A Polished Approach To Silver Stocks

December 1979 was not a happy time around the world. Ted Koppel was still new on his *Nightline* gig, proclaiming "America held hostage, day…." and it was the Russians who were pounding Afghanistan to smithereens. If someone offered you the opportunity to buy silver at $2 an ounce then, you would have jumped at the opportunity to do so.

You still should. Incredibly, the inflation-adjusted price of silver in December 1979 dollars at the end of December 2001 was $1.98. Remember, it's buy low and sell high, not the other way around, and we're at the low end of a range that's persisted for more than a decade.

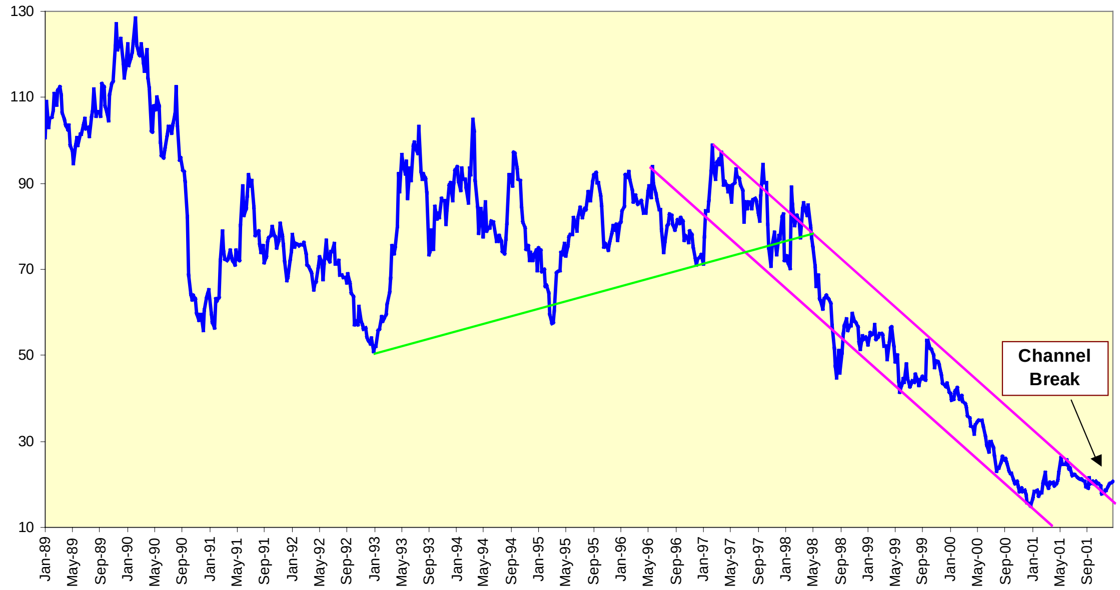
Spot Silver Futures, Constant December 1979 Dollars

A Tough Trade

Of course, the long silver trade has frustrated some pretty high-rolling investors; the Hunt brothers' debacle in 1980 was one, but even the eminently sober Warren Buffett has tried his hand. In 1997, the Oracle of Omaha bought 129.7 million ounces of the white metal. You could make a lot of tea sets out of that. In real dollars, the price is back below where it was when he started. His net real return, therefore, would be negative by the opportunity cost of capital and the physical costs of storing silver.

The biggest losers, collectively, have been the world's silver miners. The Hong Kong & Shanghai (HSBC) silver index, which is a basket of national mining sector indices, hasn't even accomplished the trick of going nowhere over the past decade. Once its trendline support broke in 1998, it dropped to a level of 14 from its 1985 base of 100. However, this downtrend is showing signs of ending.

HSBC Silver Index: Breaking A Trend?

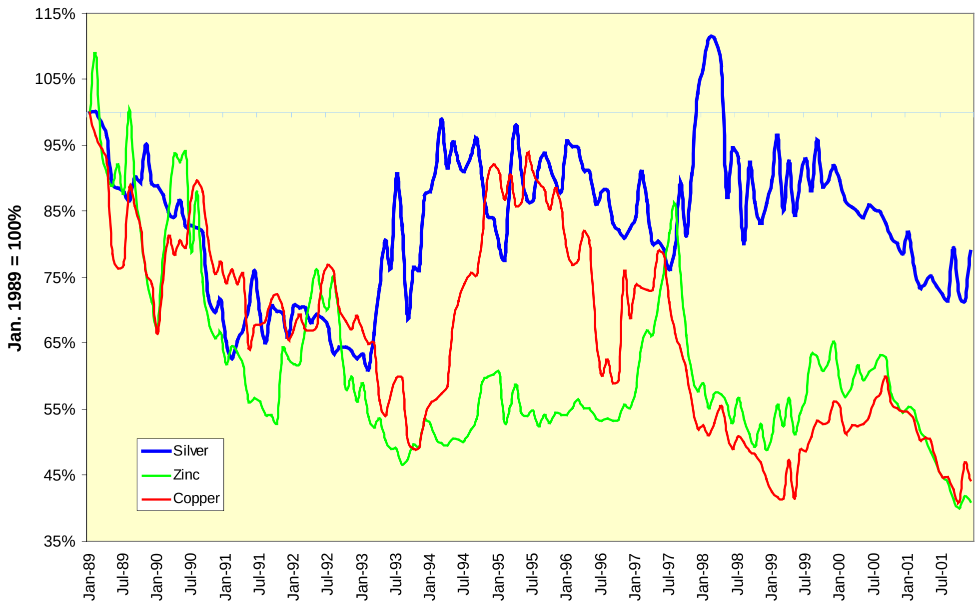


Both Precious And Base

While silver inevitably is paired with gold, the two metals differ in important ways. Unlike gold, silver is consumed in applications such as photography, jewelry, coinage, and electronics. World silver supply has fallen short of final demand every year since 1985, according to The Silver Institute. At low prices, the incentive to shift away from silver in applications other than photography, where digital technology continues to make inroads, is missing. This suggests real prices must rise eventually to slow demand and stimulate new supply.

Unlike gold again, however, silver is not mined per se, but mostly as a by-product of either copper or lead and zinc mining. As these base metals are produced, silver is produced as a credit and sold for whatever the prevailing price is at the moment. Copper and zinc prices have been weak since the Asian crisis of 1997, which has acted as a disincentive to new mine investments. These metals' prices have stabilized at low levels, and lead prices have firmed recently. However, it will take a prolonged period of rising prices for these base metals for silver production to increase significantly.

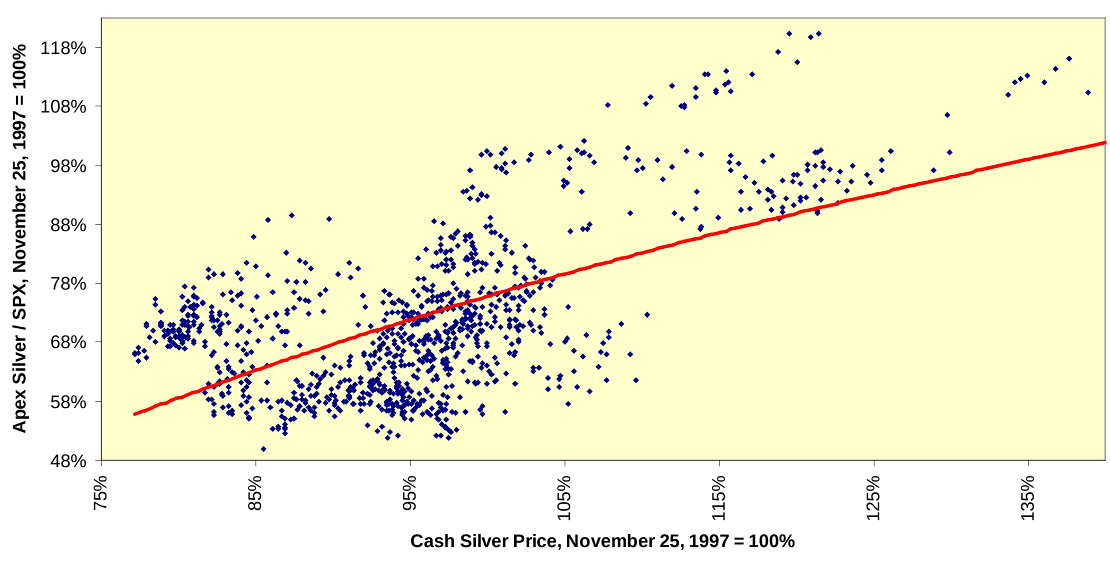
Silver Prices Relative To Associated Base Metals



Delinquency Of A Miner

The "associated" nature of most silver production and the sordid history of many silver mines involved in penny stock scams makes it hard to identify singular silver-linked equities. However, Apex Silver Mines (SIL), which has properties in South America and Central Asia, fits the bill. Over the four years since its IPO, the stock's relative performance to the S&P 500 has been linked strongly to silver prices.

Relative Performance of Apex Silver Mines To S&P 500
As A Function Of Silver Prices



The declining marginal impact on the stock price of higher commodity prices is typical of mining firms; long experience has shown 1) higher prices lead to higher mining and production costs as suppliers capture the economic rent, and 2) higher prices stimulate new supply quickly. A good time to buy silver mining stocks is when prices are low when an economic recovery, which will boost silver demand, is about to get underway. Both conditions apply now.

A more diversified way to express your opinions is with the Philadelphia Stock Exchange Gold & Silver index (XAU). The ten-member index has gained more than 20% in the past year, and still stands at only 58% of its 1979 base value. The XAU's trailing P/E is 37.75, well below the S&P 500's 48.2, and yet the option implied volatility on the index is far higher, over 30%, as compared to levels near 20% for the S&P 500.

The recent high return on the XAU relative to silver prices suggests that equities have capitalized a good deal of the anticipated bullion price increase already. This is a typical pattern for resource stocks, and it implies that future stock prices gains will lag those, if any, on the underlying metal. A trading strategy of going long silver and short either silver mining stocks or the richly priced XAU index options might afford greater potential in any rally. And be ready to take a profit: The only trading strategy in precious metals that has worked over time is selling too soon.