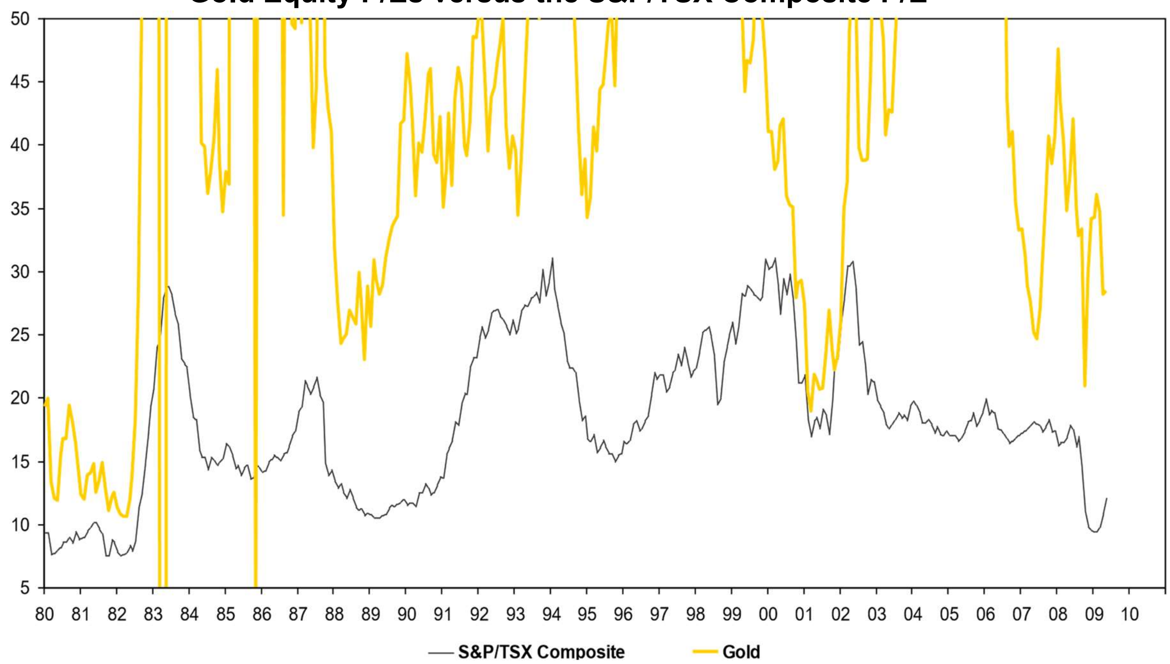
October 2009

Why is Sionna Market Weight Gold?

(The following is based on a presentation from earlier this year).

It is commonly accepted wisdom that value managers tend to avoid gold stocks. Why? In general, gold stocks trade at multiples that are much higher than the market and conventional value stocks, and therefore are unattractive to investors that seek “value”. The chart below illustrates the expensive nature of gold stocks, as the gold sector normally trades at P/E multiples of 30-50x, while the S&P/TSX trades at a long-term average P/E of 14x. As a result, value-oriented managers typically cannot justify paying such high multiples for gold stocks when cheaper opportunities exist elsewhere in the market.

Gold Equity P/Es versus the S&P/TSX Composite P/E



Source: Bloomberg

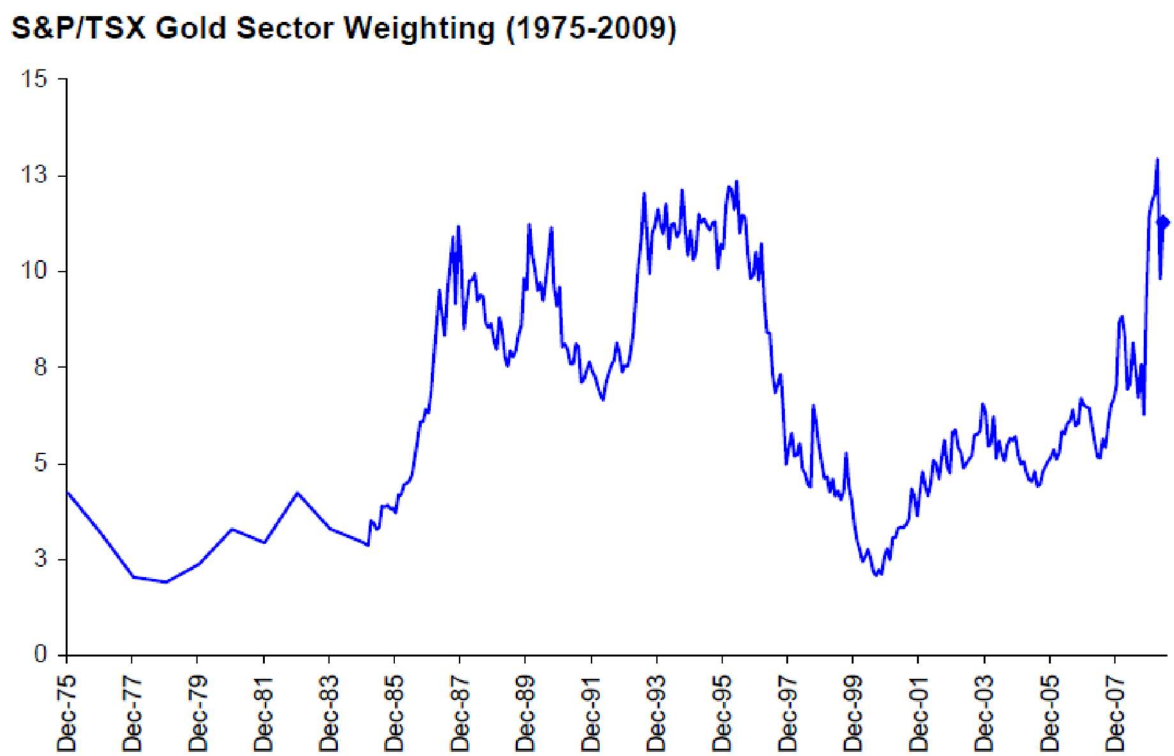
However, instead of avoiding the sector completely because of excessive valuations, there are a number of important issues to consider:

Gold is a minor sector in the US market….

For many investment managers, it is not a major issue to avoid investing in gold. For example, in the S&P500, gold stocks currently represent only 0.3% of the index and have historically been relatively insignificant in that index. So, if a portfolio manager's benchmark is the S&P500, avoiding gold stocks is not likely to have a dramatic impact on his/her relative performance since this sector's size in the index is rather insignificant. Even if the sector were to triple in value, a zero percent weight in gold would have little effect on overall relative performance.

…but a significant one in Canada.

However, in Canada the story is very different. As shown in the chart below, since 1975, the S&P/TSX gold sector weighting has ranged anywhere from 3% to over 13%. Clearly, any portfolio manager who benchmarks against the S&P/TSX and chooses to ignore the gold sector has the potential to expose their clients to significant periods of underperformance.



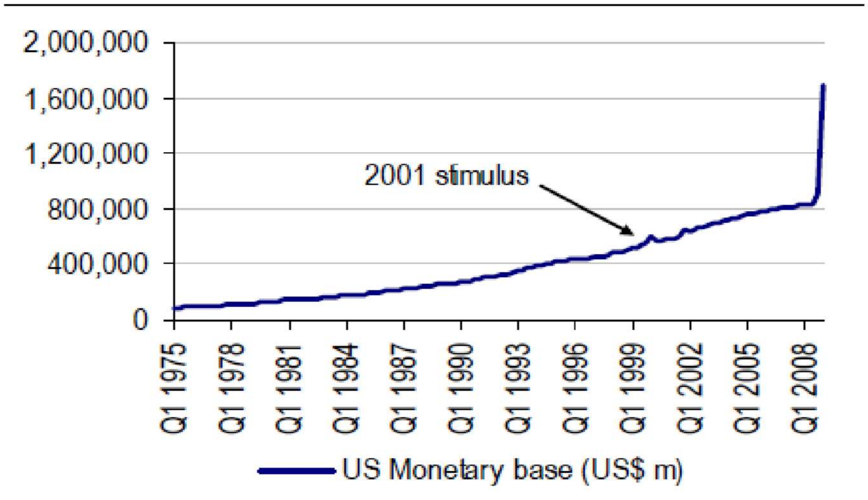
Annual year-end figures prior to 1985, monthly data thereafter

Source: Scotia Capital

Unprecedented government intervention

Sionna believes that we are currently living in extraordinary times and that this is relevant to the outlook for gold. The chart below shows the US monetary base (all the cash in circulation or held in commercial bank deposits in the central bank's reserves) from 1975 to the present. In the last 12 months, the US monetary base has more than doubled as a result of the various bailout and stimulus programs in the US. This trend is not only present in the United States but in other countries around the world.

Chart 10: US monetary base (from 1975)

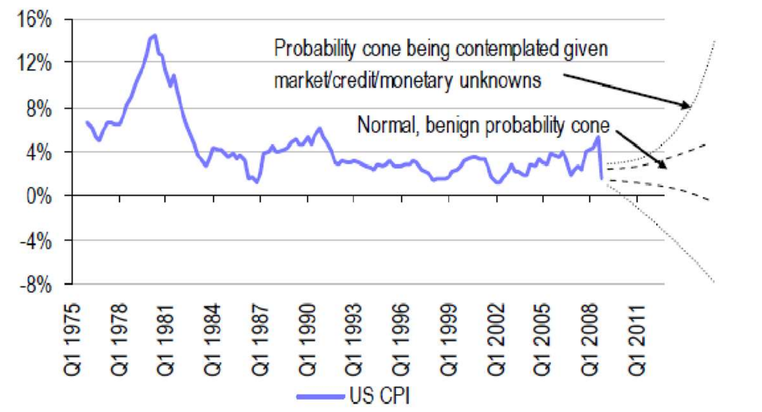


Source: Thomson Financial, UBS

Unintended consequences?

While it is impossible to predict the result of this unprecedented monetary stimulus, it is likely that it will have unintended consequences. The chart below from UBS shows the historic US Consumer Price Index (CPI) and projections for the next five years. Historically, growth in the CPI (inflation) has ranged between 1% and 4%. However, UBS believes that the stimulus is so significant that inflation could exceed 12% in the next five years. Alternatively, the economy could prove to be in such a disastrous state and the destruction of wealth to have been so immense, that deflation of up to 8% is also possible.

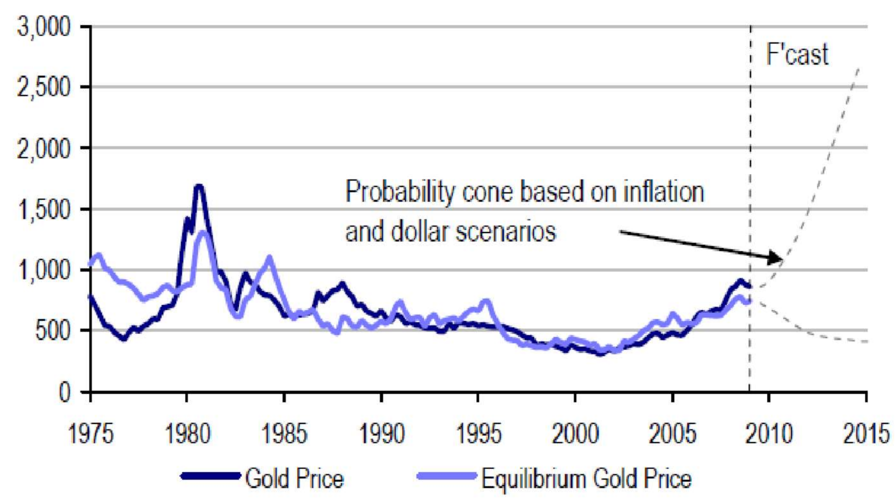
Chart 1: US CPI (from 1975)



Source: Thomson Financial, UBS estimates

Sionna is not attempting to forecast inflation or deflation for the US CPI; this chart is merely evidence of the extreme uncertainty that still exists in the market. What is the impact of this inflation outlook? The graph below shows both the historic and UBS's forecasted price of gold, based on the inflation scenario presented above. The price of gold over the next five years could be anywhere from U$500/oz to over U$2500/oz. Again, while Sionna cannot predict the future price of gold, this degree of uncertainty compels us to position our portfolios defensively.

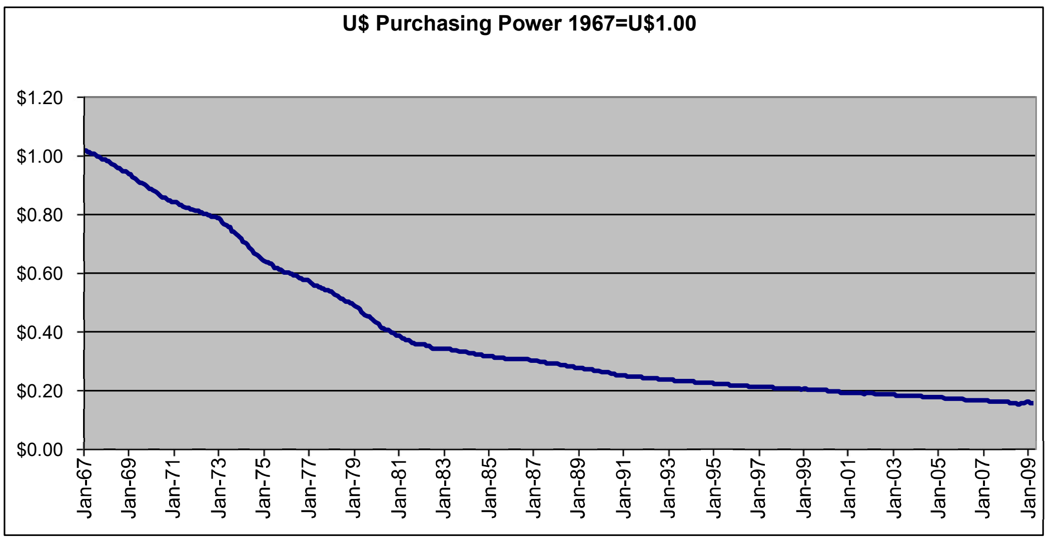
Chart 2: Estimated probability cone of gold price outcomes (real)



Source: UBS estimates

Paper money loses value over time…

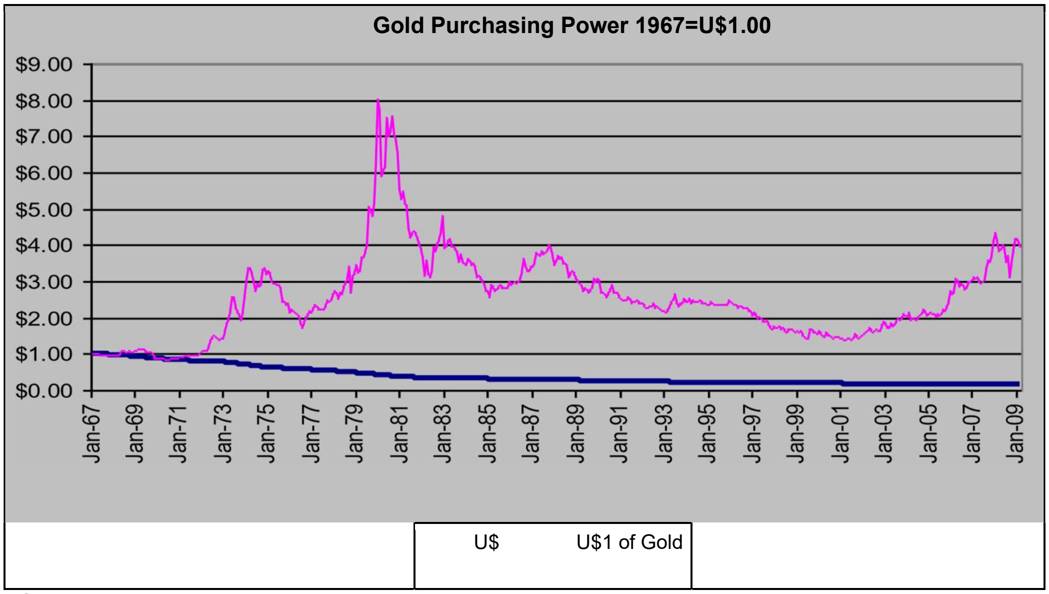
Given the immense amount of economic stimulus, Sionna is also concerned about the potential debasement of paper money and its effect on the overall purchasing power of the US dollar. Stimulus packages, and the massive deficits caused by them, have increased the likelihood that the US dollar may be devalued. Consider that even without massive stimulus, paper money declines in value over time. The chart below shows the purchasing power of one US dollar held from 1967 to the present. A dollar held from 1967 would only buy about 16 cents worth of goods today. Over 40 years, the US dollar has lost about 84% of its purchasing power.



Source: Bloomberg

…but gold does not tend to lose value over time.

If the US dollar is not a reliable store of value, what is? The next chart compares the value of one dollar of gold purchased over time. One dollar of gold purchased in 1967 would today be able to purchase about four dollars worth of goods, versus the 18 cents for a dollar of cash held over the same period. This is not a forecast for future gains in the value of gold, but simply an argument that gold appears to retain its value in a way that paper money does not.



Source: Bloomberg

Is gold really a store of value?

The idea of gold as a store of value is controversial: it is frequently debated at Sionna and by other "industry experts". Peter Burshre, a financial commentator, once said that, "Regardless of the dollar price involved, one ounce of gold would purchase a good-quality man's suit at the conclusion of the Revolutionary War [American War of Independence], the Civil War, the presidency of Franklin Roosevelt and today". We decided to test this theory to see if it withstands modern scrutiny. In 1967, the most expensive suit in the now-defunct Eaton's catalogue cost $35 and the price of gold was around $35/ounce. In 1979, the Eaton's catalogue exhibited its best suit at $100, and the price of gold was about $100/ounce. Probably the most controversial question is how much is a decent suit in 2009? Luckily at Sionna, we have access to Teresa Lee, Sionna Portfolio Manager and fashion maven, who opined that the price of a decent suit is currently about $950. Following its tendency, the price of an ounce of gold is approximately $950/ounce this year. Clearly, as anecdotally evidenced, gold does hold its value over time; at least, it does if you are in the market for a decent suit.

The importance of gold in the Canadian market and gold's ability to retain value, combined with the unprecedented government monetary intervention we have seen, and the potential unintended economic consequences, suggest that completely avoiding the sector is ill-advised.

Ignoring the gold sector can be costly

In fact, in 1993, Kim Shannon, Sionna's founder, chose not to invest in the gold sector due to high valuations and was zero weight in gold. The sector increased from about 8% of the index in early 1993 to almost 13% later the same year. The sector itself rallied over 100% and Kim materially underperformed the index because she avoided an expensive sector completely.

Sionna's initial response

As a result of this experience, Sionna has had a challenge to solve. How do we balance the demands of responsible portfolio management, and our desire to remain sector neutral, with our value principles? Sionna's initial response to this question was to rely on our Intrinsic Value Model and relative value strategy to build a half-weight position in the gold sector. This was an attempt to balance our desire to remain sector neutral with our concerns about the expensive nature of gold.

Continue to focus on value within the gold sector

It is important to note that although Sionna made a decision to purchase relatively expensive gold stocks, we have not abandoned our relative value philosophy. Instead, we continue to use our Intrinsic Value Model to determine which gold equities offer the most value on a relative basis – we focused on the cheapest stocks in the sector. This method led to our initial purchase of Barrick Gold a few years ago. Barrick is a high quality company with low political and operational risk and the stock looked quite attractive on the model relative to its gold peers. Additionally, Sionna uses gold bullion trusts and exchange traded funds (ETFs) to gain exposure to the price of gold.

Why use gold trusts and ETFs?

The nature of gold mining has changed considerably over the past century. Historically, miners were able to pan for gold and find significant amounts, but now this process is much more complicated and intensive. Gold companies must mine deposits miles under the earth's surface, pulverize the ore, chemically treat it with acid, and heat the ore to recover a relatively small amount of this precious metal. This process forces companies to deal with a host of environmental problems and also to venture deeper and deeper into politically unstable countries in order to find economic deposits.

Gold bullion trusts and ETFs avoid the high valuations and the high operational and political risk that gold equities carry. In addition, gold bullion trusts and ETFs are included in Sionna's portfolios because the price of gold and the price of gold equities often diverge considerably. In the past, we have taken advantage of this dynamic by adding incrementally to one investment vehicle and reducing the other.

Sionna's current position

However, our current position in gold is now market-weight. This decision was made approximately two years ago, when Sionna became increasingly concerned about the stability of the global financial system. The freezing of the Asset Backed Commercial

Paper market in summer 2007 (which was thought to be among the most liquid markets in Canada) was one of the first signs that something was amiss in the Canadian credit and financial markets. This event, among others, prompted us to act defensively and, as a result, we made three key decisions. First, we decided to move to market weight in gold. Second, we reduced our bank exposure, and finally, we increased our cash holdings. The results of these decisions have proven to be positive for Sionna's funds, especially as equity markets deteriorated and gold increased in relative value. We have had to sell some gold holdings in order to maintain our market weight position.

Sionna will maintain a defensive portfolio positioning

Sionna believes that it is prudent for us to continue to position the portfolio defensively. In the recent past, we saw the failure of multiple financial institutions and we remain concerned about the state of the Canadian banking system. In addition, the stimulus packages continue to be spent and, as is usually the case with government, once spending begins, it may be difficult to stop. We do not know what the effects of this will be, just that the consequences of such unprecedented actions may be unprecedented themselves.

Over the past few months, we have also seen the downgrade of UK debt. The downgrade of US debt has also been suggested as a possibility, increasing the threat of currency debasement. The results of these scenarios are unknown, but these possibilities support Sionna's defensive portfolio position and market weight in gold.

Given these uncertain times, gold should continue to play its historic role: to retain its value, specifically relative to paper money. Sionna's market weight position in gold should help shelter our clients from the risks of inflation and currency devaluation. Sionna is a bottom-up manager, so we have never been comfortable making macro economic judgments based on things like stimulus packages, inflation expectations, or monetary and fiscal policy. Unfortunately, we continue to believe that we live in extraordinary times which the equity markets are not reflecting. When we do see compelling value in the market, we will certainly reduce our exposure to gold and invest that capital elsewhere in the market. Until then, Sionna will remain market weight in the gold sector.

"You have to choose [as an investor] between trusting to the natural stability of gold and the natural stability of the honesty and intelligence of the members of the Government. And, with due respect for these gentlemen, I advise you, as long as the Capitalist system lasts, to vote for gold."

- George Bernard Shaw