By Dan Weiskopf
Access ETF Solutions Portfolios

Interview series: Investment Factors that can drive ETF performance

Criipple Creek Victor Mine

Interview with Joe Foster, Gold Strategist and Portfolio Manager at Van Eck Global: Factors helping to drive gold mining stocks

Joe Foster is relatively unknown in the ETF market as his focus is that of a gold strategist and portfolio manager at Van Eck® Global, which is the firm behind the large-cap gold mining ETF (GDX) and small-cap miner ETF (GDXJ). However, given Joe's expertise as the firm's active gold mining mutual fund portfolio manager, we thought it would be constructive to sit down with him regarding what factors might be a catalyst to drive gold mining stocks.

Date: July 9, 2015

Title: Current market turbulence demands a look at the gold factor?

Dan Weiskopf: In the short and long term, what factors should investors be looking for as catalyst for small- and large-cap mining companies?

Joe Foster: Historically gold stock indices have had a high correlation with gold. Therefore, movement in the gold price is the primary driver of gold stocks. The price of gold bullion is driven by risks to the global financial system, and especially the U.S. financial system. Gold has been in a bear market since 2011. This sector is out of favor and most of the selling pressure has probably run its course. As we believe gold is forming a base in the $1150 - $1300 range, we look forward to catalysts that might increase financial risk and drive gold higher. In the near-term, the anticipated Federal Reserve (the "Fed") rate action could prove a turning point for gold, as well as other markets. Will the Fed have the conviction to raise rates? Can the U.S. and global economies withstand a rising rate environment? In the longer term, we believe the radical fiscal and monetary policies of the past decade could bring unintended consequences. Global imbalances brought on by quantitative easing, ultra-low interest rates, and massive accumulations of sovereign debt in my view have the potential to create dangerous asset bubbles and misallocations of wealth. The current U.S. expansion is six years old, and no previous expansion has lasted longer than 9.5 years. Perhaps the next downturn will expose these embedded financial risks.

Dan Weiskopf: Could this sector be considered reasonably valued over historic metrics? What are those metrics? Should we be looking for more consolidation in the group of stocks you follow?

Joe Foster: Gold stocks are undervalued by historic metrics. Price to Cash Flow and Price to Net Asset Value ("NAV") are the most commonly used valuation metrics and both show stocks below long-term averages. Gold stock/gold ratios are also at or near all-time lows. (NAV values companies using discounted cash flow methodology.)

Merger and Acquisition activity is an ongoing feature of the gold sector. Companies combine to gain financial strength or operating synergy. Producers generally look to smaller companies to sustain their production. I think consolidation will proceed at the same pace we have seen during the past couple of years. It could pick up once the current gold price gets moving higher and if valuations move to more normal levels.

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Dan Weiskopf: Can you put into context how you view the order of the factors that might drive price performance for your sector? Currency trends – the U.S dollar vs. instability of other currencies, the current price of gold, inflation/deflation, central bank purchases and sales.

Joe Foster: The price of gold is the primary driver as I said earlier. Financial stress or "tail risk" are significant drivers and this can come from many places – inflation, deflation, currency turmoil, banking problems, etc. Anything that places undue stress on the financial system can be a catalyst for gold and gold stocks. There is a strong negative correlation between the U.S. dollar and gold, so gold usually has a tough time when the dollar is gaining. Other supply/demand factors that generally influence gold are physical demand (mainly from Asia), central bank demand, scrap supply and mine supply. All of these factors have been supportive and are helping gold to form a base. Physical demand from India and China have been firm. Central banks have been net buyers for several years. Scrap supply is down and mine supply is expected to peak by 2016.

Dan Weiskopf: Should investors look at the gold miners as beta to gold price?

Joe Foster: Gold stocks have a high correlation to gold and they normally provide leverage or "beta" to the metal. The beta typically comes from their earnings power, in-ground resources, potential discoveries, and operating improvements. Over the past decade the beta has been higher on down-side than up-side moves in the gold price. As a result, many companies have underperformed gold. This was caused by tremendous cost inflation that put a squeeze on profits and disappointed investors. Many of these factors have changed as managements have implemented cost controls and engineering improvements that should help to preserve margins going forward. As a result, we believe the companies will carry higher betas going forward, especially on the up-side.

Dan Weiskopf: A key factor with balancing the supply/demand equilibrium in the gold mining sector has been central bank transactions. What countries should we be focused on in the near term as a catalyst?

Joe Foster: Central banks have been strong buyers recently, with 2014 as the second strongest year on record. Russia has been the biggest purchaser. China doesn't report official gold holdings, but it is widely believed they have been accumulating gold. They last reported in 2009 and many expect China to become more open as they seek to establish the Yuan as a reserve currency. This could become a catalyst for gold.

Dan Weiskopf: Is the price of oil a factor to watch for profitability in the mining area and as a factor that is correlated to gold price?

Joe Foster: Like many other sectors, oil sometimes correlates with gold, but it is an indirect link that is highly dependent on other factors that are going on in the economy and financial system, so it has generally limited value as a predictor. Gold mines, especially open pits, are significant energy consumers. Fuel can be up to 10% of a mine's cost, so the low oil prices had a positive impact on costs in 2015 to date. Another area of cost savings are weak currencies globally, especially Latin America, Australia, and Canada. Gold is a U.S. dollar-based commodity, so weak currencies reduce the cost of locally derived labor and materials in U.S. dollar terms.

Dan Weiskopf: Thank you Joe for sharing your insights on what metrics to watch as factors that might drive the group.

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Background:

The views on the gold market expressed in the interview below are those of Joe Foster, Portfolio Manager for Van Eck® Global's active gold strategies and the firm's Senior Gold Analyst. Mr. Foster is one of the most seasoned investment managers in the field of gold equity portfolio management, with over 34 years of experience in the industry as a geologist and investment manager. He has been featured on CNBC, Reuters and Bloomberg Television and quoted in The Wall Street Journal and Barron's. Mr. Foster is a contributing author for Mining Engineering, Society of Economic Geology and Geological Society of Nevada.

The Van Eck International Investors Gold Fund (the "fund"), the firm's flagship gold mutual fund, seeks long-term capital appreciation by investing in common stocks of gold-mining companies. Income is a secondary consideration. The Fund is an actively managed portfolio, with a 40+ year track record, that invests in gold-mining equities.

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