Week of June 24, 2013

Analysts' Ideas of the Week – Gold's Free Fall

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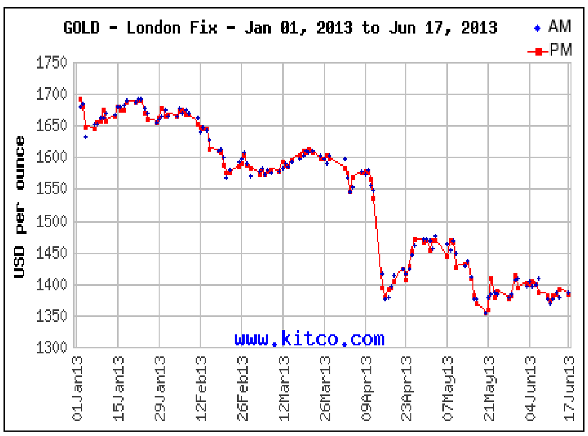
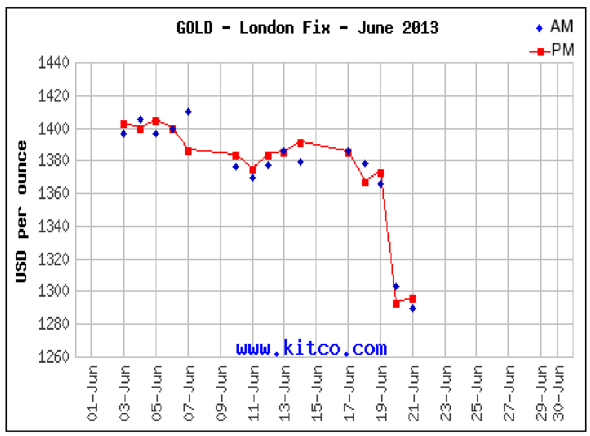
Gold's Free Fall

Gold's drop to below $1,300 per oz was the first time in over 30 months. Gold has dropped 24% year-to-date (YTD). The charts below show YTD prices and the sharp fall last week.





I have never been a believer of gold at $1,500+ per ounce levels. Gold as an investment generates zero cash flows; also, there is a cost associated with storing gold. However, it is the best hedge against the US$ and inflation. Gold works very well when the rest of the world performs better than the U.S., and poorly when the U.S. does better than the rest of the world. During global recessions, and uncertainty, investors tend to move to the US$, and not gold, as a safe haven. A good example of this behavior is 2008. Gold was down 20%+ in 2008, as investors flocked to the US$.

With a lot of good news coming out of the U.S., and not so good news from China and Europe, I think the market reacted properly by pulling gold down. The primary reason for the sharp drop was the Fed's decision to lower its debt buying program, and potentially end it in 2014. So far, the massive bond buying, or the 'money printing' program', has failed to spur inflation. The Fed, in fact, doest not see inflation as a concern at all. The Fed expects inflation to be just 0.8% - 1.2% in 2013.

At $1,200 - $1,300 per oz, I think gold has reached its right price level. Although we might see further drop in the next few months from a possible market overreaction, I think any drop should be temporary. The key reasons why I believe a price point of $1,200 - $1,300 per oz is right for gold are the following:

- The operating costs of miners is currently at $700 - $1,000 per oz; although miners are expected to cut their operating costs, gold has to stay over $1,200 per oz for mines to generate reasonable profits. Remember, miners can easily cut their production if gold drops further; which will impact global supply, and stop gold from going down further.
- Inflation has not increased with the massive money printing program primarily because of high unemployment, and the extremely slow recovery in the U.S. However, I expect inflation will kick in with the continuing improvement in the job market, and economic growth. The Fed expects the unemployment rate to fall to 7.2% - 7.3% by the end of the year, down from the current rate of 7.6%. The US housing market has also been showing strong signs of improvement. All the above, and the extremely low interest rate environment (which is likely to be case for another 12 -18 months), are highly conducive for inflation.

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Refractory vs. Non-Refractory Gold Ore

There are two common types of gold bearing ores: refractory and non-refractory. What many do not know are the differences between the two, and what this means for processing and costs. Historically, gold mines extracted non-refractory ore, these are rocks that contain “free” gold typically within (or associated with) veining structures. Free gold means that the gold atoms are not locked within the crystal structure of the associated minerals. When companies refer to “visible gold” in drill core or grab samples, they are seeing free gold. Gold from these deposits is relativity easy to extract, typically using a gravity and cyanide leach circuit, or heap leaching process.

As gold deposits are discovered, and exploited, the easy to find, mine, and process deposits, are getting used up. This has caused a greater number of refractory gold deposits to be explored and brought online. Refractory ore means that the gold is "trapped" within the crystal structure of the associated minerals, such as pyrite. This means that when the ore is treated, the leach solutions cannot come in contact with the gold atoms, so recoveries are significantly lower.

Something to keep in mind when reading through a company's material is the metallurgical testing and whether the ore is refractory or not. Refractory ore is not necessarily a bad thing. However, it does mean that there could be additional initial capital costs to the mining project as additional equipment is needed to fully realize the maximum gold recoveries from refractory ores.

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How to Benefit From Increased Market Volatility.

The anticipated end to quantitative easing (QE), and rising interest rates, has led to considerable uncertainty and fear in the markets. In a conference call on June 20, 2013, Ben Bernanke said quantitative easing could slow later this year and come to an end as early as mid-2014. The Federal Reserve has maintained that interest rates will likely increase once the unemployment rate hits 6.5%; as of May 2013, it was at 7.6%, and is anticipated to hit 6.5% by 2015, at the current rate of job creation. These two factors affect all aspects of the markets, and we anticipate that as investors try to gauge the impact of these changes, there will be considerable volatility in the short to medium term. In anticipation of this, we feel that the CME Group Inc (NASDAQ:CME), the world's leading derivatives market place, is a way to capitalize on increased volatility in the market.

The CME Group operates the worlds' largest derivatives marketplace, as well as the Dow Jones. They offer trading in futures and options contracts that allows investors and companies the ability to manage risk. Contracts are available on interest rates, commodity prices, and currencies. A majority of CME's revenue comes from clearing and transaction fees on the contracts traded. Year to date (YTD), there have been 1.16 billion contracts traded electronically on CME group products. Derivatives have become increasingly popular to manage risk as displayed by increased volume, and consistently setting transaction records after Federal Reserve announcements.

On May 29, after the Boston Federal reserve announced that they could begin tapering quantitative easing this year, the CME set a record single day trading volume. *The May 29 record volume day was larger than previous* *market-moving days such as Aug 4-10, 2011 (US Debt Downgrade), May 6, 2010 (Flash Crash), or September 16-17, 2008 (Lehman Brothers bankruptcy (Source: CME).* Electronic Transaction volumes on CME group products in the month of May were up 13.7% over May 2012.

Following the Federal Reserve announcement on Wednesday June 19, where they maintained their previous guidance, trading on the CME again set records. There were a record number of option contracts on the S&P 500, and Treasury rate contracts written; interest rate swaps also set a record with a notional value of $114 billion being trading, exceeding the old record of $96 billion.

Year to date trading on the CME is up 8.2% over 2012 on electronically traded CME group products. Floor trading of CME products has been decreasing, due to the shift to electronic trading, but it makes up a less than 10% of CME volume. There were 95.5 million contracts traded on exchange floors YTD 2013, compared to 1.16 billion YTD trades electronically.

In addition to the increased volume from volatility, we feel that the CME has a strong position as the market leader in its industry. Although it trades at a premium (P/E of nearly 30), there is little competition for derivatives trading. We also feel that the access to derivatives provided by electronic trading will increase volume to the CME.

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Independent Film as An Asset Class

The film business as a whole has been profitable for the past hundred years, even during economic downturns, and it is still growing. Cinema even today, in spite of the presence of all other competing diversions, is approaching $100 billion a year in global revenues in terms of spending across all distribution media.

Although about 80% of film business revenue lies in the hands of the Hollywood studios, since the late 1960s, there has also been a sector of “independent” or “indies” (existing outside of the studio system). that has expanded with specialized market niches with smaller budget movies that require lower advertising expenses. These independent films have become large mass-market hits in their own right, potentially generating high returns on investment. In 2007, the last year that the Hollywood studios released data on their combined production and marketing expenditure, it had been recorded that $11 billion was channeled in to producing and releasing independent films. Given the many risks cited in association with film investments, that is a considerable allocation of capital.

Provided certain conditions are met, independent films represent a way for individual investors to capitalize on the entertainment and movie industry; as the Hollywood studios are not in the habit of sharing their profit with private investors, and they will partner with large financial institutions, and major investment funds, in order to fund their financing requirements. Consequently, the only way to indirectly own a piece of a blockbuster franchise is through buying shares in the parent company. One way to participate in these types of investment is through independent films. Independent projects are financed outside the major studio system. These films are an asset class that has a low correlation with the equity/bond markets, and have been showing a recession resilient history of film returns.

However, more than 95% of independently financed films never go on to be seen in theatres, meaning that the large majority have a hard time making back their investment. Success therefore depends on determining which independent films have the highest probability of achieving distribution, as many hundreds of movies are completed each year, and never distributed. Investors should invest in production companies that have a track record of working with packaging and sales agents who validate these projects' potential in the marketplace even before a dollar is spent.

Some of the exit strategies in the film do not even involve waiting until a film is released in theaters. In such cases, a film starts generating an income from its distribution, and as a result, everyone in that film earns a theoretical profit before the film has begun its commercial life; this return of capital eliminates the investor's exposure to performance risk. As an example, typically, an exhibitor that operates a movie theaters retains about 60% of all ticket sales revenue. Of the remaining 40%, first the distribution company will collect a distribution fee, as well as print and advertisement expenses. Second, depending on the agreements, residual payments and talent participations will be paid. At the next stage, financiers and investors start to receive their money back.

As a result, independent film projects as lower-budgeted movies, not only are cheaper than Hollywood movies to invest in, but also they can offer investors high-yielding assets with more logical and faster recoupment position. At FRC, we are currently conducting due diligence on a number of film funds, which will offer investors a way to gain exposure to the sector.

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