Eidelman Virant
CAPITAL

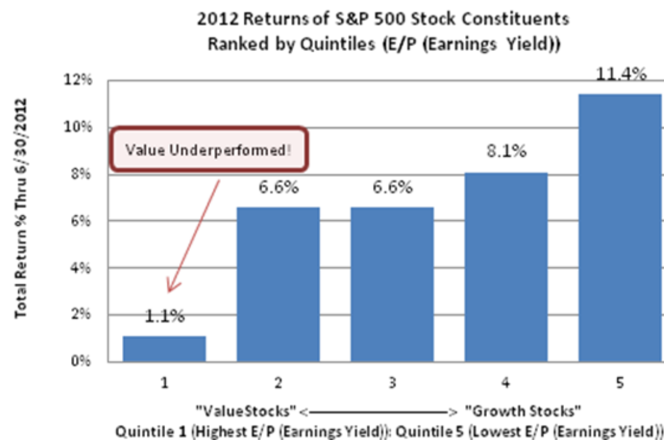
Quarterly Letter June 2012

Dear Clients and Friends,

After a fantastic start, the stock market was quite volatile in the 2nd quarter. Despite the 10% mid-quarter correction, the S&P 500 and Russell 2000 indices are up 9% and 8% respectively for the year. Many of the concerns spooking the market were familiar: European economic woes, China slowdown, and the looming U.S. "fiscal cliff" which refers to the potential economic consequences of the expiring Bush tax cuts and automatic spending cuts left over from the last debt ceiling deal. To top it all off, Facebook shocked investors with dismal post-IPO performance. With all of this news, what do we see for rest of 2012?

We are optimistic for the second half of 2012. Historically, in the second half of Presidential election years, the S&P 500 has been up 81% of the time since 1928 (17 of 21 cases). The stock market's appreciation potential is further bolstered by its low forward S&P 500 P/E ratio of 12x earnings, suggesting that the market could appreciate 25% and still trade at its historical average of 15x. Stocks are particularly attractive relative to bonds, whose paltry yields are exemplified by the 1.5% yield on the 10-year U.S. Treasury bond. Investor skepticism and accommodative Federal Reserve policy could further boost stocks upward momentum throughout the rest of the year.

The key to superior investment performance is great individual stock selection. We are obsessed and constantly improving on discovering what factors contribute to outsized gains. One of the most important factors has been the price paid relative to a company's earnings (the P/E ratio). The P/E ratio is just one of many "value" factors that we evaluate. Our studies show that a portfolio of the 50 stocks in the S&P 500 Index trading at the lowest price/earnings ratios have earned 14.5% annually vs. just 8.0% for the S&P 500 index since 1984. Unfortunately, low P/E investing does not work every year. In fact, for the first six months of this year, the more expensive "growth" stocks are up 11.4% while the cheapest P/E quintile of "value" stocks are up only 1.1% (See Chart below). We are optimistic that "value" stocks will outperform in the future and will be prime beneficiaries in the event the market appreciates in the second half of the year.



Source: Ned Davis

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During the second quarter, we initiated a position in the Market Vectors Gold Miners ETF (Ticker: GDX). This exchange-traded-fund is our preferred way to capitalize on the opportunity we see in gold mining stocks. Given gold's meteoric rise and historically high gold miner valuations, this may come as surprise. However, while gold prices have risen, gold mining stocks have lagged dramatically. The disparity between the price of gold bullion and the price of gold mining stocks has reached levels that we believe imply attractive risk adjusted returns going forward. In the next section, I'll explain why we think it's the gold miners time to shine. For those of you who are concerned about the value of gold itself, I've including a final section on why strong supply, limited demand, and macroeconomic uncertainly will likely keep gold prices high and going higher. We believe strong gold prices will set the stage for a big rebound in gold mining stocks.

While an attractive opportunity alone, our new investment in gold mining stocks also serves as a powerful diversifier in case the Europe, China, and U.S. economies don't recover as we expect. As we've written about numerous times, the bank stocks have been one of our favorite themes given their low price/book ratios and growing returns on capital as real estate, problem loans, and the economy recovers. In a moderate economic growth scenario, we think both financial stocks and gold miners could do very well. Should we see a sharper than expected recovery, the banks could exceed our expectations while the value of gold as an insurance policy may not perform as well. Conversely, should the European financial crisis worsen, bank stocks may disappoint, but gold and gold stocks would likely outperform. It is ideal when our investment ideas can work together to take advantage of different unpredictable events that may occur. This is an example of how we construct portfolios which we believe we have the opportunity to achieve superior returns while minimizing risk.

Thank you for your continued support and confidence.

Sincerely,

Tom Eidelman, CFA
Vice President

A GOLD MINE

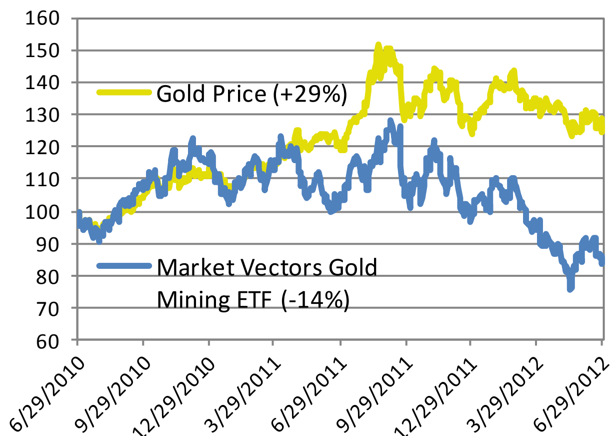
BY TOM EIDELMAN

We think investing in gold mining stocks could be… well… a gold mine. Growing jewelry and investment demand compared to limited supply has led to rising gold prices. Despite having vast reserves in the ground, gold mining stocks have lagged the metal price significantly. Because of this discrepancy, gold stocks now trade at record low valuations versus the metal itself. Even if gold prices decline a bit, gold mining stocks have the potential to generate high returns on capital and pay healthy dividends. Since we believe gold will rise, we expect gold stocks to do even better. Strong gold supply/demand fundamentals, low valuations, negative sentiment could lead to attractive risk-adjusted returns for gold mining stocks.

Strong Fundamentals

Gold mining is a highly profitable business with high barriers to entry. With gold prices rising from $300 to $1,500 an ounce, gold mining profit margins have quadrupled from roughly 11% to 43%. The large producers have captured mining rights, equipment, labor and other assets long before gold appreciated above $1000/oz. In addition, gold's scarcity and 10-year timeframe to build new mines limits competition. Despite rising margins, gold mining stocks have lagged the performance of gold. Over the past 2 years, gold is up 29% while the Market Vectors Gold Miners ETF (GDX) is down 14%. (See Chart A) Going forward, we think this trend will reverse.

Chart A: Gold Stocks Underperformed Gold

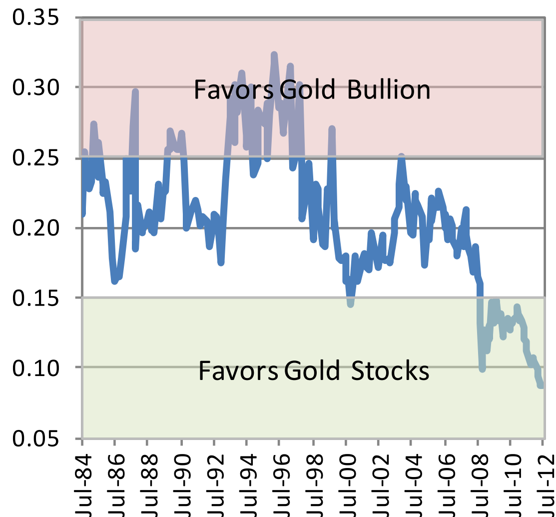


Source: Factset

Gold Stock/Gold Bullion Ratio Favors Miners

Gold stocks underperformance to gold bullion has brought the Gold Stock/Bullion ratio to record low levels. This relationship can best be viewed by looking at the PHLX Gold/Silver Sector Index (XAU) vs. the spot price of gold bullion. Historically, when the XAU index traded below its average of .2x the spot price, the gold stocks appreciated an average of 18% annually. Gold stocks now trade at their lowest levels on record relative to gold bullion (See Chart B below).

Chart B: Favorable Gold Stocks/Bullion Ratio



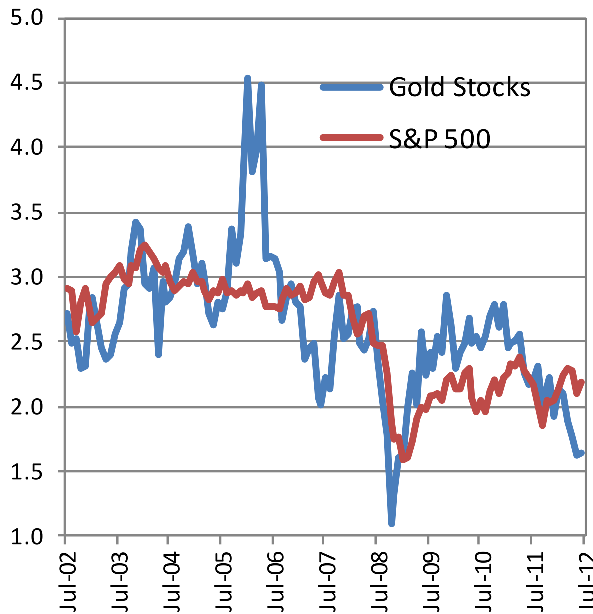
Source: Factset

Gold Miner's Low Valuations

Buying gold mining stocks is a great way to invest in gold at a discount. For example, the largest gold mining stock, Barrick Gold (ABX), has a total of 140 million ounces of proven gold reserves as well as an additional 120 million ounces of indicated and inferred reserves. At a total enterprise value of $45 billion, Barrick's shares trade at just $320/oz of proven reserves and $173/oz of total reserves compared to the current price of gold at $1,500/oz.

Gold mining stocks are also the cheapest they've been in years based on traditional valuation metrics like price/earnings (P/E), price/book (P/B), and dividend yield. Chart C on the next page shows the mining stocks trade at their lowest P/B ratio since 2008 .

Chart C: P/B Ratio of Gold Stocks Near Record Low

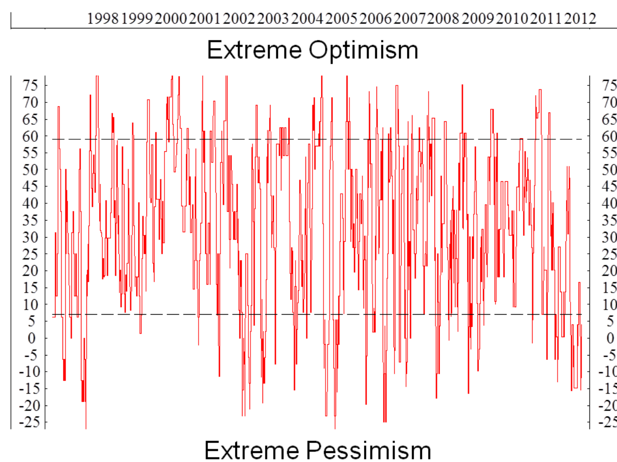


Source: Factset

Sentiment at Extreme Lows May Point to a Bottom

While gold has performed well, investors are still skeptical. Sentiment for both gold and gold stocks are at pessimistic extremes according to Ned Davis's Gold Sentiment composite and the Hulbert Newsletter Gold Sentiment Index. Since 1996, when sentiment was at such extreme levels, subsequent returns on the XAU Gold/Silver mining index averaged 47% annually.

Chart D: Gold Sentiment at Extreme Pessimism



Source: Ned Davis, Hulbert Newsletter Gold Sentiment Index

Debunking the Criticism

Skeptics point to four key reasons why gold stocks have disappointed in the past and may continue lagging in the future. Below I will respond to each:

1. Gold mining stocks were the old way to invest in gold, but now investors prefer investing in gold directly through ETFs .

Response: If the price of gold stays at current levels or even declines a bit, gold mining is still highly profitable. Given their relative undervaluation, gold mining stocks may perform well even if gold prices decline. While some investors will be more comfortable owning the bullion, we think the gold mining stocks offer a better risk-adjusted return profile as well as a dividend.

2. Rising energy prices (a key mining input) will limit profitability.

Response: Energy prices have already declined dramatically. With tepid economic growth and large shale gas and liquids found, energy prices may remain subdued.

3. Dilutive acquisitions are wasting profits.

Response: Mining companies are licking their wounds from overpriced acquisitions and many have learned their lesson. In addition, mining valuations are so low that acquisitions would now be at bargain prices.

4. Gold prices may decline.

Response: Our gold mining stock thesis holds even if gold declines a little bit. Gold mining stocks are highly profitable and historically undervalued to gold bullion even if gold declines to $1000/oz. While we think gold mining stocks have some leeway with respect to the price of gold declining, the value of gold is critical to the gold mining stocks. For this reason, the next section is devoted to explaining why we think gold prices will remain near current levels or even go higher.

Conclusion

Due to strong fundamentals, low valuations relative to the price of gold, negative sentiment, and a positive environment for gold, we think the gold stocks represent a great value opportunity in the market today. We think an effective way to take advantage of the opportunity is through investing in the Market Vectors Gold Mining ETF (GDX); which is a diversified group of gold mining stocks with gold reserves all over the world. We think it's the gold stocks time to shine.

POSITIVE ON GOLD

In addition to articulating why the gold mining stocks are the best way to play gold going forward, we need to explain the current supply, demand, and macroeconomic dynamics that have led to the price rise in gold and why we think gold may continue upward.

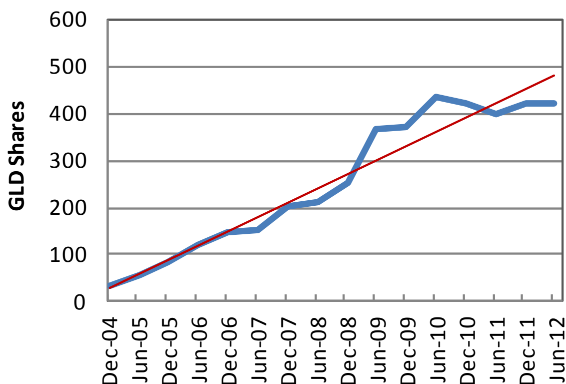
Robust Indian Jewelry Demand

"No gold, no wedding," is a saying in India, indicating the importance of gold to Indian culture and tradition. India is the largest consumer of gold in the world and half of the gold bought in India is jewelry bought for a wedding. In fact, gold serves as financial security for a bride as she enters a wedding and is controlled by her throughout the marriage. On February 21st, 2012, *60 Minutes* did a segment entitled: "India's Love Affair With Gold" where Bryan Pitts interviewed two wedding planners who espoused the importance of gold as a symbol of a family's wealth and prosperity. As India's economy and standard of living grows, wedding and gold demand will likely continue growing as well.

Growing Investment Demand

Investment demand for gold continues to be high for individuals, institutions, and central banks. Since 2004, the SPDR Gold Trust ETF (GLD) has grown to over $60 billion in assets and grown its share count 40% annually (See Chart E below). Gold ETFs are now estimated to be the 6th largest holder of gold ahead of the central bank of China. Central banks in Korea, Russia, and Mexico have also been net buyers of gold. In fact, while the U.S., Germany, and France have over 70% of their foreign reserves in gold, India and China only have 9.2% and 1.6% of their foreign reserves in gold respectively. Central banks may continue to be big buyers of gold to diversify away from the dollar and euro.

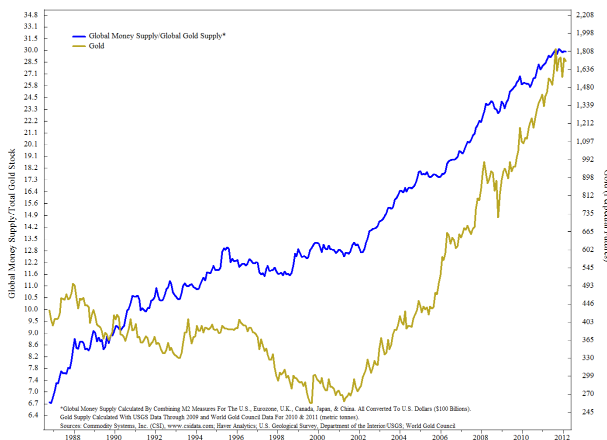
Chart E: SPDR Gold Shares ETF Share Growth



Limited Supply

Aging mines and lack of new discoveries has limited total gold supply to a 1.5% increase per year. In contrast, the world money supply (M2) has grown 10% compounded over the past 10 years as countries have used easy monetary policy to combat economic slowdowns. The ratio between the supply of money and gold is a key reason for gold's price ascent. Since 1987, the supply of money/gold has increased 4.5x while the price of gold has increased 3.7x. In fact, Chart F shows that if the supply of money/gold remained constant, gold should trade at $1,800 /oz. As developed governments continue to expand the money supply, we think the limited supply of gold will drive prices higher.

Chart F: Global Money Supply/Gold Supply



Source: Ned Davis

Gold Valuable as Disaster Insurance

After the financial crisis of 2008, it is my view that the role of gold as an investment has fundamentally changed. Thought by many to be a barbaric relic, gold proved to provide resilient capital protection during the worst of times. For this reason, gold is now viewed as a hedge against a sovereign, monetary, or banking crisis. In a world where financial assets are mistrusted and governments are printing money, gold is relied upon as a currency that can't be printed.

Is Gold a Bubble? Not Likely.

Gold skeptics often claim that since gold has no cash flow or rational productive use, gold has no real value. With no cash flow yields to rely upon and soaring prices, many say gold is experiencing a speculative bubble. I respectfully disagree. There are a number of rational ways to triangulate the value of gold and even a couple of fun rules of thumb for good measure.

Marginal Cost of Production Plus Profit - $1,100/oz - The most economically rational way to value a commodity is to look at the cost to produce it and add some reasonable economic profit. Morningstar and Newmont Mining estimate the marginal cost of production at roughly $1,100, and $900 respectively.

Relative to Money Supply - $1800/oz – Another way to value gold is to compare the ratio of total money supply to total gold supply. Using an average 1990's price and adjusting for the increase in global money supply would imply a current $1,800 price of gold (See Chart F on previous page).

Relative to Other Commodities - $1,200/oz value - Gold looks reasonable compared with other commodities. Since 1900, an ounce of gold has on average purchased 50 times as much silver, 340 times as much copper, and 13.4 barrels of oil. If those ratios were constant today, gold's price would be $1,350, $1,150, and $1,140 respectively.

Fun Rules of Thumb - $1,150/oz value – More informally, there are a couple of old rules-of-thumb to value gold. One standard is that an ounce of gold should purchase a nice tailored gentleman's suit. A trip to Bloomingdales showed them offering a Burberry navy suit for $1,195. In Babylonian times, it was said that an ounce of gold bought 350 loaves of bread. I walked down the street to Companion bakery in Clayton and saw them selling a simple baguette for $3.15, which suggests a fair price for gold of about $1,100/oz.

All of these methods imply a gold value higher than $1,000 per ounce, which is the level by which gold miners are highly profitable and gold stocks remain attractive relative to the metal price. Having said that, we believe the fundamental supply/demand situation, easy global monetary policies, and risks around the world we've outlined on the previous page support gold prices increasing further.

Summary

With growing demand from Indian consumers and central banks combined with the limited supply, we think the value of gold will go higher. Gold's recent behavior as a disaster hedge further boosts its value and should keep prices higher during soft demand periods.
While we view gold as a reasonable investment, we think it's the gold mining stocks time to shine. Gold mining stocks currently trade at big discounts to their reserve values and at record lows relative to gold bullion. The bottom line is that we like gold, but we like gold stocks even better.

Disclosure: Past performance is not indicative of future results. This newsletter is for informational purposes only and does not constitute a complete description of our investment advisory services. Our clients do have a long position in the Market Vectors Gold Miner's Index (GDX). Barrick Gold (ABX) is the largest stock position in the GDX ETF. This newsletter is in no way a recommendation of any security or a solicitation or offer to sell investment advisory services. This newsletter should not be construed as advice to buy or sell any particular security.