HAS HEDGING KILLED THE GOOSE THAT WAS TO LAY THE GOLDEN EGG?

Second, Concluding Part

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Gold Standard University Live

Introduction

The English language apparently doesn't have words forceful enough to describe the pig-headed and ham-handed approach of the gold mining industry to the marketing of its unique product, the king of metals and the metal of kings. One is reminded of the words of the late conductor, Sit Thomas Beecham, who once publicly upbraided a cellist in his orchestra in these words: „Lady, you don't realize that you have a most precious instrument between your legs, but all you can do with it is scratch it!"

I founded Gold Standard University Live with one main purpose in mind: to make the producers and long-term holders of gold aware of the importance of the basis. Mr. Eric Sprott of Sprott Asset Management, Inc., offered financial support without my soliciting it. Of course, I gladly accepted the offer and I thought that we now had a winning combination. Mr. Sprott sent out a circular to some eighty gold mining executives urging them to delegate representatives to the Gold Standard University Live Conference in Dallas, Texas, where the subject was gold basis and how it should play a role in marketing. Mr. Sprott could not attend the conference in person, but he must have received a negative feedback from the gold mining industry disdainful of my efforts, because he abruptly withdrew his financial support. As a consequence I felt obliged to suspend the operations of Gold Standard University Live. There will be just one more session in Canberra, Australia, November 11-14, 2008, the title of which is:

Primer on the Gold Basis — *Trading Tool for Gold Investors,*
Marketing Tool for Gold Miners,
and Early Warning Signal for Everybody Else.

The lectures will be taped and made available to the public together with the conference proceedings. This seminar will be of special interest to shareholders of gold mining companies who may feel that the marketing strategy of the industry is hopelessly antiquated. I make a case for shareholder revolt against management which should be forced to adopt the modern strategy for marketing gold with the battle cry:

"*Stop selling the gold price and start trading the gold basis!"*

I expect that this last session will convincingly prove Mr. Sprott wrong, who has told me that the results of Gold Standard University Live do not justify the expenditure.

A tale of two IQ's

The gold basis is the difference between the nearby futures price of gold and the price at which the gold mine is selling its product. Thus the gold basis could vary from mine to mine. The gold miner *sells the basis* when he sells cash gold and buys an equivalent amount of futures. He *buys the basis* when he buys cash gold and sells an equivalent amount of futures. Clearly, a gold miner who is short the basis should strive to cover after the basis has widened. Note that when his short position is covered, the gold miner's net change of cash gold is zero, so in principle he can profit without selling any gold. In practice, some selling may be necessary, but the measure of good management is that it can successfully *minimize* the sale of cash gold. The prevailing ethos in gold mining executive suites is that they ought to *maximize* it. What a profound pitfall! *Profits from short covering, rather than from net sales of cash gold, should be the mainstay of the gold mine's income*. The gold miner, if he was really smart, could also buy the basis even before he dug up as much as a bucketful of dirt. It is profitable to buy the basis when it is wide to sell it when it subsequently narrows — replicating the procedure of the grain elevator operator.

There are still some old line grain elevator operators out there whose marketing strategy is exhausted by selling the grain price. They apparently do not understand the first principles of modern basis trading, which is the marketing strategy of the vast majority of grain elevator operators with a higher IQ. Modern marketing of grain is not about buying from farmers and selling with a mark-up to processors. Such a simplistic approach is ante-diluvian. Modern marketing is about trading the basis, that is, buying it whenever it is wide and selling it whenever it is narrow.

It is true that the basis for grain shows a pattern radically different from that of the gold basis. The former exhibits a pretty regular annual cycle, the guiding star the grain elevator operator. The latter exhibits a long-term secular decline which is destined to end in backwardation ("the last contango in Washington"), which should be the guiding star of the gold miner — if only he had eyes to see and ears to hear. Trading the gold basis, however, does not belong to the repertory of gold miners. This, of course, is not meant to be a flattering comment on their IQ. If they did trade the gold basis, it would render market manipulation of the gold price, official or unofficial, real or imagined, a counter-productive exercise. Indeed, manipulation inevitably shows up as a widening of the gold basis, which should be immediately countered through spirited buying of the gold mines. Manipulators are facing a powerful head-wind: the secular decline of the gold basis, but it would serve as a tail-wind for the gold miner. This important source of energy is left fallow.

The cycle for the grain basis shows an annual peak at harvest time when the new crop is being brought in and cash grain is available at the farm gate in abundance. It shows an annual trough at the end of the crop year, just before the new harvest, when operators are scraping the bottom of their elevators. In practice, there are many cross-currents making the grain basis more unpredictable, although it would never be as unpredictable as the grain price. The end-game is critical: every elevator operator would love to be the one selling the last truckload of the old crop, but if he waits too long, then the arrival of the new crop may make him suffer losses. Bottom-picking, at least in this instance, does not pay.

Mesh marketing and basis trading

The gold basis, no less than the grain basis, is also subject to a number of powerful cross-currents. These should be analyzed and studied in order to develop a profitable trading strategy. The gold mining industry is in a unique position to take advantage of the fluctuation in the basis. The opportunity is spurned. If gold mines meshed their trading strategy with their marketing strategy, they could greatly increase profitability while reducing attrition at all the producing sites.

Why is this important? Ideally, the gold mine should sell a minimum amount of gold from its mining operations, and cover its operating expenses from profits derived from trading the basis. The objective of prolonging the working life of the gold mine should be an overriding consideration. Ore deposits should be treated with almost religious respect. They are worth far more than their meager gold content. But to get that extra value out, the gold miner must be trading the basis. You cannot recycle tailings, but you can recycle ore deposits after you have extracted value from it through basis trading again and again.

Depletion of ore deposits should be reduced by all means available. The industry is doing the exact opposite: it seeks salvation in increasing its tailings heap by hook or crook. I can tell you, the market for gold shares does not like it a bit.

Any marketing strategy that results in a premature exhaustion of the gold mine is wasteful and indicates gross incompetence. It shows that managers either do not use basis trading or, if they do, then they don't do it adroitly. In either case management should be fired and new managers should be hired who understand the importance of maximizing the working life of the gold mine, and are willing to learn the intricacies of basis trading, which is the number one tool to achieve that goal.

Mistaking money for frozen pork bellies

The question arises why gold miners ignore the modern methods of marketing, through trading the gold basis, and prefer to stick with the old-line method of selling output hot from the shaft, with the result that their gold mine gets exhausted prematurely while the shareholder gets a pittance. My answer to this question is that mining executives are oblivious to the fact that gold is a monetary metal.

Shortly after the U.S. government defaulted on its gold obligations to foreigners in the early 1970's, and started babbling about the desirability of "demonetizing gold", futures trading started in Winnipeg, Canada, for the first time in history. The un-Austrian Austrian economist Fritz Machlup, professor at Princeton University, hailed that event saying that, at the long last, gold has become a commodity just like frozen pork bellies (he could not think of a more derogatory or more insulting example) and the two commodities are being traded in the same way, in the same market, sometimes in the same pit. The good professor did not know what he was talking about. He was blind to the fact that it is not the government but the market that makes gold money, and if you deliberately confuse gold and frozen pork bellies, you will suffer the consequences.

There are two kinds of mindset. The first looks at gold as money regardless what the government may say or do. The other fails to see any difference between gold and frozen pork bellies. It urges producers to dig the gold out with all deliberate speed and throw it on the market regardless of conditions prevailing there, and invest the proceeds in government securities for the yield they fetch. The first mindset realizes that, under the regime of irredeemable currency, bonds are just "certificates of guaranteed confiscation" (a phrase we owe to the late Dr. Franz Pick), and gold is the only life-saver available in turbulent times. The second springs from a servile ideology worshipping government omnipotence. An extreme polarization has taken place between the two, and no meaningful dialogue is possible between the protagonists.

Instinctively, shareholders are of the first mindset, while gold mining executives are of the second. This bunch of usurpers has long since ceased to represent the interest of the shareholders. They have betrayed their trust. I may leave the question aside whether the managers have been bribed or blackmailed by the government. Their action of pursuing blatantly anti-conservationist policies at the expense of the shareholders condemns them. They should be fired and replaced by new guys who are loyal to shareholders and are willing to learn modern efficient methods of marketing through utilizing the basis. This is the telltale that the shockingly low gold mining share prices are telling you.

Shareholder revolution

The challenge to the gold mining industry is enormous, but there are no signs that it is up to it. In retrospect, the industry has been selling gold for the past sixty years at ridiculous prices. It has frittered away the patrimony of shareholders, the top brass has been lining its own pockets and helping government profligacy. Shareholders are confused. They were hoping against hope that higher gold prices would ultimately change all that. Well, higher gold prices have come, but the wasteful exploitation and the rip-off continues. There is no noticeable change in the pittance gold executives dish out as dividends.

The best little whorehouse in Nevada

Gold mining executives would do anything to blow money on irrelevant construction projects. They build tire-factories, power-plants, even bordellos in Nevada. But they would not do the one thing they ought to do: conserving gold-bearing ore through basis trading.

Shareholders are disenfranchised. There is only one thing left they can do to protest against the gap between gold prices and gold share prices: vote with their feet. They should sell their gold-mining shares and put the proceeds into cash gold. In this way they can start a revolution to overthrow usurpers in the gold mining executive suites. But be warned: the gap will widen if a Lehman-size collapse of the gold mining industry is in the cards, so do the switch at your early convenience. If you wait, you will have to pay a steep price for procrastinating.

If there is a way to resuscitate the goose to lay the golden egg, this is it.

Calendar of events

New York City, October 16, 2008
Committee for Monetary Research and Education, Inc., Annual Fall Dinner.
Professor Fekete is an invited speaker. The title of his talk is:
The Mechanism of Capital Destruction.
Inquiries: cmre@bellsouth.net

Santa Clara, California, November 3, 2008
Santa Clara University, hosted by the **Civil Society Institute**
Professor Fekete is the invited speaker. The title of his talk is:
Monetary Reform: Gold ***and*** *Bills of Exchange.*
Inquiries: ffoldvary@scu.edu

San Francisco, California, November 4, 2008
Economic Club of San Francisco
Professor Fekete is the invited speaker. The title of his talk is:

The Revisionist Theory and History of the Great Depression — Can It Happen Again?
Inquiries: ifkbischoff@yahoo.com

Canberra, Australia, November 11-14, 2008
Gold Standard University Live, Session Five. (This is the last session of GSUL since our sponsor, Mr. Eric Sprott of Sprott Asset Management, Inc., has withdrawn his support saying that in his opinion the results do not justify the expenditure. Come along and judge for yourself.) This 4-day seminar is a *Primer on the Gold Basis — Trading Tool for Gold Investors, Marketing Tool for Gold Miners, and Early Warning System for Everybody Else.*
Inquiries: feketeaustralia@yahoo.com . A more detailed description of this seminar is found at the end of my article *Cut Off Your Tail to Save My Face!* September 1, www.professorfekete.com

September 16, 2008