PEAK GOLD!

A Primer on the Economics of Gold Mining, Part Five

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BARRICK EXECS CONTINUE TO EXERCISE OPTIONS AND SELL SHARES

In Part Four I revealed that when it comes to owning Barrick shares, the two top Barrick executives, CEO Greg Wilkins and CFO Jamie Sokalsky have voted with their feet. In retrospect it looks more like a stampede of insiders out of Barrick shares and options.

As reported by the Canadian newspaper National Post on September 21 and 25, Barrick executive vice president Alexander Davidson exercised 25,000 options for company shares at $23.85 each on Sept. 18 and then sold these shares for $39 each the same day. Davidson exercised 5,600 more options at the same price on Sept. 20, then sold the shares. He exercised another 19,400 options at the same price the following day, then sold the shares for $41 each.

Patrick Carver, executive vice president and general counsel at Barrick exercised 12,100 options at $29.60 on Sept. 18, then sold these shares for prices ranging from $39.35 to $39.41 the same day. He exercised another 12,000 options at $29.60 on Sept. 20, then sold these shares for $40.30 each the same day.

Peter Kniver, executive vice president and COO, exercised 40,000 options for Barrick shares at $23.80 each on Sept.21, then sold these shares the same day for prices ranging from $40.26 to $40.32.

Executive vice president and CFO Jamie Sokalsky exercised 49,100 options at $30,70 each on Sept. 19, then sold these shares the same day for prices ranging from $39.45 to $39.61. This is in addition to selling 135,000 shares between Sept. 1 and 14 as mentioned in Part 4 of this series. Many others at Barrick have exercised options and sold company shares. The National Post comments:

> „Looking for someone to pick up the tab for a night on town? Well, you might want to track down one of the 28 executives, directors and/or officers at Barrick who since Sept. 1, 2007 have exercised and sold more than 1.2 million options for company shares. Consider the 420,050 options that were exercised and then sold in four days, from Sept. 10 to Sept. 14. They generated $3,254,651 plus $1,439,812 in total profits for the 15 Barrick officers who performed these transactions. That's one helluva dinner for starters."

More pertinently I ask the question: *what's the rush to get rid of Barrick shares? What is it that insiders do know but shareholders may not?*

Barrick throws in the towel

It could have very well been the impending bombshell timed to explode on September 28 when Barrick CEO Greg Wilkins was to announce that the company „has no plans to return to the futures markets to hedge its gold production". This amazing announcement is in my opinion nothing short of an admission of guilt. Barrick's hedging policy has caused a financial disaster that was perfectly foreseeable and avoidable. Barrick executives have been warned that their so-called hedge-plan was fraudulent and involved the company with unacceptable risks. I told CFO Sokalsky in person about the errors of his ways already ten years ago. My 50-page memorandum *Gold Mining and Hedging — Will hedging kill the goose laying the golden egg?* that I prepared for Barrick executives is in the public domain. Ferdinand Lips in his book *Gold Wars* quotes extensively from it.

Shareholders would be perfectly justified in launching class action suits against Barrick executives. Insiders are well aware of this. Hence the spectacular stampede to dump Barrick shares that may have their origin in illegally paid bonuses. Why, these bonuses could possibly represent *paper* profits rather than *earned* profits. It is criminally fraudulent to pay yourself a bonus out of paper profits. The contingent liability encumbering paper profits could turn into real losses for which the funds paid out in bonuses should have served as cover. Apparently this is what happened to Barrick: the rising gold price made paper profits from Barrick's „hedges" evaporate while turning all remaining „hedges" into a loss-maker. Millions of dollars that Barrick executives have recently pocketed from bonuses could conceivably be part of the cover for losses embodied by the 9½ million ounces of „hedges" under water.

It is remarkable and noteworthy that CFO Sokalsky has got off from his high horse. He is no longer touting his so-called hedge plan that involved using paper profits for the purposes of window-dressing operational profits. Quite possibly company counsels have warned him that such a tactic may be deemed illegal and actionable by shareholders.

As reported by Reuters quoting an interview on CNBC, on Friday, September 28 company president Wilkins announced the end of the saga of „hedging" in gold mining. He still appeared to be defending the practice by promising that the company is going to continue to hedge its copper production. The red herring of copper hedging will lull nobody into believing that the discontinued gold hedging strategy was unobjectionable from the legal point of view. The objection is *not* against the use of the futures markets in hedging; it is against the practice of *selling leased metal*. There is no lease market for copper so Barrick cannot sell leased copper.

As this series *Peak Gold!*, a primer on the economics of gold mining, has set out to show, the economics of copper mining is as different from that of gold mining as night is different from day, on account of the different behavior of the underlying marginal utilities (see below).

Be that as it may, Barrick has thrown in the towel. Truth has won over falsehood. President Wilkins said in the interview: „Frankly, our investors are really looking to benefit from the upside of gold and we share that point of view." He did not explain why it took him so long to come around to honoring the wishes of shareholders, nor did he say what other criteria than serving the interest of shareholders may guide his actions. Deafening silence surrounds the question what he is planning to do with the 9½ million ounces worth of „hedges", now deeply under water as a direct result of the foolish hedging policies of management, and a potential source of further horrendous losses in case the price of gold advances further.

The fact is that Barrick is haemorrhaging gold, and the executives are trying to cover it up. Rome is burning and Nero fiddles on the roof. A few days earlier, at the Denver Gold Group Forum, Wilkins talked to the assembled mining experts complaining about the high price of truck tires explaining how he was going to fix the problem. Not one word was said about the 9½ million ounces of „hedges" under water, or how they can be lifted before they do further damage to the company and its shareholders. The CEO talks about building a truck tire factory when the gold mine is on fire. Perhaps, if he put out the fire first, then he could afford to pay the going price for truck tires.

Of course, he must have noted that „hedging was practically anathema" at the Forum, as niftily put by Citigroup analyst John Hill. Was Wilkins just trying to be considerate in avoiding an unpleasant subject? The gold price reacted to the news that Barrick has thrown in the towel by jumping almost $10 to $744, a 28-year high. That cost the company and its shareholders a cool 95 million dollars.

Still, Barrick shareholders have every reason to celebrate. I take this opportunity to congratulate them upon their victory over a fossilized management. I pledge my further support to them with my pen. I shall provide a *post mortem* on Barrick's unilateral hedging strategy. I have changed the subtitle of this series to: *A Primer on the Economics of Gold Mining*, to indicate that a new era has started in the history of gold mining. The mindless rush of gold mining companies to play „follow the leader" is over. I could not find anybody willing to defend Barrick's indefensible strategy of unilateral hedging. This strategy has been thrown where it belongs: to the garbage dump of history. Make no mistake about it: *this was the greatest mining disaster in the history of gold mining.*

Two-legged straddles

I shall now explain what Barrick has done wrong, and how it should have proceeded instead. What I have to say is basically no different from what I told Sokalsky ten years ago. Selling gold futures at price spikes in excess of annual output is no hedging, it is naked forward selling. As events have proved, I was right: naked short selling is a foolish strategy as it can make even the #1 gold miner suffer, not just a loss of face, but also the loss of billions of dollars.

Consider two hypothetical gold mines, AXY and XAB. Compare their operations which are very similar yet fundamentally different. Both mines work with two-legged straddles having a short and a long leg. With their short legs they both enter the gold futures market. The difference is in where they put the long leg. I wish to emphasise that this example is schematic, that is, oversimplified for easier comprehension. The actual situation is considerably more complicated, but simplifying it does not affect the underlying principle. AXY enters the long leg of its straddle into the bond market; XAB keeps the long leg anchored in the gold mine itself.

From this it should already be clear that XAB's are true hedges in the sense that they are rooted in mining. By contrast, AXY's hedges are false. The gold mine has been turned into a hedge fund. At any rate, its „hedges" have nothing to do with gold production. AXY needs gold only as a source of cheap financing for its gambling ventures.

Fraudulent hedging

Suppose there is a $10 upwards spike in the gold price. AXY reacts by selling 100 gold futures contracts. In doing so it locks in a selling price for gold, gold that it arranges to borrow from a bullion bank at 1 percent per annum interest, in order to sell it and invest the proceeds at 6 percent in the bond market for a net income of 5 percent per annum. AXY does not think that it is in any danger on account of a possible advance in the gold price. „What goes up must come down". In any case it reasons that the gold sold forward is in hand: it can be scooped up from its mines at any time. But as we have seen in Part Three, this is a fundamental mistake. AXY does not have the gold in hand: it only has a bird in the bush. The hedge is fraudulent because the 5 percent net interest income is commingled with operative profits, disregarding the contingent liability that AXY still has on its open „hedges". As we have observed, it is criminally fraudulent to represent paper profits as earned profits.

True hedging

The other gold mine XAB reacts the same way to the initial $10 upwards spike in the gold price: it also sells 100 contracts of gold futures, the short leg of the straddle. The difference, as already suggested, is in the long leg which in this case is entered into the actual production of gold from the mine.

In more details, XAB is alive to the opportunity offered by the fact that *the upward spike in the gold price has promoted some of its submarginal grades of ore into the payable category.* To fix our ideas suppose that XAB has a submarginal vein of gold bearing ore it affectionately calls Moonbeam. Even though submarginal, Moonbeam it is not barren. It is pregnant with profits which XAB wants to capture.

A godsend, XAB finds that Moonbeam is now payable, thanks to the $10 upwards spike in the gold price. The trouble is that the godsend may be available only for a couple of minutes, and it is not possible to get the gold out of the ore and take it to the market in such a short space of time. No problem. That is where hedging, in the true meaning of the word, comes in. Using the facility offered by the gold futures market XAB can lock in the spiking price now; mine and deliver the gold later. Geologists at XAB know exactly how much of Moonbeam ore should be earmarked and mined in order to come up with the right amount of gold that must match the amount sold forward. The mine goes ahead and produces the gold. Never mind if the price of gold has fallen back in the meantime. The higher selling price is locked in. When the gold produced from Moonbeam ore is sold, the mine lifts its hedges, i.e., covers the short position in the futures market.

In effect, XAB has sold gold at a profit from ore that, absent hedging, represents zero value. It looks like prestidigitation, but it isn't. It is the same idea as harnessing energy from the tide-and-ebb movement of the oceans. XAB harnesses the fluctuating gold price which represents energy. The energy of tides, given the skill of engineers, can be put to use. Likewise, the skilled gold miner can squeeze gold out of worthless rock. That's the challenge of the profession, challenge that not every gold miner can meet.

Notice that XAB does not care if the price of gold has increased between its selling of gold futures, and its selling cash gold later. It is true that any increase generates a loss on the short leg, but it is compensated dollar for dollar by the higher price it will receive for the gold extracted from Moonbeam. XAB only cares about the opportunity of selling gold profitably, gold, the production of which in the absence of hedging would involve the mine with a loss. If, on the other hand, the gold price fell back, then the short position of XAB in the gold futures market would show a profit. That profit could be taken immediately.

Suppose that the chance of the gold price moving up or down after every $10 spike is 50-50. Then the mine will enjoy an *extra income* from its hedging operations because 50 percent of its hedges will be closed out profitably *without even touching any gold bearing ore*. The other 50 percent is just as beneficial making it possible to extract gold profitably from submarginal grades of ore. Herein you have a win-win strategy. Quite unlike Barrick's which is a lose-lose strategy — except in a bear market for gold.

Fool's gold future

This being a *post mortem* I want to explain most carefully what has made the boat of Barrick hit reef. The #1 gold miner did not understand the subtle difference between selling gold futures and selling borrowed gold. While both come under the heading „selling gold forward", there is an important difference. The gold mine selling gold futures *has not sold the gold*, so any possible mis-judgement in timing is self-correcting. On the other hand, the gold mine selling borrowed gold has thereby finalized the terms of the sale. Only delivery is put off. The self-correcting feature is missing. Any error in timing could be disastrous.

Barrick is totally ignorant of (true) hedging. Observe the difference between two operations:
(1) Selling gold futures for hedging purposes is one thing. It simply means booking a selling price now, with the actual sale of newly mined gold to follow later. A subsequent increase in the price of gold is not hurting because the gold mine has retained the right to sell gold at the higher price later.
(2) Selling borrowed gold is another thing altogether. The actual sale of newly mined gold at a fixed price has been consummated, only delivery remains. Every cent of an increase in the price of gold is hurting because the increase means that the gold has been sold at the wrong price.

AXY acts as a hedge fund. Its straddles are fraudulent. Even if the financial results are positive in the end, it cannot report, still less pay out, a profit. Profits are paper profits. They will not be finalized until the „hedges" are lifted. There is a contingent liability which can turn into real losses if the gold price has a subsequent run on the upside. Paying out paper profits in bonus is a criminal fraud. The fact that AXY is a gold mine has nothing to do with its adventures in the world of gambling. Any hedge fund can do it (and will probably do a better job of it). The problem plaguing Barrick now is that it has commingled paper profits from gold and bond speculation with operating profits from gold mining and has, apparently, dipped into its treasury and paid hefty bonuses to executives and directors. The money is gone, but the contingent liability remains. When the gold price increases, it becomes a loss that gets larger with every cent of an increase in the gold price. The potential loss is open-ended.

Double jeopardy

No wonder that the 28 Barrick executives are in such a mad hurry to cut and run before their bonuses are attached by court injunction in a possible class action suit. Damn whoever invented bonuses in the form of options. Cash bonuses would not have left such a stinking paper trail.

By contrast, consider XAB. It acts as any proper hedger does who is involved in the production of real goods. Its straddles are true hedges: they aim at benefiting the company from favorable price hikes by producing gold from ore body whose market value is zero in the absence of a hedging strategy. This operation is completely independent of the fickleness of interest rates and of the variation of the gold price.

Note that the profitability of the „hedges" of AXY is exposed to „double jeopardy". It depends on the assumption that neither interest rates nor the gold price will rise. Should either do, the „hedges" will show an immediate loss. Higher interest rates make the market value of bonds fall, hurting the long leg of the straddle. A higher gold price will increase the cost of lifting the straddle.

Maximizing the life of the gold mine

But the main difference between the two strategies has to do with the fact that true hedging (the strategy of XAB) extends the working life of the gold mine, while fraudulent hedging (the strategy of AXY) shortens it. True hedging spares the richest ore bodies and shifts mining towards the submarginal grades or ore. This also means the most efficient deployment of the capital of the mine.

Barrick-type hedges result in a ruthless exploitation of the mining resource. Naturally, AXY wants to squeeze the maximum amount of cash out of its „hedges", regardless of the damage it may cause to the logevity of the mine, because it wants to buy as many bonds as possible. In consequence the richest grades of ore are extracted first and the mine is exhausted prematurely. When it is forced to close down, it will still have a lot of valuable gold-bearing ore left behind.

Economics of Gold Mining

The economics of gold mining is as different from that of base metal mining as day from night. The aim of a copper mine, for example, is to maximize profits without regard for the working life of the mine. The reason is that the marginal utility of copper is declining. This means that if you do not market your copper at the earliest opportunity, then competition grabs your market share and runs with it. *Tarda venientibus ossa* — says the Latin proverb (late-comers to the meal get the bones). In the case of copper miners late-comers have to sell at a lower price.

By contrast, the marginal utility of gold is declining so slowly that it is practically constant. There is no pressure on the miner to rush his product to the market. His concern is to get as much gold throughout the mine's extended working life as possible, regardless how long it may take. If it takes longer, no harm done. The mine stands to benefit from deliberate currency debasement practiced by governments. Debasement has the unintended effect of promoting the submarginal ore bodies of the gold mines to the payable category.

Incidentally, this is the secret of the popularity of owning gold mining shares in spite of the meager returns to invested capital. Gold mining shares have a built-in option-feature. The option expires when the gold mine is exhausted. Thus given two identical gold mines with exactly the same geological features, the one worked more conservatively will command the higher share price and the higher market capitalization, because the underlying option has the longer maturity date. The market will assign the lowest market capitalizartion to the gold mines that go after the highest grade of ore, even if the dividends paid by that mine are higher.

Having said that, we find that the hedging stategy of XAB still has shortcomings and calls for further improvements. Both AXY and XAB are using unilateral hedging strategies. As a side-effect speculators are invited to converge on the short side of the market and compete with the gold mines to nip every gold rally in the bud. What is needed, clearly, is bilateral hedging and its four-legged straddles to eliminate that threat. This is the subject of the next instalment of *Peak Gold!*.

GOLD STANDARD UNIVERSITY LIVE

Session Three of Gold Standard University Live will take place in Dallas, Texas, from February 11 through 17, 2008 (please note the change of place and date.) It will have three parts:
(1) a course on *Adam Smith's Real Bill Doctrine and its Relevance Today,* consisting of 13 lectures, from February 11 through 14;
(2) a debate on the *Economics of Gold Mining* with industry participation;
(3) a panel discussion entitled *Gold Profits in Troubled Times* where paraphernalia such as the basis, the gold and silver lease rate, the NAV of gold and silver ETF's and the variation of these will be discussed with invited experts. Program (2) and (3) are scheduled for the week-end February 15-17. The registration fee covers participation in the debates during the week-end. It is also possible to register for the week-end program only at a reduced fee. Participation is limited; first come first served. Participants pay their own hotel and meal bills. The cost of the closing banquet is included in the registration fee.

For the benefit of European friends of Gold Standard University, Session Three, will be repeated in March, 2008, at Martineum Academy in Szombathely, Hungary, where the first two sessions were held, *provided that a sufficient number of people register*. More details will follow later.

For further information please inquire at GSUL@t-online.hu.

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