

Contrarian Chronicles

Making the case to own gold

Weighing a position in gold? Here's a primer on the choices available: gold bullion itself and gold mining stocks.

By [Bill Fleckenstein](#)

Owning precious metals is an insurance policy against the Fed, inflation, tough economic times and a currency debacle. In view of last week's attempt by our government to champion a lower dollar, which I think is an incredibly bad move, I'd like to devote this edition of the Contrarian Chronicles to the precious metals, gold in particular.

For readers weighing a position, I'll focus on how to value a gold-mining company (which is basically ore in the ground) and gold bullion itself.

How to gauge a gold grubstake

First, a word on assessing the size of a potential position. You need to judge your exposure, I believe, in terms of your overall net worth and its composition, as well as the amount of "insurance" you feel you need. In the recent past, people decided they didn't need any kind of insurance, unlike the old days, when their desire for protection translated into a gold (and silver) exposure of 5% to 10%.

Now it is clear -- witness the accumulation of gold occurring around the world -- that protection is once again on folks' minds. Richard Russell, whose opinion I greatly respect, advocates owning about a third of one's net worth in some sort of metals. I have a much larger position than even 35%, but that's what works for *me*.

Folks need to gauge their own comfort level, factoring in their response not just to a rise but also a decline in the price of gold (currently around \$382 a troy ounce), as well as what that would mean for other components of their portfolio. For most people, the bulk of their net worth is measured in dollars, in the form of electrons. That's not a very comforting thought, given who (the Fed) is in charge of those electrons.

Bullion: The bullish case

As for how to value gold bullion itself, I'd like to quote from "Value Hedge," an absolutely brilliant essay by my good friend Jim Grant. In his latest issue of Grant's Interest Rate Observer, he writes: "(Gold) is a hedge. However, in my opinion, it is a hedge bargain. The value of a hedge should vary according to the cost and imminence of the risks being hedged against. In the case of gold, the risks are monetary. They are potentially *very* costly, and they are more than imminent. They are *upon* us in the shape of burgeoning deficits and a radically reflationary policy stance. Owning gold, you are insuring not against what may be, but against what already *is*." (The added emphasis is mine.)

Indeed you are. Folks who do not understand or see the insurance/currency aspect of gold will have a hard time protecting themselves from the consequences of policies wrought by the Fed and the present administration. While the timing is in question, the eventual outcome of this macro mess is not debatable.

A valuation primer for a gold miner

Now for my method of valuing a gold-mining company -- one that I arrived at many years ago, before actually becoming a director of **Pan-American Silver** ([PAAS](#), [news](#), [msgs](#)). It hasn't changed in the years since I have been on the inside. For the many folks who ask me how a value investor can buy gold stocks despite their apparently large price-to-earnings or price-to-sales ratio, I'll explain the process by looking at an example: **Newmont Mining** ([NEM](#), [news](#), [msgs](#)).

If you look at Newmont's proven and probable reserves of about 83 million ounces, you're paying about \$190 an ounce to buy those reserves. Add in Newmont's cash costs of about

\$203 an ounce (having risen from about \$182 a few years ago, but heading back to \$175-\$190, according to company statements last week), and you're paying a functional equivalent of \$393 for an ounce of gold, i.e., what it costs to acquire those reserves and what it costs to yank those reserves out of the ground. So, you can buy gold for about \$382 an ounce, or Newmont's gold extracted from the ground for about \$393.

Pregnant with potential

Compared with bullion, Newmont looks slightly expensive. Further, there are its non-cash costs, about \$60 an ounce, for depreciation and amortization of the cost of exploration. But on the other hand, for that \$60 an ounce, you're also getting 55 million ounces of unproven and probable mineralization (and whatever exploration prospects exist). The way the calculation shapes up, you're paying \$393 per ounce plus \$60 per ounce for this "land package" (which *could just maybe* yield two-thirds of an ounce or more) vs. \$382 an ounce for bullion.

Why does this land package matter? Often, unproven and probable reserves can be turned into proven and probable reserves with more drilling or higher prices. A company may only attempt to "prove up" eight to 10 years' worth of reserves, when in fact, more drilling could extend the life of a mine. So, depending on the individual company, unproven and probable reserves can have a higher probability of becoming proved than one might think.

Management you can trust: an evergreen asset

That said, it's very difficult for an outsider to assess a land package properly. The mining business is a very difficult one. This is why folks considering a mining stock need to have utmost confidence in its management. This is why I have been so keen on Newmont Mining. In my opinion, Seymour Schulich and Pierre Lassonde, who both came to Newmont when it acquired Franco-Nevada Mining Corp., are the best operators in the gold business. I trust them to make my decisions in the gold market.

I am quite comfortable at this time owning Newmont Mining in lieu of gold (though I own it, too). That equation may change at some point, but for now, I like the upside at Newmont, vs. gold itself. However, I actually sold some gold last Thursday at just over \$390, as it felt like a shakeout might be brewing. Though this strategy may be right for me, as I have, for me, a pretty big personal position in precious metals and related ideas, it isn't meant to be a "call to action" for others. I intend to repurchase what I sold, and more, as the right situation presents itself.

One final word on valuation: For those folks who prefer to own smaller, more speculative companies, the same method I used in this case is applicable, though the due diligence may be more difficult.

Lastly, on the subject of central banks and gold, there's been no decision yet on whether to dismantle the so-called Washington Agreement, which limits gold sales by its members (15 European central banks, plus the United States, Japan, Australia, the Bank for International Settlements and the International Monetary Fund) to about 400 to 500 tons a year.

But let's look at the big scheme of things. While 400 to 500 tons of gold sounds like a whole lot, it comes to only about \$6 billion to \$6.5 billion. If the Chinese wanted to kill two birds with one stone, they could tell the G7, "You're done," buy the 500 tons, and give the central banks dollars. In so doing, the Chinese would have valuable gold and a lightened load of dollars, without having pressured the yuan/dollar exchange rate.

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