

## INTERVIEW

# «The Gold Mining Sector Outshines All Other Investment Opportunities»

For James Rasteh, Investment Director of Coast Capital, the outlook for gold mining stocks has rarely been as attractive as it is today. He explains why he expects the price of gold to rise significantly and which mining companies will profit most from a secular bull market.

Investors in the gold mining sector have experienced a turbulent year. Stocks of industry leaders such as Newmont, Barrick Gold and Agnico-Eagle Mines were steaming ahead at full speed until late summer. In recent weeks, however, some consternation has set in.

For James Rasteh, the investment case for gold miners has not changed a bit. On the contrary: The head of the New York based investment boutique Coast Capital is as convinced as ever that there is hardly a more exciting sector than the gold mining industry.

«With increasing demand, decreasing supply and the tsunami of newly printed money sweeping into the system, the price of gold is going to be squeezed up like toothpaste when you step on the tube, » says Rasteh.

In this in-depth interview with The Market NZZ, Rasteh explains why mining companies are in a more attractive position than almost any other sector and what companies will benefit the most from the gold boom.

**Mr. Rasteh, the price of gold has corrected more than 12% since its all-time high in August. What is the outlook for the precious metal?**

We're living in unprecedented times: Demand for gold is at an all-time high, and one of the main factors are emerging markets. The rise of the middle class in China and India has led to more demand for gold. But most importantly, central banks in developing markets hold 5% or less of their reserves in gold. That's compared to 15% or more for their developed markets counterparts. The only exception is China which is more like a western economy with its significant gold exposure.

**What does this mean for the price of gold?**

Emerging market central banks feel that the Dollar is being printed like it's worthless. For years, they have been looking to increase their exposure to gold. So, as they catch up with their western counterparts, they could acquire the entirety of the world's gold production - at current rates - for the next twenty years.

**How does this compare to the demand for gold as an investment? In the week of November 16th, more money was withdrawn from gold funds than ever before.**

For many years, investors have shunned gold. But with the outbreak of the global pandemic, they have started entering the market. The nearly \$17 trillion in global negative yielding debt has removed the barrier to entry for investors since the opportunity cost of holding gold has disappeared. Now, they must rethink and rebalance their standard 60/40 portfolios. Yet, there is still very little capital invested in gold. At the start of my career 25 years ago, up to 2% of an average institutional fund's assets were allocated to precious metals. Today, it's only at around 20 basis points.

**What is happening on the supply side?**

Here's an interesting fact: 2020 marks the first year in a long time where we have entered a period of declining gold production. Every year going forward, there will be less gold produced than this year. Today, for every ounce of gold we take out of the ground, we find only 0.2 ounces of new reserves. Ten years from now, we will be producing 50% less gold than we do today.

**Then again, it's also a fact that a higher gold price gives a strong incentive to explore and discover new reserves. What's more, private households usually tend to sell gold and other jewelry when they get more money for it. In addition, the pandemic has made production more difficult this year.**

Covid has nothing to do with that. At the margin, most of production remains unimpaired. But we are running out of gold. Last year, the mining industry spent three times as much capital in terms of exploration to look for gold than it did twenty years ago. There are exceptions of course, but on average, gold miners find only 5% as much gold as they did twenty years ago. Plus, the quality of the gold they're finding is very low, much of it is not mineable.

**These are some of the same «peak gold» arguments we've heard during the last bull market. We know what happened then: the price collapsed by over 40%.**

We do make huge discoveries every few years. However, in aggregate new reserves are declining. Also, for a new mine, it takes a long time to come into production because you need to build infrastructure, you need environmental rights, operating rights and a deal with the government in terms of sharing revenues. It's way more complicated than, say, building a new airport. Ten years ago, it took 15 years on average for a new mine to come into production, now it's like 20 to 25 years.

**What are the consequences of these difficulties?**

Putting fundamental factors aside, gold responds powerfully to massive increases in the monetary base. The last time we printed as much currency as we do right now, was in 2008-09. During those two years, the Federal Reserve printed \$1.5 trillion, and the price of gold tripled from its lows in 2008 to a record high in 2011. And remember: Back then, gold production was increasing. This

time, production is decreasing, and the Fed has already printed more than \$3 trillion just over the past nine months. So, with increasing demand, decreasing supply and this tsunami of newly printed money sweeping into the system, the price of gold is going to be squeezed up like toothpaste when you step on the tube.

**Nevertheless, the price has been trending lower for almost four months.**

In the short-term, it's possible that the price of gold can go back to 1700 \$ per ounce. Yet, we've had a massive stimulus, and it takes a while for these things to work through the system. Like cool water in a pot placed over high fire, gold does not bubble up immediately, but over time. So, all of this short-term, nervous trading action that's been driving the price of gold in recent weeks is of no interest and no concern to us.

**What could break the downward trend? Inflation?**

I'm not a macro guy, but I think the traditional depiction of inflation and deflation is dead. Today, a hotdog costs less than it did 25 years ago, but a Hermès bag is 2.5 times more expensive than back then. An apartment in Manhattan may cost five times more today, but a house in Detroit costs 50% less. In other words: Inflation and deflation need to be treated the way they actually occur in the system. Also, the definition of inflation has kept changing. It basically started when Alan Greenspan kept changing the definition of inflation so that he could keep rates very low which ultimately tripped us up. I think he's the most destructive central banker of our lifetime.

**Yet, it was Greenspan's successor Ben Bernanke who flooded the system with liquidity during the financial crisis and launched a total of three quantitative easing programs.**

They're birds of a feather. When Bernanke took over, monetary policy in the US was already set and evolving. Essentially, he was just following Greenspan's script. Again: When you print a lot of money, the value of real assets that are scarce in nature keeps going up. Also, gold does very well in periods of deflation, too. When there's money printing and you ultimately inject that money into the system, that means higher prices of goods that are stores of value and in limited supply. The big difference between now and prior episodes is that we're injecting much more money into the system, and we see a decline in the production of gold. So, guess what: Even Warren Buffett is investing in gold. We believe that his recent allocation to gold miners is notable in light of his historical commitment never to invest in gold.

**However, rumor has it that it's not Buffett himself who is responsible for the investment in Barrick Gold, but one of his two adjutants who help him manage the Berkshire portfolio?**

Right, that investment was made by one of his portfolio managers. But more importantly, gold mining is a highly profitable business. At the start of this year, a gold producing miner was earning a 20% operating margin. For the average company in the S&P 500, this metric was 10%. Today, the operating margin of an average gold miner is at over 40% which means gold mining is one of

the most lucrative businesses in the world. What's more, the sector is as underleveraged as it's ever been. Nevertheless, valuations are close to or at all-time lows. That means we will see a lot more consolidation going forward. Thomas Edison once remarked that «opportunity is missed by most people because it is dressed in overalls and looks like work». That's doubtlessly the case with gold miners. The gold mining sector outshines all other investment opportunities.

### **What is the current mentality in the industry?**

Part of the reason why there is no capital allocated to the sector is that the industry has been a terrible custodian of capital. In the past, the management team of an average miner did not own stock in the company. Instead, they paid themselves as much in cash-based compensation as they could, based on how big their companies were. When you work under such conditions, you want to buy the biggest asset possible. So, when the price of gold goes up, your share price rises, and the bankers throw money at you, you say: «This is it, I'm going to take my chances». Therefore, the average management team often bought the biggest asset available, and thereby levered their company up. As a result, they made a lot of money in salary and bonuses. But when the price of gold goes down, you have a whole bunch of debt on your balance sheet, your cash flows are drying up, and your share price is declining. So, these management teams sold the very same assets they've bought for pennies on the dollar and really crystallized capital destruction.

### **What were the consequences?**

The ethos in the industry has changed 180 degrees. Today, the gold mining industry has its own equivalent of established proxy advisory services like Glass Lewis and ISS. It's called the Gold Shareholders Council, and we are one of the founders. So, when a management team is about to make a destructive investment in exploration, or is about to overpay for an asset, we publicly tell the management to stop and recommend that investors vote against them. That means management teams are on watch. In other words: People are watching them, they're paying attention, they're scrutinizing all their transactions.

### **Does this service really help investors?**

When the global production of gold goes down, and when you really mess up as a CEO and your share price goes down, investors are going to be upset. So, when someone comes in and puts a bid for your company, your investors aren't going to come for your defense because you're the idiot. As a consequence, CEOs are frightened of low share prices because that would lead them to lose control over their companies. Now, they actually care about their share price. They're trying to do a good job and to earn the support and admiration of their shareholders. Otherwise, their companies are going to get sold, and they are going to lose their job.

### **So where are the best investment opportunities in the mining space today?**

Small- and mid-cap miners are the most attractive ones to invest in. The GDXJ, an exchange traded fund that tracks small and midcap miners, was started in 2009. Since its inception, the price of

gold is up almost 100%, but the index is actually down close to 50%. These companies are much more valuable today, but their share prices are lower. There is no capital being invested in mining stocks.

**Why are you so bullish when it comes to junior companies?**

Today, the largest gold miners trade at twice the multiples of smaller companies. But the largest miners are running out of reserves, and they are not discovering any more gold. That's why we believe that the largest miners have to buy the smaller companies just to survive. Just listen to Mark Bristow, the CEO of Barrick Gold, who is talking about the need for consolidation all the time.

**Is it true that you once had a «lively discussion» with Mr. Bristow?**

We got into an altercation with Mark Bristow because we are invested in Newmont. Historically, Newmont has been a much better investment than Barrick. By any objective criteria, it's a better and a better managed company: It created more value, it performed better, it has a higher profitability and a higher return on capital. So, when Bristow became the CEO of Barrick, he put a bid for Newmont with zero premium and claimed that he's going to be a better manager of these assets. So, he basically tells the world that Newmont's management is incompetent and not fast enough. That's very arrogant and unprofessional. Therefore, we were calling Newmont to defend themselves publicly since, at that time, most investors were tempted to accept Barrick's offer. Additionally, Newmont had just acquired Goldcorp, and we could see all that value they were going to create for investors. So why should this company be given away to some buccaneer called Mark Bristow?

**Are you still invested in Newmont?**

Yes, we own a bit of Newmont. It's not a large investment, but they have a wonderful management team. They're very professional, very diligent, and they are the opposite of promotional.

**What other mining stocks do you hold in your portfolio?**

We've just launched our fund and we're buying into a number of companies. So, we don't want to go into details. But here's a company I can talk about: Jaguar Mining. It's the second largest gold miner in Brazil, and it has some interesting exploration assets on its balance sheet that the world doesn't appreciate. They have a mine where they already produce gold and they have around twenty years of production in there. At \$1800 an ounce, that mine throws off \$70 million of cash flow a year. Today, the company's market cap is around \$350 million. So, at \$2000 an ounce the cash flow yield is pretty extraordinary.

**How do you deal with the risk of resource nationalism as a gold investor?**

Jurisdiction is a very important risk. Much of Africa and especially Western Africa is problematic. Parts of Asia as well, and parts of Latin America too. There are provinces in Mexico we wouldn't invest in. In general, gold is produced in countries that are national resource rich. Meaning, it's usually mined in countries that have large oil and gas reserves as well. Since the start of the pandemic, the price of oil and gas has declined. That means the revenue contribution of the energy industry in these countries has declined or disappeared. Meanwhile, gold miners have become hyper profitable assets, and they're throwing off a lot of cash. So, in countries where the rule of law hasn't been consistent and consistently respected, the risk of asset nationalization is much higher than it has been in a long time.