The Gold Report

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Exclusive!

Brian Ostroff: Junior Gold Equities Worthy of Praise

Source: Brian Sylvester of *The Gold Report* (11/30/11)

As the market sloshes around, gold is searching for its identity. It has played currency hedge and equity adeptly at different times this year. While other investors wade through the confusion, Brian Ostroff, managing director of Montreal-based Windermere Capital, is taking the opportunity to snatch up gold mining equities that have been quietly performing under the radar. In this exclusive interview with *The Gold Report,* he contemplates why the market isn't rewarding junior gold equities worthy of praise.

Companies Mentioned: **Adventure Gold Inc.**- Agnico-Eagle Mines Ltd. - Arianne Resources Inc. - Breakwater Resources Ltd. - Cartier Resources Inc. - Full Metal Zinc Ltd. - Teck Resources Ltd.

The Gold Report: There are unprecedented debt problems threatening the existence of the European Union. The U.S. government is exploring ways to cut more than $1 trillion from its annual budget, which could put the brakes on the U.S. economy. However, you don't forecast a market plunge like in 2008. Why?

Brian Ostroff: It's a tale of two cities. On the one hand, Europe has a lot of issues addressing sovereign debt and it has structural issues. The EU is a group of countries that has been put together, but it's difficult to get a consensus to deal with those issues. A domino effect started with Ireland, Greece and Portugal. Just today there was news about a poor bond auction in France.

Unlike the European economy, the U.S. economy doesn't seem to be stalled despite its debt issues. Economic indicators seem to be showing some improvement. Jobless claims in the U.S. were recently at a seven-month low and industrial production numbers are good. Even confidence numbers have been pretty good.

At this time, I don't expect that the U.S. will face a double-dip recession. The U.S. economy is starting from a lower level than it was at in 2008, so it can't fall that far again. Home prices aren't going to fall another 30% or 40% and job losses aren't going to triple from here.

In 2008, commercial lending completely dried up. The biggest and the best companies that relied on the commercial paper markets to get funding faced liquidity issues. However, over the last couple of years, there's been billions of dollars in bond issuances by those companies as they moved out of commercial paper and into longer-term debt. They wouldn't be subject to another liquidity crunch because they no longer have to rollover their paper every 30, 60, or 90 days.

The primary risk, which unfortunately is currently outweighing the statistics, is a psychological one. It takes a toll when you wake up every day and hear how bad things are and how inept the politicians seem to be at getting a consensus. To what degree is the U.S. economy impacted by Europe beyond psychology That's the big question but U.S. banks don't appear to have huge exposure to European sovereign debt on their balance sheets and let's hope not too much counter-party risk.

TGR: But we really don't know.

BO: Fitch Ratings has raised concerns, but St. Louis Federal Reserve President James Bullard said recently that the European debt crisis is unlikely to impact the U.S. so I guess we will see but, realistically the Europeans are not a big driver of the U.S. economy.

TGR: How will the global economic picture ultimately prove positive for precious metals?

BO: The reason to be bullish on gold is that there is most likely going to be more money printed. The European Central Bank will likely get the okay from its member nations to put together a bailout fund of $1 trillion euros or more—whatever is required. Although there are signs of an improving economy in the U.S., I don't see the Federal Reserve tightening any time soon. The last piece to this puzzle is China. It tightened up last year and early into this year. Some are now concerned that China is slowing down too much and with that the next move by the Chinese could actually be a loosening.

Our belief has always been that gold is a currency no different from the euro, dollar or yen. But gold can't just be printed. It's just a relative valuation. We see gold continuing to gain on the back of all this printing

TGR: Some days gold trades like a reserve currency, but other days it trades like common stocks. When do you expect gold to find its identity in this Jekyll-and-Hyde situation?

BO: Gold seems to get caught up in the risk-on/risk-off trade. Historically, gold has been inversely correlated to markets as a whole. That was apparent this summer when things really started to deteriorate in Europe. With all asset classes dropping, gold rallied up to $1,900/ounce (oz). It really was starting to regain its luster as a safe-haven asset. Lately everyone is saying, "Where's gold, where's gold? Why isn't it doing its job?" But let's be realistic, the gold price is still $1,750/oz with all the headwinds it seems to be facing. I'm encouraged that gold is going to continue to be a good place to be.

TGR: What do you expect the trading range to be in 2012?

BO: I'm not much for prognostication on trading ranges. I do believe that the trend is going to continue to be higher.

TGR: Do you forecast a similar trend for silver?

BO: Silver is the poor man's gold. It might be difficult for people to pay $1,750/oz for gold, but $33/oz fo silver is pretty attainable. As more people start to understand the benefit of precious metals as a hedge, silver will gain from that.

TGR: Windermere Capital currently manages two open-ended hedge funds with a natural resource focus, Breakaway Strategic Resource Fund and Navigator Fund, both domiciled in the Cayman Islands. How exposed are those funds to precious metals?

BO: Breakaway is exclusively mining and Navigator is across all natural resources. Both funds have moderate-size positions in precious metals, but our focus is on a micro level. We go company by company. Right now, there is great value in stocks and we anticipate taking our holdings up.

Gold stocks are also a tale of two cities. Are they gold or are they stocks? Lately, they have acted more like stocks. I like to look at the ratio of how much gold it would take to buy the Philadelphia Stock Exchange Gold and Silver Index (XAU). Over the last 30 years, on average it would take about 0.23 oz gold to buy that basket of stocks, whereas today it would be about 0.116 oz gold. That's about half of the historic norm. One could conclude that gold stocks are acting more like stocks than gold. Our anticipation is that the ratio will make its way back toward the norm.

One reason we have seen such a distortion is gold exchange-traded funds (ETFs). Before ETFs existed, anyone who wanted exposure to gold typically bought gold equities. Gold ETFs have definitely drawn in a lot of money that might have otherwise headed for the equities. Gold ETFs, however, really serve a different purpose than gold itself. People who buy gold ETFs lean more toward the speculative crowd looking to profit from gold's movement as opposed to people who buy physical gold seeing it as a hedge and aren't necessarily looking to profit from it.

If we were going to go through a period of a relatively narrow range on gold, the hot money would leave ETFs. The profit would have been made [or lost] and the trade would be over. Then that fast money would look for whatever other opportunities exist. With the gold price at these levels, gold companies are going to make a lot of money. The sector is going to start to pick up attention and money will flow to it. We think the ETF effect on the gold:stock ratio will dissipate over the next few months.

TGR: Silver ETFs have proven to be much more stable than gold ETFs. Do you have any explanation for why the averages are much different for the SPDR Gold Trust ETF compared to the iShares Silver Trust ETF?

BO: Silver is really just gold on steroids. Silver had a speculative spike last spring where it ran up to about $50/oz. It's since worked its way back into the low $30s. That's a pretty amazing collapse really—and it only took about a week. Silver is probably consolidating its gains. A lot of investors are licking their wounds, but silver will make another move.

TGR: Do your funds invest in ETFs at all?

BO: From time to time, however, the focus of our fund is mostly on the small- to mid-cap equities themselves. Our performance is driven by our ability to find some interesting, young companies much earlier than when other financial players would look at them. Our group has a strong technical bias to it. A lot of our guys are geologists, mining engineers or metallurgists. We're even comfortable with micro- and nano-cap stories where we feel there's the backing of good management on a good property that the market inevitably will start to recognize.

TGR: Haven't the juniors suffered an even more drastic underperformance than the seniors have?

BO: I call the juniors a one-way market because investors typically either want in or they want out; there's very rarely equilibrium. In August and September, there was a lot of wholesale liquidation in the sector. A lot of funds had come down to the juniors looking for beta. Then they found themselves in a situation where they had to get out, but they were in a market where there wasn't much liquidity. It has really created a lot of opportunity going forward for the juniors in particular.

TGR: Catalysts that once significantly moved share prices in the junior precious metal equity space are either not moving the share price or they're moving it only a negligible amount. How are you taking advantage of that?

BO: These markets run in cycles. Right now, investors are exiting this sector. Even if a company issues some good news investors see that as a liquidity event and use it as an opportunity to sell rather than buy. For us, it continues to be a matter of looking at the company and looking at its progress. It's a perfect environment because there are companies that have done a great job advancing their projects, but their share price has not responded. I'd go one step further—there are people that are looking to exit their position and providing us the liquidity we need to get into some of the stories that we find very attractive.

TGR: Adventure Gold Inc. (AGE:TSX.V) seems to be a good example of a company that has issued some very good news on several fronts, but its share price has really not responded.

BO: A couple of weeks ago Adventure Gold put out some early results on its Meunier-144 property in Ontario that is a joint venture with Lake Shore Gold Corp. (LSG:TSX; LSG:NYSE.A) and RT Minerals Corp. (RTM: TSX.V). Early drilling has been very encouraging. The nature of the rock has been exactly what they were looking for. There should be further results coming in the next few weeks from that property. The hole is about 2.4 kilometers deep and has taken roughly a year to drill.

There have also been more results out of Adventure Gold's Pascalis-Colombiere property in Québec, which was the old Béliveau mine operated by Cambior Inc. That mine had produced roughly 170,000 oz over a four-year period in the early '90s and then was closed due to low gold prices. When IAMGOLD Corp. (IMG:TSX; IAG:NYSE) bought Cambior, it was no longer a core asset and it gave Adventure Gold the opportunity to pick up the property.

Adventure Gold subsequently initiated a couple of drill programs around the mine that have hit some very substantial results at surface just to the northwest of the historic mine, including long intercepts from surface. We're really quite encouraged by what that means for the company going forward and for that particular property.

TGR: One of the intercepts you're talking about was about 65 meters of 2.7 grams per ton. That's still open at depth. It could be a bulk tonnage target. It's in Val-d'Or, so there are established mines and a lot of infrastructure in the area. Why wouldn't a result like that push the share price higher?

BO: Adventure Gold is not alone. Many companies have put out very positive results and have seen very little effect on their share price. The management of Adventure is topnotch and is not discouraged. It really is a matter of them continuing to do their work. They're onto something very exciting and they're going to continue to prove it up.

TGR: Another development in that area recently is that Agnico-Eagle Mines Ltd. (AEM:TSX; AEM:NYSE) shut down its underground bulk tonnage Goldex mine due to water problems. Is that likely to have any impact on Adventure Gold's various properties?

BO: Agnico-Eagle and Adventure do have a joint venture on the Dubuisson Property in Val-d'Or. A few weeks ago there were some releases on the preliminary drill program. That will be followed up with a secondary drill program into next year.

Agnico has to reassess its situation with Goldex. It has shown itself to be an acquisitive company with a couple of recent transactions. Going forward, it may continue to go the acquisition route to make up for the shortfall from Goldex.

TGR: You seem to favor a lot of companies operating in Québec. Is it because you are in Montreal and this is the space and people you know?

BO: Foremost for us is making an investment in a sound jurisdiction. It's hard enough to find an ore body that's big enough to be economic and take it down the path to production. To layer on an additional wild card of whether or not a company may or may not own that mine tomorrow is just not where our appetite is. We tend to stay in stable, well-known jurisdictions. It's pretty tough to beat Canada. And within Canada, Québec is a wonderful place to do business. We do have a lot of investments outside of Québec, but Québec definitely plays an important role in our portfolios. The government is very pro-mining. It recently introduced the "Plan Nord," which will put billions of dollars toward infrastructure to assist mining companies.

TGR: Another Québec-based company you like is Cartier Resources Inc. (ECR:TSX.V). It has done some channel sampling on the Cadillac Extension property in the Abitibi gold belt north of Adventure Gold. Cartier is going to test its geological theories with some drilling there. What do you expect?

BO: The Cadillac Extension has had some significant finds. Cartier has a very large package along that. The best place to find a new deposit is right beside an old deposit and, along that trend, there has been no shortage of significant finds. Cartier is a little earlier stage than Adventure, but it does have a good suite of properties and an excellent management team. Given some time and some resources, we're encouraged that the company will be able to find something of significance.

TGR: Are there other commodities that you're bullish on?

BO: Our fund does look beyond gold and silver across the spectrum of metals. We are pretty excited about the prospects for zinc looking out a bit. There will be some significant closures of mines that will distort supply and demand over the next few years.

As an investor however, it is difficult to find a pure play in zinc. Teck Resources Ltd. (TCK:NYSE; TCK.A:TSX) is one of the largest zinc companies in the world, yet a significant portion of its revenues come from coal. BHP Billiton Ltd. (BHP:NYSE; BHPLF:OTCPK) and Rio Tinto plc (RIO:NYSE; RIO:ASX) are major players in zinc, but a significant move in the price of zinc isn't going to make a huge difference to such big companies.

There are only a few pure plays on zinc and one of the purest [and early] plays we've found in zinc is Full Metal Zinc Ltd. (FZ: TSX.V), a spinout from Full Metal Minerals Ltd. (FMM:TSX.V). It took Full Metal Minerals' zinc asset, the Fortymile property in Alaska, in order to build out a zinc-focused company. It recently brought on Steve Hayes as chief executive, who used to head business development at Breakwater Resources Ltd. (BWR:TSX) in Ontario.

Breakwater was a pure play on zinc and was bought by Nyrstar NV (NYR:EN Brussels), which is a zinc smelter. As a smelter, it needs feed. It probably sees the same thing coming down the line as we do in the next two to three years. It chose to vertically integrate to secure that feed.

TGR: Are there other commodities that you're bullish on?

BO: The largest holdings in our fund are in the phosphate sector. About 85% of phosphate is used in fertilizer. The dynamics of the phosphate market are very compelling, particularly in North America. North America runs a deficit in phosphate and the deficit is going to become more severe in the coming years as Agrium Inc.'s (AGU:NYSE; AGU:TSX) Kapuskasing mine in Ontario shuts down. The Mosaic Co. (MOS:NYSE) has encountered some environmental problems that have shut down some of its expansion plans in Florida, as well.

The bulk of the North American deficit in phosphate is made up through imports from Morocco. I've got to believe that North American producers would love to have greater security of supply. We have holding in several phosphate plays, but our largest holding is currently in Arianne Resources Inc. (DAN:TSX.V; DRRSF:OTCBB; JE9N:Fkft) in Québec. It recently put out a prefeasibility study and is advancing nicely. I think it shows it to be a world-class asset.

The company said that it is going to enlarge its study to include a larger production profile of 3 million tons (Mt) a year of phosphate instead of 2 Mt. Preliminary numbers show it would improve its net present value by about 60%, or over $1 billion, with just a 20% increase in capital expenditures. As far as we are concerned, the prefeasibility report has shown what's important: It is a large, high quality ore body that makes a very high-purity concentrate, which has been turned into a high-quality phosphoric acid.

TGR: Institutions that get involved in these types of projects usually like to see a faster payback period then that and probably a rate of return maybe a bit higher. You believe that by tweaking some of the aspects of that study they can get there?

BO: Yes. The study currently assumes a $175/ton (t) sale price for the rock, while the current market pric is north of $200/t. For every $1 in margin, by either cost savings or selling at a higher price, it will mean $17 million in pre-tax NPV to the project.

TGR: The price can fluctuate greatly so that's why companies use a lower-than-market price in studies.

BO: Absolutely, however the fact that Arianne can produce one of the purest phosphate concentrates in the world should give it pricing power well above benchmark pricing.

TGR: Arianne sounds very compelling. That will certainly remain on our radar screens. Do you have any parting thoughts for us today, Brian?

BO: It's important for investors in the sector to understand the nature of this market—it's a very volatile sector. It's important to understand the company as an investor, so that when there are periods where the market doesn't give any appreciation for the assets, investors understand why they are holding it. If the company does a good job moving forward, inevitably investors will get a good return on their investments

TGR: Do investors also need to have a defined exit strategy?

BO: It has to be a little bit more fluid. Investors definitely have to understand why they invested in a company. They should understand what that company's benchmarks are to see that it hits them. Then they'll understand why they should continue to hold a stock or, if a company has fallen short of those benchmarks, why it's time to exit.

TGR: Thanks for sharing your thoughts with us, Brian.

Brian Ostroff graduated from the University of Toronto in 1986 and joined RBC Dominion Securities in 1987 where his focus was on small-cap special situations and alternative investments. In 1999, Mr. Ostro *joined M&A advisory firm Goodrich Capital where he was the Canadian managing partner overseeing mandates across a spectrum of industries with a focus on display technologies and mining. In 2004, Mr. Ostroff moved over to the trading side of the business where he spent a year as a proprietary trader with a large Canadian bank and then subsequently on his own for four years before joining Windermere. His area of focus is the junior and mid-tier mining sector.*

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