Hedging Gold Not Free For Miners

Part of the futures industry's mythology is hedging is virtuous; speculators exist to accommodate hedgers' needs. How charming. In reality, hedging has a mixed bag of costs for investors in the firm; moreover, those costs often depend on management's compensation structure.

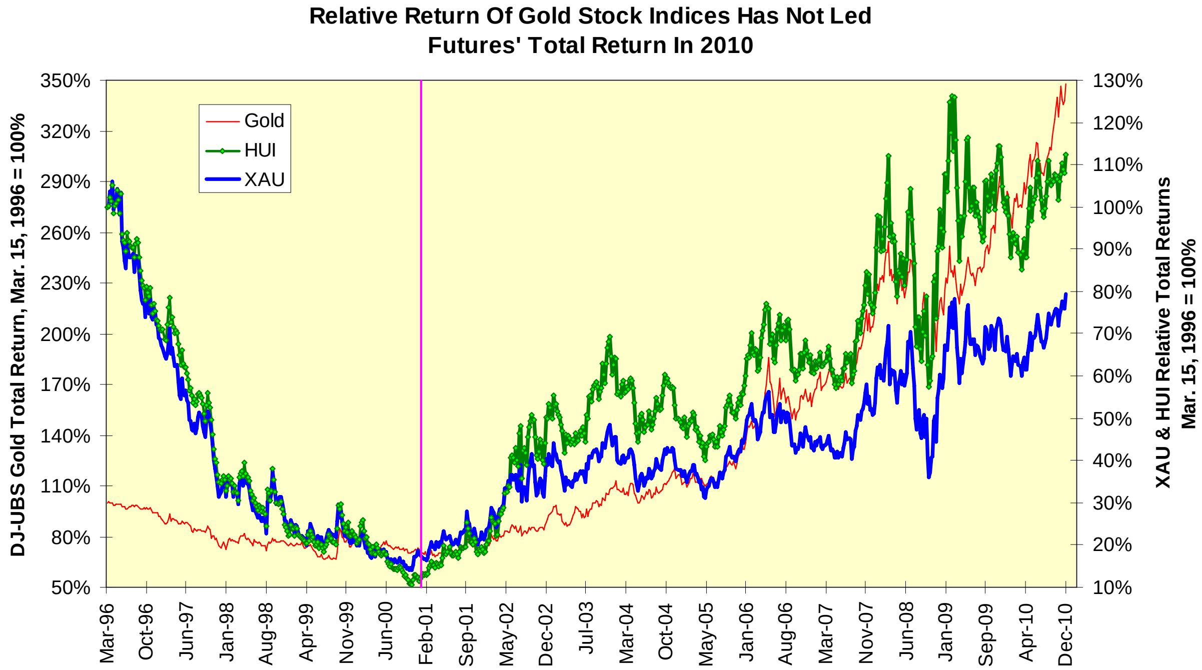
As a general principle, an investor in a gold miner who is treating the mining stock as a proxy for bullion – a very dubious proposition, but I digress – should not want the firm to hedge. Selling gold forward at a fixed price removes the upside for the investor and transforms the external risk of the market to the internal risk of whether the firm timed its hedges well. Hedging with put options or flooring swaps involves more direct costs.

Hedged And Unhedged

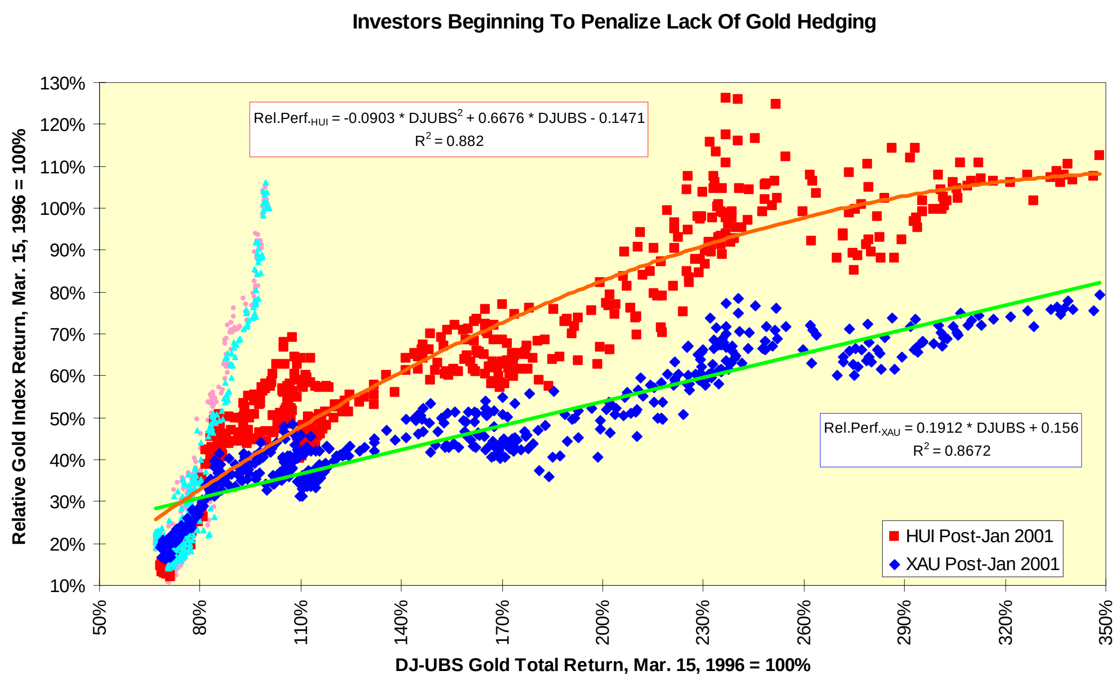
Let's take two precious metals indices, the capitalization-weighted Philadelphia Gold & Silver index (XAU) and the equal-weighted NYSE Arca Gold BUGS index (HUI). Firms in the HUI do not hedge their production forward past 18 months. A table of their members is presented below; firms in both indices are highlighted with a turquoise background.

XAU	HUI
Agnico-Eagle Mines Ltd	Agnico-Eagle Mines Ltd
AngloGold Ashanti Ltd	AngloGold Ashanti Ltd
Barrick Gold Corp	Barrick Gold Corp
Cia de Minas Buenaventura SA	Cia de Minas Buenaventura SA
Freeport-McMoRan Copper & Gold Inc	Coeur d'Alene Mines Corp
Gold Fields Ltd	Eldorado Gold Corp
Goldcorp Inc	Gold Fields Ltd
Harmony Gold Mining Co Ltd	Goldcorp Inc
Kinross Gold Corp	Harmony Gold Mining Co Ltd
Newmont Mining Corp	Hecla Mining Co
Pan American Silver Corp	IAMGOLD Corp
Randgold Resources Ltd	Kinross Gold Corp
Royal Gold Inc	New Gold Inc
Silver Standard Resources Inc	Newmont Mining Corp
Silver Wheaton Corp	Randgold Resources Ltd
Yamana Gold Inc	Yamana Gold Inc

The total returns of these two indices relative to the total return of the S&P 500 and equal-weighted S&P 500 are presented below with a marker denoting the first "surprise" rate cut by Alan Greenspan (remember when *this* guy was the embodiment of easy money?) in January 2001, ten fun-filled years ago. The total return for the Dow Jones-UBS gold sub-index is presented as well.



If we rearrange the data above split out the pre-January 2001 data points, we find the relative performance of the XAU has been a linear function of the DJ-UBS gold sub-index while the relative performance of the HUI has been a quadratic function. Restated, investors in unhedged gold miners are starting to act as if the firms' exposure to gold is too risky at these levels.



Should gold's enthusiasts pay attention? Probably: The relative performance of the mining indices led bullion prices higher ten years ago. While nothing in the stocks' relative performance today is flashing red, the very fact investors in unhedged firms are bidding less is significant. Of course, if the magic money fountain keeps gushing, gold will go higher as paper goes to zero.

Finally, one of the chief determinants of whether a firm hedges or not has been discovered by Peter Tufano at the Harvard Business School to be management's share holdings. If managements are invested heavily in the firm, they are more likely to hedge production forward. If management's holdings are small, they are content to let external shareholders assume the price risk, both higher and lower, of gold.