Australian Gold Fund

Performance Report
For Quarter and Year Ending 31st March 2022

Summary

2022 March Fund Performance Statistics				
	Australian Gold Fund	ASX Gold Index (XGD)	Van Eck GDX	Van Eck GDXJ
Quarter Performance	3.42%	9.99%	19.73%	11.79%
Quarter Volatility (%)	29.65%	36.57%	35.30%	38.85%
12 Month Performance	23.83%	16.62%	20.07%	6.08%
12 Month Volatility (%)	26.98%	30.03%	28.34%	33.10%
Performance Since Inception	28.56%	-3.40%	37.62%	22.81%
Volatility Since Inception (%)	35.26%	37.46%	43.07%	52.61%
Quarter % Days Outperform XGD	46.88%			
12 Month % Days Outperform	49.04%			
% Days Outperform Since Inception	51.34%			

The Australian Gold Fund finished the March 2021 quarter well behind its peer indices due to the divergence in the performance of gold producers and the more speculative developers and explorers. Our fund delivered a 3.42% return for the quarter while competitors delivered between 10-20% higher. The fund outperformed the ASX Gold Index on 46.88% of the trading days during the quarter, which was better than the previous quarter. However, the fund experienced some sharp daily losses that caused the underperformance.

The US gold stocks performed more strongly during this quarter, especially the larger producers that have propelled the Van Eck GDX fund to deliver almost 20% for the quarter. As a result, our fund's performance is now ranked behind the Van Eck GDX fund since our inception, but ahead of the Van Eck GDXJ fund and the ASX Gold Index.

The beginning of 2022 saw gold and gold stocks attempt to stage a breakout in mid-January, which saw massive gains on 20th January when the ASX Gold Index rose by over 7%. This followed straight after by a sharp retreat that brought the ASX Gold Index to lows close to that seen at the end of September 2021.

The subsequent recovery for gold and gold stocks followed as the markets saw that the Federal Reserve was going to follow through with rate rises through the year to deal with accelerating inflation. There was a view that the Federal Reserve would be behind the curve as the inflation rate headed above 7% on a year-on-year basis.

The breakout of a military conflict between Russia and Ukraine at the end of February brought renewed interest in gold as almost every asset retreated within twelve hours after Russia's announcement that it was conducting a 'special military operation'. This cemented gold's status as a suitable 'safe haven' in times of a crisis. Cryptocurrencies such as Bitcoin, once touted to be the replacement for gold, fell alongside the broader market. These risky assets recovered very soon after as the market expected that the conflict would not be too serious and it returned to business as usual trading (even though this expectation regarding the length of the conflict seemed to be incorrect).

Gold peaked in early March as the fears over the Russia-Ukraine conflict threaten to become global as the US and several European Union nations delivered rhetoric about how they would staunchly defend Ukraine. However, the continual rhetoric soon became moral posturing as it was clear that these nations would not escalate the conflict further by sending their own forces into the region to engage Russian forces.

The Federal Reserve delivered its first rate rise in mid-March, increasing the Federal Funds Rate by an anemic 0.25%. This caused the broader markets to rally further, while gold drifted lower and traded just above US$1,900 to close the quarter. Gold stocks followed suit, though the more speculative miners headed down further as the few speculators that remained with them sought value elsewhere.

The fund's composition as at 31st March 2022 is given below:

	% Portfolio by Market Value	Range
Cash	2.1%	2-10%
Major and Large Producers	7.9%	0-20%
Mid-Tier Producers	33.9%	0-60%
Junior and Micro Producers	15.8%	0-60%
Developers and Explorers	37.5%	0-25%
Precious Metals ETF	2.8%	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 37.5% of our portfolio by market value. This is in excess of our normal mandate but we have chosen to tilt heavily on these companies due to our belief that the market is seriously undervaluing these companies.

Our Top 5 holdings are given below:

Top 5 Holdings
Kingsgate Consolidated
Oceanagold Corporation
Ramelius Resources
Evolution Mining
Short NASDAQ ETF

Our expectations going forward are that the looming rate hike cycle from central banks around the world will help gold play a more important role as a "safe haven" asset. Gold mining companies have gone through challenging times in the last two years due to a lack of investor interest, border restrictions and an environment of higher operating costs amidst labour shortages and higher oil prices so they are better positioned to deal with the unfavourable environment. The lifting of border restrictions and the crude oil price remaining at levels around US$80-100 a barrel should provide support to boost this industry, potentially causing investor interest to rise in the coming months.

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 – 150 000-500 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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