

Gold Stock Valuations 5

Way back in late 2000, only the very hardest-core contrarians even considered investing in gold stocks. This sector was all but obliterated after a multi-decade bear in gold. Its flagship HUI gold-stock index was languishing in the 40s, while the headline S&P 500 still traded in the 1400s. Most investors didn't even know the tiny gold-mining sector even existed.

Those few willing to deploy capital into such a wasteland needed to have very good reasons for making such seemingly hopeless bets. One of the arguments we used to buy gold stocks back then was as a counterpoint to the newly-born secular stock bear. Since general stocks were likely doomed to poor performance for over a decade to come due to their [excessive valuations](#), why not buy gold stocks?

Time has clearly vindicated us early contrarians in this decision. From its 2000 close to its worst levels a few weeks ago, the S&P 500 fell 48.8%. Meanwhile over this exact same span, which is actually quite *unfavorable* for the HUI, it still soared 573.2%! Emerging from utter despair, gold stocks have indeed become one of the best-performing sectors of this entire decade.

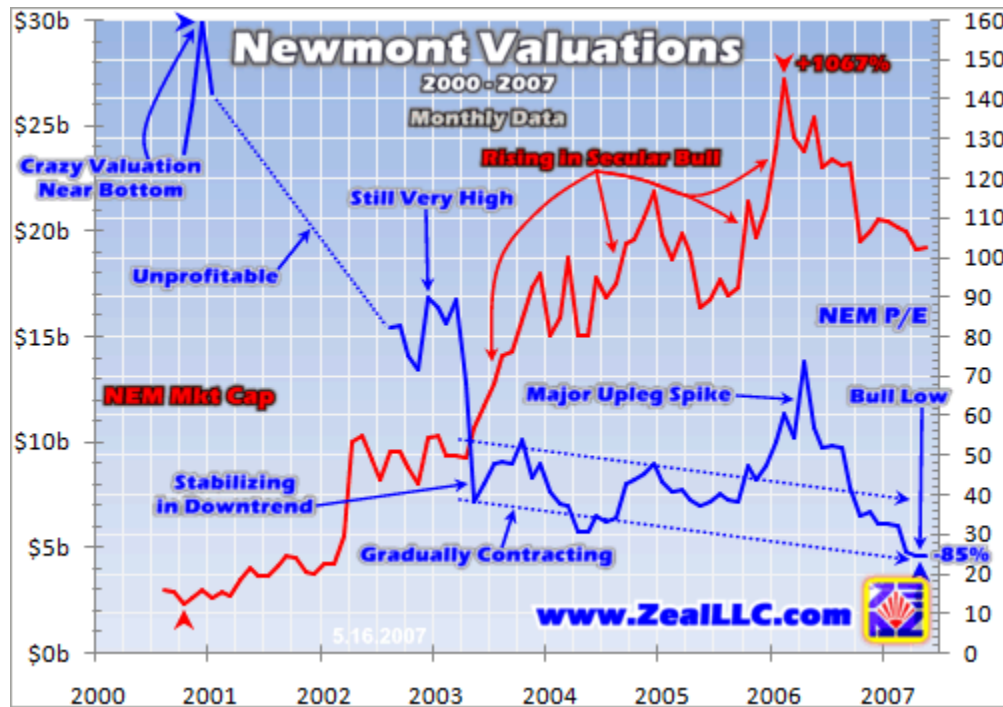
While excessive general-stock valuations certainly weren't the only, or even the primary, reason to buy gold stocks when no one else wanted to, this thesis still generated a lot of controversy in the early 2000s. Astute investors rightfully pointed out that the valuations on the gold stocks were often *higher* than those of the tech-stock bubble we were betting against. Was a gold stock trading at 150x earnings a better investment than a tech stock "merely" trading at 75x?

Many called us hypocrites, as we were railing about the imploding tech-stock bubble (an unsustainable valuation anomaly) yet simultaneously buying gold stocks with little or no earnings of their own. But we weren't ignoring the ludicrous gold-stock valuations, we were anticipating their future earnings potential. As the expected secular *gold* bull gradually gained steam, we expected gold-mining earnings to grow at a faster pace than gold-stock prices climbed. This would gradually collapse their high P/E ratios.

Since I was not only deploying my own capital in the battered-down gold stocks, but advancing this gold-stock-valuation-contraction thesis publicly, I started a thread of research on gold-stock valuations. I needed to understand if this was indeed happening as expected. As gold-stock prices marched higher since the early 2000s, was their earnings growth indeed outpacing their stock-price gains? Were their early outrageous valuations indeed contracting?

Initially in this research, we used the world's largest gold miner (Newmont Mining at the time) as a proxy for this sector as a whole. Newmont, then and now, was the only primary gold miner included in the S&P 500. We were doing a ton of

general-stock-market [valuation work](#) so we had monthly valuation data on every S&P 500 component including Newmont. Here is a chart of this data from [the 4th essay](#) of this series.



Newmont Mining, the world's premier gold miner over most of this span, was indeed following the model. It traded as high as *160x earnings* in late 2000 when it could barely eke out any profits in the brutal \$260s gold environment. And then it was unprofitable for the next year and a half, so it had no P/E. But when it started producing profitably again in mid-2002, its P/E had been cut in half to 80x. And since then, NEM's valuation has continued to gradually contract on balance.

While I don't want to spend too much time on this old chart today, the key point is Newmont's market capitalization soared 1067% at best while its P/E ratio simultaneously *fell* 85%. You need to have *brehtaking* earnings growth to support a greater-than 5/6ths plunge in a company's valuation at the same time its market cap multiplies by an order of magnitude. The thesis was unfolding as I had expected!

While this research proved that gold-stock earnings growth was far-outpacing stock-price appreciation, so valuations were becoming more reasonable, I was never quite comfortable with it. It is never optimal to use one stock as a proxy for an entire sector. There are too many company-specific developments that affect its earnings and stock price that don't affect its peers', which dilutes its representative usefulness.

In Newmont's case, it issued great quantities of new stock to expand. Barrick Gold usurped its place as the world's largest gold miner. NEM has also faced serious operational challenges over the last couple years, hurting profits. While I am still satisfied with my long-term investment in Newmont I made in March 2002, it has fallen out of favor among gold-stock investors in recent years. I have no doubt this perception will reverse, they usually do, but it still highlights the danger of using any single company as a sector proxy.

So back in late 2006, at Zeal we started collecting valuation data for the entire HUI. The HUI is not only the world's flagship gold-stock index, but its 15 component companies vary greatly by size, operations, locations of mines, and a myriad of other factors. Thus the HUI is a superior and *diversified* representation of this sector, unlike any single company. Last month my business partner Scott Wright wrote a fantastic essay briefly surveying each of the HUI's [component companies](#). Read it if you'd like to better understand this index's impressive fundamental breadth.

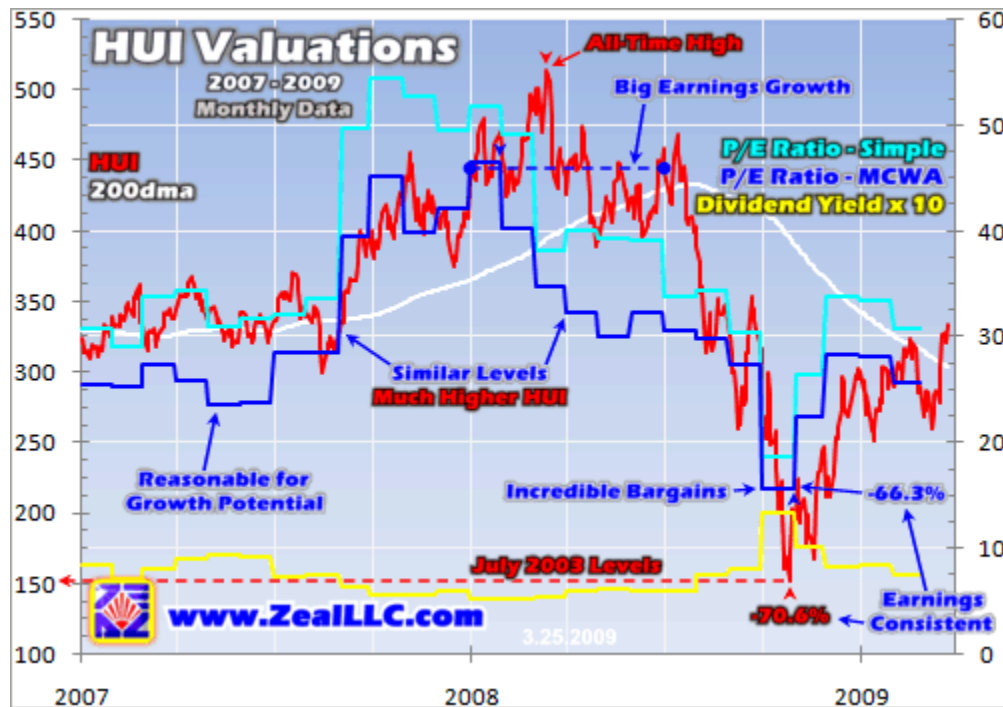
Unfortunately building a new dataset takes time. For an obscure sector like gold stocks, most of this data can only be secured in real-time the day it happens. After that it is lost forever. Data companies only tend to save data there is considerable demand for, so to the best of my knowledge you can't even buy historical HUI valuation data. No one cares even now, despite this being one of this decade's best-performing sectors. Which suggests this gold-stock stealth bull has a long way higher to run yet!

Like our famous general-stock-market valuation data (charted on our website for subscribers), we have been compiling the HUI valuation data at the end of every month. We look at the P/E ratios and dividend yields of each individual HUI component in order to compute these key valuation metrics for this index as a whole. We do both simple averages of these metrics as well as market-capitalization-weighted averages.

I have long thought this MCWA approach is superior for valuation work. Imagine an index of 2 stocks. One trades at a P/E ratio of 100x while the other is sporting a 10x multiple. Their simple average is 55x earnings. But if one company is way bigger than the other, this number is skewed. If the 10x company is worth \$20b, but the 100x company only has a \$1b market cap, then the larger company should have proportionally more influence than the smaller one. After all, investors have much more capital at stake in it!

So by weighting valuation metrics by the market capitalizations of individual index components, I believe we get a much sounder view of gold-stock valuations over the long term. And since the HUI is such a small index, just 15 stocks compared to the S&P 500's 500 stocks, this MCWA approach also helps reduce the overall valuation impact of the sometimes wildly-fluctuating earnings results of the smaller gold miners.

After more than 2 years of painstakingly collecting HUI valuation data each month, here is the first chart of it. I've been excited to see this for a long time. As we continue to add to this dataset going forward, it will allow for superior gold-stock-valuation analysis. And you really could not ask for a wilder period of time in HUI terms to analyze from a valuation perspective. This sector has been crazy-volatile.



After hitting an all-time high in March 2008, a staggering 1331% run from the HUI's bear low of November 2000, this index was ultimately driven to plunge 70.6% by October 2008 in the stock panic. Since those dismal lows, its initial recovery has already surged 120.5% higher by this week. While gold stock valuations are gradually contracting, this is still an extremely volatile sector not for the faint of heart.

But despite this short span of time, and the [once-in-a-lifetime](#) stock panic that drove such wild anomalies, there are still some interesting HUI valuation observations. For example, in the first two quarters of 2007 the HUI averaged 335 on close and its MCWA P/E (all P/Es I use from now on will be MCWA, although both it and simple are shown in this chart) averaged 25.3x earnings. 25x is really quite reasonable.

Mainstream stock investors usually have no problem paying 20x to 30x earnings for stocks with outstanding potential for profits growth. And the gold stocks certainly have this due to the [secular gold bull](#) and their impressive [profits leverage](#) inherent with higher gold prices. To see the elite gold stocks of the HUI

trading in the mid-20s in P/E ratio terms is incredible, it totally vindicates those of us who bought at far higher valuations yet far lower stock prices in the early 2000s.

In Q3 2007, the HUI started powering higher in another upleg. Valuations initially shot up with stock prices, as earnings are always slower to change than stock prices and they are only reported quarterly for any given stock. But gradually the higher gold prices translated into higher earnings as expected, dropping gold-stock valuations. By the end of Q1 2008 the HUI was near the 450s compared to the 400s at the end of Q3 2007. Yet its valuations remained at similar levels, gold stocks were growing earnings.

During the first half of 2008 (before the bond and stock panics started), the HUI averaged 443 on close. It generally consolidated sideways over this span while the general stock markets ground lower in a [strengthening bear](#). Yet despite gold-stock prices remaining high, the HUI valuation shrunk considerably. Trading at 46.6x earnings in January, by July the HUI's P/E had contracted to 30.7x. This is a microcosm episode of the secular trend of outsized earnings growth evident in Newmont in the first chart.

Of course the stock panic (and the preceding bond panic which [indirectly hit gold](#) and hence gold stocks) in the second half of last year cast all the financial markets into unbelievable disarray. The gold-stock investors, once so brave, panicked too. By late October thanks to the HUI's plunge, it was trading at an incredible 15.7x earnings! To give you an idea of how cheap this is, the S&P 500 was trading at 13.9x right then. Gold stocks were almost as cheap in pure valuation terms as the general stock markets!

Such events almost never happen in high-potential speculative sectors, so the bargains in gold stocks were obviously immense. In late October we started aggressively buying gold stocks and silver stocks and recommended our [subscription newsletter](#) subscribers do the same. We not only added short-term trades, but our first long-term investments in gold stocks in years. As of this week, our new long-term investments in this sector are up an average of 91.6% *since late October*.

Since then, the HUI has recovered back up to early-2007 levels and the latest valuation read we computed at the end of February is running at 25.7x earnings. While this is reasonable, I don't expect this situation to persist. Odds are high that HUI valuations will fall considerably soon after Q1 earnings are reported. This will make gold stocks even more attractive to investors than they are today.

Back in Q1 2007 when the HUI last traded consistently at today's levels, gold averaged \$649 on close. But so far in Q1 2009 it is averaging \$909, 40.0% higher! So gold miners are going to have much higher revenue this quarter, and thus far higher profits, than they did back in early 2007. Further magnifying this

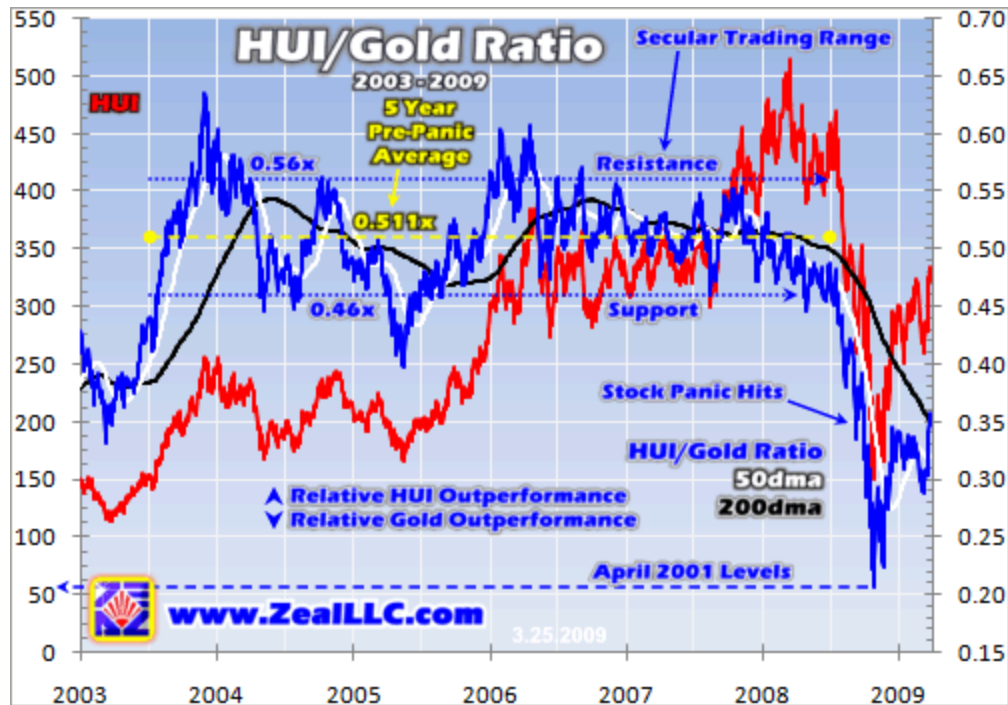
effect, the average oil price this quarter is running 26.6% cheaper than it did back then. Thus many of gold miners' big energy costs of mining will be lower this quarter, resulting in even higher operating profits.

So unlike most other sectors in the stock markets that are looking at slow earnings in this first post-panic quarter, gold miners are likely to announce excellent profits. This should garner a lot of attention and increase investor interest in this high-potential sector. And since gold's own future looks so dazzlingly bullish for [many fundamental reasons](#), this trend should only accelerate. I fully expect the next update on this thread of research to show HUI profits growing nicely on balance.

In addition, many of the world's biggest and best gold miners have been gradually transitioning from old to new mines over the last few years. This drove much higher costs (hence lower profits) for miners on a couple fronts. First, as old mines are depleted their costs are spread over fewer ounces of gold. Second, as new mines are brought online, their initial production gradually ramps up which results in costs spread over fewer ounces as well. So when the old mines are fully retired and the new ones fully up to speed, this industry's profits should increase markedly.

Conventional valuation analysis like this is critically important for all long-term stock investors to study. After all, it was looking at market P/E ratios that warned contrarians way back [in 2000 and 2001](#) that a devastating *secular* stock bear had been born. And with the stock markets likely to trade sideways [for 17 years](#) after 2000, alternative investments [like commodities](#) were the place to be. Valuation analysis has made fortunes for us and our subscribers, and I will always keep studying it.

But as I've pondered the specific case of gold-stock valuations in recent years, I'm gradually becoming convinced an unconventional approach is more useful than the classic P/E ratio approach. Rather than looking at earnings themselves, why not look at the one thing that drives gold-stock earnings? The price of gold, of course! Thus the HUI/Gold Ratio, the HUI index level divided by the gold price, has proven much more useful for gold-stock trading decisions than P/E ratio analysis.



It was [this HGR chart](#), not the low P/E ratios, that led me to aggressively buy and recommend gold stocks in late October when most traders and analysts were running for the exits in terror. In the 5 years prior to the stock panic, the HGR had traded in a tight secular range between 0.46x and 0.56x. Note above that each time after the HGR neared or pierced support of 0.46x, tradable HUI rallies soon emerged. Some of these were very large and massively profitable.

Traders buying gold stocks whenever the HGR neared its support, and tightening stops when it neared resistance, were rewarded with outstandingly profitable gold-stock investments and speculations. And there is a real fundamental basis for this relationship since gold-stock prices are ultimately driven by mining profits, which in turn are ultimately driven by the price of gold. Gold stocks' innate ability to leverage a gold bull is the very reason people invest in them in the first place.

The HGR's 5-year pre-panic average was 0.511x, meaning the HUI averaged just over *half* the price of gold. To think of this in valuation terms, this 0.5x number is essentially "fair value". When the HUI was trading well over it gold stocks were getting ahead of themselves, temporarily overbought. But when the HUI fell well under it, they were lagging gold and not yet reflecting their true earnings potential.

And then 2008's epic stock panic arrived, shattering this secular trading range like it did so many other longstanding relationships. Both gold and the HUI fell in the heart of the panic as the fear bubble climaxed, but the HUI plunged faster and farther than gold. This meant gold outperformed the HUI, which of course

drove the HGR lower. You can see the resulting deep anomaly on this chart, as the HGR was driven to unthinkably low levels in the depths of the panic.

It was this absurd HGR that led me to buy gold stocks in late October. The HUI was trading at the same place it was when gold was in the \$350s, yet gold's *worst* close of the entire panic was *over twice as high*. Even if gold had never recovered, it made no sense at all for gold stocks to be discounting \$350 gold when the metal itself was in the low \$700s. The HGR proved a much more powerful valuation proxy than classical valuation analysis!

So while I am excited to see how the true HUI P/E ratio valuations play out in the coming years, I think that looking at the HUI's levels relative to its primary driver gold also has great "valuation" merit. Odds are the HUI will gradually return to its historical relationship with gold, which means gold-stock prices are far too cheap even today. Eventually they *will* reflect today's gold price, since it drives their profits.

At Zeal we'll continue our decade-long quest to really understand gold stocks, and what drives them, at a deep level. Knowledge is power, and as always in the financial markets the biggest profits over the long term will accrue to those who are the most diligent in seeking understanding. Yet you can share in the valuable fruits of our research for an infinitesimal fraction of the costs we bear. [Subscribe today](#) to our acclaimed [monthly newsletter](#)!

We also just finished a deep 3-month study of the universe of junior gold stocks. These small explorers are the riskiest stocks of the gold realm, many will totally fail but a few will achieve dazzling success and earn fortunes for their owners. We painstakingly whittled down the multitudes of junior golds to our 12 favorites, those we believe have the best prospects for success for fundamental reasons. And we just published a comprehensive new 25-page [report](#) profiling each of these elite companies. [Buy it today!](#)

The bottom line is gold-stock valuations are indeed gradually contracting on balance, just as we contrarians expected back in the early 2000s. The secular gold bull is driving such large profits increases for the gold-mining sector that valuations have plunged despite radically higher gold-stock prices. As gold powers higher, this trend should continue. Gold stocks' future earnings potential in a gold bull is vast.

In addition gold stocks are not only reasonable today in P/E terms, but very cheap relative to prevailing gold prices. Sooner or later this residual stock-panic discount will totally vanish. Ultimately over the long term, all stock prices gravitate to their underlying companies' earnings. And since the gold price controls the gold miners' future profits, their stocks will continue to follow and leverage gold as always.

Adam Hamilton, CPA

March 27, 2009

So how can you profit from this information? We publish an acclaimed monthly newsletter, [Zeal Intelligence](#), that details exactly what we are doing in terms of actual stock and options trading based on all the lessons we have learned in our market research. Please consider joining us each month for tactical trading details and more in our premium Zeal Intelligence service at ...

www.zeallc.com/subscribe.htm

Questions for Adam? I would be more than happy to address them through my private consulting business. Please visit www.zeallc.com/adam.htm for more information.

Thoughts, comments, or flames? Fire away at zelotes@zeallc.com. Due to my staggering and perpetually increasing e-mail load, I regret that I am not able to respond to comments personally. I will read all messages though and really appreciate your feedback!

Copyright 2000 - 2009 Zeal Research (www.ZealLLC.com)