three years and, ultimately, "significant" hyperinflation on a global scale over the next decade.

The Gold Report: Jamie and Charles, on your site you've posted a recently updated report, "Reasons to Own Gold." In it you say that the impact of the derivatives has yet to express itself. Can you explain that for our readers?

Charles Oliver: There are many reasons to own gold. I think one of the biggest ones is the actual devaluation and debasement of currencies. Having said that, one of the lesser-known ones is the derivative market; if you look at the derivative market on a global basis, it is absolutely enormous.

And the downfall of the financial system last year in part was the fact that many of the banks in the financial system in the U.S. and around the world had a capital base that was leveraged up 30 times or more on their balance sheet. The derivatives market is hundreds of trillions of dollars. When you look at that relative to the capital base of the whole financial system, the whole financial system gets dwarfed.

So, in periods of volatility, you can have some huge swings in some of these instruments. Some of these instruments may be off balance sheets, and there's certainly an element of risk should some of these need to be unwound.

Jamie Horvat: We're in a deleveraging process now and we need to get our personal savings rate back in line, as well as our personal balance sheets and the banking balance sheets. When you have that leverage you get less lending. You need to continue with that growth; so, as a result of all of that, we're seeing governments move to quantitative easing, which is printing money and trying to force money into the system and force spending. Then what happens is currency is debased against all hard assets; and gold, as the ultimate

store of value and a hard asset class in an exchange of money, over time reacts to that environment. It will have a positive bias going forward.

TGR: We read a lot about U.S. dollar devaluation and expected worldwide inflation. Why hasn't gold gone over $1,000?

CO: That's an excellent question. My own personal viewpoint is that today it should be at $2,000 an ounce, but it's not. I think that sometimes these things take a long time to work their way out. For example, look at something like Freddie Mac and Fannie Mae. Last year they basically fell out of bed. There were people shouting out very loudly four to five years before that these companies were effectively bankrupt and insolvent. It just took a long period of time for the valuations to work their way out. In the case of gold, I do believe that it will be higher, but sometimes you've just got to be patient and wait for these things to unfold.

JH: The other thing we've been witnessing is the battle between deflation vs. inflation. People in the deflation camp think we're going into another Great Depression, the Dow is going to 1000 points and the only thing you should hold is cash, as the global economy will continue to shrink.

Since we have come off the gold standard—and the reason I believe we will never go back to the gold standard—governments have used quantitative easing or the expansion of money supply to reflate the system. We're going through one of those periods again where they print massive amounts of money and debase currencies vs. hard assets, in an attempt to reflate the system. I believe we are in a bottoming phase in the market; but we may retest the lows. The markets will continue to move sideways and be volatile as consumers continue to save and balance sheets are slowly repaired. Governments will continue to print and throw money into the system to expand the monetary supply and reflate the system. As you do that, you simply debase currencies.

So, you have this short-term fight between deflation and inflation similar to the sideways moving markets of 1973 - 1976. Gold moved from $33 an ounce to $38 to $180 or so, and in that sideways, volatile market from '73 to '76, it was knocked back down to around $100. Unfortunately, the end result of the quantitative easing resulted in stagflation. And that set up for the euphoric run of gold into the $800 range in the early '80s.

TGR: So would we expect to see something like that again, where gold will cross, and continue to trade, above $1,000? Or would we expect it to cross $1,000, spike and then come back down into that $900 range again?

CO: I don't think $1,000 is a magical number; it is a round number, so people look at it. But as I said, my own personal viewpoint is that gold will go through $2,000. I think there will be a spike at some point in the future, but I don't know how high that spike will be. I've heard people talk about $5,000, $10,000—I've even heard some numbers higher than that—and I can see the potential spike going to such levels. It's not a forecast at this point in time; I will keep a conservative call of $2,000 in the next three years, which is what I have been saying for a while. But, yes, I expect the spike will likely be significantly higher than that.

JH: The other aspect of that—where gold falls back to after the spike days—is we have to look at it in real terms and think of what the new marginal cost of production will be after that spike. So, whether it's $600, $700, or $900 gold as the new marginal cost of production, we will have to make that call at that time.

CO: Marginal production—and I may have a debate with my co-partner on this one—is a very valid comment. I think one of the other things you also have to look at is, in the spiking period, a number of other things will be going on. There will be a huge expansion of the

monetary base probably over the next decade from a number of governments on this planet, and there will be a significant amount of inflation that occurs during the next decade. We do believe that hyperinflation is going to occur, and it will be quite significant.

So, I think in the next decade you've got to put it into a relative situation. I think the long-term norm price for gold will actually probably be well over $1,000 when we look back 5 to 10 years from now.

TGR: When you say hyperinflation will occur, are you expecting that to be worldwide or isolated as it is now while the major countries look at a large inflation period?

CO: I believe that hyperinflation is probably going to be on a large global scale, as most of the countries around the world competitively devalue their currencies. But it's a fact of life right now as the quantitative easing is going on, and in this type of situation, you are going to get significant inflationary impacts.

TGR: Once we go into stagflation or hyperinflation, I'm going to guess that it makes sense to be holding gold bullion.

CO: Gold bullion or assets that hold their value against inflation. And the stock market, funnily enough, can act as an inflation hedge. In fact, if you look at a lot of the studies, the stock market has been one of the best ways to protect your assets against the ravages of inflation.

JH: As Charles just touched on earlier, the hard asset classes—the companies with clean balance sheets that can pass through cost price increases, whether it's precious metals companies or gold bullion acting as a hedge or agricultural companies or other commodities companies—they tend to significantly outperform all the companies that are financially-based "lever" companies that don't produce real goods.

In terms of companies acting as inflation hedges, we've been looking for companies with sound balance sheets that are not going to go bankrupt in this environment. That's been a lot of our focus over the last year. If there is a product out there that people need and will continue to buy, it doesn't matter if it's a technology company; it doesn't matter what kind of good it is as long as there will continue to be a market for the end products. Even if times get tough, they will continue to buy it.

JH: Yes, you have to look at the balance sheets of the companies and really distinguish what is, and will, trade as a financial-based levered asset vs. those companies (whether it's technology, commodities, healthcare or consumer staples) that will be able to pass through those cost increases, has a clean balance sheet and will act as a store of value.

TGR: So, if we do find something that is acting as a hard asset and not a financial asset, how would you suggest investors look at something like gold sector equities compared to technology or other types of equities?

CO: When investors put together their portfolios, they have different needs, long-term objectives and risk tolerances. Ultimately, you've got to put together a well-diversified portfolio that has a number of different sectors and asset classes. One of the things that we individually, and over at Sprott, firmly believe is that in the current environment gold should definitely be a significant component. Over the last 20 years, most people were selling their gold and many did not own or believe in gold as an asset class.

JH: I would agree with that. Like all sectors, you have to look at the companies individually. Since about November of last year you saw people gravitate more toward the large liquid names in the gold space versus the small caps.

Since the start of this year, there's been a resurgence of the small-cap names. But even

then, you still have to diversify and dig down deeper to look at companies that are pure explorers that don't have the balance sheet. They may not have the ability to obtain funding and may trade as a financial asset because they need to come back to the market; they have been overlooked and left behind.

The companies that are developing stories, or have production and are bringing on a new project and have cash flows and growth, are able to benefit in this market. So, even in the gold space you have to distinguish between which companies will not trade up as a hard asset.

TGR: Since last November and December, the gold majors have had quite a run up. Would we expect to see any more significant appreciation in the major gold equities?

CO: The simple answer is yes, because I believe the price of gold is going higher. So, I think many of these companies will benefit from increasing earnings and cash flow. Having said that, being the largest gold producer in the world is not a good thing because it's very hard to grow when you're at the top. In fact, most of the big guys, they're just doing mergers and acquisitions to maintain their current level. I believe that on a long-term basis, the best value and growth really comes from the smaller- and mid-cap sector of a well-diversified portfolio of gold companies.

JH: Along those lines, you have to look once again at the individual companies, the projects they're bringing on, the net asset values, IRRs or returns on those projects. Are they going to add value in the gold price scenarios under which they work? So, that's another aspect of looking at valuations between the various sectors of small-, mid- and large-caps—what projects they have, the viability of those projects, and how you would skew the portfolio to the various names as well.

JH: The other thing that we should just touch on is that we also like unhedged producers—the guys who are going to benefit from the upside in the movement of the gold price.

TGR: Following the guidelines you've just outlined, do you have any companies in that small- and mid-cap sector that you're looking at that you can share with our readers?

JH: Some of the names that we like and hold in the portfolio include: Allied Nevada Gold Corp. (TSX:ANV) (ANV), Lake Shore Gold Corp. (TSX:LSG), West Timmins Mining Inc. (TSX:WTM), International Tower Hill Mines Ltd. (TSX.V:ITH) (NYSE.A:THM), IAMGOLD Corporation (TSX:IMG) (NYSE:IAG), Osisko Mining Corp. (TSX:OSK), Romarco Minerals (TSX.V:R), Wesdome Gold Mines (TSX:WDO)—a mixed bag of some junior producers and growing production, some mid-cap names, pretty strong balance sheets and located in geopolitically safe jurisdictions of the world.

CO: In the juniors that are currently producing is a company like Wesdome, which is in Quebec. In Canada we also have Rainy River Resources Ltd. (TSX.V:RR) and Detour Gold (TSX:DGC), which are multimillion-ounce deposits currently undergoing studies. Another producer in the junior area in Canada would be San Gold Corporation (TSX.V:SGR).

A lot of our focus currently is on areas of the world that are politically safe and sound; so within the names Jamie just mentioned are a number of companies that are focused in North America, where you may be paying a bit of a premium for that. But I'm quite happy to have that safe jurisdiction because there are places around the world where you may think you have an asset, but the asset either gets taken away from you or the equity terms are renegotiated. So, there are risks that you try and minimize as best you can.

TGR: Could you tell us at a very high level what "baskets" these companies fall into (i.e., near-term producers, small producers, explorers)?

JH: Our all-cap portfolio is a blend of mid, large and small. We have a component of large-cap names at the core of the portfolio; but, as Charles mentioned earlier, the larger part of the alpha return of the fund comes from the small- and mid-cap names. One of the things we've done well over time has been manage on the margin—based on valuations and movements in the sector over time—a movement between mid-, large- and small-cap names on the margin of the portfolio to take advantage of the valuation discrepancies.

So, the list of the names that I gave earlier—they're in more politically safe jurisdictions focused on North America. We lean towards producers or near-term producers, development stories and away from pure exploration companies, and skewed towards that basket and all-cap approach, as well.

One of the names on the list is a development story; they're building a mine right now. One of them is a late-stage exploration company development story doing feasibility work. Three of them are ramping up production even as we speak. One of them is a mid-cap name. Osisko has all the financing in place and everything to build a mine. So, it is a mix, but it is skewed towards the late-stage development and near-term producers or ramping production or producing companies.

CO: In terms of the larger producers, some of the names that we have on our top-10 would be companies like IAMGOLD, Goldcorp (TSX:G) (NYSE:GG), Kinross Gold Corporation (K.TO) (NYSE:KGC)—we like all those names. In the slightly smaller areas in the development stages—and Jamie mentioned some of them—Osisko is going to be bringing on a mine in Quebec next year. Lake Shore Gold is ramping up right now. Allied Nevada just commenced commercial production.

As Jamie said, we're somewhat cautious on exploration because it's looking for a needle in the haystack; and sometimes it's hard to find the right haystack in the first place. One of the things we do engage in is a little earlier stage. We put a portion into names that usually have a fair amount of drilling, and although they've been given credit for this in the market, they may not have an official 43-101 confirming that they have a resource or a reserve. The amount of data that we can see in the public domain leads us to believe there's a very good chance that this will be a mine at some point in the future and has the potential to grow into a big resource and, ultimately, we will get a big multiple return.

TGR: One of the holdings that you have, Colossus Minerals Inc. (TSX:CSI), was never mentioned in your all-cap portfolio.

CO: If you look at the Precious Metals Fund, one of the first acquisitions we made when we came over to Sprott was Colossus. I went to Eric [Sprott] and said I was buying it for the Precious Minerals Fund, and he was very interested in the story. So, if you go and look at the annual reports, you will see that we've been a big shareholder of Colossus.

JH: Colossus is an example of what Charles touched on earlier—the very few and far between. A company that we could wrap our head around their geological setting, the historic database and holes being presented, the fact that it was a past producer, etc., and we could get a very good sense even before a 43-101 that this has a large potential of being a mine one day.

TGR: During 2008 you increased your bullion percentage, but I see right now from fund stats that bullion is at 5%.

CO: As we all know, the market was horrible last year. Gold stocks were being treated like any other stock; they were, in fact, probably being treated worse. So we felt that bullion was probably better, and increased the bullion weighting. We actually ramped up bullion from single digits to about 20% when we peaked in November, and that was because we liked the defensive nature of bullion. In retrospect, the bullion held up much better than the stocks,

so it was a good thing to do.

As we looked at the valuations last fall, we said, "You know what? These stocks are so cheap it's ridiculous," and we started to reduce our position in bullion and redivest into the market. If you look at what's happened since that point in time, it's been a good call. We've taken our bullion down to about 5% of the fund, and if you look at the stocks, year-to-date, we're up 50%. If you look at gold bullion itself, in U.S. dollars, it's up 5% to 10%. In Canadian dollars, I think it's actually flat to down.

TGR: Well, that turned out to be a brilliant move. Let's talk silver. Many people are saying silver is really going to run up faster than gold due to its increased volatility. Do you have any thoughts on silver, and is it a counter-hedge inflation play like gold?

JH: We like silver. We expect silver to move with the gold price. Obviously, silver is often viewed as poor man's gold. Basically, it's easier to buy in smaller quantities because it's cheaper by the ounce and it's easier to store for the smaller investor.

If we want to look at a cycle and break it up into thirds, during the first two-thirds of a gold cycle, as we see it, silver largely trades as an industrial commodity. But in the last one-third of a cycle, it tends to play catch-up to the gold price and close that silver-to-gold ratio. So, historically, if you go back to 1971 when gold really came off the gold standard and you look at that silver-to-gold ratio, the median has been about 55- or 56-to-1. If you go back to the 1980s, it's hovered around 65- or 66-to-1. We got as high as, I believe, 81- or 82-to-1 in that gold-to-silver ratio, and now we're back down to that 65-to-1 range. So, it depends on your viewpoint of how much movement you see in the silver price going forward. As we see the precious metals or gold price appreciate, we obviously expect silver to move along with that.

TGR: In the last third you would expect it to move faster than gold, but it would really be more of a spike?

CO: If you look at what's happened in the last six months, silver has way outperformed gold. And I would say it's now sort of getting to that point where it's pretty close to fair value with gold under the models we've been running. So I am almost indifferent to owning either gold or silver right now, but silver's momentum from the last six months is probably still with it somewhat. So, it could overshoot to the downside, but, again, I think I am largely indifferent at this current level.

TGR: Are there any other observations you'd like to convey to our readers who are precious metals investors, as we look across 2009?

CO: Last year was very tough—it really took a toll on all of us. I've got scars on my back to prove it still. What I want to say is continue to believe in that higher gold price because that it is going to come. I am still convinced of that. Keep the faith.

JH: I was going to make a comment along similar lines. You know there were a lot of people who, I think, were in a very similar cycle from 1965 to 1984. We're experiencing that again, and we're in the '73 - '76 volatile sideways market. A lot of people made significant money from that first gold move from $35 to over $180 an ounce. And then a lot of people lost the faith during the quantitative-easing phase in the sideways volatile market and got squeezed out of gold. Whether you believe in this conspiracy theory or not, gold was pushed down to $100—or just below a $100—an ounce and missed that last euphoric run from '76 to the early '80s.

So, as Charles said, I would keep the faith; don't lose sight of the larger picture. Don't lose sight of the quantitative easing and the debasement of currencies versus hard assets and real things, and you will do well going forward.

TGR: Very good. Jamie and Charles, I appreciate your time.

DISCLOSURE: Charles Oliver
I personally and/or my family own the following companies mentioned in this interview: None
I personally and/or my family am paid by the following companies mentioned in this interview: None

DISCLOSURE: Jamie Horvat
I personally and/or my family own the following companies mentioned in this interview: None
I personally and/or my family am paid by the following companies mentioned in this interview: None

Bringing more than 21 years of experience in the investment industry, Charles Oliver joined Sprott Asset Management (SAM) in January 2008 as an Investment Strategist with focus on the Sprott Gold and Precious Minerals Fund. Prior to joining SAM, Charles was at AGF Management Limited, where he led the team that was awarded the Canadian Investment Awards Best Precious Metals Fund in 2004, 2006, 2007, and was a finalist for the best Canadian Small Cap fund in 2007. At the 2007 Canadian Lipper Fund awards, the AGF Precious Metals Fund was awarded the best 5-year return in the Precious Metals category, and the AGF Canadian Resources Fund was awarded the best 10-year return in the Natural Resources category.

Jamie Horvat joined SAM in January 2008. Jamie is co-manager of the Sprott All Cap Fund, the Sprott Gold and Precious Minerals Fund and the Sprott Global Equity Fund. Jamie has over 10 years of investment experience. Prior to joining SAM, he was co-manager of the Canadian Small Cap, Global Resources, Canadian Resources and Precious Metals funds at AGF Management Limited. He was also the Associate Portfolio Manager of the AGF Canadian Growth Equity Fund, as well as an instrumental contributor to a number of structured products and institutional mandates while at AGF. He joined AGF in 2004 as a Canadian Equity Analyst with a special focus on Canadian and Global resources, as well as Canadian small-cap companies. Prior to joining AGF he spent 5 years at another large Canadian mutual fund company as an Investment Analyst.

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