Australian Gold Fund

Performance Report

For Quarter and Year Ending 30th September 2022

Summary

2022 September Fund Performance Statistics				
	Australian Gold Fund	ASX Gold Index (XGD)	Van Eck GDX	Van Eck GDXJ
Quarter Performance	0.57%	-5.51%	-11.92%	-7.94%
Quarter Volatility (%)	29.59%	36.10%	35.30%	38.85%
12 Month Performance	-19.72%	-18.57%	-16.73%	-21.73%
12 Month Volatility (%)	29.15%	33.59%	28.34%	33.10%
Performance Since Inception	-11.52%	-36.46%	-13.45%	-22.81%
Volatility Since Inception (%)	34.70%	37.23%	43.07%	52.61%
Quarter % Days Outperform XGD	55.22%			
12 Month % Days Outperform	49.62%			
% Days Outperform Since Inception	51.78%			

The Australian Gold Fund finished the September 2022 quarter outperforming significantly against its peers. This came even as our optimism at the start of the quarter appears misplaced. Our fund delivered a 0.57% gain for the quarter while the peer indices all fell by more than 5% over the same period. The fund outperformed the ASX Gold Index on 55.22% of the trading days during the quarter. Once again, our fund had the lowest volatility over the quarter while delivering the best return.

Since inception, the Australian Gold Fund is down 11.52%, significantly ahead of the ASX Gold Index and the Van Eck GDXJ Index, and slightly ahead of the Van Eck GDX Index. Our fund has a risk profile closer to the GDXJ in the recent 18 months as our exposure to the more speculative end of the mining companies. However, through careful stock selection and using the Global X Ultrashort NASDAQ Hedge ETF, the fund has been able to offset the losses from gold explorers and developers.

The September quarter was characterised by two major selloffs. At the start of the quarter, the ASX Gold Index continued its decline into mid-July as the rising CPI reading in the US led to expectations that the US Federal Reserve would continue to aggressively raise the Federal Funds Rate. At both the scheduled Federal Open Market Committee meetings at the end of July and September, the Federal Funds Rate increased by 0.75%. The Federal Funds Rate ended the quarter at 3-3.25%.

Gold stocks staged a small rally for three weeks into August as no FOMC meeting was scheduled during the month, offering the markets a temporary reprieve. However, during the Jackson Hole Summit, the Federal Reserve renewed its aggressive stance on monetary policy as it recognised it acted too slow on inflation. This sparked a renewed selloff for gold and gold stocks as the US dollar strengthened.

From mid-September, another sharp selloff of gold stocks occurred. This happened over two weeks taking gold stocks to new lows. Gold producers fared better in this retreat, though several mid-tier and junior gold producers fell below levels last seen in mid-July. Gold explorers and developers faced a brutal selloff that saw them hit new lows over the past two years.

A silver lining in this bleak environment for gold and gold stocks during this quarter was that the price of crude oil retreated from over US$110 a barrel to the $80-90 range. This meant the gold-oil ratio improved from 15 to around 20 by the end of the quarter. However, gold producers reported significantly higher operating costs for the September quarter when they released their quarterly reports. Challenging operating conditions will persist for at least two quarters as the price of crude oil is expected to rise in the northern hemisphere winter as well as continued labour shortage brought about by a combination of border restrictions, health mandates and an increasing number of absentees resulting from illness or side effects from the mandated treatments associated with the Wuhan virus and its variants.

Going forward, we expect a delay in the true rally in gold and gold stocks as we believe that the US Federal Reserve is unlikely to reverse its aggressive monetary policy stance while the US CPI reading remains high. Furthermore, we expect that the shortage in petrol and diesel due to the push to decarbonisation will result in a rally in the price of crude oil into the northern hemisphere winter. This could send inflation soaring once more. A combination of accelerating inflation, massive global debt and an aggressive monetary policy could bring about a severe market crash. Only with a market crash do we expect the central banks to all reverse course, since they all have the naïve view that a soft landing for the global economy is possible. We believe that a hard landing is inevitable and it is only a matter of how big this crash will be when it occurs.

Our best scenario is for the US markets to fall 20% from current levels. The worst case scenario is for a 50% decline. However, we believe that while gold will also follow suit with the broader market due to the rising US dollar pushing asset prices down, it will hit a low of US$1,500 an ounce.

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

	% Portfolio by Market Value	Range
Cash	-0.9%	2-10%
Major and Large Producers	7.7%	0-20%
Mid-Tier Producers	17.1%	0-60%
Junior and Micro Producers	20.2%	0-60%
Developers and Explorers	50.9%	0-25%
Precious Metals and Tech ETF	4.9%	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 50% of our portfolio by market value. We have continued to overweight on this category relative to our mandate as we see a parallel to the gold stock bear market of 2013-14. However, we are aware that the recent recovery in gold producers has provided us with a good idea of which companies we will increase our exposure to when gold stocks stage a true rally, conditional on the Federal Reserve reversing course on its monetary policy. The recovery in the recent weeks in gold producers is pointing to how producers are likely to lead the industry when the rally finally arrives.

Our Top 5 holdings are given below:

Top 5 Holdings
Kingsgate Consolidated
Oceanagold Corporation
Red Dirt Metals
Ramelius Resources
ETFS Short NASDAQ Index

At the end of the September quarter, our largest holding continues to be Kingsgate Consolidated. The company has held its ground and even gained due to the company's plan to resume production at the Chatree mine, scheduled to occur early next year. It is also expecting to reach a settlement with the Thai government on damages over the closure of the mine in 2016.

We also retain a large holding of Oceanagold Corporation, which has delisted from the ASX and will trade in its primary listing on the Toronto Stock Exchange.

Red Dirt Metals is our third largest holding as we hold it in high regard thanks to its well-timed purchase of the Mount Ida Gold Project last year that has exceptional gold ore grades. The company has since added value to the deposit with a discovery of a significant lithium resource, announced in October.

We continue to hold a significant stake of Ramelius Resources shares. Even though the company has retreated sharply due to rising costs and capital expenditure spend going forward, it holds a substantial cash reserve and there is significant growth potential.

Finally, we continue to have a substantial exposure to the ETFS Short NASDAQ Index. In light of the weakening economy and exposure of malfeasance in Silicon Valley tech and social media giants that could fall under criminal investigation, we believe that the downside risk for these companies offers us significant gains taking a short position against them. The September quarter saw us earn a sizable trading profit on this position and we continue to see this in the coming quarter.

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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