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THE PETE ANDRESEN INVESTMENT NEWS ANDRESEN & ASSOCIATES

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THE GOLD TRAP

Although you would think that we have all learned our lesson from the cataclysmic technology market “bubble”, it appears that speculation is alive and well. Unnoticed by many investors, gold mining stock mutual funds are up 72% so far this year, while gold is up 21% from its 2001 low of about \$270.

Precious metals stocks are mostly gold mining stocks, with a few distributors sprinkled into the mix. It is important not to confuse the metal with the mining stock. The mining stocks own the unmined metal in the ground that they own, the mined metal on hand, and the physical mine itself, including all the equipment. Because these stocks usually have control over a great deal of unmined metal, they are priced by everyone’s expectations about the future price of gold. They represent a leveraged play on the metal: they tend to move radically in response to a slight price in gold. For example, from its 2001 low of about \$270 an ounce, gold has moved up to \$328 an ounce. That’s an increase of about 21%. Precious metals stocks have moved up over 70% just in 2002.

Investors buy these stocks when they expect the price of gold to go up due to industrial demand, or, less rationally, when they wish to gamble about political events.

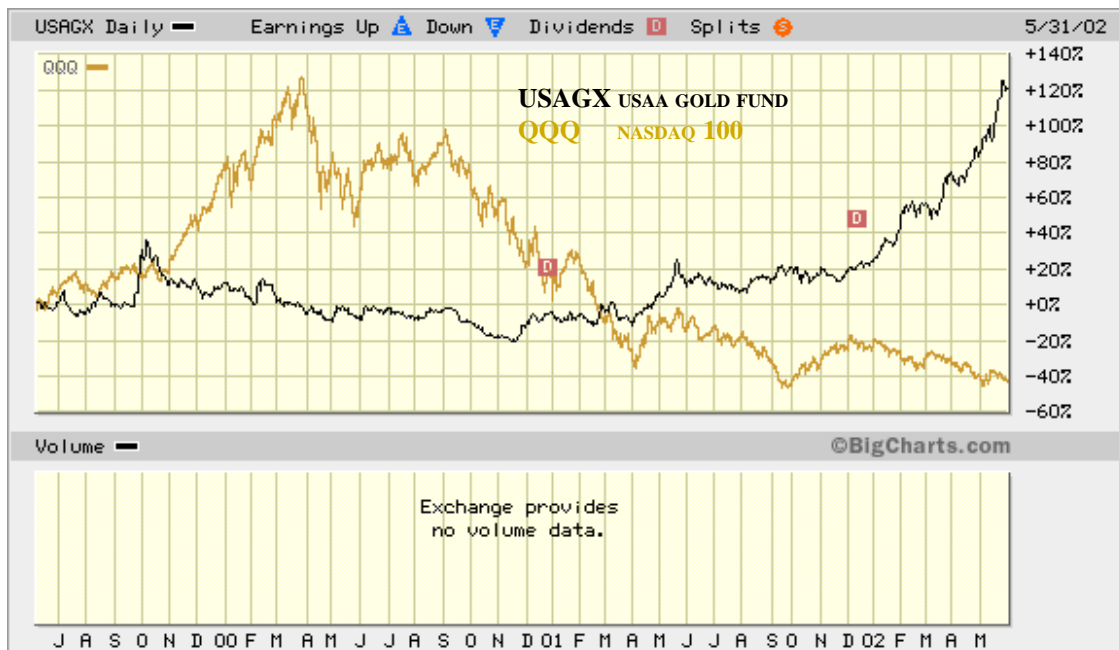
For over five hundred years, the use of gold as an international financial standard was an inviolate rule. In a world without democracy or rule of law, where all governments systematically looted their citizens, gold coinage represented uniquely portable, concealable, and tradable wealth. It also resisted inflation in a world where governments routinely destroyed their own currencies to pay off debts.

In Elizabethan England, five hundred years ago, one ounce of gold bought one good quality man’s suit with two pairs of “breeks”. Now, gold is at \$328 an ounce, so it can still make exactly the same purchase, hopefully without the ruffs and codpiece.

As recently as World War II, many refugees who fled the Nazis actually carried their wealth in gold form into exile

because the concept of wiring or computer transferring capital had not yet been fully created. In the past twenty years, however, wars and crises have not led to a rush to gold because computers have given us much more liquidity than in the past. It is now just too easy to transfer capital from one investment to another without using an international medium such as gold.

GRAPH 1



As an investment, the metal itself does not produce anything. Like diamonds, gold is a high priced rock, and it behaves like a rock. It does not provide dividends, and it does not grow. It incorporates no intrinsic human capital. As far as I know, gold has never invented anything or had an original thought.

In the past, the sterile non-productive nature of gold was vastly overruled by its place as a uniform standard of value. An investor in 2002 has other options: bonds, insured bank deposits, international currencies, and access to all the stock markets of the world within one trading day. For the longer-term investor, there is also real estate. A rational investor would buy gold only when he or she perceived that the entire financial system was suspect. As a result, most world-class investment professionals have largely retired gold as a medium of exchange.

The shelving of precious metals as the medium of exchange has been punishing to mining companies. Many of these concerns have been losing money for years. As in the case of the “dot com” stocks in the tech boom, many of these stocks have no positive earnings. Yet we have watched them soar upwards in the past several months.

Investors seem to be pouring money into these stocks as a speculation that the dollar will fall against foreign currencies, there will be more terrorist events in the US, and interest rates will increase. In other words, they are betting that disaster will strike and metals prices will go up. As in the case of the soaring earnings of tech stocks, these investors are gambling that rapidly rising metals prices will create positive earnings for the mining stocks.

That’s a giant speculation, and very similar to the tech version of a few years ago. In 1998, investors were betting that the

“dot coms” which were devoid of earnings could somehow become vastly profitable. Now they are dreaming that mining companies with a long history of red ink can now become wealth-builders. This has all the appearances of yet another financial bubble. (GRAPH 1)

Another indicator that we are witnessing a bubble is the Australian initial public offering market. Just as we observed in the 1997-2000 Tech IPO bubble in the US, the mining sector is experiencing a spate of takeovers and initial offerings. This is most pronounced in Australia where new mining concerns without profits race to join a host of other profit-free gold producers. And yes, just as in our own IPO bubble, many of these initial issues are over-subscribed. There are often more buyers than expected. This is clearly “bubble psychology” at work.

History tells us that disaster is unlikely to create such chaos that gold becomes a preferable investment. In fact, any precious metal has only been preferable when you need to pack up your wealth and run for it. As always, my advise is that if you must own gold, please consider buying and storing gold or silver coins, as well as plenty of cash and foodstuffs.

Meanwhile, the historical returns for precious metals stocks have been dismal, with uniquely low returns and high risk. Many precious metals mutual funds have fifteen-year returns averaging about 1% a year. This is a much lower return than you’ve been able to obtain in any reasonably conservative investment. I’ve noticed that recently many of these mining stocks have been losing money. In other words, like the tech stocks of yore, they have no earnings, and thus no measurable valuations. If gold prices continue to climb, perhaps that will change and these stocks will morph into attractive investments. Meanwhile, however, it looks like a high-risk gamble to me. I’d rather put my money into something with more attractive long-

term prospects, such as small and mid cap value stock mutual funds (GRAPH 2). As I wrote in our last newsletter, these are not having a bear market at all.

Meanwhile, these markets are telling us something even more important. People are scared, disillusioned, and willing to seek irrational answers. Even more critically, the dice-rolling demon of speculation that possessed so many investors to create the tech bubble is still breathing. It has merely migrated to other, smaller, seedier casinos. ☹

GRAPH 2

