ADRIAN DAY ASSET MANAGEMENT

PORTFOLIO REVIEW

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Few will regret the passing of Anno Domino 2020, though investors per se for the most part did well. (This letter focuses on investments, without any callousness to other considerations.) The U.S. stock indices closed at highs; global equity indices, gold, bonds, real estate, all closed at or near highs. This apparent dichotomy between the economy, slammed by restrictions imposed as a response to covid, and markets is explained (as we have before) quite simply: when central banks around the world create excess credit, that new "money" has to go somewhere, and it has gone, for the most part into stocks and other investments. The flood of new money will, we suspect, see the rising consumer prices next year that were largely lacking this past year. With the changes expected in 2021, including a revitalized economy due to covid vaccines (though expectations may be overly-optimistic, at least in the short term), and a new administration with its own spending priorities, the Federal Reserve's accommodation of unfunded spending will continue; we see no change there. That all augers well for the stock market and particularly for gold.

Most markets and assets up this past year

Most global markets and sectors were up strongly this past year, though in some markets, particularly the U.S., it was with few stocks making most of the running. The broad-based S&P was up over 12% for the quarter, 18% for the year (with dividends reinvested), while global markets (per MSCI World ex-U.S.) played catch-up, rising 17% and outperforming the U.S. in the final quarter, though up "only" 8.6% for the full year after a slow recovery from March's collapse.

U.S. markets, including the Dow, S&P, Nasdaq and Russell all hit highs at the end of the year, while global markets in aggregate are just below highs of mid-2017 and the all-time highs of 2007. Global markets were mixed, though with no particular themes as to winners and losers. Instead, particularly among the losers, it was for market specific reasons: the U.K. was down on concerns about Brexit and a worsening covid situation; China was up, over 25%, while Hong Kong fell on concerns about the tightening vice on the supposedly self-governing state; Spain and Latin America also ended the year negative—Mexico and Brazil's strong moves up, particularly in local currency terms, just failed to make up the losses suffered throughout the first quarter.

Most markets were up, however, led by China, Sweden, Germany, Switzerland, and Australia. If there is a theme among the winners, perhaps it was those countries that handled covid better. The strongest market of all, however, was the tech-heavy Nasdaq, up 43% for the year.

Managers outperformed; gold helped us

Global managers as usual outperformed the indices, with global equity funds (per the Bloomberg index) up 15.6% in the last quarter and 20.6% for the year. (Note: fund returns include reinvestment of dividends while the individual market returns above do not, unless noted.)

Our mid-risk global accounts lagged in the last quarter, up 9.8%, but outperformed for the year, up 21%. Aggressive accounts performed better while conservative accounts, per their mandate, had more modest returns, in the high single digits (up 9.6% for the year).*

Our outperformance for the year was due to a high weighting to gold and resource stocks, though a small exposure to the U.S. and particularly Nasdaq, hurt in the last quarter.

Commodities mixed but gold soars

Commodities diverged, with precious and base metals both performing very well for the year, generally outperforming the S&P for example, though energy and agricultural commodities lagged severely. Using the Bloomberg Commodity Index, the overall sector, though up nearly 10% in the last quarter, ended the year down, over 4%.

Our resource accounts did well, up 11% for the quarter and 36% for the year, the result of being overweight gold, silver and copper, and underweight energy and agriculture. In addition, our gold stocks outperformed the group (see below).

Gold and gold stocks have a good year, though most of the gains came in April-June, with the stocks outperforming the metal, while funds lagged.

	4Q	Year
Gold	0.0	25%
XAU[1]	3.1%	38.8%
Funds[2]	-3.2%	25.7%
Our gold accounts	17.1%	52.7%

[1]Index of major gold and silver stocks. [2]Bloomberg Precious Metals Funds Index.

The significant outperformance is due largely to a handful of spectacular winners (which we are not allowed by the SEC to discuss). In addition, our timing of buys was generally a positive, as well as the trimming of some positions also at good moments. We largely avoided some of the major disasters of the year, though we were not without losing positions. Gold (and resource) accounts tend to have more divergent returns among individual positions since stocks in these sectors are more idiosyncratic than most markets and sectors. It is impossible to avoid losers if one is to have outsized gainers, and in this sector, stocks can fall rapidly. That is why it is preferable to look at an account in totality.

Going forward, we expect relatively modest returns for the global accounts, but buoyed by the tailwinds of global market performance as well as for us, exposure to gold and resources. We anticipate strong returns for gold and resources this coming year however, on the back of high global liquidity.

How quickly will the economy respond?

There have been new lockdowns and restrictions around the world in response to so-called second waves of the virus and new strains, even as five vaccines have been approved and rolled out. (Both Russia and China developed their own vaccines which have been in use for months now.)

There are many questions about the vaccines, the answers to which are outside my competence, but the questions themselves suggest there may be misplaced optimism about how quickly the populations can be inoculated and herd immunity developed. Not least among the concerns are potential longer-term side effects, currently unknown due to the very abbreviated testing period. But however quickly the population can be inoculated and the economy in aggregate recovers, we know that many sectors and areas will be left behind for a significant period of time. We may well see significant restrictions on business activity well into 2021, continuing to hurt the economy.

Certainly, recent economic news cannot be considered positive. In particular, the employment picture has deteriorated with initial jobless claims rising to 10% above estimates, to the highest level since the beginning of September. The number of people continuing to receive unemployment assistance also rose again, by about 8% to almost 20 million. Much of the increase is due to more small businesses finally giving up after the renewed lockdowns, having exhausted savings in the first lockdown. The increase has also been driven by independent contractors and other non-salaried workers. (I am using the word "lockdown" to cover the various restrictions and limitations imposed around the country.) And we did not see the same temporary Christmas retail hiring spurt of previous years.

■ Is there any limit to spending?

Following the signing of the $1 trillion "Covid Relief Plan" there is more spending already in the works. President-elect Joe Biden had already called the $1 trillion "a down payment". Before the new administration and Congress is seated, there have been numerous bills introduced for more spending and many more proposals, including a move to cancel all outstanding rents and mortgage payments (Rep. Ilhan Omar). Approximately one-third of the 18 million households behind on rent or mortgage payments say they face eviction or foreclosure over the next two months. There are moves to forgive student debt. Will landlords and private lenders be expected to simply forego repayment or will the government step in, and if so, at what cost?

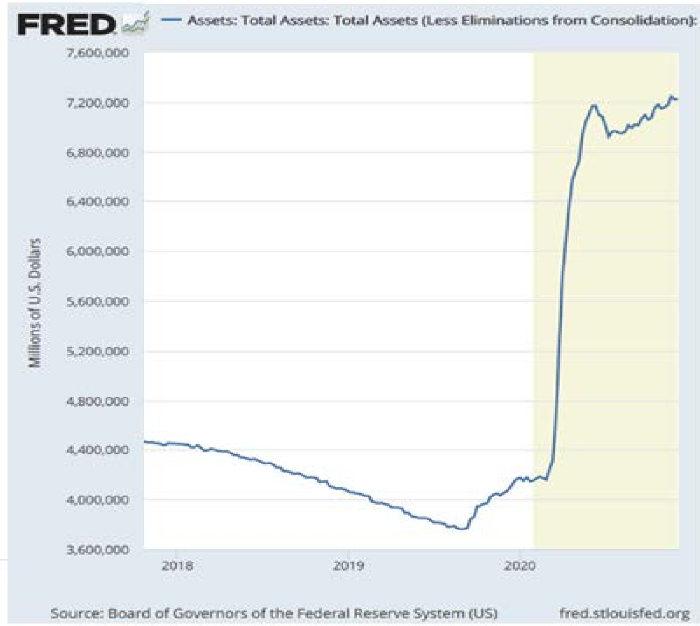
Once the new Congress is seated, there will be many more multi-billion dollar spending plans. Many high-tax states and cities were already effectively bankrupt before the corona virus lockdowns hit. These have sharply reduced tax and other revenue (transportation revenue) while increasing spending. If there is even a small move towards permanent remote working, that will only further decrease tax bases, exacerbating the move out of cities to suburbs, a move already well underway due to high city taxes. New York city, for example, facing a $3.8 billion deficit, is seeing several large employers leave, including such long-time iconic names as Goldman Sachs. California is seeing some very high-profile (and high taxpaying) firms move out of Silicon Valley, to Texas. Florida and elsewhere. These are indeed the high-tax chickens coming home to roost. The odds are that the incoming Congress and Administration will look to bail out the high-tax and mismanaged cities and states.

Then there are plans for infrastructure spending, arguably more likely under the new Administration than under previous administrations; as well as for "green energy" spending. Will there be new tax credits for various green energy projects, or perhaps a government program to establish electric vehicle recharging stations across the country? The spending plans and proposals are endless, and under Modern Monetary Theory there is apparently no limit on implementing them.

■ Where is the money coming from?

Already, the "untouchable three" of federal spending--entitlements, defense, and interest on debt—alone are running at about 140% of tax receipts. If current spending is not being funded, so much less so will the future spending. With AOC snapping in the wings, Yellen at the Treasury, and Powell at the Fed we have the perfect triumvirate for higher, unfunded spending. Already, after a slight pause after the crazy days of April and May, the money supply is picking up again. Federal Reserve bank credit is up at a rate over 14% in the last three months, compared with 3.4% since June. In the latest week to be reported, mid-month, the Fed's balance sheet jumped by $119 billion, the largest one-week increase since May, to a new record of $7.36 trillion, this despite vaccines and new optimism on the economy recovering.

Fed Resumes Growth



Rates continue to bounce along at all-time lows, with every maturity from one to seven years falling again in December. You can now lend the government money for seven years at a rate of 0.66%, that's lower than even the Fed's own somewhat distorted view of current inflation.

The fact that quantitative easing and various easy money policies implemented around the world particularly since 2008, but even before that particularly in the case of Japan, have not had the effect of driving economic growth does not stop central bankers. Indeed, if their policies have not produced strong growth, then the answer, they think, must be to do more of the same. Never once do they consider the possibility that their easy policies—ultra-low interest rates and excess credit creation—are the very cause of sluggish growth. Increasing the odds of the Fed continuing its policies this coming year is that in its annual rotation of members of the Open Market Committee which sets rates, the overall composition is even more dovish this year than last.

■ High debt? No problem

In his major press conference earlier this month, FedHead Jerome Powell could not have been more dovish on both rates and money supply growth.   In one astonishing comment, he arrogantly said that the Fed buying assets "help(s) foster smooth market functioning." Yellen has urged Congress to give the Fed the authority to buy equities (though given some of their illegal programs earlier in the year, one wonders why exactly they are requesting authorization to take this step.)

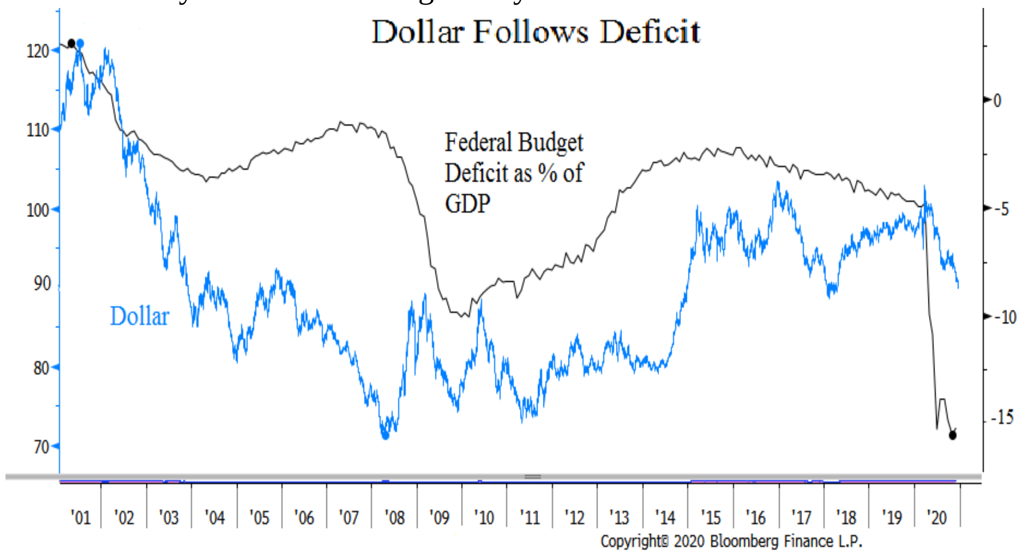
He also said that the debt levels were not a concern, given the low level of debt-service payments as a percentage of the economy. Such a comment would have more validity were rates not at all-time historic lows, and raises the question whether rates can ever meaningfully increase, but it echoes comments by former Obama economic advisors Larry Summers and Jason Furman as well as former FedHead Ben Bernanke, who urged the government not to attempt to reduce the deficit but instead implement more stimulus.

They suggest that so long as interest rates are kept lower than the rate of GDP growth then the level of debt doesn't matter. Once central banks set out of this path, it becomes increasing difficult for them to turn around, as we have seen in the increasing feeble attempts over the past 25 years to "normalize" after spurts of easy money (*vide* the brief slowdown over the summer).   It will take a crisis for the Fed, the European Central Bank, the Bank of Japan, and others to change course.

“It’s different this time”

This new policy of excessive credit creation to support unfunded spending—the essence of Modern Monetary Theory—has many unintended consequences, which we have discussed before. But one consequence this time around will be inflation. As we discussed before, the fundamental difference between now and the various QEs after 2008 is in the distribution of newly created “money”.

The great Austrian economist Ludwig von Mises used to ask, “Who gets the money first?” It is important. After 2008, the new money all went to the big money centre banks and thence into stocks and real estate (as well as fine art and antique automobiles). It hardly touched Main Street. This time, more money is going directly to households. During the lockdown and associated unemployment, many households used these funds to pay down crippling debt, which in economic terms is the same as if the funds had gone directly to the big banks. But once the economy opens up, new direct stimulus will increasingly be spent on consumption, and this will lead to rising price inflation.



Inflation is beginning to rise

The Fed and other central banks, following MMT, think unbridled money creation does not need to lead to inflation, one increasingly lone wolf being William White, the former chief economist at the Bank for International Settlements, who notes that “history shows that high inflation is a common outcome when large government deficits are increasingly financed—as they are now—by Central Banks.”

We are already beginning to see the signs of inflation that the central banks cannot deny. The commodity index was up 11% in November alone and that will wend its weary way through to consumer goods. Indeed, according to Markit PMI, “the rate of input price inflation was the quickest (sic) on record.” So-called “core” inflation rate, which has been increasing slowly since mid-year, was up last month by 1.4%, the highest since 2012. Expect this trend to continue as input costs get passed on to the consumer.

The Fed perversely wants higher inflation, and says its 2% goal is an “average”, so it will tolerate higher inflation to compensate for prior lower inflation. As unbridled spending accelerates, accommodated by a Fed which has caved, inflation will speed past 2%, assuming an economic recovery, and become stubbornly higher.

Everyone is doing it

The U.S. is not alone. Almost every country around the world is facing a new surge of covid cases, has imposed new economic restrictions, has a sluggish economy, and in almost every case, the governments have answered by shoveling money to households and businesses, while central banks have responded with excessively easy monetary policies.

The major economies—Europe and Japan in particular—are "ahead" of the U.S. in lowering interest rates. There is now a record of over $18 trillion of negative-yielding bonds outstanding, up from less than $10 trillion in March, accounting for one-third of all outstanding senior securities globally. Canada, formerly the model of fiscal rectitude (at least relatively speaking) has introduced stimulus measures that on a per-capita basis are among the largest in the world. In the U.K., Chancellor Rishi Sunak is doling out, money like a drunken sailor.

■ China is a standout

China, first in and first out of corona epidemic, is the only major economy to post a positive GDP growth number for 2020. Key indicators such as production, exports and capital spending, are all accelerating, while the labor market is also recovering strongly. It also is the only major economy not to be fighting sluggishness with broad infusions of newly created credit (coincidence?). Indeed, policy has turned towards tightening in recent months.

Not that everything in China is rosy; the growth rate is lower than last year, while consumer prices have turned negative, and corporate defaults have risen. Not surprisingly, given the strong economy and tighter monetary policy, the *yuan* has been appreciating.

The Bank of Japan, the first central bank to pursue QE policies decades ago, has said it is "reassessing currency policy to make it more effective and sustainable." Given the long period of a stagnant economy, once again falling into deflation, this is hardly surprising. We shall see. Given how far they have come, with the BoJ owning most of the bond and equity ETFs in the country, and banks destroyed, it will be difficult to backtrack meaningfully but perhaps, just perhaps, they will "stop digging".

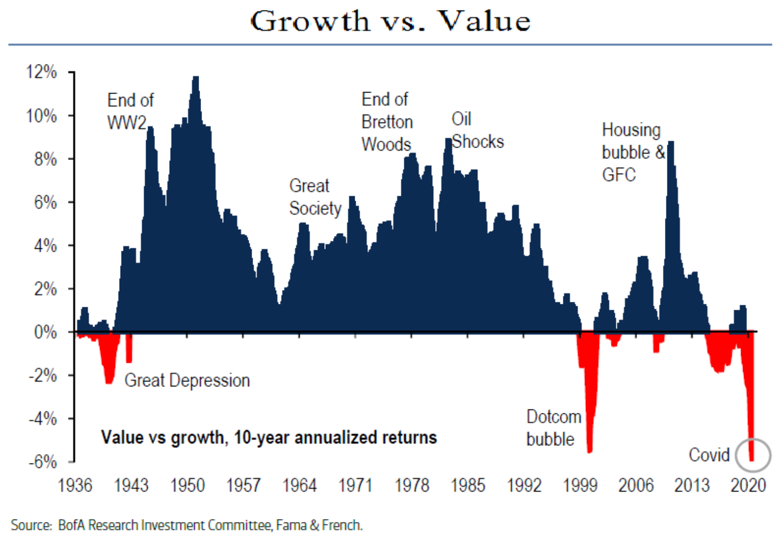
■ The dollar will decline under Biden

The dollar fell to its lowest level in nearly three years following the presidential election. Traders are net short at record levels, while incoming Treasury Secretary Yellen has openly called for a weaker dollar. Although President Trump also wanted a lower dollar, his policies of lower taxes and the trade war with China actually supported the currency (as did the Fed keeping interest rates above other major competitors). If a Biden administration reverses tax cuts and pursues policies which will worsen the twin deficits (fiscal and trade), that will be a negative for the dollar. We see the dollar falling in the year or two ahead, though there is a limit to how far it will decline (in the near term) given the relatively attractive level of rates, compared with other major economies.

■ Despite the economy, stocks soar

Global stock markets soared in the second half of 2020, despite sluggish economies, on the back of excess liquidity created by the world's central banks. In the U.S., all four major indices hit record highs in December, while international markets, still a tad below previous peaks, are close and at highs for the year.

In the U.S. valuations are nearing extremes, with the price-earnings multiple of the S&P now at 29.7 times; of course, Tesla's inclusion does not help, but the ratio was already in the high 20s. Other fundamental measures of the broad-based index are at extremes: price-to-book over 4 times, price-to-cash flow at over 16 times, double where it was in 2010-2012. Stocks can move well above any rational



valuation, especially when the Federal Reserve keeps replenishing the punch bowl. But valuations are a good guide, if not to the upside, certainly to the downside risk in the market.

Sentiment is also at extremes, standing over 1. 5 earlier in December, the highest level since the height of the dotcom bubble, and well above the normal range. One indicator of extreme bullishness is the volume of option call buying, much of it very short-term and anecdotally of neophyte investors. This is a disaster waiting to happen. Another sign of extreme bullishness is the underperformance of value stocks, driven by stocks with no earnings. Over the past 100 years, value stocks have generally outperformed, though there have been periods when growth has. The recent period of value underperformance has been the longest and deepest on record.

■ BDCs recover

One sector we like that has performed well recently is the Business Development group. These companies have performed better than expected and far better since March than they did after the 2008 credit crisis. In particular, loss rates have been improving since the spring, suggesting the companies were very aggressive in pulling losses forward to the first quarter. For the most part, the BDCs have avoided making loans to companies particularly vulnerable to the lockdowns. The main problem in 2008-2009 was not the losses at portfolio companies but rather that the BDCs themselves faced liquidity issues when banks pulled lines of credit. That this has not happened this year is largely due to the fact that the BDCs are much better prepared with multiple sources of capital. Generally, the BDC stocks have doubled since March, rising strongly in the last two months, though they remain below the pre-covid levels and continue to sport attractive yields (over 8% to 9.5%).

■ Major global markets also vulnerable

Chinese stocks are generally very sensitive to liquidity conditions, and with the People's Bank of China tightening, as well as renewed tensions with the U.S. (including the recent ban on Americans holding certain Chinese stocks), we could see a flattening of performance after the strong bull run since the end of covid in that country.

Japanese stocks may outperform as the global economy recovers. Japanese companies already generate much of their earnings, and particularly earnings growth, from overseas, and this will continue, despite a yen that will likely remain firm, as the dollar declines steadily.

Emerging markets are more undervalued relative to U.S. stocks than they have been since 2000. An environment of a declining dollar and rising inflation is generally to the benefit of emerging markets. With commodities likely to be strong, the commodity exporters will perform better than the commodity importers.

European stocks will likely lag this coming year. They are not inexpensive to begin with and have already discounted a reasonably strong economic and earnings recovery. But the new virus strain is taking hold and can move across the continent quickly if economies start to open. Moreover, while the focus of Brexit downsides is all on the U.K. at the moment, continental Europe (the EU part) has more to lose in any trade restrictions.

We are cautious on global equities, partly because of the main reason they continue to move up, and partly because valuations imply significant downside risk. This is so even though we continue to think that, on balance, stocks will move up. We are mostly buying stocks that for some temporary reason are particularly depressed, or else where there seems to be a valid reason for them to move up in the near term.

Strong recovery for resources, but still undervalued

As always, resources have been mixed, but the precious metals and base metals have been among top performing assets this year, outpacing the S&P. Agriculture and energy lagged. The metals have been strong because of the macro economic environment of a falling dollar, rising inflation, and low interest rates. Gold has been helped by easy money policies, while the base metals have been boosted by a recovering global economy and particularly the resurgence of demand from China, as well as concerns about supply as stockpiles tumbled. Despite the recent rallies, commodities as a whole remain close to all-time historical lows relative to equities.

Copper has been a leader, now at its highest since the beginning of 2014, with growing demand from electric vehicles and green energy, as well as prospects for greater infrastructure spending not only in China but in the U.S. as well. The outlook continues to be positive, with demand from those two sectors likely to ramp up, while many of the world's largest mines see increased depletion even as there is a paucity of significant new projects in the next five years.

The strongest major resource, however, has been iron ore, which had also been one of the more depressed. Used to make steel, with demand from China on a streak, iron ore prices increased nearly 70% last year. While there is no fundamental shortage, there is a lack of the higher-quality ore which commands price premiums. Increased infrastructure spending in the U.S. will support iron ore prices.

Cautious of uranium near term

Uranium has also recovered from very depressed prices, partly because of President Trump's plans to support the U.S. industry. That was followed by optimism following the election that Biden would be more supportive of nuclear energy as part of his green-energy plans.

In the near term, there is supply overhang from both Kazakhstan, the world's leading producer which curtailed exports, as well as Cameco, the world's largest private producer, which has suspended production from both McArthur River and Cigar Lake. Increased production from both sources could come back on in a relatively short period of time should uranium hold higher prices. So while we are bullish on uranium over the longer term, especially as new generators come online in China, and Japan and even Europe restart their nuclear sectors, supply is not an issue in the shorter term.

Oil: Supply won't Keep Up with Demand

Oil and gas are beginning to look more attractive. On the demand side, it could come back very rapidly as the virus-lockdowns end and the economy recovers, first with global trade and second with resumption of travel. Even if business travel does not recover to pre-covid levels any time soon, there is still tremendous recovery potential from current levels and, as with leisure travel, huge pent-up demand (for example, on-site visits that Zoom does not satisfy).

Where will increased supply come from?

On the supply side, though there is potential for higher production, it is mostly in places such as Mexico or Venezuela whose industries are producing well under capacity. The question of Saudi reserves is a controversial one, though there is clearly room for an increase in production, as there is in Russia. We do not think oil and gas demand will suddenly end in a couple of decades, but one has to ask how much capex companies will be willing to spend on new projects with long payoffs when both the western world and China have plans to curtail hydrocarbon use.

Shale has been the major source of growth outside OPEC in the last decade. There are uncertainties about U.S. shale. It appears these fields have very high decline rates and drilling productivity has been falling. When there is a large voluntary decline in production, as we saw in 2020, one would expect better fields to keep producing and nominal productivity to go up, but this does not seem to have been happening. One can probably assert that the best fields have been well exploited. Other than relatively marginal resumption of production, it will take sustained higher prices to get production to grow significantly.

Given that the consensus seems to be underestimating demand and overstating supply, there is potential for an unexpected increase in price. We are not expecting oil, for example, to move over $100/bbl any time soon, but it could approach $60 and on a sustained basis that would give tremendous leverage to the oil companies, few of which have any earnings for the last year and many not even positive cash flow. Even if there have been strong moves off the bottom, they remain well exposed to any move up in the oil and gas prices.

We are looking for any pullback to take long-term positions in quality copper, nickel and oil companies, while we already have exposure to many smaller and exploration companies.

Precious Metals take the Gold

Gold and silver well outperformed the S&P this past year, even though for most of the second-half prices were trending lower. The sentiment turned negative on news of a vaccine, and with that, the optimism about the global economy. Mainstream “analysts” led the reversal with Bank of America abandoning its famous $3,000 target, and Macquarie predicting $1,550 a year from now. November saw the first monthly outflows from gold ETFs in the past 12 months, and the second largest ever, about 3% of total assets. Silver saw its largest ETF outflows since 2011.

Gold has also had to fight the move in cryptocurrencies. As crypto has moved more into the mainstream, it has come at the expense of gold, with some high-profile investors making the switch. The narrative gained momentum particularly in November, but though crypto will pull some investment from gold, it is at the margin and it will not be sufficient to derail the bull move in gold.

Factors that had caused gold to decline quickly lost their clout. Questions were raised about the vaccine and the testing that had been done. There are only so many gold holders even considering switching to cryptocurrencies, so the momentum ran out of steam pretty quickly. And most importantly it was not the virus that caused gold to go up, but the central banks’ response. Nothing we see suggests Congress will stop spending, the Fed will stop printing money, and debt levels will shrink, and the same applies to most countries around the world. As an analyst at Citibank, bucking the trend, nicely put it, “the vaccine can kill the virus but it can't kill the mountain of debt." As the Federal Reserve and other central banks resumed their easy-money policies in December after the briefest of pauses, gold moved back up.

So, ETFs saw renewed inflows in December. Central banks, which had been net sellers in the third quarter led by Uzbekistan and Turkey, renewed net purchases, with both countries rebuying and several Arab countries also buying. In all, gold had its best year in a decade.

■ Silver Shows its Metal

Silver demonstrated its leverage to gold, falling more sharply in November, but ending the year up over 40%. As we have discussed, though silver has different characteristics than gold—there are only small reserves; most silver production is by-product of base metals; and its demand is mostly industrial—nonetheless silver trades like a monetary metal. Silver's production is at its lowest level since 2009, as less metal comes from primary silver mines while zinc and other base metal mines have struggled to boost output. As with gold, the most important influence on the silver price is global liquidity. It tends to leverage gold's returns up and down, and does particularly well during periods of strong inflation.

■ Major gold stocks lag

Although the gold stocks traded broadly in line with the gold price throughout the year, they have not yet demonstrated the leverage one would expect in a rising market. Throughout 2020, gold rose almost 25% while the XAU Index (of major gold and silver miners) was up 35%, meaningfully better but a narrower gap than would be expected. Partly, perhaps, this is because a lot of gold buying has been defensive rather than more speculative.

As the gold price improves but the cost of energy and the commodity currencies move up at a far slower pace, the margins for gold producers have expanded and will continue to do so. When they report their fourth-quarter results, this will be clear and with the full resumption of most mining operations after covid-lockdowns, results should be strong and the stocks will likely respond. Costs have actually declined throughout the year as miners focus on operational efficiency, though are still above 2019's levels. But margins have moved up strongly, over $950 per ounce in the 3Q, up from $400 a year ago.

■ Replacing production is a challenge

Miners still face challenges, however, the most fundamental of which is replacing their reserves and production. Despite a higher gold price, it is expected that year-end 2020 reserves will fall again with lower mine grades. One analyst is looking at reserve depletion of 8.3% after an 8.4% drop in 2019, with mine grades at only 90% of reserve grade. Most mining companies are simply not replacing ounces mined. Significantly, most of the additional ounces come from acquisitions not discovery.

This is a long-term problem which we and others have discussed in detail before. There has been a steady decline in new ounces discovered over the past 40 years, even though the industry continues to spend money on exploration (mostly juniors if not the seniors, who focus on mine-site expansion rather than greenfields). The ounces being discovered on an annual basis are not even half of the ounces being produced, and we expect a meaningful decline in production starting in three or four years.

This will lead inevitably to more M&A as companies try to maintain their production by buying ounces. This year has seen a few deals mostly of intermediate companies, but we suspect there are more deals in the wings waiting until covid restrictions are lifted so companies can conduct site due diligence. For the time being, this will be mostly larger companies acquiring mid-tier producers, while the juniors are seeing more joint-ventures rather than acquisitions.

Review of Individual Accounts

Global Accounts

There were a few more changes in global accounts this past quarter although overall allocations did not change much. Cash levels declined a little, as we took advantage of depressed prices in specific stocks to add; across all accounts, we are just around 5% cash. Allocation to global equities inched down to just under 6%, despite some new buys; see below. The Business Development Company (BDC) sector remains a high allocation, particularly for more conservative accounts, even inching up as prices moved. And gold and resources continue to be a large weighting in all portfolios, with additions to the resource sector this past quarter, both as prices rose and with new oil exposure.

We found a handful of global buys

We had a handful of new buys this past quarter, though not for all clients. These include a strong Puerto Rican bank which will benefit from long-term growth in the economy, barely recovered from Hurricane Maria in 2017; a U.K. drug company, undervalued on its own merits and to benefit from the Brexit rally; a Japanese finance company, to benefit from a strong yen and low rates; and a Hong Kong leisure company, which should benefit from increased tourism from the Mainland still not venturing globally. Most of these are intended as long-term positions.

We had two sells, held broadly in global accounts. **Mitchell and Butlers**, a U.K. pub chain, was intended as a short-term play on pubs reopening after the first lockdown, as well as a recovery in the formerly heavily indebted group; we sold after the second lockdown was introduced thinking a recovery would be postponed. And we were forced to sell **China Railway** after the company found itself on the list of stocks prohibited for Americans to own, more is the shame.

The stocks we sold were more widely owned than the ones we have purchased, so on balance, exposure to global equities inched down as other areas—including U.S. stocks, BDCs, gold and resources—all moved up.

Holding BDCs, gold and resources

We continued to trim positions in BDCs as prices moved, but with higher prices, this sector increased its allocation slightly. We held our high exposure to gold, which, for global accounts, is both a hedge as well as an investment in its own right; and increased exposure to resources, in particular adding a new major oil company, with strong leverage to rising prices and a high dividend.

Looking ahead, we expect to continue our general approach, holding high allocations to BDCs as well as gold and resources; and constantly looking for quality global companies whose stock prices are not extreme and where the risk is moderate. Many of these will be intended as shorter term trades, though we will occasionally find quality stocks we want to hold for the longer term, as we did this past quarter. Where authorized, we will sell puts on quality companies, earning a return on cash we are holding. We expect to maintain a reasonably high cash level in global accounts, preferring cash to overvalued equities; we also like to have fire-power available in the event of market or sector sell-offs.

Gold Accounts

As discussed above, our gold accounts performed very well this past quarter and year. There was a lot of movement both with new buys and sells, and in the relative performance of different subsectors. Most dramatically, the weighting to senior stocks fell sharply again, despite new investments. Following the third-quarter decline from 30% of portfolios to just under 25%, the allocation plunged again to end the year at just 19% of portfolios. We discuss this below.

Silver outperformed

Offsetting that, exposure to resources other than gold, which includes silver, rose sharply from 17% to 23% of portfolios, and the allocation to exploration also rose as many of the warrants that we get with private placements moved into the money.

The leverage from warrants is obviously powerful, and the value of all warrants jumped six-fold in the quarter alone. (Excluding the warrants, our exposure to exploration stocks fell marginally as we did some selling, both trimming some strong winners, and selling a major laggard.) We remain fully invested to gold, with cash declining again to just 2% of accounts.

Buying was focused on laggard majors

We did a lot of new buying among seniors, increasing positions in some top North American miners during the October-November slide in gold stocks, which affected the more liquid seniors more than the juniors. We also added a major Australian and two large Russian miners that all look undervalued relative to peers. In all, we added about 35% to our senior position, but by the end of the year, the value had increased only marginally, while the weighting was down significantly.

The major royalty companies fell sharply, although the declines in the larger companies were across the board over the last quarter. However, we continue to have large exposure to the major royalty companies which provide relatively low-risk and broad exposure to the sector. We expect to see a recovery in this group, and a continued recovery in the major miners as gold itself moves up.

We increased our investments in the intermediate and junior producers by about 20%; the value moved up about 15% while the allocation slipped marginally to around 10% of portfolios. (Note: in our last *Review* we mis-stated that the allocation to this group was around 40% whereas that was the weighting to exploration stocks.) The relative underperformance of this group was due to a slide in a couple of holdings.

It is among this group however that we are more likely to see M&A activity, and indeed one of our companies was acquired in the last month at an attractive premium to the then-stock price. We generally do not buy stocks solely because they are acquisition candidates, but companies with good assets and undervalued stock prices are clearly more likely to be taken over.

Sold some juniors, bought others

The junior and exploration group fell marginally as we did some selling in this group, both trimming on rallies and exiting a few positions. We added a few new positions, including a mid-tier royalty company and two exploration companies, though we sold more than we bought. Notwithstanding that, the value of this group was up, primarily because of strong performance from a couple of companies. As discussed above, some warrants moved into the money as well.

The largest increase percentage-wise was in the resource sector, which includes silver and diversified companies, even though the investment in the sectors barely inched up. A handful of stocks did well, including a top silver company and a new diversified royalty company.

Looking ahead, we expect to continue to be fully invested in gold accounts. We anticipate that the senior miners and royalty companies will make a comeback as the gold price continues to move up, though as the bull market develops we expect to shift our focus increasingly to the junior producers and exploration companies which offer the potential for higher returns. As always, we expect more activity in gold accounts than in global accounts, and as the bull market progresses, we shall be quicker to move out of laggards unless we have strong reasons to hold. Overall, however, we are well positioned with a blend of major and junior royalty companies; major miners; junior miners and development companies; and exploration companies. This provides us with broad exposure to the sector as well as potential for some outsized returns from takeovers or discoveries among the smaller companies.

Resource Accounts

Resource accounts also remained fully invested, though cash moved up to just under 4% of accounts, a coincidence of timing of sales rather than a sign of any caution. Our largest weighting continues to be to major and intermediate gold miners and royalty companies, around 33% of accounts, down moderately from 37%. This is a reflection of relative price movements during the quarter, as discussed above.

Our other largest sector weightings continue to be silver (11%), followed by copper and diversified companies. Though we are underweight energy, we have been slowly increasing exposure to oil and gas companies, both global majors and intermediate E&P companies.

Cut copper on rally

We did significant selling in the last quarter, primarily of copper companies, both major producers and exploration plays, following large run-ups in prices. In the case of a couple of major producers, we may have been premature, though we expect opportunities to buy back to the sector. Offsetting that, we increased exposure to nickel, another metal with high exposure to growing electrification. It should be noted that many of our major and second-tier gold producers, as well as junior royalties and exploration companies, have exposure to copper, even if they are not pure plays, and in many cases have been bought precisely because of this exposure. Although we think copper may be ahead of itself, we remain very bullish to this metal on a three- to five-year basis, due not only to growing demand from EV, green energy and infrastructure but also because of the shortage of large-scale projects close to production.

Looking ahead, we expect to remain fully invested in resource accounts. Though we anticipate gold and silver remaining a major component of accounts, we expect over time and steadily to continue to increase investments in base metals and oil and gas.

In sum, we are confident that global central banks will continue to pursue excessively easy monetary policies, even if the global economy recovers as strongly as some expect. This will be as protection against any setback, but it will also be to accommodate new spending plans and new social objectives of central banks. This spending will support global stock markets, particularly if the economy is strong, and will be especially bullish for gold and silver. Our accounts will continue, therefore, to hold high allocations to the precious metals, and increasingly to other resource sectors, including oil. Our global equities tend toward more value or defensive sectors, though we are constantly seeking out growth opportunities, even as shorter-term trades. We remain concerned about valuations in broad stock markets, though are unlikely to see broad selling from our already low holdings. While gold and resource accounts will remain fully invested, we continue to hold cash in global accounts, some set aside against put selling, and also holding so we are ready for any opportunities that arise, either declines in specific sectors, markets or individual stocks, or in the event of a broader market decline.

Adrian Day, January 1st, 2021

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