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

Part One

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Introduction

Gold mining executives would like to forget the hedging fiasco as you would the worst nightmare of your life. But the ghost of this greatest shareholder rip-off will not let them. It keeps haunting them, and for a very good reason, too. There are still more skeletons in the cupboard. Just take a look at gold mining share prices and their reaction, or rather the lack of it, to the unfolding banking crisis. They eloquently tell a tale of deep distrust in the veracity and competence of gold mining executives. This is an industry that is totally incapable of analyzing and admitting past mistakes, let alone learning from them. The full extent of the fiasco will not be known for many more years because we don't know how high the gold price will go in the wake of the banking crisis. What is clear already is the disconnect between gold and gold mining shares. It will remain as long as the industry fails to get its past and present sins off its chest and reform itself.

According to a Hungarian proverb, dead fish stink because of the head. This can be readily applied to the gold mining industry which obviously stinks. Senior gold producers pretend that it is business as usual. *It is not.* The same executives responsible for the rip-off are still in charge. They are not trusted, and they are not to be trusted. The hedging fiasco was bad because it accelerated the aging process of producing gold mines. It was an appalling case of wasteful exploitation of a world resource. It was a case of robbing shareholders. *Forward selling* may be gone, but wasteful exploitation is still very much with us. It will be, until a new generation of managers is brought in to initiate a new program of *forward buying*. This means that at every major decline in the gold price (such as the present one, for example), the gold mines should step into the breach and buy gold forward with the same *élan* as they were selling it short under their hare-brained scheme of hedging. This strategy would accomplish three things: (1) it would slow down the aging process of their producing gold properties; (2) it would facilitate locking in a good price for new gold properties the purchase of which the management may be in the process of negotiating; (3) it would be the first step in replacing the obsolete marketing model of selling output hot from the mine, by the up-to-date marketing model of *trading the basis*.

Hedging or speculation?

If the gold mining industry is reluctant to draw the balance sheet of its adventures in hedging, we shall be happy to do it for them. Hedging was a conspiracy to rob shareholders of their most durable long-term asset: gold locked up in ore deposits. It was a design to dissipate those assets in aid of government profligacy. Nor is it over yet. As the unresponsiveness of the share price to the banking crisis demonstrates, shareholders are still unconvinced.

The rest of this article is an excerpt (slightly edited) from the late Ferdinand Lips' book *Gold Wars* published in 2002 by FAME (www.fame.org), p 160-167.

„A closer look at hedging reveals that, in many cases, it has turned into outright speculation. Professor Fekete describes these practices as follows.

> „The Hedging Revolution started in 1985. Barrick Gold (then called American Barrick) was one of the pioneers. Hedging looked like a brilliant idea when it was first conceived at Barrick. It put the gold mining industry in a category by itself as the only segment of the economy that could pull itself out of the debt-morass by its own bootstraps.
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> Barrick's hedging policy as described in the company's annual reports (see in particular those for 1994, 1995 and 1996) is not, strictly speaking, an exercise in hedging, but an exercise in speculation. Barrick is betting that the gold price will never again be able to repeat the feat it has performed several times since 1968, namely to break out on the upside, never again to fall back to those old levels. Should it try, Barrick and others stand ready, and would promptly club it down with their persistent short selling. This was a revolution indeed. The gold miner cut a strange figure, showing him as gold's worst enemy second only to the government. He made every budding rally abort through unilateral hedging. The result of Barrick's innovation was competitive, industry-wide short selling. This was most demoralizing to the market, certainly on the supply side but no less on the demand side. It has turned the industry into a bunch of cannibals: everybody wanted to sell before everybody else. But it was even more demoralizing to potential buyers and all long-term holders of gold. The market perception was that the industry was being led down the primrose path to ruin. While selling gold short, these so-called hedgers were ultimately ruining their own market. They would kill the upside potential. *They would kill the goose that was to lay the golden egg.*
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> Even more ominously, there was also a bearish element in the picture. The powerful speculative following of the gold market, traditionally bullish, was alienated *en bloc*. They were chased away from the long end of the market to join Barrick on the short.
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> From Barrick's own point of view, unilateral short selling appears to be a short-sighted and, in the long run, self-destructing strategy. It throws all conservative principles to the winds in an aggressive pursuit of short-term profitability. Whatever the short-term benefits may have been, the strategy ultimately shortened the working life of Barrick's gold properties, hurting shareholders. Barrick had to close down operations at five of its ten working sites as they became 'mined out' — not through extraction but through evaporating payable ore reserves. *It is for the first time in history that productive gold mines were forced to close down — not through attrition but because the falling gold price was wiping out big chunks of payable grades of ore.* These mine closures reflect a colossal destruction of capital represented by abandoned milling plants

> and other mining equipment. Nobody could predict the fiasco — least of all the officers of Barrick. How could it happen? Observers stress the fact that while there is a physical limit on the production of cash gold, namely, milling capacity, there is no limit on the ’production’ of futures contracts, or paper gold, if its maturity dates are being pushed ever farther out into the future. Barrick’s anti-conservationist mining practices and aggressive short sales were the flip-side of the inundation of the market with unlimited amounts of paper gold.”

Barrick’s cost of production from top grades may well be reduced to $150 per ounce — as boasted by management — but how long will these top grades last? In Fekete’s view the only solution to the dilemma is *bilateral hedging*. The strategy of forward sales must be complemented with a strategy of forward purchases. As it is, every rise in the price of gold is countered by forward sales — but nothing is done to counter a fall! Properly understood, neither forward sales nor forward purchases need to involve speculation, but are what they are: *true* hedging in the interest of the company and its shareholders.

Unmitigated fraud

In the fall of 2000 I asked Professor Fekete whether he has revised his position regarding Barrick. He said that he has not changed his mind at all; quite the contrary.

> „You should bring in the very serious charge that Barrick knowingly misleads shareholders, creditors, and the general public. For several years in a row, in its Annual Reports, at its shareholders meetings, press conferences, Barrick has been reporting consistently higher profits, attributed to its mythical ability to realize higher prices for its newly mined gold than prices bid in the market during the entire year in question. These reports of higher profits have been duly certified by reputable accounting firms, and they have never been questioned by academia, let alone the financial press.
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> We all know what academia and the financial press would say if a company with publicly traded shares announced that it was manufacturing and marketing the 21st century version of *perpetuum mobile*.
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> Barrick boasts that it could accomplish the miracle of consistently selling gold at a price higher than the market has ever bid during the entire year through its ’sophisticated tool of hedging’.
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> Here is a sophisticated question I want to address to Barrick: „Why not share this ’secret’ with the American farmer? Would it not be wonderful if they, too, could consistently realize higher wheat prices than the market is willing to bid? Where are the farmers organizations to demand that they be told the secret of turning the stone into bread?
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> Well, Barrick could not share its secret with anybody because the ’miracle’ can only be performed through fraud. If we wanted to be charitable, we would assume that the accounting firms did not understand what they were certifying. Otherwise they would not lend their good name to this chicanery aiming at misleading the public. It is hard to escape the suspicion that the accounting profession may be an accomplice in this conspiracy to defraud.
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> *It is not, has never been, and will never be possible to sell gold forward consistently at a higher price than the highest price bid by the markets during the year under review, any more than it is possible to turn lead into gold profitably.*

Here is what Barrick is doing. It sells gold borrowed at the low lease rate, and invests the proceeds into high-yielding U.S. Treasury paper. Then it recalculates its revenues boosted by the positive spread between the yield on Treasury paper and the gold lease rate, and reports its profits as if it had been earned through consistently reaping a higher price for its gold than that quoted by the market.

Why is this procedure an unmitigated fraud? Apart from reporting profits under false pretenses, observe the fact that the transaction remains incomplete. Profits are merely 'paper profits' as long as all deals have not been closed out and borrowed gold returned to the owners. *It may not be possible to realize those paper profits*, *ever*. It is quite conceivable that these forward commitments can only be closed out at hideous losses. For such a scenario, nothing more drastic need to happen than for the price of gold to return to a higher level where it has already traded for years or decades.

Barrick is speculating: it assumes that 'what goes up must come down'. If the gold price goes up, say, $200 per ounce, then it is duty-bound to come down at least that much in due course. Those with financial staying power (such as Barrick considers itself to possess in good measure) will be able to ride out any storm caused by temporary spikes in the gold price. Barrick lives in a fools' paradise thinking that it can roll over all futures contracts showing a loss, several times if necessary, until the gold price comes down again and the commitment can be covered at a profit.

Double standards

The truth remains, however, that all Barrick has accomplished was to sweep margin calls on its short positions of gold under the rug, thus concealing the potential liability from its shareholders and creditors. Therein lies the fraud which accountants should point out, and if they fail to do so, the SEC should uncover, expose, and prosecute. Instead, they adopt the 'hear no evil, see no evil' attitude.

Barrick wasn't around in 1968. But suppose for the sake of argument that it was. Assume further that Barrick had sold borrowed gold at $38 per ounce (which may have appeared an incredibly smart thing to do at the time) In that case Barrick would, a third of a century later, still be rolling over its gold loans in the forlorn hope that the gold price would be good enough to drop below $38 in order to enable Barrick to unwind its losing position with a profit. In fact, after 1968, the year the U.S. Treasury defaulted on its obligation to pay foreign creditors, as contracted, in gold at $35 an ounce, the price of gold took off never to come back again. Barrick could still be holding the bag, a bag of losses, and keep reporting huge profits, because the conspiring bullion banks allow it to roll over its losing short position on gold sold at $38 an ounce. (It may be worth pointing out that today the position of the US Treasury *vis-à-vis* its foreign creditors is far worse than it was in 1968.)

It has happened any number of times in history that the gold price took off never ever again to come back to the level it has started from. For this reason, any accounting assumption that a commitment to deliver gold at a future date can be closed out profitably if one is willing and able to wait long enough, is simply fraudulent. *It should never be allowed in a society with self-respecting legislators making meaningful contract laws. And the fraud should be exposed by self-respecting accountants and other watchdogs of fair play.*

Just as grain-elevator operators are not allowed to calculate and report profits derived from forward sales of wheat several years into the future in the same way as they calculate and report profits on the sale of wheat physically present in their elevators, gold mines should not be allowed to calculate and report profits on the forward sale of borrowed gold in the same way as they calculate and report profits on the sale of newly mined gold from their mines. There is a contingent liability on the short positions. Until and unless they are closed out *there is no profit to report*. As the proverb says, "there's many a slip between cup and lip".

It is disgraceful that public prosecutors allow this double standard to prevail. What is rightly prohibited to grain elevators should not be permitted to gold mines. *It is to the eternal shame of our civilization that it allows this unsavory conspiracy between the banks, the gold mines, and the government (with the accounting profession, academia, and the financial press looking on) to defraud the general public through the hocus-pocus of 'hedging' and forward selling.*"

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This was written in 2000. Writing in 2008 I can add that the worst-case scenario eventually caught up with Barrick. The gold price has been increasing so much and so fast that Barrick was unable to lift its short positions in an orderly manner. Most of it is still on. The company's finances still sag under the burden of selling gold short at $300 and below. The president of the company had to eat his words that 'forward selling will always play a role in the marketing strategy of Barrick.' Barrick did not sell as much as one ounce of gold short at $1040 last April to take advantage of the coming fall by $250 in August.

The company is trying to camouflage the financial mayhem by charging all its losses to just one producing unit and promote the remaining ones as hedge-free. But can shuffling really eliminate the bad card from the deck? This smacks just like another ploy to short-change shareholders. Those who buy Barrick shares are buying the warts, no matter how thoroughly management tries to shuffle the deck. The company is still hemorrhaging gold, and a better policy would be to close the hedge book and burn it for once and all.

In the second, concluding part of this article I shall explain that the marketing strategy of Barrick to sell newly mined gold hot from the shaft is obsolete and wasteful. It is a pig-headed and ham-handed approach in view of the fact that a more efficient modern marketing strategy is available. *Barrick should stop selling the gold price and start selling the gold basis*.

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 — A Most Important Trading Tool, Mining Tool, and Early Warning System.* Inquiries: www.feketeaustralia.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 9, 2008