Looking For A Silver Lining

There aren't too many free shots involved in being a financial writer. Markets have a way of humbling one and all. However, being bearish on silver has been a very safe bet for a very long time, so much so that familiarity with the brief silver boom of the late 1970s and early 1980s is one way of separating the veterans from the latecomers in the financial markets.

Will this outlook change, and what investment opportunities, besides trading futures and bullion, would arise therefrom?

A Tarnished Record

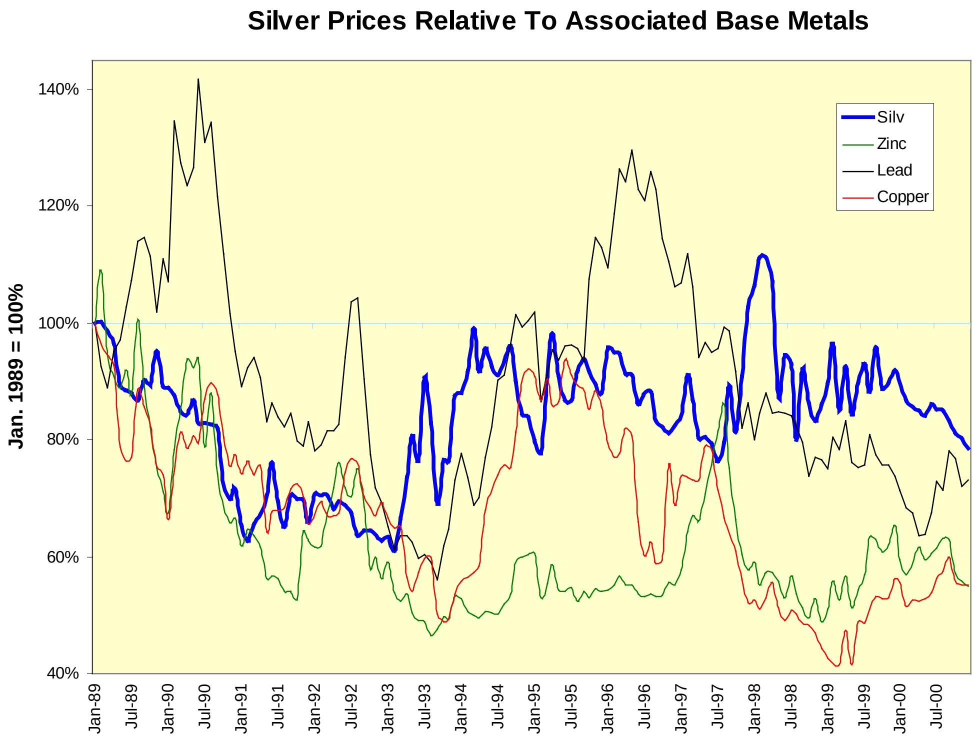
One of the attributes of a market any of us should care about is price movement, and this has been absent in silver since late 1993. The monthly silver chart for the past quarter-century really has only two features of significance, the jump associated with the Hunt brothers' fiasco of 1980 and a nearly continuous downtrend with brief interruptions only in 1983 and 1987 from the end of that episode all the way until 1993. In real dollar (deflated back to March 1975) terms silver has been bouncing along between $1 and $2 per ounce for nearly a decade. In the late 1970s, the economic glory days of the Ford and Carter administrations, silver could be had for between $4 and $5 per ounce.

Warren Buffett, the decreasingly legendary value investor with an eye for a bargain, jumped into the silver market in 1997 in a big way: He bought 129.7 million ounces. In layman's terms, that's a lot of silver. 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.

Will It Ever Move Higher Again?

It depends what the meaning of the word "ever" is. Unlike gold, silver is consumed in applications such as photography, jewelry, coinage, and electronics. In fact, 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 for themselves, 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, and lead prices have been falling since 1996. This suggests a cutback in production of those metals is likely to occur, which will reduce the supply of silver produced as a mine credit.

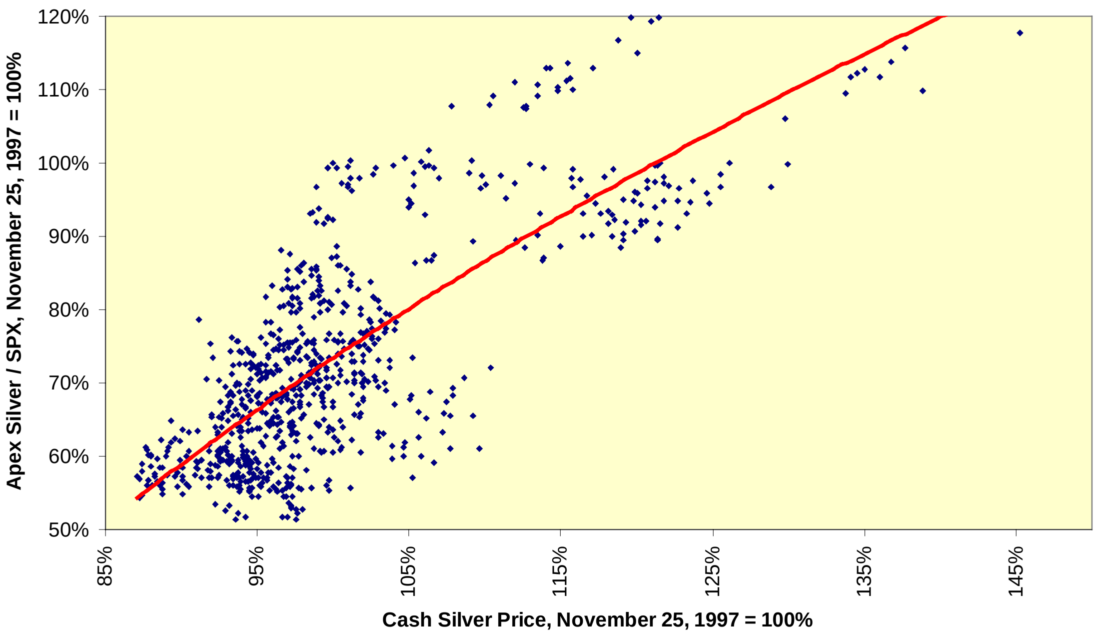
The longer-term supply/demand balance for silver is starting to turn bullish, regardless of what the inflation outlook may be.

Few Sterling Reputations

Since most silver is produced as a by-product of base metals mining and since many silver mines were involved in penny stock scams, it's hard to identify singular silver-linked equities. However, Apex Silver Mines (SIL), which has properties in South America and Central Asia – do you know the difference between Kyrgyzstan and Tajikstan? – fits the bill. Over the three years since its IPO, the stock's relative performance to the S&P 500 has been linked strongly to silver prices:

$(\text{Apex} / \text{SPX}) = .734 + 1.381 * \log(\text{silver}_{ti} / \text{silver}_{t0}),\ r^2 = .61$

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 and falling, and when the Fed is about to start lowering interest rates. Both conditions apply now.

A second and more diversified way to express your opinions is with the Philadelphia Stock Exchange Gold & Silver index (XAU). The nine-member index lost 24% in 2000, and stands at only 68% of its 1979 base value. The XAU is not cheap; its trailing P/E of 136 is oddly high given years of poor stock performance in the precious metals group. The index options, which trade on the PHLX, aren't cheap either, with an implied volatility level frequently between 40-50%.

The combination of cheap commodities, expensive equities, and a diminishing equity return to commodity price suggests a trading strategy of going long silver and short either silver mining stocks or XAU index options. And be ready to take a profit: The only trading strategy in precious metals that has worked over time is selling too soon.