# 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we wondered whether he thought that hedge funds had actually invested in Tin Pot Mines N.L. or their ilk and then withdrawn, hence the crisis.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.