Stock selection starts with a careful look at management and seeks firms with increasing production cash flow and reasonable valuations.

Investing in Gold-Mining Firms With a Focus on Smaller-Sized Companies

An interview with Victor Flores, portfolio manager, U.S. World Gold fund

Gold lost its luster last year—in 1995, the glimmering returns came from the S&P 500, at 37.5%; at the same time the average gold fund returned a dull 2.3%. The average gold fund has outperformed the S&P 500 over the past three years—18.5% versus the S&P's 15.3%, but over the last five years the average gold fund has substantially underperformed the stock market, 5.6% versus 16.5%.

The varying annual returns over the last five years (2.3%, –11.5%, 86.9%, –15.7%, –4.8%) illustrate gold's volatility. Nonetheless, its independent movement relative to other financial assets means that it may provide diversification benefits to an investor's portfolio, and many individuals continue to be drawn to the commodity.

One of the best-performing gold funds over the past five years has been the U.S. World Gold fund. In 1995, the fund was up 15.9%, the top-performing fund in the category, according to AAII's Quarterly Low-Load Mutual Fund Update. *Its three-year average annual return of 22.2% is the second-best performance for that time period, while its five-year average annual return of 10.9% is again at the top of the list.*

Currently, the fund has about $225 million in assets.

In early January, portfolio manager Victor Flores discussed the fund and its management with Maria Crawford Scott.

What is the objective of the World Gold fund?

The objective as stated in the prospectus is to deliver capital gains. My own objective is to deliver capital gains above and beyond the major gold indexes and the other competitors.

You've done well versus many competitors. What differentiates your fund?

We differentiate ourselves from our competitors by the kinds of stocks we invest in—we invest in gold mining companies like the others do, but that's about as far as the similarities go. We tend to focus a lot on smaller-sized companies. We have a sprinkling of exploration stocks, and the scope is very international.

What are the major indexes you compare your fund to?

The one that I look at the most is the Toronto Gold and Silver Index because it is a good broad-based barometer for the North American gold mining industry. Because the fund does not invest in South Africa, the Toronto index is the one that is closely related to the types of stocks I buy.

Why doesn't the fund invest in South Africa?

The original reason for not investing in South Africa was political—the country was facing sanctions and had a lot of civil problems. We [the fund family] offer the Gold Shares fund, which is predominantly South African gold companies, and we started the World Gold fund for those who didn't want to invest in South Africa. More recently, with the ending of apartheid and multiracial elections, it's okay for us to invest there, politically speaking. However, from an investment point of view, given the kinds of companies that I buy for the World Gold fund, there really isn't much in South Africa for me to buy. I'm focusing the World Gold fund on companies that are growing and the South African gold mining industry is a very mature industry, with little, if any, growth left there.

What is your criteria for selection?

The first thing I look at very carefully is management. Mark Twain once said that a gold mine is a hole in the ground with a liar on top and, unfortunately, that still happens a lot, so you have to focus very carefully on management.

How do you judge management's ability?

There are several things that you have to look at and it depends on the size of the company. When you are dealing with the exploration-type companies, you have to have three components to management, and it can be in one person or it can be part of team. First, you need someone that actually knows something about finding gold deposits—an

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The U.S. World Gold fund is part of the United Services family of funds, P.O. Box 781234, San Antonio, Texas 78278, (800) 873-8637, (210) 308-1222.

experienced exploration person or team. The second thing you need is someone who has an ability to tap the capital markets, someone who can "sell the story" because exploration is a cash-consuming exercise. And the third thing you need is for these people to be honest and for them to actually be able to do what they say they're going to do. And that's something you can only get by being in the industry and getting to know who the good guys are and who the bad guys are.

Is that well-known within the industry?

If you've been around the industry for a while it gets to be fairly easy. What tends to happen is that you have these cycles of investment where all of a sudden there's a lot of cash available for gold mining exploration. When that happens, a lot of people who have never been able to produce anything crawl out of the woodwork. Then you go through this financing cycle, their stock prices go way up, they don't find anything, prices come crashing down and the guys disappear back into the woodwork for five or six or seven or eight years or however long it takes between one of these cycles. It's amazing to see the same characters turn up again and again. Because I've been through it before, I recognize them, but a lot of people haven't and they get caught up in the excitement and then they lose their shirts.

I don't want to characterize this as a totally lawless industry—there's a lot of very good people doing very good work. But you have to be careful, learn not to be greedy, and you have to buy these exploration properties at very cheap prices, when the market doesn't want them, because once you get into the euphoria, you're going to end up paying too much and sooner or later there's going to be a disappointment.

But these exploration companies are just one type of company that you're investing in?

Just one type and it's the smallest part of the portfolio, but it's the one where you get the big hits. It's the high-risk, high-return portion of the portfolio.

The other 90% to 95% of the portfolio is in companies that are producing gold and they range from companies that are just getting ready to start production to the very biggest companies that have a dozen mines throughout the world. And as you move from the exploration phase into the larger companies, the depth of management has to increase—their experience and abilities have to increase. They have to have a team that's good at doing more than one thing.

What other criteria do you use when investing?

Once management has passed the "smell test," if you will, I'm looking for companies that are increasing their production, increasing their reserves, and are trading on a valuation that makes sense given their production cash flow.

I look very closely at the net present value calculation. In other words, I will look at a mining company and say, "Okay, how many ounces is this company going to produce, how much are they going to sell it for, how much money are they going to earn off of that over the next few years?" Then I discount those future cash flows back to the present and compare that to the market value of the company. The reason I do this is very simple: That is how the mining industry transacts. In other words, if one mining company is going to buy another mining company, they would go through the exact same exercise. We very much consider ourselves part of the gold mining industry and we make our investment decisions as other mining companies would.

In terms of market capitalization, what is the range of the firms you invest in?

At the small end, we bought into a little exploration company recently, which is actually already producing, and the market capitalization was $3 million.

That's pretty small.

It's real small, but the thing is, it's a gem and an absolute steal. And we also have companies with market caps of $5 billion or $6 billion.

Is the $3 million company a "penny stock"?

I dislike that word tremendously because of the many implications that go with it. I guess technically it would be because we paid the 15 cents for it, although now its somewhere around 40 cents so my pennies have increased. Do I consider it a bad investment or a very speculative one? No, not really. I know the management very well, I know the property fairly well. They did an interesting merger with another fellow whom I didn't know, but for whom I have some respect.

How did you find it?

They called me up and asked if I would look at this deal they were doing. We spent a whole afternoon going over everything and I said, yeah, I'm definitely going to pay 15 cents for some stock here.

So it's not a bunch of boiler-room brokers calling you up and selling you stock?

No. In order to do all these things that I'm talking about—the valuation, the research, checking on the management—it requires a fair amount of knowledge of this industry, and we're all very technically oriented here. By technical, I don't mean looking at stock charts; I mean we all have technical backgrounds: I'm a geologist and a mineral economist by training; the research director is also a geologist and a mineral economist by training; I've got two petroleum engineers with graduate degrees working for me. So we have the kind of people here that can actually make technical evaluations, on site if necessary.

One other sector that the annual report stated you invest in is mining finance—what's that?

It's kind of a catch-all heading. There are a couple of companies that have been very successful buying royalties on gold-mining operations, so they're not actually in the gold-mining business per se—they don't mine any gold, but they are making money off of gold mining.

Would they tend to be less volatile than a gold production company?

Theoretically yes, but they're not, because people who understand the industry view them almost directly as gold-mining companies.

And ironically one of those companies is a company that runs mutual funds as well?

Pioneer. They are in the mining finance category, but they aren't in the royalty business. Pioneer is a mutual fund company, as you pointed out, but they also have a gold-mining subsidiary, which in fact is worth more than the fund business, and that's why I bought it—because it is an absolute steal. Here you have a mutual fund company that's trading based only on the mutual fund assets, and the market is paying little or nothing for the gold-mining subsidiary.

What would prompt you to sell a gold stock?

Certainly if the valuation gets ridiculous, and you see that happen often where the market's expectation of what a company is going to do gets way ahead of the reality of the company.

Primarily what I sell on is disappointment, on a sense that the company just isn't going to do what they said they were going to do.

The other thing that would make me sell a stock is when they announce a bad deal—if the company says they're going to pay X millions of dollars to buy Company B, and I feel that they are nuts and they've way overpaid, I'm out of there.

Does that happen a fair amount in the gold business?

There is lots of corporate activity, all the time—companies buying other companies, companies merging, companies buying properties. It's a very active business.

Are you always fully invested in gold stocks?

Always. I'll tell you why. First of all, no one can judge with any accuracy what the price of gold is going to do, or what the stocks are going to do. You can have a sense that a stock's overvalued or undervalued, but you don't know when the price of gold is suddenly going to run. Secondly, people buy your gold fund because you are going to own gold stocks. They're forgiving when gold goes down and your stocks go down, but they're very unforgiving if gold goes up and your fund doesn't go up because you were worried about the market and were not invested in gold stocks. Third, we're part of a mutual fund family that offers the World Gold fund because it's a diversifier for an individual's portfolio. People buy into my fund and they buy other assets, as well. If I'm not invested in gold stocks, they're not really getting what they thought they were buying. Finally—and most importantly—I take a long-term view of gold-mining companies, and I'm looking at companies that I think are going to grow and prosper over time, so I tend to just hold them.

Has the industry changed over the last decade or so?

Dramatically. If you look at the gold-mining industry 15 years ago, the industry was dominated by South African gold-mining companies and the gold-mining activity taking place outside of South Africa was small. But new technology that was developed at the time opened up a lot of the western U.S. and parts of western Australia to gold-mining production. So you had this big boom in production that was part of the creation of a new industry. Since then this industry has become more sophisticated and stratified—you have exploration companies and small mining companies that didn't exist five or 10 years ago, and you have big gold-mining companies running around the world doing all kinds of things.

The other big change is the internationalization of the industry. As the world has opened up to free trade, the same thing has happened in the mining industry worldwide—so countries like Chile, Peru and Mexico, which were closed to foreign investments, all of a sudden have privatized state-owned assets. And that has really been the big boom movement in the past six or seven years. It's also moved—it started in Latin America, and it's moved to parts of Africa, southeast Asia, and the former Soviet Union.

But is your fund invested in all these countries? It appears from the holdings that they are primarily Canadian, U.S. and Australian stocks.

But it is international. Remember where the capital comes from— primarily North America and Australia to a certain extent. But this industry has gotten very sophisticated—you can headquarter the company in Toronto, list it in Vancouver, raise money in the United States, and pick up mining assets in Peru.

So, I'm invested in Peru without taking any risk of investing in the Latin American stock market, or I'm investing in a country where there is no stock market. But I am participating in mining development in a very deep place like Peru, which is fantastic in terms of geology. We are very much participating worldwide, you just don't see it in the names of the stocks or the places that they're listed.