LEITH WHEELER INVESTMENT OUTLOOK

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Gold Rush or Fool's Gold…Our Thoughts

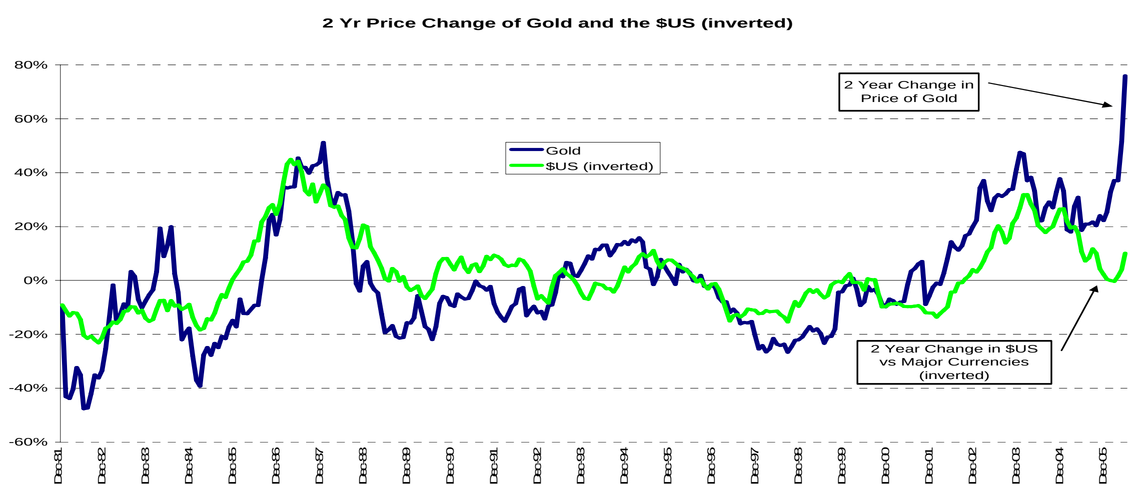
The price of gold has been on a tear since mid-2005 and investors are asking themselves (and us!) whether or not they should have some exposure to gold or gold stocks. Attempting to predict the price of any commodity, particularly gold, is fraught with difficulties. However, in this Outlook we review some of the key factors that impact the price of gold and explain how we evaluate gold stocks as investments.

A Hedge Against Inflation?

Conventional wisdom suggests that the price of gold (denominated in US dollars) moves up when the US inflation rate increases. We tested this relationship over the past 25 years and found no meaningful correlation between the price of gold and the US inflation rate. Some would argue that the price of gold is a leading indicator of the future US inflation rate and that the recent rise in the price of gold is anticipating a future rise in the US inflation rate. This is possible, however we found no statistical evidence of such a relationship over the past 25 years.

A Hedge Against A Falling US Dollar?

Conventional wisdom would also suggest that the price of gold moves up when the value of the US dollar moves down. This view assumes that gold acts as a so-called "reserve currency" and preserves value when the leading world currency, the US dollar, is under pressure. Our testing of this relationship over the past 25 years generated some interesting observations. Initially, there is no meaningful short-term relationship between the price of gold and the value of the US dollar (relative to a basket of major currencies). However, there is a fairly strong relationship between the two year rate of change in the price of gold and the two year rate of change in the value of the US dollar. In other words, the correlation between gold and the US dollar is weak on a day-to-day basis, but quite strong when looking at longer-term price trends.



It is interesting to note the significant divergence in the price changes of gold and the US dollar recently. While the US dollar has fallen moderately (compared to other major currencies) in the past 2 years, the price of gold has risen dramatically. It appears that the price of gold has been driven up well ahead of where its relationship with the US dollar suggests it should be trading. We sympathize with the view that the massive US current account deficit will continue to put downward pressure on the US dollar. However, we suspect that the dramatic recent rise of gold to $730 was fed by substantial speculative demand that is unsustainable.

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What About Supply and Demand?

Approximately 3,300 tonnes of gold are used each year in the fabrication of jewellery and in dental and electronic applications. A similar amount of gold is supplied each year from mine production and scrap recovery. This core (non-investment-related) demand and supply of gold has been relatively stable in the past few years. The wildcard in terms of demand is the level of investment demand through the purchase of bullion, coins, and recently, exchange-traded gold-related securities (which are backed by the physical storing of bullion). This source of demand is volatile and unpredictable, but usually increases **after** the price of gold has gone up as investors are afraid of missing out on a seemingly obvious upward price move. The wildcard in terms of supply is the action of the world's Central Banks and the IMF which collectively own 32,000 tonnes of gold (almost ten years of core demand) and tend to be net sellers of the commodity (usually **after** the price has done poorly for several years!).

An important development in terms of gold supply has been the dramatic recent increase in gold mine production costs including labour, energy, power and consumables such as cyanide and parts for heavy equipment. Production costs for North American gold mining companies have increased from about US$250 per ounce two years ago to the US$350 per ounce level. Production costs in South Africa and Australia, which are generally higher than costs in North America, have also risen appreciably.

What is a reasonable gold price?

In summary, many factors influence the price of gold. So where do we put the pin in? The ten year average price of gold to the end of 2005 was US$ 337 per ounce. We suspect that continued downward pressure on the US dollar combined with the material increase in gold mine production costs will push this average higher over the next few years. We use a long term average gold price of US$500 when evaluating gold investment opportunities.

Gold Stocks

We believe that the appropriate method to value a gold company is a discounted cash flow approach. Gold companies, like other commodity producers, typically have depleting asset bases. An investor should estimate the stream of free cash flow that is likely to be generated over the life of the ore bodies owned by the company, while adjusting for risk with what is known as a discount rate.

We discount the free cash flow of a gold company (or any other mining company) at a rate that we feel compensates us for the risk inherent in the stream of free cash flows. We use a discount rate of about 10% for a high quality mine located in a politically stable location. The discount rate we use increases as our view of the risks associated with the investment increase. The reason we do not currently own any gold company shares is that we have been unable to find a gold company that trades close to its underlying intrinsic value, as determined by our discounted cash flow approach.

The stock market currently values a typical gold company at almost **2 times** its underlying discounted cash flow value, using an extremely low discount rate of between **0% and 3%!** This makes no sense to us and does not pass our test of "if the stock market was closed, would we buy the whole company at its current price?" We will continue to search for a suitable gold company investment. In the meantime, our portfolios remain focused on the shares of companies that have strong business franchises, that are run by capable management teams, and which are available at attractive prices relative to their intrinsic business values.

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