

Gold Stock Valuations 6

As gold stocks continue to power higher in their usual spring rally, they are starting to attract investors' attention again. This includes some value investors, a group that is always concerned with valuations. Unfortunately, valuation analysis of gold stocks is fairly rare. But I've been researching this thread for [over 6 years](#) now, and this week is a great time for an update.

Valuation is exceedingly important for stock investing in general. It measures how cheap or expensive individual stocks happen to be, greatly enhancing investors' ability to buy low and sell high. Valuation is expressed in terms of price-to-earnings ratios. It shows where a stock happens to be trading *relative to* the underlying earnings per share that company can generate for investors. The more profits a company can spin off relative to any stock price, the cheaper the stock and the greater the odds it will be bid higher.

General-stock-market valuations drive the massive overarching 34-year [Long Valuation Waves](#), a 17-year secular bull followed by a 17-year secular bear. They effectively provide a strategic roadmap for prudent investors, highlighting the best times to buy (and not to buy) stocks. By monitoring valuations and integrating them into buy-and-sell timing, value investors like Warren Buffett achieve great long-term success.

While these valuation concepts do apply to gold stocks, this small sector has a much looser relationship with valuations than the broader stock markets. This is actually the case with many sectors, valuations don't directly scale down from the markets as a whole to affect all sectors the same way. While gold stocks will probably never meet the classic definition of value investing (low P/Es), this doesn't mean they aren't great buys.

Since late 2000 the flagship HUI gold-stock index is up a staggering 1331% at best! And remember this is over a decade when the general stock markets traded *flat to lower*, making gold stocks' massive gains even more impressive. But back when we started buying and recommending elite gold stocks to our subscribers almost a decade ago, their valuations looked terrible. Most were losing money due to bear-market gold prices, while a few managed to eke out embarrassingly tiny profits.

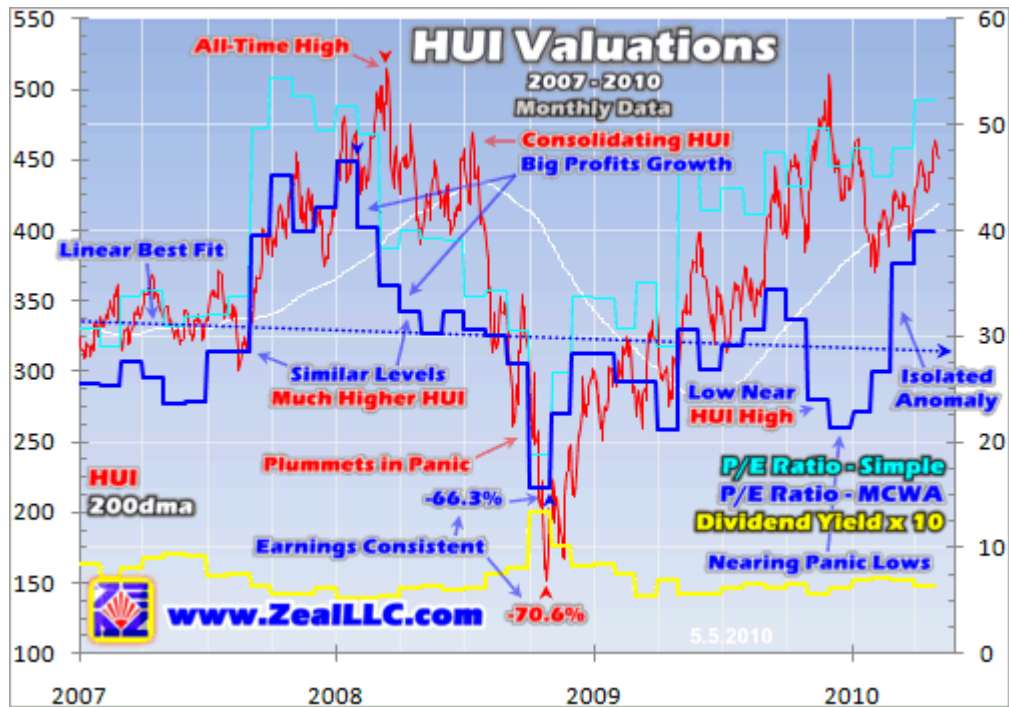
Near the beginning of this mighty bull, the world's largest gold miner (Newmont back then) was trading with [a P/E between](#) 130x to 160x! This was comparable with the bubblicious tech stocks at that time, leading many value investors to shake their heads at us early contrarians betting on gold stocks. Yet by the end of last month, this same company was trading at 21x earnings at a stock price that had multiplied over *4x higher*.

Despite the enormous bull-market gains in most gold stocks, as a group their valuations have dropped dramatically from the early days. Why? As I predicted many years ago, their profits have climbed much faster than their stock prices. Gold stocks' [profits leverage](#) to rising gold prices has always been extraordinary. During [secular gold bulls](#), few investments manage to outperform the gold stocks.

While the epic volatility generated by the once-in-a-century stock panic and the markets' subsequent rebound has distorted gold stocks' declining secular valuation trend in recent years, it is still apparent. Contrary to many value investors' expectations, the higher the gold price goes the cheaper gold stocks as a group get. This first chart, the index valuation of the HUI gold-stock index, drives home this crucial point.

At the end of every month, at Zeal we crunch the numbers to compute the HUI valuation. Each HUI component stock's individual P/E ratio feeds into this index's. A couple P/Es are rendered below, a simple average in light blue and a market-capitalization weighted average in dark blue. In a small index like the HUI (16 components today), weighting by market-cap is very important to avoid distortions. The MCWA P/E ratio is *usually* much more representative of what is really happening in gold-stock valuations.

It's easy to understand why. Imagine two gold stocks, a world-class major worth \$20b trading at 30x earnings and a smaller intermediate worth \$5b trading at 60x earnings. A simple average yields an "index" P/E ratio of 45x, but obviously this is very distorted by the smaller company. If you weight these companies by their market capitalizations, their MCWA P/E is 36x which is much more representative of their aggregate reality. Outliers that happen to be small have far less influence on the overall average.



Before we get into the details, note the strategic gold-stock valuation trend. The dotted blue line is the mathematical linear-best-fit line of the monthly MCWA HUI P/E ratio. And despite all the panic-induced volatility and chaos, it is *still trending lower*. So just like we've witnessed for the great majority of this gold-stock bull, gold stocks continue to get cheaper on balance even as their stock prices rally higher.

Back in the first half of 2007 the HUI averaged around 335 with an index P/E around 25x. Then as gold surged in late 2007, the gold stocks followed it higher as usual. The gold price is gold stocks' primary driver of course, as it determines their ultimate profitability and hence future stock prices. Initially in that late-2007 surge, HUI valuations shot up with the index itself. But as quarterly earnings results started to arrive reflecting the higher gold prices, valuations dropped in early 2008.

Despite a much higher HUI, valuations fell back down to similar levels seen in mid-2007 before the gold surge. Even though the HUI was consolidating high in 2008 prior to the stock panic, gold-stock valuations were shrinking rapidly on *big profits growth*. Then like many speculative sectors, gold stocks were utterly crushed in the panic. The HUI lost 71% between March and October 2008, brutal! Meanwhile the HUI's P/E fell by a similar 66%, which showed gold stocks as a group maintained consistent earnings despite the huge panic disruptions.

Between its ridiculously-silly stock-panic lows and December 2009, the HUI rocketed 237% higher in one of the best sector recoveries in the entire stock markets. Yet over this span its MCWA P/E climbed from 15.7x at the depths of

panic despair to merely 21.3x in December 2009. This trivial 36% increase in the face of a 237% stock-price rally clearly reveals how fast gold-stock earnings surged since the panic days. Earnings growth nearly paced stock-price appreciation, leaving gold stocks still cheap despite their gigantic price gains.

Traditional value investors tend to avoid gold stocks like the Black Death when they see individual-stock P/Es running 30x, 40x, or 50x. And there is no doubt that compared to the conventional stock-market metric of 7x being dirt-cheap these gold-stock valuations are very expensive. But general-stock valuation standards don't translate directly into gold-stock terms. No matter how high gold-stock P/Es are, over time as gold's bull powers higher these valuations still tend to contract making gold stocks cheaper.

After nearing panic lows again in late 2009 as the HUI corrected with gold, valuations have rocketed higher in 2010. This recent spike looks troubling, but even it isn't enough to shift the best-fit trend away from down. As I dug into the individual-stock valuation data underneath the HUI's, it quickly became apparent that this is an isolated anomaly. I fully expect it to fade away in the coming quarters.

P/E ratios are based on accounting profits, and all kinds of non-cash charges flow through accounting profits from time to time. Big non-cash charges for things such as byproduct hedging, tax adjustments, or currency fluctuations occasionally eat up most of the operating profits of some unfortunate gold miner. And if that company is big enough, especially within the small population of the HUI, it really distorts this index's P/E.

Provocatively the culprit behind this recent gold-stock valuation spike is none other than Goldcorp, the most-widely-loved major gold miner. At the end of January it was trading at 21.9x earnings, right in line with the HUI at 22.8x. And by the end of February GG's P/E rose modestly to 24.4x driven by the gold-stock recovery from the HUI's preceding correction. This jibed with the broader HUI at 26.6x.

But by the end of March, Goldcorp's P/E blasted up to 113.8x on its Q4'09 profits! This catapulted the entire HUI's P/E up to 36.8x. Without Goldcorp, the HUI's P/E actually would have *fallen* 8% that month instead of rising 38%! GG has a huge influence because it is *the* market-darling major gold miner. It has the second-largest market capitalization of all the world's gold miners, up at \$27b by the end of March. This single company represented 15.8% of the entire HUI's market cap then, hence its big outsized influence.

So what happened to GG's profits? Between Q4'08 and Q4'09 they plunged 93%! This was driven by a non-cash foreign-exchange loss on a revaluation of future income-tax liabilities, and losses on securities. On an operating basis, GG's profits actually *climbed* 116% year-over-year. But for the purposes of this

essay, why Goldcorp's accounting profits (used to calculate P/Es) fell is irrelevant.

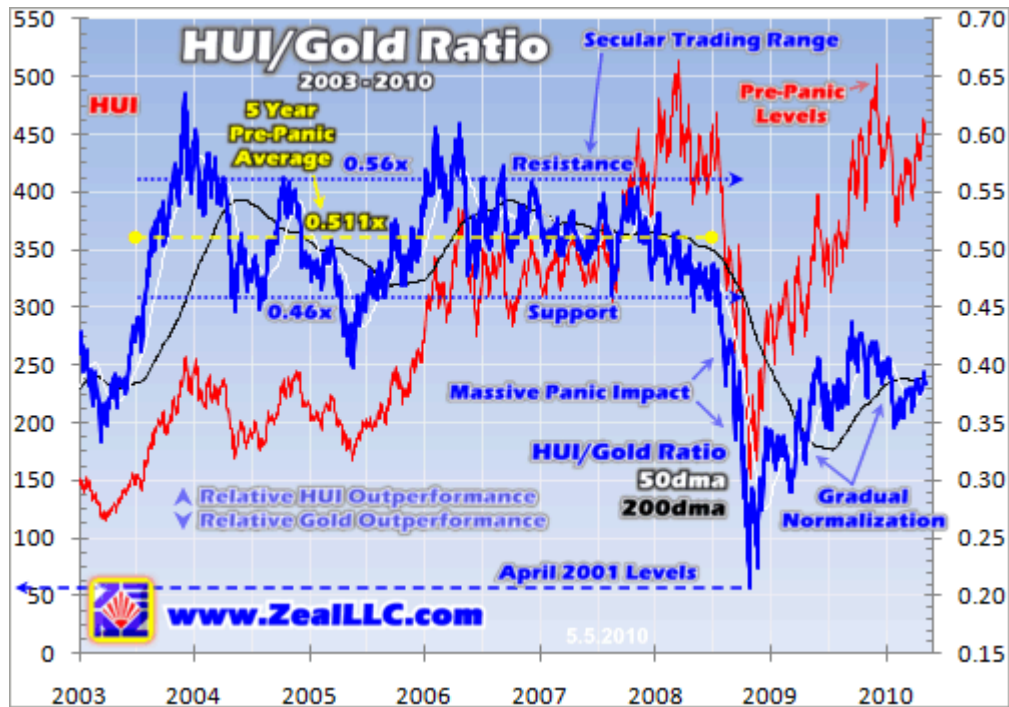
The key point here is a large company in a small index can drive wild volatility in the index's market-capitalization-weighted-average P/E ratio. This is why gold-stock valuations should mostly be considered from a long-term-trend perspective, as time smoothes out all the quarter-to-quarter noise. With just 16 component companies the HUI is particularly susceptible to this chaos, which is the primary reason I try to avoid analyzing gold-stock valuations more often than once a year or so.

If the HUI had 500 components like the S&P 500, this extreme volatility wouldn't exist. The larger the population of any given index, the less the influence any individual component company has on it. This is even true for the larger components. Of course there aren't very many intermediate and major gold miners in the world, so the HUI's custodians don't have the option of including a large index population.

While this conventional valuation analysis does clearly show gold-stock valuations are *shrinking* as their powerful secular bull powers higher, I increasingly prefer alternative valuation measures. The combination of gold stocks' big earnings fluctuations as gold flows and ebbs, along with this index's small size, renders the HUI's P/E much too volatile for any useful short-term analysis.

Thus my favorite "valuation" metric today for gold stocks is the HUI/Gold Ratio. It isn't influenced by volatile earnings and offers all kinds of buying-and-selling signals that the conventional HUI valuations never could. Naturally gold-stock prices are utterly dominated by gold, as this metal's fortunes drive their ultimate profits and hence stock prices. The HGR nicely quantifies this relationship, and is effectively an alternative measure of gold-stock valuations.

As I discussed the current very-bullish HGR trends in much depth a couple months ago [in another essay](#), I'm not going to delve deeply into HGR analysis here. But from a pure valuation perspective, the prevailing level of the HUI compared to prevailing gold prices offers all kinds of unique insights. If you are looking to buy or sell gold stocks, the HGR's valuation read is vastly more useful than conventional P/E-ratio analysis.



For 5 years prior to the ultra-rare stock panic in late 2008, the HUI gold-stock index generally traded in a tight band relative to the price of gold. This secular trading range ran between support at 0.46x and resistance at 0.56x. The long-term pre-panic HUI/Gold Ratio average was 0.511x. In other words, the HUI tended to trade at *just over half* the price of gold at any given time. The stock panic shattered this long-established relationship.

While gold faced plenty of selling pressure during the panic, the gold stocks plummeted far faster and deeper than their primary driver. Gold stocks are not only considered highly-speculative by most investors, but gold-stock investors are often easily spooked. There is such endless gold misinformation and [disinformation](#) floating around the Internet that any serious selloff is quickly multiplied psychologically into an end-of-the-world-type scare. Gold-stock investors are often highly emotional.

By the time the dust settled at the panic's nadir, gold stocks had fallen as low relative to gold as they had been in this entire secular gold bull! Of course this made no sense at all, as gold miners' earnings were still robust as the first chart showed. This was an anomaly driven by a perfect storm of fear, and it created the best buying opportunity of this entire secular bull. We bought gold stocks aggressively near the panic lows and urged our subscribers to do the same.

When prices are driven to extremes by excessive greed or fear, they always mean-revert back towards norms once those emotions abate. Gold stocks are no exception. As expected, ever since the end of the stock panic the gold stocks have been gradually normalizing relative to the gold price. In other words, their

valuations relative to gold have been rising on balance. But this doesn't mean they *aren't* still cheap.

In HGR terms, the HUI isn't even close to climbing back up into *the bottom* of its pre-panic trading range yet. It will almost certainly regain this range though. The longer any relationship persists in the markets, the more likely it is fundamentally-based. And to see gold stocks trade within a well-defined range relative to gold for *5 long years* before the panic's emotional anomaly is powerful evidence this relationship will resume. As gold-stock investors scared out by the panic gradually return, the HGR will continue to normalize.

So far more importantly than the gold stocks' P/E ratios, which are really pretty low relative to their history in this bull, is where gold stocks are trading relative to the gold price. And despite the strong gold-stock recovery since the panic, gold stocks still remain *very* undervalued relative to gold. Today's HGR remains at low levels *never seen* for 5 years before the panic. And despite periodic setbacks (sharp HUI corrections driven by gold corrections), the gold stocks generally continue to advance relative to gold.

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The bottom line is despite value investors' perceptions of gold stocks, they are really pretty cheap today. In conventional valuation-analysis terms, they are in the lower end of their bull-to-date range. And as gold stocks' legendary profits leverage amplifies gold's gains, these valuations continue to decline on balance despite much higher stock prices. And relative to gold itself, gold stocks remain quite cheap.

After being pushed far too low by the stock panic, gold stocks continue their march higher to normalize with prevailing gold prices. This mean-reversion trade has already been immensely profitable for 18 months now. And it should continue to prove lucrative until the HUI's pre-panic levels relative to gold are

regained. From both conventional and alternative metrics, today's gold-stock valuations are relatively low.

Adam Hamilton, CPA

May 7, 2010

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