



## WHY OWN JUNIOR MINING COMPANIES?

**Adrian Douglas**

When observed over a long period of time gold preserves wealth because it maintains its buying power. When you purchase something there is an exchange; you give the seller something in return for the item you are purchasing. For example, if you were to pay directly with gold for a sack of rice then the price in ounces of gold would be determined by how scarce gold is compared to rice. Because gold is very scarce with respect to rice one ounce of gold will buy hundreds of ounces of rice. On the other hand large high quality diamonds are much more scarce than gold so you would have to give several ounces of gold to get one ounce of high quality, large diamonds. The various industries of the world have considerable inertia. One can not suddenly double the production of rice overnight or the production of large, high quality diamonds, or bread, cheese, gasoline or anything else, and neither can the production of gold be doubled overnight. In fact the global production of almost all real things can only be changed by one or two percent each year and likewise the production of gold can only change by one or two percent each year. However, we don't pay for things with gold. Governments around the world have decreed that transactions should use the legal tender that they produce, the so called "fiat money". Now this is where the problem arises because, unlike the real things that you want to purchase, fiat money has no intrinsic mechanism for controlling the speed or magnitude of its production. If you are holding \$1000 in fiat dollars and the Federal Reserve doubles the money supply overnight then shortly there after your \$1000 will buy half as much rice, half as much bread, half as much cheese and so on, as it used to. If on the other hand you were holding one ounce of gold that was valued at \$1000/oz then after the Federal Reserve has doubled the money supply your gold ounce will be worth \$2000. This means you will be able to buy exactly the same amount of rice, bread, cheese or anything else as you could before.

Traditionally gold has been a way to preserve wealth not to become wealthier. The only ways in which the buying power of gold could increase are

- 1) The supply of all real goods, except for that of gold, increases dramatically
- 2) The supply of gold, and not that of other real goods, declines dramatically

Option 1 is impossible because we have already discussed that there is a certain inertia in any industry that prevents output from being significantly increased in a short period of time.

In two recent GATA dispatches entitled “How much imaginary gold has been sold?” I discussed what could essentially bring about option 2.

<http://www.gata.org/node/7908>

<http://www.gata.org/node/7911>

In those articles I looked at the gold market from an inflation point of view and from analysis of trading on the London LBMA OTC market and I infer that there are likely 50,000 tonnes of gold that have been sold that do not exist. This is possible when trading is via unallocated accounts and investors do not ask for delivery but instead trust that the gold is in fact safely in a vault. Once investors demand gold from the OTC and it is discovered that the market is run on a less than 100% reserve basis then the gold price will increase dramatically and it will be nothing to do with the money supply. It will be as if 50,000 tonnes of gold has disappeared...which it will have, except that gold has been priced up until now as if it really did exist. Over the last year investors have come to realize that the scarcest commodities in the world are “honesty” and “trust”. As a result large hedge funds are investing in physical gold, and not paper promises for gold, sovereign nations are asking for repatriation of their gold from New York and London. There are the early signs that we are starting to see the “run on the gold bank”. So if I am right the purchasing power of gold will go up and investors can become wealthier holding gold instead of just preserving their wealth as has been the time honored function of gold.

The way to become much, much wealthier is to have many more ounces of gold (or silver). Your wealth needs to be measured in ounces not in fiat money. How wealthy would you be if you receive 1 trillion Zimbabwe dollars for an ounce of gold? In the great gold bull of the 1970's investors flocked to the senior gold miners. The senior gold miners offered investors a low risk investment because they were established companies with cash flow and profits and large assets in the ground. BUT, and this is very important, these companies were also exploring and finding new reserves at a faster rate than the companies were producing existing assets. This meant that an investor buying a share in a senior mining company would have a fractional ownership of a quantity of ounces in the ground and through exploration the number of ounces would increase. This meant that senior mining companies represented a low risk leverage on the gold price. It was a way to “own” more ounces of gold.

Investors tend to invent their own paradigms and consider that what happened in the past will happen again. The senior miners no longer offer the same low risk leverage to the price of gold. Why? Because they are no longer exploring and finding more ounces. In fact most of them are not replacing their reserves. What makes matters worse is that the reserves are being produced at little or no profit

because the cost of production is close to the market price of gold or silver, courtesy of a price suppression scheme run by a cartel of bullion banks. This is without even discussing the ridiculous practice of hedging whereby many companies have already sold “yet to be produced” ounces at much less than the cost of production, thereby ingeniously locking in a loss for their investors! In short, the senior mining companies are a way for an investor to have a share of a declining amount of ounces! You don’t get more wealthy like that! Imagine you knew of a lumber company that was cutting down the trees in its forest and selling the trees for \$100 each but they had to pay the lumberjack \$100 to cut down each tree and the company was not planting any new trees because it considers that it is too expensive to plant new trees! Would you want to buy some stock in that company? (Call me if you do because I can throw in a couple of bridges in Brooklyn to sweeten the deal!)

	<b>NOV 2004</b> <b>US \$</b>	<b>NOV 2009</b> <b>US \$</b>	<b>CHANGE</b> <b>%</b>
<b>NEM</b>	<b>49</b>	<b>43</b>	<b>-12%</b>
<b>AU</b>	<b>38</b>	<b>38</b>	<b>0%</b>
<b>GFI</b>	<b>14</b>	<b>13</b>	<b>-7%</b>
<b>HMY</b>	<b>12</b>	<b>10</b>	<b>-17%</b>
<b>GOLD</b>	<b>420</b>	<b>1050</b>	<b>150%</b>

**Table 1 Senior Mining Performance vs Gold last 5 years**

In Table 1 the performance of some senior mining companies are shown for the last 5 years. The gold price has increased 150% while the senior mining stocks have gone nowhere.

	<b>NOV 2004</b> <b>US \$</b>	<b>NOV 2009</b> <b>US \$</b>	<b>CHANGE</b> <b>%</b>
<b>SA</b>	<b>3.9</b>	<b>20.3</b>	<b>421%</b>
<b>AEM</b>	<b>16</b>	<b>54</b>	<b>238%</b>
<b>ECU</b>	<b>0.35</b>	<b>0.74</b>	<b>111%</b>
<b>IAG</b>	<b>7.3</b>	<b>13</b>	<b>78%</b>
<b>GRS</b>	<b>5.1</b>	<b>8.3</b>	<b>63%</b>
<b>GOLD</b>	<b>420</b>	<b>1050</b>	<b>150%</b>

**Table 2 Junior Mining Performance vs Gold last 5 years**

Table 2 shows the performance a selection of junior miners that vary in size and their stage of development. (Juniors are all the companies who are not seniors

i.e. mid-tier companies with production and expanding resources, companies that have made discoveries but are not producing, and companies with prospective properties but who have yet to make a discovery). The companies in Table 2 have fared very well compared to the seniors, particularly when one considers that this performance includes the 2008 crash where juniors miners were viciously sold off because without mine production junior miners need to borrow or sell equity to progress their projects. In the panic last year many investors considered these companies would be able to do neither and sold them down to near bankruptcy valuations. The fact that many are now recovering quite quickly shows that the assumptions investors made were false. As fiat money is created out of thin air to prop up a bankrupt financial system the precious metals are rising and the junior mining companies are starting to look more like swans than ugly ducklings and are managing to find sources of funding if they have good prospects!

Investors face the least risk if they buy either gold or silver bullion. Bullion will never have zero purchasing power and in general it will preserve purchasing power, and, under the special set of circumstances that exist today through the inevitable unwinding of the price suppression scheme of the gold cartel, will likely increase in purchasing power.

If an investor is going to take on risk it must be in return for higher potential return. The senior miners do not offer this because they bring all the risks that are associated with stock investing and mining operations but give partial ownership of a depleting resource.

Properly selected junior miners come with risk but that risk can be offset with large potential reward. The risk associated with junior miners can be mitigated through due diligence. If you consider all the junior miners available for consideration of your investment 80-90% can be eliminated by just looking at whether they have any qualified geologist with experience on the management team and whether the management team is comprised of full time employees or not.

Then out of the short list you need to consider if they have land claims that are in good prospective areas, politically stable countries, and located where it is relatively easy to construct a mine. You need to know something about geology to do this or if you don't you need to depend on someone who you trust who is capable of performing the due diligence. Buying junior mining stocks on a tip from a friend or even on chart analysis is not the way to mitigate risk.

The companies in my core holding I have researched thoroughly, I understand the geology, I understand their prospects, I know the management is competent and experienced. This has already proven to be successful in the case of one of the companies that has increased its resources such that I have a partial ownership of 16 times as many 43-101 compliant ounces as when I first bought the stock and furthermore the company is now producing. The share price of the

company doesn't reflect this massive improvement in the asset base or the risk reduction from transitioning from a cash burning explorer to cash generating producer. But I have every confidence that it will and so I don't have to fret about the daily movements of the share price.

Another company in the portfolio has been quietly acquiring highly prospective properties in Chile. On one of these properties a significant gold discovery has been made and even independent third parties are beginning to recognize the potential bonanza the company may be sitting on. While this company represents a higher risk profile if it is successful I will have a partial ownership of a substantial number of ounces of gold in the ground where as currently there are none proven.

By doing thorough research and due diligence it is possible to assemble a portfolio of junior companies with high growth prospects and at various stages of exploration and development and who are run by competent and experienced management teams. A well constructed portfolio of such juniors will be the route to increased wealth which coupled with a significant investment in bullion will ensure at least a substantial wealth preservation strategy.

The simplistic approach of choosing the biggest names in the business, the so called senior mining companies, will not be the key to success. What you can count on is that the seniors will be looking to buy out successful juniors and at good premiums because it will be the only way to replace their reserves quickly and at low risk. This of course will eventually drive up the price of juniors as the large mining companies compete with retail investors to own the successful companies.

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