Investing in Gold Mining Equities

EisnerAmper Engaging Alternatives Spotlight (September 12, 2024)

Host: Elana Margulies-Snyderman, Director, Publications

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[Elana Margulies-Snyderman]

Hello, and welcome to the EisnerAmper Engaging Alternatives podcast series. I'm your host, Elana Margulies-Snyderman, and with me today is Brian Hirschmann, Managing Partner at Hirschmann Capital. This Puerto Rico-headquartered hedge fund manager invests in gold mining equities. Brian, who previously worked at Hotchkis & Wiley and Goldman Sachs' Principal Strategies Group before launching the Hirschmann Partnership a decade ago, will share his outlook for investing in gold mining equities, including the greatest opportunities, challenges, and more.

Hi, Brian. Thank you so much for being with me today.

[Brian Hirschmann, Managing Partner, Hirschmann Capital]

Thank you. It's great to be here. Thanks for having me.

[Elana]

Absolutely, Brian. To kick off the conversation, tell us a little about your firm and how you got to where you are today.

[Brian]

Sure. My senior essay advisor and professor when I was in college was David Swensen, the legendary former head of the Yale Endowment. And one of the many things Swensen is famous for is pointing out the many conflicts of interest in the investment management industry that contribute to poor returns for clients.

So when I launched Hirschmann Capital a decade ago, I wanted to create a better-aligned fund that was consistent with the principles I had learned from Swensen and from other great investors like Warren

Buffett.[1] For example, nearly every fund in the industry is paid based on assets under management (AUM), which, of course, incentivizes firms to focus on increasing AUM and marketing. But the problem with that is that higher AUM is bad for clients because it limits the universe of securities and companies a fund can buy and raises trading costs.

So as a solution, my fund is one of the very few in the world that doesn't charge any management fees, only a performance allocation above a 6% hurdle rate. We use a fee structure similar to the one Warren Buffett used for his hedge fund before he went on to Berkshire Hathaway.[2] So, I only do well if the client does well.

In addition, I'm the second largest investor in the fund. So there's strong incentive alignment. Another thing Swensen and Buffett talked about was that the best way for an investor to outperform was to be a long-term contrarian, because everybody wants to make a quick buck.

So, there's a lot more competition for short-term investments. But what I found is that although nearly every firm says that they are long-term contrarian investors, almost none actually are. And I think a big reason for that is that many firms have institutional clients who are neither long-term nor contrarian.

For example, a pension fund manager might be a typical hedge fund client, and is often very focused on keeping his job. And the best way to do that is often to avoid long-term contrarian investments, because if you invest in an out-of-favor, undervalued security, there's always a chance that a cheap stock will get cheaper. And so, it's very easy for the pension fund manager to get fired if the investment doesn't do well initially because he stuck his neck out and did something unconventional.

Whereas if the pension fund manager sticks to the same portfolio everyone else has, even if it performs very poorly, he'll probably keep his job because he was doing the same thing as everyone else. And so that kind of consensus-driven, short-term-focused behavior carries over to the hedge funds and private equity funds that the pension fund manager hires. And therefore, pretty much everyone who's investing on behalf of the pension fund is often afraid to make the kind of long-term contrarian investments that are usually necessary to outperform.

So, my solution to that is that my fund only accepts capital from the owners of the capital, because a wealthy family can't get fired from managing its own money. And so, if the family understands why an investment strategy should deliver long-term outperformance, they can stick with that strategy through the inevitable periods of short-term underperformance. And so, I think these advantages in incentives and time horizon have been a major reason my fund has outperformed all its gold benchmarks over the last decade. [3]

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[1] References to Warren Buffett or Berkshire Hathaway are for historical context only. Neither Warren Buffett nor Berkshire Hathaway is affiliated with, has reviewed, or endorses Hirschmann Capital or the Fund. Similarity in fee structure does not imply similarity in strategy, risk, or performance.
[2] This statement refers generally to the Fund's Class A terms. The Fund offers multiple classes of interests with different performance-allocation terms. Class A interests are subject to a 25% performance allocation above a 6% annualized threshold, while Class B interests are subject to a different S&P 500-based threshold and performance-allocation structure. Please review the Fund's private offering memorandum and limited partnership agreement for complete fee and allocation terms.
[3] This performance comparison refers to the period from October 1, 2014, through August 21, 2024. Fund returns are presented net of applicable Fund fees and expenses, including any performance allocation, and include reinvestment of dividends and other earnings. Benchmark and market comparisons use the benchmarks, ETFs, indices, or commodity-price series identified in the Complete Returns PDF, which

And as we'll probably talk about today, I'm very confident that the best is yet to come.[4]

[Elana]

Brian, as a follow-up, given your focus on investing in gold, I'd love to hear your high-level outlook for the space.

[Brian]

Sure. In short, I think this is probably the most dangerous time in U.S. financial history because it's the first time any major economy has had three bubbles, three large bubbles in equities, real estate, and bonds all at the same time. And I think there's a good chance that all three of these bubbles will burst at the same time, and that could happen soon.

But the silver lining is that it should be the opportunity of a lifetime for gold investors. As an example of the equity bubble, last month, U.S. equities reached their highest market-capitalization-to-sales ratio ever and their highest market-capitalization-to-replacement-cost ratio ever. And in the real estate market, the price-to-rent ratio and the price-to-income ratio are near all-time highs, even higher than during the 2000s housing bubble.

And in the bond market, interest rates remain very low, even though government debt is at levels that have always led to default. And the consensus is that all of this is OK because the government will always be able to bail out the economy and lower interest rates to zero. But I think that couldn't be more wrong.

If the government could always bail out the private sector and keep interest rates at 0%, it would have been discovered 2,000 years ago, not in the last decade. So instead of a bailout, what I think we're likely to get is a government debt crisis with much higher sustained inflation and much higher interest rates, because the U.S. has this toxic combination of high deficits, high government debt-to-GDP, elevated inflation, and heavy borrowing from foreigners. And high deficits and high debt-to-GDP are a problem because they mean our government debt is growing faster than our capacity to pay.

And elevated inflation is a problem because it means the U.S. government has already started to default due to high inflation. And high borrowing from foreigners is an issue because foreign investors tend to be more fickle and harder to regulate. And so, there are many studies showing that governments that borrow heavily from foreigners tend to have crises more often and sooner.

In fact, there have been 21 instances of this combination of four factors globally since 1914. And all 21 of those countries defaulted within two years, and their median average annual inflation over the subsequent four years was 18 percent. And none of them were able to avoid sustained high inflation through a recession or some central bank policy.

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may include GDX, GDXJ, gold, and a global-equities benchmark. These benchmarks and market instruments are materially different from the Fund's concentrated private-fund strategy. Indices and commodity-price series do not reflect Fund fees or expenses, and investors generally cannot invest directly in an index or commodity-price series. Past performance is not indicative of future results. Please review the Complete Returns PDF for full net-of-fee performance, benchmark information, and methodology.

[4] Statements regarding future Fund performance, future relative performance, gold prices, gold mining equities, portfolio appreciation, or potential Fund outcomes are forward-looking opinions as of the recording date and are not guarantees or official projections of Fund performance. Actual results may differ materially, and investors may lose all or a substantial portion of their investment.

What's important to remember is that if a government is in a debt crisis and defaulting through inflation, it loses its ability to bail out the private sector, because if you already have high inflation and then cut interest rates to zero, that's just going to cause more inflation. Or if investors are already worried about how much debt a government has, and it then starts taking on additional debt by bailing out the private sector, that's just going to cause more inflation and worsen the crisis. So instead of a bailout, what we're likely to get is a doom loop where a government debt crisis torpedoes the private sector, which in turn makes the government debt crisis even worse.

And that's similar to what's happened recently in countries like Argentina, Greece and Turkey. So, I agree with Jim Rogers that the next bear market may be the worst of our lifetimes, but the silver lining is that it should be an incredible opportunity for gold investors.[5]

[Elana]

And Brian, more specifically, where do you see some of the greatest opportunities in your space and why?

[Brian]

Sure. As these bubbles implode and the U.S. government defaults through inflation, I think the gold price should soar dramatically. And why is that?

Well, the first reason is that inflation reduces the value of fixed-dollar payments in the future, which is why it is a disaster for bonds. But gold doesn't depend on fixed future payments. And so, when you have an inflation crisis, investors often shift from debt instruments such as bonds to gold, which causes the gold price to soar.

We saw an example of that in the 1970s when gold's valuation reached an all-time high. And it's important to remember that right now the value of all the world's debt is about 20 times the value of the world's gold. So only a small shift in investors' allocation from bonds and equities to gold could potentially cause a huge increase in the gold price.

The second reason gold would do well in a crisis is that defaults by both governments and corporations would increase. And as the cliché goes, gold is the one asset that is no one's liability and is thus immune from default risk. And so, when you have a big increase in defaults and a big increase in risk aversion, investors tend to shift into gold.

And so right now, gold's valuation is around its 50-year average, despite all these risks and despite this looming inflation crisis. And so, if gold returns to its 1980 peak valuation at the tail end of the last inflation crisis, its price should reach more than $7,000, a huge increase.[6] And to answer your question more

[5] Statements regarding future recessions, government-debt crises, inflation, interest rates, equity valuations, real estate valuations, gold prices, gold mining equities, Fund holdings, or potential Fund outcomes are forward-looking opinions as of the recording date. Actual outcomes may differ materially. Gold mining equities involve substantial risks, including commodity-price risk, financing risk, permitting risk, operational risk, political risk, currency risk, liquidity risk, and the risk of permanent capital loss. Historical market data and comparisons are based on Hirschmann Capital research using sources believed to be reliable. Definitions, time periods, index composition, and methodology can materially affect results.

[6] Price targets and asset-price forecasts are subjective opinions as of the recording date, based on assumptions that may prove incorrect. They are not guarantees, are not recommendations to buy or sell

directly, I think the best opportunity is in the sorts of small gold mining equities that my fund owns, because they should go up even more than the gold price does when the crisis inevitably occurs.

And one simple reason for that is operating leverage. For example, if you have a gold mine with a 50 percent profit margin and the gold price goes up 10 percent, the mine's profits would increase by around 20 percent. And so, the stock price should rise much more than the gold price.

And that operating leverage effect can be very powerful. For instance, we currently own a company that trades for $5 per gold resource ounce. Resource ounces refer to gold in the ground that the company owns but has not yet mined. And if the gold price returns to its 1980 peak valuation, that company could go from trading for five dollars per ounce to more than five hundred dollars per ounce. So potentially more than a 100x return.[7]

And then at current gold prices, our companies are still trading at a fraction of their present value. So, if gold prices don't go anywhere, I would expect our portfolio to continue to appreciate as valuations improve.[8]

For example, this year, the fund is up around 60 percent year to date,[9] even though the crises haven't yet started. And even though it seems the U.S. economy hasn't yet entered a recession, and even if the gold price dips temporarily, I think any impact on the small gold mining equities we own will be temporary due to their low valuations, low production costs, and lack of debt.

And so regardless of what happens with the gold price in the short term, I would expect our portfolio to outperform dramatically over the long term.[10] And an important reason for that is that my fund has total flexibility in the types of gold projects it invests in. In contrast, if you invest in the gold mining index or the gold mining ETF, which many investors do, the index is restricted to companies with a certain market cap. And so, what my fund can often do is buy high-quality companies that have been orphaned and are

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any security, commodity, cryptocurrency, option, or other instrument, and should not be relied upon as predictions of actual market outcomes.

[7] This statement was an unscripted, valuation-based opinion as of the recording date. It was based on the manager's subjective estimate of intrinsic value for certain portfolio holdings and should not be interpreted as a target return, expected return, guarantee, or official projection of individual securities, portfolio holdings, or Fund outcomes. The assumptions underlying this statement may prove incorrect. Actual Fund results may be materially lower and investors may lose all or a substantial portion of their investment. The statement does not account for all fees, expenses, taxes, liquidity constraints, changes in portfolio holdings, changes in commodity prices, financing risk, permitting risk, operational risk, political risk, currency risk, or other risks described in the Fund's private offering memorandum.

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[9] This year-to-date performance reference refers to the period from January 1, 2024 through August 21, 2024. Fund returns are presented net of applicable Fund fees and expenses, including any performance allocation, and include reinvestment of dividends and other earnings. This performance figure was a point-in-time estimate or summary as of the recording date, may have been unaudited, and is subject to revision. Past performance is not indicative of future results. Please review the Complete Returns PDF for full net-of-fee performance, benchmark information, and methodology.

[10] Statements regarding future relative performance, including potential Fund outperformance of any index, ETF, sector, or benchmark, are forward-looking opinions as of the recording date and are not guarantees or official projections of Fund performance. Actual results may differ materially, and investors may lose all or a substantial portion of their investment.

trading at a low valuation simply because they're not yet eligible. They're a little too small for the index. Or we can invest in high-quality deposits trading at a large discount because they're not yet producing. And then we can sell them at a much higher price once they start producing and their valuation has improved. Examples of that include our investments in Atlantic Gold in Canada and Capricorn Metals in Australia.

[Elana]

Brian, on the other hand, what are some of the greatest challenges you face and why?

[Brian]

Sure. So, one challenge is that, in the short term, gold mining equities can fluctuate in value due to changes in the gold price and in production and exploration results. So I think they're only appropriate for a long-term investor.

Another challenge is that these bubbles have lasted a very long time and could last even longer. But I think all bubbles eventually break, and the bigger a bubble gets and the longer it lasts, the more we should profit when they inevitably do burst. And so, I don't think it matters much whether a crisis happens in 2024 or 2026.

Inevitably, gold should skyrocket. And in the meantime, our gold mining equities should continue to appreciate as they generate cash and discover more gold.[11] And so that's a big difference from other bearish strategies, such as buying put options, where you tend to lose money over time if a crisis doesn't happen.

[Elana]

Brian, we've covered a lot of ground today and wanted to see if there are any final thoughts you'd like to share with us.

[Brian]

Yeah, when a crisis happens, as I mentioned, I expect gold to skyrocket.[12] And I think the S&P 500's valuation will probably get crushed, but that'll create incredible opportunities in sectors such as health care, consumer goods, and industrial equipment. So perhaps if I'm on the show again, I'll be talking about investing in small technology companies rather than gold mining equities.[13]

[Elana]

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[11] Statements regarding future Fund performance, future relative performance, gold prices, gold mining equities, portfolio appreciation, or potential Fund outcomes are forward-looking opinions as of the recording date and are not guarantees or official projections of Fund performance. Actual results may differ materially, and investors may lose all or a substantial portion of their investment.

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Brian, I want to thank you so much for sharing your perspective with our listeners.

[Brian]

Thank you. Thanks for having me.

[Elana]

And thank you for listening to the EisnerAmper podcast series. Visit EisnerAmper.com for more information on this and a host of other topics. And join us for our next EisnerAmper podcast when we get down to business.

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