Australian Gold Fund

Performance Report
For Quarter Ending 31st March 2020

Summary

The March 2020 quarter is the second full quarter for the Australian Gold Fund. During this quarter, the fund delivered a time-weighted rate of return of -20.4%. This compares to the ASX All Ordinaries Gold Index quarterly return of -13.4%, the GDX (in USD) returning -21.3% and the GDXJ (In USD) returning -33.5%. Since 23rd August 2019 to the end of the year, the Australian Gold Fund delivered a -22.1% return. Over the same period, the ASX All Ordinaries Gold Index returned -23%, the GDX returned -19.2% and the GDXJ returned -28.8%. This performance is disappointing by any standards.

This quarter's performance should be considered in light of the backdrop of the global financial markets declining over 30% in the wake of major global events occurring – the assassination of IRGC General Soleimani, the attempt to impeach US President Trump and his acquittal by the Senate, the global pandemic arising from the coronavirus that originated in Wuhan, China and the collapse of the oil price due to the failure of OPEC to cut supply. The confluence of such events was akin to a perfect storm and culminated in substantial market selloff across almost all sectors and asset markets. One could say that one or two of the above events would have moved the markets substantially, let alone all of the above occurring.

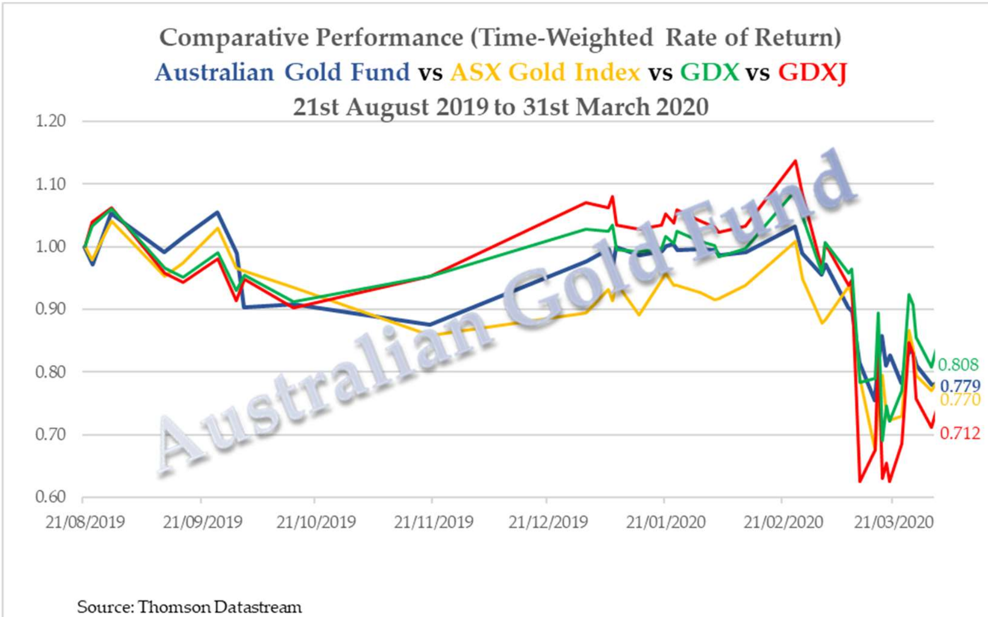
The fund's composition as at 31st March 2020 is given in the table below:

	% Portfolio by Market Value	Range
Cash	0.7%	2-10%
Major and Large Producers	13.2%	0-20%
Mid-Tier Producers	57.3%	0-60%
Junior and Micro Producers	16.0%	0-60%
Developers and Explorers	11.2%	0-10%
Precious Metals ETF	1.6%	0-30%

The Top 5 holdings is given in the table below:

Top 5 Holdings
Westgold Resources
Perseus Mining
Resolute Mining
Silver Lake Resources
Ramelius Resources

The relative performance of the fund against the ASX Gold Mining Index (XGD), the VanEck Vectors Gold Miners Exchange Traded Fund (GDX) and the VanEck Vectors Junior Gold Miners Exchange Traded Fund (GDXJ) during this quarter is given in the figure below:



The events that occurred over the March quarter caught us by surprise given that it all occurred together in such a short period of time. When 2020 began, we saw the gold price rise sharply within the first eight days as a result of the drone strike by the US Army against Iranian General Soleimani at Baghdad Airport that had many speculate the potential for World War 3 to begin. However, this appeared to have blown over and the stock markets continued to head up into January and the first half of February. What was surprising during these six weeks was that the gold price and gold mining stocks moved together with the stock markets. This phenomenon suggests market exuberance as well as market awareness that the currency supply from central banks was beginning to be excessive.

The financial markets peaked in early February as news on the coronavirus spreading began to grip market headlines and investors started to consider the potential for this to become a more serious epidemic. Initially, the markets moved towards gold mining stocks and that industry peaked on 24th February. However, the markets began their vicious selling off over that week, with most global asset markets falling by 10% as the month closed. This was only the beginning.

During March, the markets accelerated their decline especially at the end of the first week when Russia and Saudi Arabia threatened to bring down OPEC as they could not agree to production cuts. The crude oil prices fell over 30% over Friday and Monday trading. The gold price, on the other hand, rose from US$1 595/oz at the start of March to over $1 700/oz during intra-day trading. In mid-March, even gold and silver started to head down, the latter falling to the US$11-12/oz range on 17th March. Gold mining companies also saw a heavy sell-off into 16th-17th March and then began their recovery. The broader markets bottomed a week later, and quite sharply as well.

The Australian Gold Fund started the quarter with a positive outlook and also noted that some mid-tier and junior gold mining companies were beginning to appear to be trading above fair value, in particular Gold Road Resources and Red 5 Limited as it traded over 35c. We decreased our holdings of Gold Road Resources and Red 5 Limited gradually. We added holdings into West African Resources gradually over the quarter as the company announced that their Sanbrado gold project was expecting to pour their first gold by around April and the market capitalisation was around $350m at the time we added them to our holdings. As the gold mining stocks began to start selling down in late February, we were surprised to see how even the larger and well-run gold producers such as Kirkland Lake Gold, Evolution Mining and Saracen Mineral Holdings were being dumped into the market. Thus, we added those to our holdings partly due to its robustness as well as taking advantage of the subsequent recover. We expected the larger companies would recover faster and they could be sold down to allow us to increase our holdings of the mid-tier and junior producers that have more growth potential going forward.

Some of our most successful tactical trades related to Gold Road Resources and Silver Lake Resources, where we sold some of our holdings at above $1.40 for both, and repurchased them below in the $1.10-$1.30 range. Given that both have relatively low-cost operations, they were poised to recover quite strongly. We also purchased Alacer Gold on the way down to as low as $5, completely surprised by the violence in which the company was sold down in mid-March despite their high profit margin and being well regarded as a cash cow.

Regarding our largest holding in the previous quarter of Red 5 Limited, we decreased our holding by around 65% as the stock price remained over 30c during the general market downturn. Furthermore, we were cautious about the fact that the company needed additional capital to eventually fund the King of the Hills project that is expected to commence near the end of the year. We made a good call selling down as the company surprised the market firstly with a March quarter production downgrade followed by a $125m capital raising at 18c. We also increased our holdings in Perseus Mining, given the expectation of Yaoure commencing production by the end of the year, and move the company closer to being a large gold producer that will command a significant re-rating.

We are sad to announce that our holding of Millennium Minerals Limited was a failure as the company entered into a DOCA whereby all the assets were to be transferred to the creditors at the end of April. Our holdings was less than 5% of our portfolio. Furthermore, we expect that our holdings in Dacian Gold will be cut down substantially as a result of the $98m recapitalisation plan at 30c. We held around 5% of our portfolio in this stock, having inherited from our directors who had purchased some of these stocks from early June to September 2019 after last year's plunge.

Valuation Thesis

The gold mining companies are classified based on their production level on an annual basis. The classification used in this report is as follows – **A** (major producer – 1Moz p.a. or more),

B (large producer – 0.5-1Moz p.a.), **C** (mid-tier producer – 150 000-500 000oz p.a.), **D** (junior producer – 50 000-150 000oz p.a.) and **E** (micro producer – less than 50 000oz p.a.).

We use the **EV/AISC-Adjusted Annual Production** as a *comparative measure* to evaluate the companies we study. This metric is able to standardise the production and production costs and hence allow for comparison across all classes of producers. The **Enterprise Value** is the sum of the market value of equity (stock price multiplied by number of issued stocks) and net debt (total borrowings less cash and gold bullion, but excluding gold in circuit and ore stockpiles). The **AISC-Adjusted Annual Production** is measure whereby the annual production of gold per oz is divided by the AISC adjusted by a factor of 1 000. The intuition behind this measure is to value the company by taking into account annual production but giving favourable treatment for lower AISC and penalising for higher AISC. The factor of 1 000 is arbitrarily chosen. As an illustration, if a company produces 250 000oz p.a. at AISC of $1 250, the AISC-adjusted production is 200 000.

The **Price Range** determines a reasonable range for which the company stock price should be trading at. This range is relatively wide as it considers the *margin of safety*. A company whose stock price is currently outside the fair value range is significantly over or undervalued and investors should look more deeply into the company's operations, financial performance and recent market announcements. This range should not be taken as the sole driver for investment decisions, but as a starting point for further research to identify the potential causes for the current stock price.

Given the rise in gold price in the recent three months, we see reason to re-rate the gold mining companies' valuation metrics upwards to reflect their improving profitability as well as increased enthusiasm from investors. As a rough guide, the fair value ranges for different mining company classes are as follows:

Major and Large Companies *- $8 000-$11 000/oz*

Mid-Tier Companies *- $3 000-$6 000/oz*

Micro and Junior Companies *- $1 500-$2 500/oz*

The metric is by no means perfect and other factors should be considered including reserve and resource life, projected production volume and costs, management quality and geographic location. Further, it is of a retrospective nature, focusing on past performance and this may not be a good indicator for future performance.

Glossary

The **All-in Sustaining Cost (AISC)** is a measure adopted by the World Gold Council as a standardised measure of production costs. This cost includes typically the **Cash Cost** associated with the direct production (extraction, transportation, processing and refining costs, staff salary and wages and relevant corporate costs) as well as **Sustaining Expenditure** that may include maintenance of mine equipment and infrastructure, insurance and administration costs over its production life. Companies may still have discretion in apportioning their expenses.

The **Net Cash/Debt** is the net amount of cash and bullion the company holds after their borrowings and interest-bearing debt are paid. This represents the liquidity position of the company, although this measure does not consider whether the debt is current (due within the next twelve months) or not. A company in a significant net debt position is owing more than they currently have in cash and bullion, which may potentially put them in financial distress if the debt is due soon.

The **Net Cashflow from Operations Excluding Maintenance Capital Expenditure** measures to what extent the company can generate cashflows from its operations after paying for its operating costs as well as Cash Paid for Purchases of Property, Plant and Equipment and the Cash Paid for Development Expenditure in the Investing Cashflows section of the Statement of Cash Flows. It does not include Cash Paid for Exploration and Evaluation, which is assumed to be growth capital expenditure. This is by no means a stable and comparable measure as different companies may have discretionary interpretation of what constitutes as Operating Activities and Investing Activities or Development, Exploration and Evaluation expenditures.

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