THE TEXAS HEDGES OF BARRICK

There is a fundamental difference between speculation and arbitrage. The speculator deliberately takes large risks in the hope of large profits. The arbitrageur is not interested in increasing risks, in fact, he wants to reduce them. His main instrument is the straddle with two legs: a long leg representing purchase in one market, and a short leg representing a compensating sale in another. In closing out the straddle both legs must be lifted simultaneously, otherwise the arbitrage is turned into speculation. The activity of the arbitrageur is also known as hedging, and another name for a straddle is a hedge. As the objectives of speculation and arbitrage are diagonally opposite to one another, it is a bad mistake to confuse the two, as is the case all too often. This confusion is epitomized by the story about the Texas rancher. When it was pointed out to him that the long positions in cattle futures he was affectionately calling "me hedges" were in fact no hedges at all because they lacked the short leg, he proudly answered: "them are Texas hedges." The title of this paper suggests that the hedges of Barrick are no hedges at all because they lack the long leg.

Limited versus Unlimited Liability

Worse still, the Texas hedges of Barrick represent an unlimited liability, in contrast with those of the rancher which represent but a limited liability. This difference is due to the fact that while the price of a commodity can never fall below zero (thus limiting risks involved in a forward purchase), there is no identifiable limit above which it may not rise (thus making risks involved in a forward sale unlimited). Another way of expressing the same fact is that Barrick's Texas hedges are subject to a short squeeze and, possibly, a corner. By contrast, there is no way to squeeze or to corner the rancher on account of his net long position. It is a fundamental fact of commodity markets that only the bears can be squeezed and, if the worst comes to the worst, cornered. Bulls are immune.

Total net short sales must never exceed one year's output. If Barrick and its epigoni limited their forward selling activities to one year's output, then one could argue that their hedges were legitimate. But the hedging program of Barrick and its imitators call for the forward sale of several years' output. The justification for limiting net forward sales to one year's output is that a hedge larger than that is programmed to self-destruct within a year. Mine output is sold and the long leg lifted by the end of the fiscal year, so the short leg must be moved forward to the next. If the open short leg is profitable, paper profits are paid out in the form of dividends. Paper losses, if any, are suppressed. This exhausts the concept of a fraud. The practice transgresses the bounds of prudence and integrity. A gold mine selling forward in excess of one year's output is concealing a potentially unlimited liability. The shareholders and creditors are misled.

Barrick's Apology

Barrick argues that all its hedges are proper, regardless whether one or more years' output is sold forward. In either case there is a long leg, namely, gold in the ground owned by the company.

The apology is lame. In case the hedge plan is limited to one year's output the gold sold forward is no longer in the ground but already in the production pipeline. It is gold on the move. It will reach the market and be sold to the cash-paying customer in less than a year. It is very different economically from gold sold forward under an unlimited hedge plan. This gold is tied up in ore bodies deep down below surface. It is no use describing it as the long leg of a Texas hedge. This gold is not available, and the Texas hedge has no long leg. We want to make this distinction very clear. Gold in the pipelines that will reach the cash-paying customer within a year is one thing, and gold sitting maybe a mile down below surface is another. The latter cannot be considered as a proper long leg for hedging, nor as a proper collateral for gold loans. The company may go bankrupt before it can be dug up and put into marketable form. Borrowing gold short-term against such a phony collateral in the hope that the gold loan can be rolled over several times until many years later the borrowed gold can be replaced out of mine production is gambling, not hedging.

Spot-Deferred Contracts

This also exposes the fraud involved in Barrick's much-vaunted spot-deferred contracts. These can be characterized as a forward sale with the margin call swept under the rug. Barrick has the option of either delivering the newly mined gold into the hedge book, or selling it in the open market, according as the gold price is below or above the forward sale price. This sounds too good to be true, as normally an embarrassing and financially onerous margin call would be in order whenever gold was trading above the forward sale price. But we are told that there would be no margin call (note that we are not allowed to read the small print in the contract). After all, what goes up must eventually come down, mustn't it? Margin calls are for the financially weak, who cannot ride out storms. The financially strong can. They just wait until the gold price comes down to make the forward sale profitable again. Barrick boasts that the final settlement of its spot-deferred contracts can be put off as much as 15 years. But what if the gold price doesn't come down in 15 years? Come, come, don't be ridiculous. The price chart for the past 15 years clearly shows that every time the price goes up, sooner or later it will come down, making the spot deferred contracts profitable. But gold has been around a lot longer than 15 years. Wouldn't it be advisable to examine charts covering a longer period? Barrick is not interested: history started when Barrick was established.

Jamie Sokalsky, Senior Vice President and CFO, is on record as saying that Barrick has the unique flexibility to defer settlement on its contracts up to 15 years, which is ample time for the high-flying gold price to return to earth. "If the price of gold shot up to $600 and stayed there for 15 years, we would still realize every cent of that increase." Every cent? Bob Landis is pondering the unthinkable (see References below). Assuming that annual production stays at the same level of 6 million ounces, Barrick's proven and probable ore reserves of 82 million ounces would be more than exhausted in 15 years. The situation would then be as follows. The 82 million ounces have been sold in the open market. Barrick would have 0 ore reserves left, and a liability to return 18 million ounces of borrowed gold to the owners. Goodness knows what Barrick would have to pay for new gold-bearing properties in the $600 per ounce gold environment, and goodness knows what Barrick's bidding for 18 million ounce of cash gold would do to the gold price. I may add a small correction to the study of Bob Landis: Barrick's proven and probable reserves would actually be larger at $600 gold than they are now. But his point is well-taken: the cost of liquidating the liability of owing 18 million ounces of gold, if the gold price goes from $300 to more than $600 and never drops below $600 for 15 years, is so huge that it may well ruin the company financially. This cost cannot even be estimated, as we haven't got a clue what the cost of replacing ore reserves will be when gold is selling above $600, nor do we have a clue where Barrick's well-known liability, to restore to the owners 18 million ounces of gold it hasn't got, would take the gold price.

The prospect that the gold price may never ever fall below $600, so that the spot-deferred contract can never ever be closed out profitably even if Barrick gets perpetual deferral, cannot be ignored. Rather than being a wonderful flexible marketing tool, doesn't the spot-deferred contract look like an invitation to bankruptcy?

Margin call by another name

On May 8, 2002, at its Annual Meeting, Barrick made an important announcement. It is simplifying its Premium Gold Sales Program. It will close its book on gold call option writing and variable price sales, to go back to the simple spot deferred program, "to be better positioned to take advantage of rising gold prices". But there is also a change in the spot deferred program. The company will no longer invest part of the proceeds from the spot deferred contracts in the bond market, but "will instead leave all proceeds invested with its bank counterparties."

This gives the lie to earlier boastful statements that margin calls are for the financially weak, but not for Barrick. Lo and behold, the modest recent gains in the gold price have resulted in a margin call on the call options written by Barrick, so it is closing them out. But, more surprisingly, there is a margin call if by another name on the cherished spot deferred contracts, too. The "bank counterparties" no longer allow Barrick to do as it may see fit with the proceeds from the spot deferred sales. They are put in escrow, pending on performance on the delivery schedule of newly mined gold into the hedge book.

Nice try, Barrick, to put a positive spin on the margin calls you have been innocent so far. But it won't work, because your shareholders are not stupid.

Hedges off balance sheet are fraudulent

No wonder that it is off balance sheet where Barrick keeps its Texas hedges. They could not suffer the light of the day. They cover shady deals that may benefit management, but certainly not the shareholders. As a matter of principle all hedging activity should be reported openly and fully on the books. It should be transparent, and everybody should be able to see for himself that the hedges remain profitable after both legs have been lifted and the hedge unwound. But this is impossible for a contract that has 15 more years to run. So off balance sheet we go. Never mind that hiding an unlimited liability constitutes a fraud.

The accounting profession, the commodity exchanges, and the government's watchdog agencies have never offered an acceptable explanation for the double standard they apply, one for the gold mining industry and another for everyone else. They allow mines to sell forward several years' gold production, but they would immediately blow the whistle if, for example, an agricultural producer tried to do the same in selling forward several years' grain production. There is no justification for this double standard. It is a scandal that the government grants legal immunity to gold mines using fraudulent hedges. Worse still, the fraud is facilitated by central banks willing to lease gold which, as the bank well knows, will end up being sold for cash and which, for that reason, the borrower may never be able to replace. Gold in the ground is no collateral for the gold loans of Barrick. The company may go bankrupt before it can dig it out. Central banks are accomplices in the scheme of fraudulent hedging as they report gold that had been sold as if it was still sitting in their vaults.

To recapitulate, selling forward more than one year's output is no hedging. It is outright speculation on the short side of the market in anticipation of a decline in the gold price. Such a 'naked bear' speculation is not only illegitimate as it falsifies the balance sheet and conceals an unlimited liability. It also makes the prospectus meaningless as no mention in it has been made of any intention to indulge in short selling that will inevitably result in the premature exhaustion of the ore reserves and in the dissipation of the most valuable resources of the mine at an artificially low price. On this ground alone Barrick is open to class-action suits by the shareholders.

Competitive Short Selling

Furthermore, naked bear speculation makes no economic sense. By virtue of its short position Barrick assumes vested interest in a lower and falling gold price, which clashes with its main mission to sell newly mined gold at a higher and rising price. Such division of loyalties is inadmissible for a firm commissioned by its shareholders to convert wealth represented by ore reserves into wealth represented by bullion in a most advantageous manner. The managers of Barrick have a schizophrenic stance as they are prompted to pray for a higher and a lower gold price all at the same time. No enterprise with schizophrenic managers can survive the vicissitudes of market competition and the shareholders' ire for long. Shareholders get hit three times through the schizophrenic action of the managers of the mine they own. Firstly, income from the mine is shaved every time the gold price is forced lower through short selling. Secondly, capital is being destroyed as the falling gold price makes payable ore reserves to disappear (i.e., to become non-payable). Thirdly and most seriously, the richest and most valuable ore reserves are squandered for a pittance at the artificially suppressed gold price, thereby materially shortening the working life of the mine. The share price will ultimately show not only the shaving of income and destruction of capital, but the premature ageing of the mine as well. The Texas-type hedging policy of Barrick gives rise to competitive short selling every time the gold price may be ready to break out of its coffin. This is extremely damaging to the interest of the shareholders. No producer with such an inflexible and self-defeating marketing strategy can, or deserves to, survive.

Paper Profit is No Profit

Advocates of this senseless practice, the most articulate of whom are the officers of Barrick, argue that these losses are more than compensated by the extra income the firm is generating from 'investments' made with the proceeds of forward sales. But insofar as this extra income is encumbered with unlimited liabilities represented by the Texas hedges, that is to say, naked short positions masquerading as legitimate straddles, this income consists of paper profits that should never be reported as profits, let alone paid out in the form of dividends. "There's many a slip between cup and lip," as the proverb says. Hidden liabilities may force Barrick to go out of business before it has a chance to realize its paper profits. The practice of window-dressing the firm's financial statements using unrealized paper profits, especially as they are encumbered with a potentially unlimited liability, is blatant fraud and no sophistry or government connivance will change that fact. It is the height of insolence on the part of Barrick to treat its shareholders as simpletons unable to understand the difference between paper profits on an open short position, and profits that have been consummated by closing out a short position.

That you can never fool all the people all of the time is borne out in the case of Barrick. Shareholders are voting with their feet. From the bottom in November, 2000, the XAU index of gold stocks rallied about 73% while the stocks of gold mines without a hedge book on average rallied a remarkable 185%. Meanwhile Barrick hardly managed to add a paltry 33% during that 17 month period. This repudiates the absurd claim of Barrick's officers that they could con the market by selling gold at prices well above the highest price the market has been able or willing to quote during the year under purview. If they could, they should have opened a farm advisory agency showing farmers how to sell grain at prices much higher than those quoted by the grain market.

The Bearish Case

Market sentiment turned decidedly bearish when Barrick introduced its Texas-type hedge program some fifteen years ago, and a large part of the industry mindlessly followed the leader. Although the scheme was hailed as proper arbitrage for the benefit of the shareholders, in reality it was naked bear speculation on the gold price enormously harmful to shareholder interest, and most detrimental to the mines as their working life was drastically shortened and their best ore reserves frittered away.

Speculators have traditionally been bullish on the gold price. They were well aware that the irredeemable currency in which the price of gold is quoted is historically nothing more than a dishonored promise to pay a fixed quantity of gold. After the default it could be exchanged only for diminishing quantities. That is, to be precise, until no gold whatever would be offered in exchange for it by anybody, anywhere. At that time the banker responsible for issuing the promise would feel compelled to leave the scene of his business (usually in disguise and under the cover of the night). Speculators knew this, and were willing to keep a cushion under the price of gold.

However, the cushion was removed as speculators started abandoning the long side of the gold market in droves. Who can blame them? They were not the first to betray the yellow metal. When producers of gold join the bearish camp, the speculator who tries to eke out a living by trading gold has no choice but to become active on the short side of the market. As a consequence, there was competitive selling every time the price of gold showed the slightest sign of life. Gold miners and speculators were falling over each other while rushing in to club down the price of gold as it was trying to climb out of the hole. Thus was every single budding rally beaten back in the gold market for the past fifteen years, in consequence of the hare-brained scheme of Texas hedging.

Speculators were not the only ones to be alienated from gold. Investment demand has practically dried up. Not very long ago every Swiss banker advised his clients that common prudence dictates to keep 5 to 10 percent of one's assets in gold or gold-related investments. Today no Swiss banker will make a loan on gold collateral security. The consensus is that the so-called hedging program of the gold mining industry has effectively capped the price of gold.

Worse still, the central banks' selling and leasing policy has opened up an abyss. Into this, in the opinion of many, the gold price must ultimately fall. Gold has been demonetized, they say, first by the governments, then by the market as well. By now it has become scrap metal which central banks are still foolish enough to spend a fortune to store. It would make better sense to sell it if need be at scrap values, the doomsayers insist, and invest the proceeds in earning assets such as government bonds, or even common stocks - as the president of the Bundesbank has recently suggested.

The Bullish Case

The fraud involved in Texas hedges carries with it its own punishment. It may not be immediate, but it is certainly coming. Barrick and other gold bears are digging the very ditch in which the gold bulls will trap them. Don't ask the question when; the bulls won't tell you. But the grand squeeze is coming with the same certainty as day follows night. When the first signs of the squeeze appear, market sentiment shall suddenly change. Alienated gold speculators will abandon the short side of the market and will return to their traditional spot on the long side. They are alive to gold's continuing monetary role. They have not been taken in by the silly propaganda about gold de-monetization. Speculators are keenly aware of the fact that paper currencies of the world are but dishonored promises to pay gold. They understand full well that fluctuations in the gold price, far from representing an uncertain value for gold, reflect the uncertain value of fast-depreciating irredeemable paper currencies. Speculators make it their business to know that the value of everything, including that of paper money , approaches the marginal cost of its production - which is just a polite way of saying that ultimately all fiat money is destined to become worthless, so colorfully demonstrated by history tolerating no exceptions. When it happens again the monetary metals, gold and silver, will be the only refuge for the hapless citizen trying to secure a financial future for himself and for his family.

Mene Tekel

The investment demand for gold will, Phoenix-like, rise from its ashes. As the bearish bias created by Texas hedges disappear, friends of the precious yellow (alias gold bugs) will be rewarded for their patience and perseverance. The bogey-man of central-bank gold sales will be exposed as a scarecrow. At any rate, it could scare unsophisticated crows only. People with an analytic mind did always see through the cheap trick. They understood that the threat of central bank gold sales was empty gesture. A central bank selling gold can in no way strengthen its balance sheet. Quite the contrary, it weakens it gravely, perhaps fatally, with incalculable consequences to the value of its bank notes. The central bank gives up the best possible monetary reserve in the asset-column: gold that is nobody's liability as it never enters the liability-column of the balance sheet of another central bank, in exchange for the worst: the irredeemable promises of devaluation-happy governments. It discards a default-proof asset and replaces it with a default-prone one.

It is not known whether or not officers of Barrick see the Biblical writing on the wall that reads: "Mene tekel upharsin" (you have been put on the scale and found wanting). It can be allegorically interpreted as an admonition, relating to the value of irredeemable currencies. It is possible that these officers are blockheads wrapped up in their own glory who do not understand the very nature of the product they help bring up from the bowels of the earth.

Barrick, the hit man

But it is also possible that they are not free agents. Barrick could be a front, that is, a hedge fund masquerading as a gold mine, set up in order to promote the aims of another conspiracy, far bigger in scope. We are referring to the conspiracy of bond speculators to drive the rate of interest down to zero in order to pocket the immense capital gains on their bond holdings. Don't laugh. Bond speculators in Japan already succeeded in achieving that goal. Moreover, the mechanism to drag down American interest rates in the wake of Japanese is already in place. It is called the yen-carry trade. The $100 trillion derivatives monster expanding exponentially may give you a foretaste of the power of bond speculators. That monster serves one purpose only. The purpose is to make the super-fast breeding of long positions on bond futures possible, well beyond the limits set by the amount of bonds in existence. (Goodness knows, dollar debt is being created by fast-breeders, but they are still not fast enough to serve the needs of bond speculators!).

It appears likely that the big American and Japanese banks are the anonymous leaders of this conspiracy to drive down the rate of interest to zero. For the Japanese this is a matter of life and death, so badly do they need the capital gains from their bond portfolio to mend the enormous holes in their balance sheets. The big American banks were in the same tight spot twenty years ago, and they mended theirs by the same techniques. The gold carry-trade is just a small albeit indispensable part of this global conspiracy. As long as gold can be shut out as an investment vehicle, there will be a captive market for bonds. This captive market is essential for the elimination of risks facing the bond speculating conspiracy. I have written in greater details about this in my paper "Revisionist View of the Great Depression."

According to this script Barrick was hired as the hit man, trying to hold the gold price in perpetual check. If the price of gold could somehow escape from the coffin whose lid was nailed down with Texas hedges, then the investment demand for gold would turn the bond market into a "killing field." Field where the big banks are slaughtered, and the value of the dollar is wiped out. It is clear that the hit man carries on his shoulder the entire $ 100 trillion derivatives monster, as Atlas used to carry the universe on his.

Corner by another name

Thus the questions about the conspiracy to plunge the world into another depression by driving interest rates to zero boils down to this: Can the hit man do his job? This takes us back to the question of squeezes and corners.

Scholarship on corners is scant. Most experts agree that historic corners were successful only in the light of superficial analysis. A deeper understanding shows that a true corner is an historical rarity. Economic theory also suggests that corners are no longer possible, certainly not in the 21st century economy supported, as it is, by instant telecommunication and same-day door-to-door delivery, world-wide.

But is it really a fact that there have been no true corners in the past and, as far as the future is concerned, no commodity can ever be cornered in peacetime? Well, whatever can be said of other commodities, there is certainly one for which it is not true. At least one commodity is exceptional in that it could be cornered, same-day delivery notwithstanding. Never mind that the corner does not come about by design, but is brought about spontaneously, by gut reaction and fear.

Gold has been cornered several times in the past. There is no reason to believe that it could not be cornered again in the future whenever conditions are ripe. Consider the following scenario. The Federal Reserve is desperately trying to combat deflation brought about by bond speculators out in force to drive the rate of interest to zero. The Fed is printing dollars working the presses overtime, but these dollars are snapped up by the bond speculators just as fast as they are printed. So the process must accelerate and will start spinning out of control. At one point the Federal Reserve will go overboard and print too many of them. The bond speculators will get scared and decide to cut and run. As they dump the bonds, they trigger a credit collapse. The government's credit will be ruined. Interest rates will go to outer space together with the price of marketable commodities. There will be a fatal, irreversible loss in the purchasing power of the dollar. In short, there will be a runaway inflation. A runaway inflation is but a corner in gold by another name. It is rather naive to believe that the Texas hedges of Barrick can stem the tsunami of the coming gold corner.

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