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PEAK GOLD!

A Primer on *True* Hedging, Part Two

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Hedging Fraudulent

In my previous papers I have explained that virtually all activities of gold mines that go under the name „hedging" are fraudulent. To the extent hedges go out into the future more than one year, or they exceed the quantity of one year's production, they are naked forward sales, carrying *unlimited risk* (the risk that the gold price goes to infinity, as it has in the wake of every hyperinflation). To understand the motivation to resort to fraud, and to shoulder unlimited risk to boot, we must remember that the combined short positions in the futures and derivatives markets on gold greatly exceed monetary gold in existence. Without compulsively selling paper gold, a short squeeze and even a corner in cash gold could develop if the longs decided to call the bluff. Thus any exposure to the short side forces pyramiding to fend off the danger. On the other hand some shorts, especially bullion banks, have found the creation of *ersatz* gold a profitable business. They play a cat-and-mouse game with the longs. They have fashioned the rules of gold exchanges and ETF's in their own favor in order to make delivery a cumbersome, expensive, and time-consuming procedure. As a result the price of gold could be thrown into a hole so that, whenever it tried to climb out, hedgers and speculators would rush in and club it down. The shorts can get away with it because the supply of paper gold (futures and option contracts) as well as unmined gold in the ground is virtually unlimited and can be mobilized in the anti-gold campaign. It speaks volumes of the inherent strength of gold that it could still climb out of the hole in 2001 in spite of a terrible assault to push it back. The 20th century belonged to the enemies of gold. There is no need to make predictions here about the 21st.

Changing the nature of gold speculation

Significantly, the so-called hedging activity of gold mines has altered the strategic line-up in the gold market. Speculators have typically been on the long side. They have photographic memories and recall the propensity of governments to cry down the value of the national currency in terms of gold from time to time. The opposite procedure, writing up the value of the national currency in terms of gold is virtually unknown in the annals of monetary history. Given mine hedging, so-called, speculators have changed sides and compete with the mines to sell (paper) gold at the first sign of a bullish move in the price. The fraternity of speculators conceive of risk-free profits on the short side of the market as they attempt to forestall the mines. Having abandoned their traditional haunt on the long side, they are now converging on the short side of the gold market. Peak Gold is a predictible consequence. Unhedged gold mines, too, feel compelled under the threat of a falling gold price to produce gold at break-neck speed while neglecting prospecting and the development of gold properties. Once the producing mines get exhausted, the supply of new gold will decline.

In summary we might say that fraudulent hedging carries with it its own punishment: Peak Gold. It leads to ruthless exploitation of gold mining resources, with no prudent provision for replenishing them through prospecting and new mine development.

’Give a dog a bad name, might as well shoot him’

It is unfortunate that the perfectly honest and useful word „hedging” has been allowed to be abused and given a completely distorted meaning. As the saying goes, ’give a dog a bad name, might as well shoot him!’ It is difficult to explain the distinction between ’hedging true’ and ’hedging false’ when the connotation of the word ’hedging’ in the minds of the people is unsavory. It turns them off. Yet the mission of the monetary scientist obliges him to continue on the path of truth even if it is uphill all the way.

Hedging is a wide-spread practice of producers in all walks of the economy. To be valid and effective, it must be carried on at two levels: upstream and downstream. The former refers to the input, the latter to the output of production. At the input level the producer buys the resources that go into his final product. At the output level the producer is marketing his final product. The need for hedging arises as price fluctuations at either level, especially if they occur faster than adjustments can be made, may cause losses. Thus, worrying about the downstream, the producer is anxious to lock-in a favorable selling price as it may become available for his product prior to the end of the current production cycle. Worrying about the upstream, the hedger aims at locking-in a favorable buying price as it may become available for a major ingredient of his product prior to the beginning of his next production cycle.

Upstream and downstream hedging

Hedging is most efficient if it is *bilateral*. As it has been practiced in gold mining hedging is *unilateral.* It involves forward sales by way of downstream, to the exclusion of the forward purchases by way of upstream hedging. It is a caricature of hedging. It pretends to overcome the fluctuation of the gold price as it affects the output of new gold. I say ’caricature’ because it is counter-productive. Rather than allowing the producer to sell high while preserving the value of his unmined reserves, it forces him to sell low, and *sell it fast*, as the message is that the price is going to fall, and any delay in selling will involve losses.

Yet, if done properly, either type of hedge should contribute to profitability as well as husbandry. In combination they are a legitimate form of arbitrage, provided that the hedges are carried in the balance sheet, and profits (losses) from them are reported in the income statement. Hedges carried off-balance-sheet are not legitimate as they conceal a liability with the result that the income statement is falsified. Shareholders and creditors are misled. Directors and managers lock themselves into a fools’ paradise. Especially dangerous are downstream hedges carried off-balance-sheet, for reason that the short leg (forward sale) represents an *unlimited* liability. By contrast the long leg of an upstream hedge (forward purchase) represents but a limited liability. This difference is due to the fact that while the price of a commodity can never fall below zero, there is no identifiable limit above which it may not rise. Another way of expressing it is to say that the downstream hedge is subject to a squeeze and possibly to a corner. By contrast, there is no way to squeeze or to corner a producer with an upstream hedge.

I wish to return to the question why downstream hedges must be limited in size and in volume to one year. Total net short sales must never exceed one year’s output. The reason is that at the end of the fiscal year unsold output from the previous production cycle must be moved from the ’receivables’ to the ’stockpiles’ column, and the short leg of the hedge on them must be lifted. If they weren’t, then the arbitrage would be turned from hedging into outright speculation on the short side representing unlimited liability. Profits are paid out masquarading as dividends. It results in hiding paper losses. Such antics constitute a fraud.

Capital destruction

I must confess that I cannot understand the utter lack of business acumen on the part of gold mining executives, still less on the part of investment bankers that finance their activities, in embracing such a contradictory and self-defeating strategy of marketing gold. They should be interested in maximizing the price of their product. Instead, they engineer a falling price trend. They should be interested in

maximizing the working life of their gold producing property. Instead, their marketing policy directly contributes to the premature exhaustion of the mines. A lot of observers jump to the conclusion that the gold mines and the bullion banks, in partnership with the government, form a conspiracy to club down the gold price. Theirs is a hidden agenda. The gold mine management is interested in defalcation, that is to say, to trick their stockholders out of their equity. The bullion banks think that they can harness perpetual motion in the artificially induced oscillating movement in the price of gold. Governments look at the gold price as a messenger with an embarrassing message about the depreciation of currency. The messenger had better be shot. Governments know that a steep increase in the gold price will cause panic. Such a panic has historically served as the harbinger of hyperinflation. It must be prevented by hook or crook.

I find this reasoning unattractive. Such a conspiracy can never be proved or disproved. Governments probably use more subtle methods.

Double standard

Most ’hedged’ gold mines are in violation of the important restriction that downstream hedges must not exceed one year’s gold output and they must be lifted before the end of the fiscal year. Their practice transgresses not only the limits of prudence, but also the limits of upright business management. A gold mine selling forward in excess of one year’s output is guilty of fraud. It is concealing a potentially unlimited liability. 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 one for everyone else. While they allow gold mines to sell forward several years’ production, they would immediately blow the whistle if, for example, an agricultural producer tried to do the same. It is well understood that forward sales in excess of one year’s production are a predatory practice designed to hurt or destroy competition. It is also hurting other market participants downstream.

There is no justification for this double standard. It is scandalous 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, the mine will sell for cash. Central banks are accomplices in the scheme of fraudulent hedging since they report gold that has been leased and sold as if it were still sitting in their vault. It is a form of double-counting gold by modern accounting techniques.

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. Not only is such a ’naked bear speculation’ illegitimate as it falsifies the balance sheet and conceals an unlimited liability, but it also makes the prospectus meaningless. There is no mention in the prospectus of any intention to indulge in short selling that inevitably results in the premature exhaustion of ore reserves and in the dissipation of the most valuable resources of the mine at artificially low prices. On this ground alone the gold mine is open to class action suit by the shareholders.

Shareholders being hit three times

Furthermore, naked bear speculation makes no economic sense for the mine. By virtue of its net short positions the gold mine assumes a vested interest in a lower and falling gold price which clashes with its main mission of selling newly mined gold at the highest possible 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 the ’hedging’ gold mine 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 a schizophrenic management team 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. First, income is shaved every time the gold price is forced lower through short selling. Second, capital is being destroyed as the falling gold price makes payable ore reserves to disappear (i.e., become non-payable). Third and most serious is the fact that the richest ore reserves are being frittered away for a pittance at the artificially suppressed gold price, thereby materially shortening the working life of the mine. Naturally, the share price will show not

only the shaving of income and destruction of capital, but the premature aging of the gold mine as well.

Paper profit no profit

Advocates of this senseless practice, in particular, the officers of Barrick Gold argue that these losses are more than compensated for by the extra income the firm generates from 'investments' made with the proceeds of forward sales. But insofar as this extra income is encumbered with unlimited liabilities represented by the fraudulent downstream hedge, it consists of paper profits that should not be paid out in the form of dividends. In fact, they should not be reported as profits in the first place. „There's many a slip between cup and lip", as the proverb says. Hidden liabilities may force the firm out of business before it has a chance to realize its paper profits. The practice of window-dressing income statements using unrealized paper profits, especially as they are encumbered with unlimited liability, is blatant fraud and no amount of sophistry or government connivance will change that fact. It is the height of insolence on the part of management to treat shareholders as simpletons unable to understand the difference between paper profits on an open forward sale contract, and profits that have been consummated by closing out such a contract.

Bilateral hedging

Apologists for the practice of naked bear speculation by gold mines try to push the blame on to the banks. They point out that mines could not get financing unless they heeded the bid of banks to sell forward several years of output as collateral for the loan. Let us leave aside the fact that the banks in setting conditions involving fraud become partners in crime. It is possible that they enjoy the same immunity from criminal prosecution as the mines. Even then the argument is not persuasive. The banks are not micro-managing the mines. The responsibility for fraudulent forward sale of several years of output rests with mining management. It could have used *true hedging* to satisfy the banks.

In the third, concluding part of this series I shall describe in full details bilateral hedging. It is proper hedging that gold mines can practice without harming anyone. It involves upstream hedging that consist of forward purchases of gold, to compensate for the forward sales of the downstream hedging. This will reveal that the compensating long leg of Barrick's straddle is missing. Therefore the so-called hedges of Barrick constitute no valid arbitrage. They are merely tools for illegitimate naked short speculation. They invite severe punishment in a bull market. By contrast, bilateral hedging is for all seasons. The mine prospers in a bull market as well as in a bear market.

A unilateral short hedge can always be converted into a bilateral hedge through adding a compensating unilateral long hedge. Forward sales should be matched by forward purchases. A bilateral hedge is the combination of a downstream and an upstream hedge. It is a legitimate hedge, as forward sales are compensated by forward purchases. It never gives rise to unlimited liability.

For example, an upstream hedge is created by the gold mine when a sudden fall occurs in the gold price. Since management is on the look-out for new gold-bearing properties to buy, in order to replace ore reserves that are being exhausted by its mining activities, the sudden fall in the gold price represents an outstanding yet ephemeral opportunity. It knocks down the value of gold-bearing properties and that of the stakes of prospectors. However, the opportunity to buy the property or the stake at such an excellent price is likely to elude the gold miner who has to go through the lengthy process of searching the title and checking the quality and quantity of gold ore in the ground. By the time this process is completed, the gold price might have surged forward making the opportunity to add to ore reserves at a reasonable price disappear.

To lock in a favorable price is possible nevertheless through the forward purchase of gold. The miner creates a straddle or upstream hedge, the long leg of which is a long position in the futures market, while the short is the gold-bearing property under negotiation. Care is taken to match the value of the property with the number of futures contracts to purchase. When the deal is closed out and the property is bought, the long leg is lifted and the upstream hedge unwound. The point is that the miner is under no time pressure to close out the deal prematurely. Even if eventually he is paying more in consequence of the surging gold price, the miner is compensated for that by profits on the long leg of his straddle. It is true that there would be a loss on the long leg if the gold price fell further. This is no

problem, since the lower price paid for the gold-bearing property will take care of that loss. Adding the upstream hedge converts unilateral into bilateral hedging. It makes the illegitimate forward sale of several years' mine output legitimate. The short leg of the downstream hedge is compensated for by the long leg of the upstream hedge. The forward purchase removed the unlimited liability that was created by the forward sale of gold. The fraternity of gold speculators will return to their traditional haunt, the long side of the gold market. Gold investors are not hurt by the hedging activities of the gold mines, provided the hedges are proper.

Figuratively we may describe the proper hedges of a gold mine as a *four-legged straddle*. Two legs are in the upstream and the other two in the downstream market. The short leg downstream (forward sales) is counter-balanced by the long leg upstream (forward purchases) — just as the long leg downstream (gold in the ground about to be mined) counter-balances the short leg upstream (gold property about to be acquired).

Gold Standard University Live

Gold Standard University Live has just completed its Session Two at the Martineum in Szombathely, Hungary. Session Three is planned in Bessemer (nearest airport Birmingham), Alabama, U.S., in February 2008. It will feature a one-week course entitled *Adam Smith's Real Bills Doctrine.* An *advocatus diaboli* from neighboring Mises Institute will be invited to come and challenge the wisdom of Adam Smith.

The session in Alabama will also feature a blue ribbon panel discussion on the subject of *True Hedging for Gold Mines*. Representatives of hedged and unhedged gold mines will be invited to participate. The present series *Peak Gold!* is a primer on true hedging, and a book is planned that would cover the proceedings of the conference.

For the benefit of prospective participants from Europe, Session Three may be repeated at the Martineum in early March, 2008, provided that a sufficient number register.

This is a preliminary announcement only. Stay tuned. For more information please contact: GSUL@t-online.hu

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Stop the Press!

There is wild speculation in Newmont stock on rumors that it is a candidate for a hostile takeover by Barrick. Barrick has denied the rumors; Newmont refused to comment. So it boils down to the question whether you can believe Barrick. A penny for my thought? Newmount is worth far more under the present management, that has courageously unhedged it, than it could ever be worth under the management of Barrick, which is grieviously lacking both in courage and vision. Barrick is still wedded to its idiotic hedge plan, stewing in its own juice as a consequence. Newmont could introduce bilateral hedging, the only true hedge plan for a gold mine, to be described more fully in the next instalment of *Peak Gold!* I cannot help but think that Barrick is acting out of desperation, in trying to dilute its hedgebook through hostile takeover. Barrick's management could spend its money far more efficiently if it bought back its hedge book, rather than buying out Newmont, which has a vision Barrick is sorely lacking.

My fears have been sadly confirmed. Barrick does not have and is unable to borrow the money to buy back its hedge book, but it apparently tries to wriggle off the hook through acquiring a better-managed company. It would pay for the acquisition with Barrick stock. No, not again! Stockholders of Barrick are to be barricked to death!

If the rumors are true, the takeover drama is not without its humorous aspect. The poison pill has been swallowed by Big Fish and by now it is causing indigestion and cramps, so that Big Fish wants to feed on fish that have just regurgitated theirs!

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