

## INTERVIEW

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# The Golden Mean

John Hathaway, Manager, Tocqueville Gold Fund

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***AN INTERVIEW WITH JOHN HATHAWAY: The yellow metal will continue to shine, as investors seek shelter from deflationary and inflationary pressures.***

THE INVESTMENT LANDSCAPE WAS RADICALLY DIFFERENT in the autumn of 2007, the last time we caught up with John Hathaway, manager of the \$1.4 billion [Tocqueville Gold Fund](#).

For one thing, the price of the metal was tipping the scales at \$738 an ounce, some 40% below where it's trading today.

Brad Trent for Barron's

"The financial model of the nation-state...depends on deficit finance to fund promises -- and the market is starting to say it is unsustainable," --John Hathaway



Hathaway, a thoughtful manager whose Manhattan-based fund (ticker: TGLDX) has surged 49% in a year -- more than double the Morningstar precious-metals category -- and has risen 11% year-to-date, was convinced in 2007 that bullion would easily get to \$1,000 an ounce in a year. Moreover, he rightly identified gold's upward climb to be predicting a widening of credit spreads and lower asset valuations, a view that back then couldn't be underestimated.

Although gold last month set a record of \$1,243 an ounce, and inflows into [SPDR Gold Shares \(GLD\)](#), the gold ETF, achieved a record of \$1.8 billion in the last week in May. Hathaway remains decidedly bullish, both on the metal and even more on gold-mining and royalty stocks. For more on why he thinks gold's still got plenty of room to shine, read on:

Barron's: You've said "Gold is a bubble only for those who maintain faith in the ability of politicians and financial authorities to swim against the tide of deflation." Explain, please.

Hathaway: There's an intellectual debate about whether we are going to have inflation or deflation, and, in my mind, we have both at the same time. We have market forces that are deflationary and policy response that is inflationary. The deflationary market forces brought down the housing bubble. And the policy response to that was inflationary. I can't even keep track of the trillions anymore.

Yet gold is the bubble du jour, at least in the media. You are almost a contrarian.

I love it when the media, which never told you to get into gold in the first place, is now telling you to get out. It is just classic. But [investor George] Soros has said that gold is in a bubble, and that statement has to be understood. I didn't speak to him personally. But I think what he is saying is, "This thing can really get out of hand and therefore I'm positioning my investments to reflect that, because I think people are going to go nuts about it." I don't think he was being dismissive; his funds own gold stocks and they probably own physical. But the media has taken it like that.

What do you mean by the bipolar nature of gold?

When the gold price is expressed in dollars, let's say, it is simply a ratio of the number of dollars it takes to buy an ounce of gold, and if you measure it in euros, it would be a different number. If any observer says the price of gold has gone too high, what a high rate of change in gold could reflect is the money creation that is driving it -- either current or anticipated.

So it is discounting?

Yes. The price of gold as quoted in dollars -- or in Zimbabwe dollars, to make it a really absurd example -- can look like a ridiculous chart. In terms of bubble analysis, it might look very dangerous. But then you look at what is driving it and you say, well, what is the real bubble? It really has been money creation.

Is this why we are seeing gold up at the same time as the dollar?

Right. There was a fallacy from the last couple of years, which is that when the dollar was weak against the euro that was a signal for gold to go up, the idea being that the euro was a strong currency. But now the euro has been exposed as -- to put it mildly -- a huge disappointment to anybody who thought it was a safe haven. The fact that the euro has fallen against the dollar is good news for gold.

Because it goes back to the sovereign debt?

Yes, you come back to this idea that you are running out of safe havens. What's left?

How do you see the European debt crisis?

The next bubble -- and this is the lesson of what this Greek drama was all about -- is sovereign debt. It is the financial model of the nation-state, which depends on deficit finance to fund promises that have been made in the past and promises that are still being made to the voters -- and the market is starting to say it is unsustainable.

Gold has gone up nicely, but do you see a significant trajectory -- and what would trigger it?

More damage to the monetary unit. The government's official stance is that these deficits are just temporary. And the Fed says we have an exit strategy to reduce the liquidity on the U.S.'s balance sheet. If the notion becomes widespread that this is permanent and that they have to do even more in terms of more of this bad medicine, that's the kind of thing that could lead gold to go up dramatically from here.

In the near term, do you think we are going to have a significant pullback?

Backing and filling is in order. We look at various things that flashed a yellow flag recently. But you are always going to get that in a bull-market trend. You are always going to get overbought.

Should people wait before they start investing? Can you time it?

It is very hard to say. Diversification into some form of gold exposure strategically still makes sense. If this were a football game, we would be at the beginning of the third quarter. The first two quarters lasted about 10 years. The first quarter you had this stealthy accumulation. Second quarter, gold became more fashionable to talk about, and you began to see some very high-profile, smart investors coming in. The third phase will be more people jumping on the bandwagon, and the fourth quarter is just silly season. It's just Greenspan's irrational exuberance.

Where is gold in relative measures?

The previous bull market in gold peaked when gold and the Dow were roughly the same. So 800 and \$800; and then in the '30s it was in the mid \$30s. It could be anywhere from \$15,000 if we have the superinflation, or \$5,000 if it is as bad as some people worry about. We also use gold as a percentage of financial assets. Gold worldwide is at 6%, versus 22% in 1980, and 20% in the mid '30s. We use a number of metrics, and the message of most of them is that this still has upside.

You have said that gold stocks are comparatively cheap. How do you measure that?

We have lots of ways. But the easiest one is taking our benchmark, the Philadelphia Stock Exchange's gold- and silver-stock exchange-traded fund, the P [HLX Gold/Silver Sector \[XAU\]](#), as a fraction of the gold price. This index has almost a 30-year history, and was as high as 35% or more of the gold price. In the Crash of '08 it got down to 10%. Right now, it is around 15%. But the norm was somewhere between 20% or 30%, until the ETF was launched in 2004. The ETF in a way raised the bar of gold stocks. I don't think they will ever get back to 35% of the gold price, because if you believe that, the benchmark would triple from here. That could happen, based on the gold price. But based on a change in valuation, that's a stretch. If we are at 15% now, gold stocks could easily trade in the low 20s as a fraction of the gold price. The way they get there is a slow process.

They have underperformed the metal.

Shares of gold companies have fallen into the doghouse, because there has been excessive issuance of stock, so the connection between a share and an ounce of gold has been diluted, in some cases egregiously. But why is that? It is partly because that is the culture of the industry, particularly Canadian finance, and partly because the industry didn't do a good job of capital allocation. They advanced projects that were [not economical]. And until '08, the costs of producing gold were going up almost as fast, if not faster, than the gold price. So they didn't really benefit from the margin

expansion that you would normally expect. Now, that has changed dramatically -- because gold relative to other commodities has outstripped everything. Those cost pressures have begun to disappear, so the margins of gold-mining businesses have started to expand. People have forgotten that.

Talk about asset allocation. Has the fund's percentage of bullion changed dramatically?

It is roughly 10% right now, and we've added modestly to the position....We have never reduced it. But it is also going to be a factor of how gold has done relative to the rest of the portfolio. So when we got really badly hit in '08, gold got up to something like 17% or 18%. But that was because gold was going up and the stocks were going down. I like 10% for what we are doing.

Clients of our firm also recently invested in Gold Bullion International, or GBI, similar to Goldmoney.com, where people can buy physical gold online. With GBI you can have it stored in the Brink's warehouse in one of four locations: two in the U.S. and two overseas.

You have a spectrum for asset-allocation choices. You have gold stocks, you have an ETF of stocks, you have an ETF of gold, you have closed-end gold trusts, and then you have physical gold. The gold ETF, which is backed by physical gold, was very important in making gold more accessible to people, who, before, had to buy coins at a premium to the bullion content. And you have the [Sprott Physical Gold Trust \[PHYS\]](#), which was trading at a 20% premium to the net asset value. Some people want physical gold, and GBI is another way to buy it. But based on what I'm saying, I would rather put new money flows in stocks.

Large-caps or small?

We are right across the board, and our weighted average market cap is about \$3.5 billion, well below our peer group. And the reason for that is that we invest in companies in an earlier stage of their development. We have, besides myself, three very good analysts who go all over the world. I've stopped doing it, but there is no substitute for it. You see local management. You see local political issues in the way you never get here, where you get a varnished view. Our extensive research effort gives us the confidence to invest in names that are a bit more speculative.

What are your favorites?

Before we get into that, let me add that for a conservative investor who simply wants protection and is risk-averse, whatever allocation he has to gold should be more heavily weighted to the metal, because that's safer. The only risk with gold is the price you pay. But for the investor who is more of a risk-taker, and sees gold as a strategy to get positive returns in the current macro environment, then that exposure should be more weighted to the stocks.

**Table:** [Hathaway's Picks](#)

Understood. To the names.

Osisko Mining [OSK.Canada] is a company that we have been invested in for at least six years. We first financed them at 50 cents a share; now it is 10 bucks, and we like the management. Sean Roosen owns a lot of stock personally in the company. He had a vision that we believed in six years ago, which is that a large, low-grade ore body in a politically safe jurisdiction could be economic. It is in Quebec, which is nirvana for gold. They have hydro power and they love mining and the codes are great.

They are building a mine that is backed by resources of 12 million ounces. We've financed them at every step along the way, which is why our position has become large, in addition to the appreciation.

This is what every little gold company should aspire to -- they either aspire to a takeover or what these guys have done. They will be pouring gold within the year.

What is their market cap?

It is about 3.8 billion Canadian.

Go ahead.

Randgold Resources is the next one. The ticker is GOLD; the market cap is \$7.7 billion. Terrific management, who also own a lot of the stock in the company. The mines are mainly in West Africa, which is a very good place to be doing business if you are mining gold. The governments tend to like it. Basically, gold mining is a force for good in the developing world. The companies create jobs. They educate the workforce, build hospitals and schools. This is a large company with a growth profile that's been pretty much organically driven by their own exploration.

They know what they are doing, they are finding gold.

CEO Mark Bristow is a very impressive and forceful guy, and his leadership and vision are important parts the Randgold story. This company has gone from a couple of hundred thousand ounces when we first invested in it, and they're on track to be producing, I think it is 1.2 million in a couple more years. There is enormous value creation independent of the gold price from that whole process, if it is done correctly. The return on capital is good, and again, the proviso is that they don't overissue stock; these guys have done a good job of keeping the share count tight. Bristow's a shareholder, so he understands that. It is a growth story.

Another name?

[Newmont Mining](#) [NEM], where we have been very patient holders. It has been an underperformer and they would be the first to admit it.

Dick O'Brien came in as CEO about three years ago. He is not from the industry. He is very keen on financial analysis and all the things that I think the industry has to do. It is just terrible how bad a job the industry has done. So when you see a guy like Dick come in, you say, well, that is an uptick, because that is what has to happen. Newmont isn't a growth story. They have very high-quality assets. It is more about upgrading the returns on capital, which they are doing, and that's kind of the mandate that he has given to them.

Would they be buying more reserves?

They could be an acquirer, and they certainly have made acquisitions. But I think the acquisitions they make going forward will make sense. It's a very diversified portfolio. They are in Indonesia, which isn't great. But they are in Australia, Nevada and West Africa -- those are the core operations. They have things elsewhere, too. Here is a company which has assets in place to take advantage of a rise in the gold price.

They don't have to do anything, in other words?

They're there; all they have to do is do a better job of what they already have in place, which I think they are doing. And you are already seeing it in their earnings reports; they are producing a lot of earnings and cash flow. They should be able to start paying really handsome dividends.

One of the things I think needs to happen is for the industry to commit to giving shareholders back their capital, which some of them are on board with. Then they'll go from the doghouse to more

mainstream investments, maybe even trust department core holdings. That's how the valuation goes from 15% to somewhere in the 20% ratio of the XAU to gold.

And it can even be more as long as the gold price keeps going up?

Right. The 15% to 20% is just relative. So you get 30% if the gold price is the same, and everything that we talked about takes place. But if the gold price goes up 50%, let's say, that compounds into something a lot more than 50% that you could expect from owning shares versus the metal.

Give us another name.

People should look at the gold-royalty companies. [Royal Gold](#) [RGLD] and Franco- Nevada [FNV.Canada] are terrific business models, because they just capture revenue streams from the process of mining gold. Franco-Nevada was a royalty company spun out of Newmont Mining. Both are very high-quality operations. Both have the same business model, and what's to like is that 85% of the revenues are free cash, because they are royalties. On the surface, they may look expensive, but they provide growth capital to finance new mines. They get a slice of the revenue stream, which can be defined in many different ways. They could have a very diversified portfolio, with maybe 35 to 40 assets. They give you long-dated options on the gold price. What you get with the royalty companies is the joy of optionality without the pain and suffering of mine construction and all the stress.

Sounds good. Thanks, John.