# HOW TO PROTECT ONE'S PENSION WITH GOLD

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August 23, 2003

### Carting away Mt. Price

Stock analyst Clive Maund, in an article entitled *Vista Gold Corp Takes No Prisoners* (www.321gold.com July 10, 2003) confessed as follows: "My fundamental knowledge of the company is restricted to the memory of a photo in a vast open pit of a huge mining truck of the type that carted away Mt. Price in Australia." I may add that the truck, along with three others, plus a hydraulic shovel Vista used to own, were sold back in 1998 and have not since been replaced, even though the company could produce gold at a cash cost of $183 an ounce. As CEO Ronald J. (Jock) McGregor explained, mining and selling gold at present prices would mean dissipating company assets irresponsibly.

Yes indeed. If all gold mining companies adopted the policy of Vista, the price of gold wouldn't be where it is. But even the so-called unhedged companies are falling over themselves to produce and sell all the gold the traffic can bear, cheered on by a crowd of dividend-hungry shareholders. They don't realize that they eat the seed corn, nay, they cook the goose that would lay the golden egg. So why conjure up the boogie-man of official gold-price manipulation? It is the gold mining industry as a whole, hedgers and non-hedgers alike, that must accept blame for the low gold price. But for the greed of managers the industry would have far more clout than the price-manipulators, real or imagined. It is the gold miners who have the ultimate weapon: strike action. Threatening to shut down the flow of new gold to the market would bring this point home like nothing else. Gold miners could, single-handed, cart away the mountain of depreciating paper money with Mt. (Low Gold) Price to boot, if they only treated their product with a respect appropriate to the monetary metal. Unfortunately, most have fallen victim to the official gold-demonetization hoax and they treat gold as if it was just another commodity such as frozen pork bellies (this being the example favored by economists in the pay of central banks).

### Greed overtaking husbandry

Greed is as old as human race. The last time it overtook husbandry in the realm of gold was over 35 years ago. In 1968 you could still buy gold at $35 per oz. The price had not changed for 35 years, since 1933, in spite of six years of depression; six years of World War II; six years of Marshall give-away; six years of Korean War; six years of escalation of the Vietnam War; the Berlin blockade, the Cuban missile crisis and other Cold War battles. All these historic events have contributed to monetary depreciation in the order of 75 percent. The gold mining industry was badly hurting. Yet it kept producing and selling gold at break-neck speed as if there was no tomorrow. The gold producers of the 1960s, just as those of today, were doped by the paper-money magic. They were coaxed out of their possession of a real asset to exchange it for a phony one. In giving it up at a ridiculous price they were unwitting stooges helping postpone the day when gold could break its shackles. Nobody then or since has bothered pointing out the folly of the inmate who would ingratiate himself to the jail-keepers by assisting them to make his yoke heavier.

Once more gold miners are ingratiating themselves to Dollar Almighty just at the time when the halo is fading and the crown is about to fall. The volume of gold production is increasing as gold miners zealously feed the beast. It looks as if history repeats itself.

After 1968 the price of gold ran up more than three-fold in less than three years, leaving gold miners with egg on their face for their zeal to produce and sell all that gold at the uneconomic monopsony price dictated by the government. They had frittered away the best assets of their shareholders. One might have hoped that, after the fiasco, gold-mining executives would learn their lesson. It wasn't meant to be.

**The economics of gold mining**

The lesson gold-mining executives have failed to learn in 1968, so that they are now condemned to repeating the same old mistakes, is that of the economics of gold mining which is very different from that of base metal mining. The reason for the difference is that gold is the monetary metal. It is this fact that makes the marginal utility of gold constant, while that of a base metal is declining (as is the marginal utility of anything else, for that matter).

It is declining marginal utility that compels the miner of base metals to go after the top grade of ore available. Only in this way can he protect his market share. In base metal mining "the fastest gun prevails". In gold mining, by contrast, the fastest gun invariably shoots himself in the foot. The gold miner has no market share to worry about. Husbandry takes precedence over speed and volume. The successful gold miner reaches not for the top but for the marginal grade. This is the lowest payable grade that can, at the current price of gold, still be mined profitably while the mining of lower grades would result in losses. As can be seen, in this way *the gold miner maximizes not his profits but the useful life of his mine.* The best grades are saved to the end. When an exhausted gold mine is abandoned no payable grade of ore is left behind, unlike in the case of an abandoned copper mine.

It also follows from this cardinal rule of gold mining that if the gold price falls, the defensive step the miner ought to consider will be the lowering of mill-capacity utilization, all the way down to zero if need be. Normally he would keep mill-capacity utilization constant at 100 percent as only in this way could he guarantee the profitability of his enterprise. But a falling gold price calls for extraordinary measures such as cutbacks in production to prolong the fast-shrinking life of the mine, even if it meant accepting losses as the price of protecting mining assets. It is clear that this choice is not available to the copper miner facing falling prices. He must produce in order to survive. Copper has declining marginal utility, and the miner's strategy is to bring it to market with all deliberate speed. The gold miner has no such constraints. His product has constant marginal utility. Gold locked up in underground ore bodies is valuable no less than gold locked up in bank vaults. It must be produced most sparingly in order to preserve wealth represented by mining assets. Falling gold price is a double whammy: it pushes payable grades of ore into the submarginal category, thereby causing further losses in addition to the direct loss due to the lower price of the product.

*In and out of the ground, gold teaches husbandry to mankind.*

**Perpetual option**

I fully anticipate violent objection to my thesis. My detractors will argue that no enterprise, not even a gold mining operation, can long survive while making losses. The price of shares will plunge to zero and, shorn of its source of capital, the enterprise is forced to fold. My argument is that a *well-managed* gold mine is an exception to the rule. Share prices will not fall to zero even if the gold mine is losing money, because the well-husbanded inventory of gold-bearing ores, free from attrition, retains its value indefinitely.

This leads me to the subject of a gold-mining share as a perpetual call option on gold bullion. All analysts recognize the fact that the price of a gold-mining share (but no other type) has a built-in option premium. Gold-mining shares normally trade at a premium over book value. The book value of a (debt-free) gold mine is defined as the value of gold represented by its payable grades of ore plus plant and equipment minus extraction costs. Unlike in base metal mining, depreciation of payable ore reserves is conspicuous by its absence. No one has attempted to provide a scientific explanation for the fascinating phenomenon how gold-mining shares manage to defy the law of gravity. The sole reason for the option premium is the fact that gold is the monetary commodity, a distinction shared by no other. Stockholders bid up the stock price to the point where it will reflect the full option premium, provided that managers operate the mine most conservatively, that is, they maximize the life-span of the mine rather than profits.

**The balance-sheet concept of gold**

In a well-managed gold mine only marginal grades of ore are exploited. It is remarkable and important that economy can be further enhanced by processing a blend of marginal and submarginal grades of ore. Thus the value of submarginal grades, normally considered to be zero, becomes positive *even without assuming higher gold prices in the future*. Another source of the option premium is the balance-sheet concept of gold. The fact is that gold is kept in the asset column of the balance sheet of individuals and institutions *without any promise of return to capital*. No other asset is treated in this fashion. Why? Because *gold is the only financial asset that can balance a liability without itself showing up as a liability in the balance sheet of someone else*. That someone else may happen to default, leaving one holding the bag. This makes gold the ultimate agent of portfolio insurance. It makes little sense to talk about the day-to-day "performance" of an insurance policy. Performance comes after disaster has struck. Likewise, it makes little sense to talk about performance in relation to a gold stock, except as a measure of the extent to which the full option premium is realized. And this depends solely on how conservatively the gold mine is managed.

Gold mines that husband their resources less conservatively (typically by producing and selling all the gold that the traffic can bear) are punished for their profligacy by a fast-shrinking or even zero option-premium. It is true that the share price of a producing gold mine also incorporates another, the income-premium representing the present value of the flow of expected dividends. Be warned, however, that nowadays income-premium eclipses option-premium as most gold mines pursue quick profits to the detriment of mine life-expectancy. But dividends come at the expense of attrition of ore reserves and, therefore, the income-premium is programmed to self-destruct, regardless whether the mine is put in or taken out of production. The income-premium is ephemeral and has no part to play in protecting the value of pensions. By contrast, the option-premium is durable and it is crucial for the pensioner.

Not only have gold miners failed to manage their mines more conservatively for the past fifteen years than the miners of the 1960s, they have in fact greatly accelerated attrition through mindless short-selling, misleadingly called "hedging". We must distinguish between "hedging false" as practiced by some of the most glamorous gold mining companies today, and "hedging true" as it should be practiced by conservatively managed companies. "Hedging false" is in fact unilateral short selling. It is nothing but self-fulfilling speculation in the expectation of a lower price. There is no way to get around this basic truth. We should clear up the confusion about what constitutes proper hedging or "hedging true", and what distinguishes it from short speculation in the expectation of a lower price, or "hedging false".

**"Hedging true"**

Proper hedging would have to be bilateral, that is, it should involve forward buying in addition to forward selling. The two taken together is justified by the same principles as those justifying the harvesting of energy represented by the tides and ebbs of the seas. When the tide comes in, (i.e., the gold price swings to the plus side) it is proper for the mine to sell gold for future delivery, assuming that this policy is complemented by another: when the ebb goes out (i.e., the gold price swings to the minus side) the mine will buy gold forward. In this way the futures trading activity of the gold mine remains well-balanced and will not give impetus to speculation to weigh the market down on the short side, creating a falling trend in the gold price as is the case with the present so-called "hedge plans" of some large producers, which only induce speculators to keep selling gold at the first sign of strength in the gold price but refrain from buying at the first sign of weakness.

Let us look at the economic justification of forward buying and selling in detail. Paradoxically, forward selling is an economy measure designed to lengthen the useful life of the gold mine. It permits the miner to extract his submarginal grades and spare the payable grades of ore. Every time the gold price goes up, certain submarginal grades of ore in the mine temporarily become payable. Theoretically they could be mined profitably. However, technically it is not feasible to shift ore extraction back and forth between various sites on short notice following the whims of the gold market. Such shifts are time-consuming and expensive. By the time they are completed, the gold price may have fallen back and the opportunity to mine submarginal grades profitably gets lost. This is where forward selling comes in. Every time the fluctuating gold price swings into plus territory, the company sells gold forward in the futures market as a proxy for selling cash gold obtained from submarginal grades. Notice the quantitative limit imposed on forward selling by the inventory of submarginal grades. Each forward sale must be accompanied by the earmarking of a definite part of that inventory. The short position created by the forward sale must be covered when the earmarked inventory is extracted, milled, refined, and sold (or earlier, if it can be done profitably).

The miner works the miracle of turning stone into bread. He takes a worthless piece of rock, the submarginal grade of ore, and out of it creates a most valuable asset, gold. This seemingly impossible feat can be performed for two reasons: (1) gold is the monetary metal, (2) mindless government policy has made the price of gold fluctuate. It is this fluctuation that allows the gold miner to sell forward whenever the price-swing is in plus-territory, temporarily making submarginal grades profitable to mine.

Forward buying, no less than forward selling, is also an economy measure. It allows the gold miner to replenish his diminishing ore reserves at the best possible price. A forward-looking gold mining company is always prospecting for new gold-bearing properties to replace spent ore reserves. However, the checking of the quality and quantity of gold-bearing ore at the new site, the searching of title, and the negotiating of a price is a long, time-consuming process. By the time it is completed the gold price may have moved up, rendering the new acquisition uneconomic. This is where forward buying comes in. Every time the fluctuating gold price swings into minus-territory, the company buys gold forward as a proxy for the purchase of new gold fields. Notice the quantitative limit imposed on forward buying by the scope of prospecting. Each forward purchase must be matched by a prospective new gold field under negotiation. The long position created by the forward purchase must be covered as the new gold field is acquired (or earlier, if it can be done profitably).

There is no speculation involved in "hedging true." It is neutral as to the future price of gold. It does not provide speculators with a clue about falling trends in the gold price. It does not involve fraudulent reporting of questionable profits. It does not constitute manipulating assets and liabilities off balance sheet to the detriment of the shareholders. But it does make a positive contribution to extending the life of the operation.

**"Hedging false"**

What passes for hedging today is a scam based on another scam: that of fiat money. Why is fiat money a scam? Because it is grounded in the notion that *it is proper to allow the U.S. Treasury and the Federal Reserve to issue liabilities which they have neither the means nor the intention to meet.* Nobody has ever offered a valid argument showing that there are defensible grounds for these privileges without counter-wailing responsibilities. There are none. Here we come up against a double standard: if an individual or a private firm tried to issue liabilities which they have neither the means nor the intention to meet, then they would be facing criminal prosecution. Fiat money is a gigantic legalized Ponzi-scheme.

The Constitution of the United States properly recognized the inequity and dangers inherent in such an arrangement, and forbade the government to monetize its debt. It says volumes about the shaky grounds for the dollar, and portends ill about its future, that its managers are willing to go to the length of contemptuously trampling on the Constitution in order to protect their turf.

"Hedging false" works as follows. The gold mine borrows gold from a bullion bank at the low gold-rate of interest. It sells the gold bullion in the cash market and uses the proceeds to buy U.S. Treasury securities yielding at the high paper-rate of interest. The difference between the two rates is then added to revenues, and the mine is reporting higher mining profits year in and year out. The pretence is maintained that the mine has increased revenues by selling its product forward "to take advantage of a high gold price." But what are the criteria by which it can be established that the price is high? Any price is a high price that can be pushed down by the threat of an artificial oversupply. The gold miner puts a marketing policy into effect that deliberately makes the price of gold fall and then poses as a hero who has invented hedging.

The whole procedure that passes under the name of "hedging" today is fraudulent. A forward sale is a transaction that will not be closed out for several years, when the borrowed gold is returned to the lender. But until closed out it will not be possible to determine the profitability of the deal. Not only does the gold mine indulging in "hedging false" declare profitability fraudulently, it is actually paying out phantom profits in the form of stock options to executives, thus robbing the shareholders. Ignored is the possibility that the borrowing arrangement may not be extended for a further period by lenders and the mine must buy gold in the open market at a loss to cover the liability. Also ignored is the scenario that the gold price may advance so fast, never to return to its level where forward selling occurred, that the gold mine is unable to cover its short positions profitably and must incur horrendous trading losses. Be that as it may, the premature reporting of questionable profits is a clear fraud to mislead shareholders. It should be stopped by the government's watchdog agencies. It isn't, and this makes "hedging false" a conspiracy involving the gold mine, the bullion bank, and the government. It is a scheme to manipulate assets and liabilities off balance sheet to the detriment of shareholders.

Why would the government risk the odium of being an accomplice to fraud stinking to high heaven? My guess is that it is led by the desire to perpetuate the regime of irredeemable fiat currency. The low gold-rate is the benchmark to which the paper-rate of interest is invariably compared. The spread between the two measures the decay in paper currencies. "Hedging false" is designed to manipulate this spread by closing it. That makes fiat currencies appear healthy when in fact they all suffer from the effects of advanced and possibly terminal decay.

**Tormenting the elderly**

My grandfather and, a generation later my father, accumulated pension rights in the service of the Hungarian government that should have made their retirement years care-free. Instead, they were both reduced to abject penury. In their productive years they were paying good money into the government-managed pension fund, and the government managed to pay them bad money that was hardly sufficient to buy food when they were old, helpless, and no longer able to fend for themselves.

I had served at the same Canadian university for 35 pensionable years before I retired. My university is on record that it reduced professors' salaries and pensions in the 1930's, ostensibly to compensate for the appreciation in the value of the monetary unit. There is no guarantee that the same trick will not be pulled again. In addition to my university pension I also have a smaller pension from the Canadian government. This unfunded pension plan is compulsory to all

Canadian wage-earners, but it will clearly be bankrupted by the fact that the ratio of contributors to pensioners is falling dramatically because of fewer births and longer life-expectancies. To compensate for this the government considers raising the contributions as well as the age of eligibility of wage-earners, but is facing considerable resistance on both counts. My pension may go the way of my father's and grandfather's. Church doctrine holds that tormenting widows and orphans is a sin "crying to high heaven." By the same token so is tormenting the elderly.

In planning my own retirement I had to find a way to protect the value of my pensions against the ravages of both inflation and deflation. I decided that the best protection was the purchase of out-of-the-money call options on gold bullion. (An out-of-the-money option is one having no intrinsic value, only time value, and are less expensive for that reason. By contrast, an in-the-money option has both intrinsic value and time value.) However, publicly traded options on gold bullion don't exist. (In the 1970's there was a Geneva-based investment firm Valeur-White-Weld, later acquired by Credit Suisse-First Boston, that used to trade call options on gold bullion, but apparently it no longer does.) But even if you could have them, call options on gold bullion would be too expensive and would not go out far enough into the future. I then hit upon the idea of leaps (long-dated call options) on Barrick stock. When on closer scrutiny I realized that Barrick's so-called hedge plan was utterly fraudulent, I tried to meet the (then) CEO, Peter Munk whom I didn't know in person, but knew that he was a fellow immigrant from Hungary. Not surprisingly he declined to see me. Instead, he directed me to the company treasurer Jamie Sokolsky in charge of hedging operations. During a session with Sokolsky lasting an hour and a half I presented to him my Memorandum entitled "Gold Mining and Hedging", explaining the difference between unilateral and bilateral hedging (as above). He promised to study it and would call me in a month's time. I have never heard from him again. This convinced me that Barrick was not serving the interest of its shareholders, but was probably acting as an agent for a third party (such as a government or a central bank). This assumption seemed to have been confirmed recently at the trial *Blanchard vs. Barrick et al.* where Barrick refused to answer questions on its dealings with central banks on the strength of confidentiality (indicating that Barrick has been acting as a front to cover up central bank activities in the gold derivatives markets).

**Pensioners' gold**

But let's go back to my original story. I exercised my leaps, sold my Barrick stock, and looked for an alternative. I asked a number of stock-broker friends of mine if they could recommend gold-mining companies that have deliberately reduced or, better still, stopped production in the face of falling gold prices. To my amazement, in each case my friends said that they were unaware of the existence of any such company. They are still looking.

I find it obnoxious that practically all the advice available to gold investors today is of the "get rich quick" variety. What about people who just want "to live and let live"? What about the retired people who want to protect the modest pension they have earned during their working lives? What about those on wages and salaries who in planning their retirement realize that the government-sponsored "old age security" just won't be there for them when they will need it, so that they ought to provide their own? These people are not motivated by the thought of getting rich quick. They just want real protection, because they don't trust the phony protection loudly propagated by plans sponsored by governments and employers. These plans are all suspect, because the benefits are denominated in an irredeemable currency, such as the dollar that managed to lose a record of 90 percent of its purchasing power during the very first decade after it was "cut free" from gold in 1971. There is no reason to believe that the dollar may not repeat or even beat that record in the new century! The point of my article is that these people are not being well-served by investment advisors who advocate the ownership of gold mining stocks with a management hell-bent to push up share prices by producing and selling all the gold the traffic can bear at the expense of mine-life (and there are lots of "non-hedged" companies in this category). The trouble with these companies is that they are exhausting their gold reserves prematurely, and their policy to replenish them is likely to fail as they do not reinforce prospecting with forward purchases of gold (as explained above under the caption “hedging true”).

Pensioners should be very selective, and they should only look at the most conservatively managed gold mines with a declared policy of cutting back production (or withholding produced gold from the market) in response to falling gold prices. Once invested in the stock of such a gold mine, there are several strategies that (prospective) pensioners may choose from. The simplest is to sit back and collect the ever-increasing dividends the company is expected to pay once the gold price makes sufficient advances, to supplement their shrinking pension.

Another strategy is to keep "exercising the perpetual option" as the price of gold waxes and the value of pensions wanes. After each major surge in the price of the conservatively managed gold mine the pensioner would sell part of his holdings and convert the proceeds into gold bullion. This play is based on the expectation that the price of the stock of a conservatively managed gold mine will go up much faster than the gold price. This expectation is well-grounded. There is a double bonanza at work. In addition to the *value* of payable ore reserves, the *volume* of those reserves has to increase, as submarginal reserves enter the payable range thanks to the higher gold price. In this way the pensioner acquires gold ever more advantageously. In spite of paying an ever higher dollar-price for each ounce, every subsequent share sold is buying him more ounces. The conservatively managed gold mine produces gold *for him*. If he owned the stock of a less conservatively managed gold mine, the company would be producing gold *for others*. Pensioners have no use for a gold mining operation that prefers to make a quick profit at the expense of the life expectancy of the mine. They are not suitable as protection for one's pension against inflation or deflation. Pensioners don't need additional income while their pension still has value. They will need additional income when their pension is cut because of deflation, or loses its purchasing power because of inflation.

A third strategy involves borrowing against the stock, rather than selling it, to get compensation for the decreased value of one's pension. This strategy is designed to address the problem of taxes. Since there is no selling, there are no capital gains to be taxed.

Conservatively managed gold mines are hard to find. They are not glamorous, they never hit the headlines. It is likely that they do not presently pay dividends or, worse still, they report losses as holding gold properties involves costs (such as providing security, keep renewing mining licenses, paying a skeleton crew, prospecting for new properties, etc.) On the other hand, the price of the stock of such conservatively managed gold mines tends to be low and, initially, it may not increase spectacularly as that of a glamorous gold stock would. However, the policy of postponing exploitation will pay rich dividends at the time when the glamorous companies approach the point of exhausting their mines and must get ready to shut them down, as a result of premature depletion of reserves.

I am not getting paid for writing this article by anybody. In doing it I am trying to be helpful to my fellow pensioners facing the same problem that the value of their pension may evaporate due to deflation or inflation just at the time when they need it most. This should be considered as a thought provoking exercise to challenge conventional wisdom. Pensioners and prospective pensioners should do their own due diligence to find conservatively managed gold mines that would suit their needs best in protecting the value of their pension against the ravages of deflation or inflation.