Hedge Funds and Mining – Never shall the two meet.

The mining industry's promoters have sometimes looked like cargo cultists waiting for the landing of "The Hedge Funds" in the sector which would be, supposedly, the salvation from the problems of a lack of sizeable capital in the space. We hate to be the ones to break it to them but hedge funds did land in the mining space (and quite some time ago too) reconnoitered the landscape and decided there was little of interest and took off into the wild blue yonder.

We thought it would be timely to look at the subject of hedge funds and the mining space in what is, supposedly (that word again), the second coming of the mining boom.

Narrow Focus

We received an email from one of the prime pundits of the mining space in North America last week and it began "I trust you are well despite hedge funds fleeing the commodities sector and the resulting junior market collapse". At first glance we wondered whether he thought that hedge funds had actually invested in Tin Pot Mines N.L. or their ilk and then withdrawn, hence the crisis. Second thoughts prevailed though that he was referring to the collateral damage of the hedge funds dalliance with derivatives on the mining sector, i.e. the GDXJ and the souped-up ETFs that were constructed on its back. As we have noted in recent months the inevitable (and yet avoidable) blow up of the GDXJ was caused by suspension of transactions in a derivative that gave outsized exposure to the upside (and downside) in the Gold Junior ETF. This triggered a reordering of the GDXJ with babies and bathwater going flying and the junior gold/silver space taking a pummeling, including those companies that had not a snowflake's chance in hell of ever being in the GDXJ. A rising tide sunk all boats.

That hedge funds prefer these large volume synthetic structures to actually stockpicking individual miners should be no surprise. If swiftness of entry and exit from a position is a priority then buying into an illiquid miner is not a realistic expectation. Ironically though, the managers of ETFs that are derivatives of the GDXJ were building their investment thesis upon the very illiquid juniors and mid-tier miners that the hedge funds eschewed.

So this would tend to leave the very largest hedge funds (those that make a difference) with the choice of investing in the very largest miners or in nothing at all in the space. They tend to have chosen the latter path. The most notable exception amongst the "household names" in the hedge fund space was the weird betting that was perpetrated by Paulson and Soros Funds on the eve of the 2011 Great Slump. Their bet on gold turned out to be ho-hum as the metal stayed largely rangebound between $1100 and $1300 for 5 years, while their bets on some of the largest dumbest developers were headshakingly perplexing. They deserved all they got. However their bad experience just proved to non-participating hedge funds that mining was a minefield (pardon the pun) that they best avoid.

Sure there are big names like BHP-Billiton, Freeport McMoran and Newmont that they could play in, but hedge funds piling into those names does nothing for the *Great Unwashed* of the middle and junior tiers of the mining space.

The Skillsets

It is probably a truism but we would note that the hedge fund industry is essentially a creature of tax avoidance (sorry, minimization) by high net worth investors, or at least that is how it started out. Then it became a space with outsized returns which attracted the like of endowments and pension funds that staked their “mad money” to get some (hopefully) superlative returns on at least a portion of their portfolio otherwise composed of staid bonds, munis and blue chip equities. That worked for a few decades but increasingly the returns have become pedestrian as the “smartest guys in the room” turn out to be a crowd sufficient to fill a football stadium and most of them were thinking alike and trying to squeeze juice out of the same algorithms.

Very few new funds have been started by analysts or analytical fund managers and instead most have been spawned out of the trading desks of the likes of Goldman Sachs. That means there is little perception of the intrinsic worth (or worthlessness) of a miner by hedge fund decision makers. These people can tell you that the best volume in Goldcorp is seen in the hour before the last hour of trading but they can’t tell you in what countries the company operates.

We cannot expect the hedge fund industry to seriously understand mining until it starts to employ people that actually know what is going on in the space. Quite rightly though hedge fund managements are wary of some of the more swivel-eyed personalities in mining, and that includes the analysts.

If someone came into an interview with us and started spouting $4,000 per oz gold we would push the ejector seat button faster than any hedgie could do.

Home Team Advantage?

It is quite telling that there are few hedge funds based out of Australia and Canada and certainly none of stature or massive funds under management. Without captive hedge funds it is certainly less likely that there is going to be dedicated hedge fund money for the broad mining space in either country.

The biggest player that moved and shook in both of these country’s mining markets was the London-based RAB Capital which came to grief back in 2008. Since then nothing vaguely comparable has arisen to take its place.

Conclusion

In summation we would note the problems in expecting a hedge fund surge into the mining space:

- Lack of a critical mass of hedge funds in general in Australia and Canada
- Dominance by the US of the hedge fund industry, where mining is no longer in the Wall Street DNA since most of the US majors were vaporized in the 1980s and 1990s
- Lack of skillsets amongst traders in hedge funds of anything beyond the very big and extraordinarily liquid names
- Travails of derivative ETFs upon ETFs will give ammunition to those that recommend to “stay away” from mining when the real problem was the creators/managers of these ETFs i.e. financial wizards (sic)
- Small daily turnover of many mining mid- and junior-tier companies is a buzzkill for hedge funds, even smaller ones
- Exotic locations and obscure metals (with no reliable daily pricing) make mining stocks even more unfathomable in macro terms
- Gold/silver failing to respond to “textbook stimuli” like rising political risk or inflationary trends or monetary degradation makes them less conventional hedges but more unfathomable wildcards

So the attitude amongst hedge funds these days towards mining is “who needs it?”. With mining not showing signs of getting any less complex we cannot rely upon hedge funds getting any smarter about the space. If it’s too much of a mystery, too perverse in its movements and too illiquid to enter and exit then mining will be cast into the too-hard basket. The rise of mining-focused mining hedge funds would seem to be the answer.

But who is prepared to jump out of their cosseted position at the likes of BlackRock to get down and dirty with juniors. The more logical move in recent times has been for such people to go direct to a private equity type role and play kingmaker in placings and with projects than merely being a passenger as a rank and file equity holder in a short-termist hedge fund.

What’s the problem with Hedge Funds & Mining?

The hedge fund managers like to style themselves as the “smartest guys in the room” but the mining space is littered with examples of hedge funds wandering out of their depth and sinking without trace.

It certainly does not help that mining does not have much of a close genetic relationship with many of the businesses that hedge funds traditionally play in. The problem is that the vast bulk of them don’t know it. In the run-up to 2008 the Supercycle spawned something like a handful of hedge funds that were metals & mining oriented but the debacle of 2008 severely winnowed their number. One London fund, that had become a by-word for “not being able to say no” to any financing, imploded spectacularly. It was no wonder as it reputedly had over 400 positions and the mere task of remembering what one was invested in was a full time job let alone following their activities or financial situation.

In this piece we shall do a review of what hedge funds did in the past and what they might do “this go around”.

ETFs – Sword Juggling for Amateurs

The standard meat and drink of retail mining fans in the ETF space are the GDX and GDXJ as well as the physical gold and silver ETFs. We also have a fondness of our own for the Palladium ETF. However all of this is “too boring” for your average hedgie who is trying to differentiate himself from the hoi polloi.

The latest fad consists of leveraged and inverse exchange traded funds, which are growing in popularity among technical traders who capitalize on short-term moves. The problem is that the stimuli that these traders are used to, such as FOMC minutes, PMI numbers, trade balance and housing starts do not pertain to the gold price. As we have recently noted the gold price has moved rather slightly this while the underlying gold stocks (as manifested in the GDX and GDXJ have moved by a quantum more.

I am the recipient of an emailed newsletter on ETF trends and I rarely actually read it but a recent edition caught my eye. It dealt with the more exotic ways that hedge fund traders could play the resurgent gold space via ETFs. One was the Direxion Daily Gold Miners Bear 3X Shares (NYSEArca: DUST), which takes the -3x or -300% daily performance of the NYSE Arca Gold Miners Index. This ETF had plunged on the rally in gold miners, the inverse ETF experienced millions of creations as institutional technical traders tried to catch the falling knife, betting on a reversal on the current uptrend. Not unsurprisingly, DUST declined 30.5% in just one month but saw $111.1mn in net inflows, according to ETF.com.

In contrast, the Direxion Daily Gold Miners Bull 3X Shares (NYSEArca: NUGT), the 3x bullish counterpart to DUST, saw $148.9mn in outflows after jumping 20.8% over the same period. One should note though that these might be straddle trades with the same investors on both sides!

The newsletter claimed that tactical bets were being placed on leveraged and inverse gold miner ETFs as investors try to time a bottom or trim holdings once the segment grows long in the tooth.

Traders have reputedly taken an interest in junior gold miners as well. The newsletter cited the Direxion Daily Junior Gold Miners Index Bull 3x Shares (NYSEArca: JNUG), which takes the 3x or 300% daily performance of the Market Vectors Junior Gold Miners Index (our old favorite dog to kick, the GDXJ). This ETF saw $13mn in outflows over the preceding month as the fund surged 47.7% while the Direxion Daily Junior Gold Miners Index Bear 3X Shares (NYSEArca: JDST), the inverse 3x counterpart to JNUG, attracted $29.2mn in inflows in the past month as the ETF plunged 45.2%.

For the more “conservative” there is on offer a range of products that track the miner space with “only” 2x leverage. These include the ProShares Ultra Gold Miners (NYSEArca: GDXX) and ProShares Ultra Junior Miners (NYSEArca: GDJJ) which take the 2x or 200% daily performance of NYSE Arca Gold Miners Index and the GDXJ, respectively.

The double-leveraged inverse versions of GDXX and GDJJ include the ProShares UltraShort Gold Miners (NYSEArca: GDXS) and the ProShares UltraShort Junior Miners (NYSEArca: GDJS). This is how one of the pairs has done in recent times.

If mining space investors did not have enough conspiracy/manipulation theories to deal with already, we recently started to hear complaints about these type of ETFs “spoiling the rally”.

Novagold/Seabridge

The best example of hedge funds behaving like “babes in the woods” was the adventure of two of the heavyweights of the hedge fund world into the gold exploration space (note: not the mining space and not the gold producer space) back near the height of the gold price. Indeed it may have been their intervention and "blessing" of gold as a mainstream investment that put the icing on the soufflé and led to its collapse. They had both gone from being counter-intuitive in the run-up to the sub-prime bust to the worst kind of me-tooism.

I have not liked Novacorp since I was first introduced to the stock last decade. I was boggled as to a series of properties so inaccessible and with such geographical challenges could be deemed to be attractive. Then when the company becomes a favoured stock of Paulson and George Soros (and this was deemed to be the smart money) we thought the inmates had really taken over the asylum. Paulson was of course still dining out on his perspicacity regarding sub-prime mortgages and could do no wrong. Anyway Paulson had waded into Novacorp around the turn of the decade and had, in 2012, some 36 million shares on which it has lost (according to Bloomberg) around $48mn when Barrick cast doubts on the jointly owned Donlin project. It was probably a pity that Barrick didn't also cast doubts upon its own Pascua Lama project and would have similarly saved itself a lot of grief. In any case, Novagold (and its similarly challenged doppelganger, Seabridge) have long remained darlings of a certain type of hedge fund that knows little about gold or mining. Fortunately for both the "new chums" have lined up to replace those investors that have preceded them in losing their shirts.

We were never impressed by this intervention. This was just a new version of the fat dumb money that some parts of the mining industry are in permanent pursuit. Indeed it is usually harder to find such fat dumb money than it is to encounter a 10 million oz gold deposit.

Needless to say, since that time, no hedge fund of note has made such a daring intervention in the mining space for fear of suffering the same ignominy.

Activism

Here we need to discriminate between funds wanting to improve management and those that merely want to seize control. The classic activist wants to see a change for the better resulting in an enhancement in the stock price and the chance for an exit with a substantial profit. There has been precious little of that in recent years. Looking farther back we can recall attempts to oust the management of Sherritt, but even back in the days of better markets (and more hedge funds) few of the fund managers wanted to get involved in proxy fights to enhance management. This was probably also a product of the sheer lack of hedge funds that could discriminate why current management was not performing to scratch. If you cannot lay out a good argument then one is unlikely to succeed. Combined with this the Canadian corporate scene (in particular) is blighted with a very difficult legal environment for challengers and a rather antipathetic retail base that won't vote proxies even if they don't like managements.

Then there is the other type of activism which has been all too common, the board ouster by a group wanting to take control. These have tended not to be run by hedge funds but by some of the same old, same old carpetbaggers of the mining industry. It's usually, even when the coup succeeds a case of out of the frying pan into the fire for minorities.

Distressed Debt

Usually this group in the broader markets pick up debt after it has gone sour (or well advanced towards that state) but in the mining world the distressed debt funds have tended to be Vulture Funds in disguise and to the naïve boards run by geologists and their ilk what looks like a guardian angel offering money in the darkest hour just turns out to be a buzzard that will rip their gizzards out, grabbing their project and leaving shareholders with a bankruptcy on their hands. One entity has developed a particular infamy for doing this of late, with Atna being one of the victims. Most miners know who they are now so do not fall for their blandishments.

They frankly should be hounded out of the space. Hopefully they will suffer the old Australian curse of “may all their chooks turn to emus and kick their outhouse down”.

Another case that ended more felicitously (I.e. with the fund coming a cropper) was the case of Maudore Minerals. While shareholders lost out (and several of them deserved all that was coming to them) the vulture also had its wings torn off.

Shorting

We love Short positions. There have not been many opportunities of late with values being so down and out. Shorts are meat and drink to hedge funds though the danger in the space (like ETFs) is that momentum can carry miners in one direction for a long time before gravity (the Wile E. Coyote effect) brings a stock crashing back to earth. One of our favorite shorts of the bull market was US Gold (now restyled as McEwen Mining, *la plus ca change*). This beast defied all attempts at market discipline as it had a rabid pack of retail followers who not only subscribed to the man but also to the $10,000 gold thesis. It took some gumption to stand up to this raging horde.

Hedge funds can short best when they face up to other institutions on the other side of the trade and there are (in theory, at least) some fundamentals to question. In mining the hedge fund is more often than not on the opposite side from an army of faceless retail investors marching forth with their tin-foil hats as their only battledress.

Conclusion

Hedge funds have a chequered history in the mining space. Instead of being first movers, they seem to be last movers or at least late arrivers. We suspect the mining space scares them, like the old maps used to have something at the edge that said “beyond here, there be dragons”. Liquidity tends to restrict them as they want easy ingress and egress but then they end up playing the industries proxies (Barrick, Goldcorp etc) or the more liquid wannabes (like Novagold, Seabridge) that are ultimately going nowhere. This has repeated the regrettable cycle of larger players funding the “unworthy” and “undeserving”.

Activism has flopped but there is plenty of scope for it. Bad managements have not gone away despite the market attrition. Distressed debt funds will hopefully be rousted from the scene by better financing conditions. ETFs have become more sophisticated than the last time the market was rampant, so we could very well have a situation where they become the “tail that wags the dog” in junior and larger miners. This could produce a divorcing (already maybe being seen) between physical metal movements and that of the underlying stocks in those metals.

The more players in the space the better. This group has largely been absent of late and their return would be a major help for liquidity at the very least and bringing some new mindsets and disciplines to the companies touting their wares.