Australian Gold Fund

Performance Report

For Quarter and Year Ending 30th June 2022

Summary

2022 June Fund Performance Statistics				
	Australian Gold Fund	ASX Gold Index (XGD)	Van Eck GDX	Van Eck GDXJ
Quarter Performance	-31.57%	-30.39%	-28.60%	-31.73%
Quarter Volatility (%)	32.67%	35.25%	35.30%	38.85%
12 Month Performance	-25.81%	-23.84%	-18.01%	-30.27%
12 Month Volatility (%)	28.00%	31.26%	28.34%	33.10%
Performance Since Inception	-12.03%	-32.75%	-1.74%	-16.16%
Volatility Since Inception (%)	35.13%	37.35%	43.07%	52.61%
Quarter % Days Outperform XGD	53.03%			
12 Month % Days Outperform	49.43%			
% Days Outperform Since Inception	51.64%			

The Australian Gold Fund finished the June 2022 quarter in line with the gold stock benchmark indices. This was a very difficult quarter due to a broad-based selloff that brought prices to below that in March 2020. Our fund delivered a 31.57% loss for the quarter. The fund outperformed the ASX Gold Index on 53.03% of the trading days during the quarter, which was much better than the previous quarter, despite our fund slightly underperforming the index. This is a reflection of how volatile this industry was during the quarter.

The 2021-2022 financial year ended down for gold stocks in general. The Australian Gold Fund delivered a loss of 25.81%, which is slightly behind the ASX Gold Index that shed 23.84%. The US gold stocks performed only slightly better with the GDX Index losing 18%. The junior counterpart fared the worst, falling more than 30% over the past year.

The June 2022 quarter started off well as there was no meeting in April. Gold stocks extended its bullish run since the bottom in late-January 2022 as inflation accelerated in March. The US CPI data for March came out on 18th April at 8.5%, which brought fears that the Federal Reserve would need to tighten more aggressively. The peak for gold stocks coincided with that announcement. The ASX Gold Index and the GDX Index both rallied 35% from the bottom on 31st January to its peak on 19th April.

What followed was a steep and precipitous decline across the board for gold stocks. The US Federal Reserve raised the Federal Funds Rate by 0.5% which signalled to the markets that it was serious in taking more drastic steps to control inflation. This move is certainly too little too late as central banks around the world had plenty of opportunity to raise rates earlier to reduce its currency supply.

The US CPI data for April came out a week later at 8.4%, signalling to the markets that more aggressive rate rises could come in June. This brought renewed fears into the broader markets. However, gold stocks ended the month gaining back a little bit of ground from the steep retreat after the CPI data release.

Gold stocks tanked in the month of June as the US CPI data for May came out at 8.6%. Fears of inflation spiralling out of control meant that the Federal Reserve to announce a 0.75% rate rise in the following after the CPI announcement. The broader markets were taken by surprise by this rate rise, having only factored in a 0.5% rate rise prior to this. Several central banks

also announced rate rises thus causing a global slowdown. There was a clear flight to safety at this stage.

Another threat that started to appear was the inflationary phase was giving way to deflation. This led to gold falling below US$1,850 an ounce after the Federal Reserve rate rise. It failed to break through this level since, continuing to slide into the end of the quarter. Crude oil, likewise, peaked at US$122 a barrel a week before the rate hike and never regained US$120 a barrel afterwards. It ended the quarter at US$106.

There are signs to suggest that inflation may have peaked in mid-June due to the price of crude oil peaking. However, elevated prices may continue to hit the broader markets.

The fund's composition as at 30th June 2022 is given below:

	% Portfolio by Market Value	Range
Cash	-1.0%	2-10%
Major and Large Producers	5.0%	0-20%
Mid-Tier Producers	33.6%	0-60%
Junior and Micro Producers	16.5%	0-60%
Developers and Explorers	45.4%	0-25%
Precious Metals ETF	0.6%	0-30%

The Australian Gold Fund continued to shift its portfolio more towards the speculative end of the gold stock space, increasing our exposure to developers and explorers to over 45% of our portfolio by market value. We have continued to overweight relative to our mandate as we see a parallel to the gold stock bear market of 2013-14.

Our fund used the ETFS Short NASDAQ Index as a hedge against the declining markets. This was one of the few trading positions that delivered positive returns for our fund during the quarter.

Our Top 5 holdings are given below:

Top 5 Holdings
Kingsgate Consolidated
Oceanagold Gold Corporation
Ramelius Resources
Aeris Resources
ETFS Short NASDAQ Index

Given that inflation may have peaked and deflation is setting in, it is possible that the Federal Reserve and central banks around the world have to contend with the risk of overshooting on their tightening monetary policy. Markets are likely to bounce back should central banks end their rate rises, thus allowing inflation to once again take hold of the financial system.

The fact that gold stocks bore the brunt of the market forces in the past two years suggests that it has hit the bottom. Notwithstanding falling price of gold and/or rising price of crude oil, gold stocks could stage a solid recovery in the second half of 2022. Several gold producers managed to deliver record production for the June 2022 quarter, as restrictions have lifted.

Costs and access to skilled labour continue to threaten the industry, but most companies have sufficient cash to weather the storm for another two or three quarters.

Our outlook for the upcoming quarter is more optimistic, given the June 2022 quarter was the most negative one experienced since March 2020.

Valuation Thesis (Updated 18th April 2021)

We analyse gold producing companies using the **Valuation to Profit Margin Multiple.** Our empirical studies have shown that the stock price is most aligned to this metric, as opposed to earnings, production, resources and reserves. Our metric is comparable across different classes of gold producers as it standardises by the company's scope of production. We observe that investors prefer companies with higher production and reward them with a higher multiple. The multiple combines the valuation metric, which we use the **EV/AISC-Adjusted Production,** and the **Profit Margin**.

The EV/AISC-Adjusted Production calculates the market value of one ounce of gold produced, adjusted by the All-In Sustaining Cost. The reason for scaling production by AISC is because we believe that not all ounces are equal. Companies that can produce gold at lower cost are naturally more profitable and deserve a higher multiple of their production and other operational or financial performance measures. The Profit Margin is the difference between the Realised Sale Price and the AISC.

As a rough guide, the fair value ranges for different mining company classes are as follows:

EV/AISC-Adjusted Production

***Major and Large Companies** – $8 000-$12 000/oz*

***Mid-Tier Companies** - $4 000-$7 000/oz*

***Micro and Junior Companies** - $1 500-$4 000/oz*

Valuation to Profit Margin Multiple

***Major and Large Companies** – 8-12*

***Mid-Tier Companies** – 6-10*

***Micro and Junior Companies** – 3-5*

We believe a multiples method for valuation is more suitable than the typical Discounted Cashflow approach because the latter approach requires projection of cashflows into the future. We consider projection even beyond the next twelve months to be very speculative, especially in mining. We have observed the unreliable nature of management outlook on production and costs after seeing their track record. On top of that, forecasting the gold price and broader economic conditions that impact on the company's performance are also difficult.

We use the following classes for the different tiers of gold producing companies – **A** (major producer – 1Moz p.a. or more), **B** (large producer – 0.5-1Moz p.a.), **C** (mid-tier producer – 150

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000-500 000oz p.a.), **D** (junior producer – 50 000-150 000oz p.a.) and **E** (micro producer – less than 50 000oz p.a.).

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). This calculates the market value of the company's assets deployed in the company's operations. The **AISC-Adjusted Annual Production** calculated as the annual production of gold per oz divided by the AISC adjusted by a factor of 1 000. The factor of 1 000 is arbitrarily chosen as a way to standardise the final metric. As an illustration, if a company produces 250 000oz p.a. at AISC of $1 250, the AISC-adjusted production is 200 000.

We use the management guidance in our valuation input as this is the most objective information to base our estimates. We believe that investors similarly use this information in guiding their analysis and decision making. We recognise taking the management guidance at face value may not always be optimal as they tend to report favourable outlooks and may try to delay bad news. In such cases, we seek to qualify this in our SWOT analysis and adjust it in our Valuation to Profit Margin multiple.

The **Fair Valuation Range** in our reports reflects the price range we consider to be sensible based on the company's performance and the prevailing market conditions. We trade based on this range. We adopt the **margin of safety** approach (refer to Seth Klarman's book of the same title) and hence this range is wider than what typical equity research analysts would use in their reports. Companies trading outside the fair value range are significantly over or undervalued. Investors should look more deeply into the company's operations, financial performance and recent market announcements to determine if the market anticipates a possible re-rating. 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.

We recognise that many analysts consider discretionary forecasts and adjustments on the company's production level, ore grade, cost levels, resources and reserves and economic factors into their valuation. We have studied many of these reports and recognise their merits. However, our view is that such subjective adjustments may not necessarily improve the accuracy of their estimations. This is because with mining companies, both internal and external drivers that affect the company's future performance are unpredictable. Furthermore, we understand that a company have potential to convert their resources and reserves into cashflows in future. Their success is contingent on building the infrastructure, extracting the ore from the ground and processing it in a cost-effective manner. We recognise the criticism by many regarding our approach. We have tried and tested our valuation against the actual price estimates and our investment returns. We let these results speak for themselves.

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.

Disclaimer

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