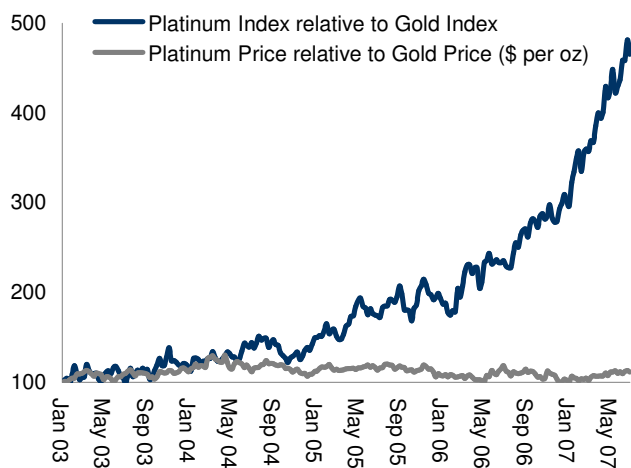




Many a gold-bug must be frustrated and horribly disappointed with their gold stocks. The price of gold has raced forward and looks on track to meet the expectations of even the most exuberant fan. Gold shares, wallowing in a mire of rising costs and falling grades, have however been slow to turn these good fundamentals into cash flow.

These points make themselves very apparent in the graph below which shows the South African gold shares' underperformance relative to South African platinum shares, even though the price performance of gold and platinum have been similar.



Source: INET

This is however the past and there is no profit in describing the past. We must look to the future if we are

to have any investment success. So what does the future hold? Will gold continue to do well? Will gold shares continue to underwhelm? Alas, we have no crystal ball, but we do have a few thoughts as to why the Dollar price of gold should continue to rise and why gold shares may continue to disappoint.

We will start with the metal and explain our optimistic Dollar price prognosis.

Gold has a number of factors working in its favour. The commodity's demand and supply metrics seem distinctly skewed (over the next couple of years) towards a supply deficit. Sentiment has also swung, once more classifying gold as a viable asset class and giving birth to not only new investment demand in the form of exchange traded funds (ETF) but less supply from central banks. While these points are indeed positive for the price of gold, they are not what cause us to be optimistic about gold's prospects.

What we really like about gold is that it is inert and it is unmoved and unfettered by the whims of central bankers. We do not see the price of gold increasing so much as we see all the currencies against which gold is measured decreasing, thereby giving the illusion of a gold run. Why are all these currencies depreciating? Well, it is once again a simple demand-supply problem. With money supply as large as it currently is, demand just cannot keep up. This, combined with the fact that no country wants its currency to appreciate significantly against its trade partners has caused a vicious cycle of monetary stimulation and a global depreciation in purchasing power. This is very good news for gold since the real value of gold stands still and maintains its

purchasing power thereby allowing its price to increase on a relative basis. In light of these factors, we continue to be positive about gold.

The gold companies on the other hand still seem fraught with peril. Their share prices already discount much better earnings and cash flow. The companies have also picked the eyes out of their mines and are now suffering declining grades and increasing costs. Consequently, gold stocks only achieve “leverage” to the Rand gold price when the metal price increases well in excess of the firm’s rampant cost growth. Without this leverage many a gold investor has started to question the rationale of holding their exposure through gold stocks versus the underlying commodity. While we take note of all these concerns, we have an even bigger issue with the gold shares.

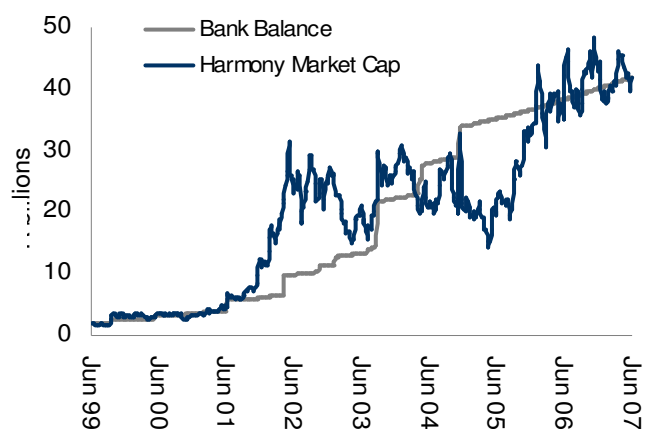
The South African gold companies have destroyed shareholder value over the last few years by being too free with their equity. This combined with poor operational performance has contributed to poor returns against the market, other precious metal stocks and the underlying commodity. We will now examine some of this value destruction.

In 2003 AngloGold bought out Ashanti Goldfields. To fund the transaction AngloGold issued about 42 million shares, or 19% of its issued share capital. AngloGold produced 5.6 million ounces of gold in 2003 and hoped with Ashanti’s help, to produce 6.4 million ounces in 2004. This year AngloGold Ashanti (the merged group) hopes to produce only 5.7 million ounces. Is it therefore any wonder that AngloGold Ashanti has performed so poorly? To be fair the transaction was required, and did

help, to fill the hole left by the decline in the existing business. The point however is simple: AngloGold had to dilute its shareholder’s equity by 19% just to stand still. This is blatant value destruction and goes some way to explaining the graph on the previous page.

In 2006 Goldfields bought the South Deep mine. To do this it bought out Western Areas and acquired Barrick’s 50% share in the actual mine. It then unwound the Western Areas hedge book. All in all, by our calculation, Goldfields spent R20 billion on the entire transaction and funded the majority of this with shareholder equity. This is an incredible quantum of money. If Goldfields is to make even a 10% return on this capital, it will have to produce R2 billion in profits. This is very unlikely given the production expected for South Deep; in fact we believe Goldfields (in a couple of year’s time) will be very lucky to make half this amount.

Bernard Swanepoel’s closing comment in Harmony’s 2006 ‘Chief Executive’s Review’ says that the company “will continue to create value wherever the opportunity arises”. This is ironic given the graph below:



Source: INET

The graph represents the result of a hypothetical situation. It shows what an investor could have achieved if given the same amount of equity as the market has given Harmony. However, instead of putting the money into Harmony, the capital was simply put in the bank. While it appears very impressive to have created a R40 billion company (market capitalization), it is not. In fact, anyone could have created as much value by simply opening a savings account. Harmony has actually destroyed value, since it has not compensated its shareholders for any risk.

So, what is our conclusion? Will gold continue to rise and gold shares continue to underperform? They might, if gold companies and gold investors continue to behave as they have. If however, as management expect, grades start to pick up, costs start to be managed, production edges higher ... and the companies are more frugal with their equity, then the current trend of underperformance can change. This combined with the shares' very shoddy relative performance has caused us to re-examine our investment rational and assess whether our underweight position is still warranted - because who knows, maybe one day the shares will once more glitter like gold.

ⁱ The article was written when **Afena Capital** was still operating under the name **Renaissance Specialist Fund Managers**.