How to Pick the Best Gold Stocks – How to Profit from the Bull Market in Commodities

The Gold Bull Market

In most of this course we have focused on broad market trends through the use of stage analysis and how to invest accordingly. Along the way we have examined many trading tactics to use in any market. By now you should start to feel confident about putting that knowledge to use.

I want to use this report to discuss gold stocks with you, because I believe they will continue to remain in a bull market for the next few years and have characteristics that are different from most other stocks in the market that you need to be aware of if you venture into the commodity arena. I expect gold stocks to remain a focus of my work for the next few years.

Although I have been investing in the stock market since the 1990's, starting in 2002 I have been an investor and trader in gold stocks. At the beginning of that year I came to the conclusion that gold and commodities were about to enter a secular bull market. Since that moment I have bought and recommended many gold, silver, and energy stocks and my subscribers and I have benefited from the bull market in commodities. I still believe that over the next few years this trend will continue. In fact I see gold rising to over $5,000 an ounce before the gold bull market comes to an end. The right gold stocks will rise exponentially over the next few years. Those that take advantage of it will reap the rewards.

Investing in Gold Companies

There are different ways that you can profit from a gold bull market. You can buy gold coins, gold bars, or purchase gold futures contracts. However, I believe that the best way to profit in a gold bull market is to invest in shares of gold companies. For one thing you have instant liquidity. If you want to take your investment out all you have to do is call your broker and sell at the quoted market price. With gold coins you have to find a gold dealer or another collector who is willing to purchase your coins.

There is an even more important reason why gold stocks can be a superior investment. The profits that mining companies generate during a gold bull market are tremendous, because when the price of gold moves up their profits explode exponentially. For example if the price of gold rises from $900 to $1,100 an ounce that represents a 22% increase. On average it costs a gold company $400 to get an ounce of gold out of the ground. A 22% move in the price of gold from $900 to $1,100 translates into a 40% increase in profits for the gold companies).

This gives a gold investor tremendous leverage for his investment dollars and gold stocks tend to rise by a much larger percentage than the price of gold itself during a gold bull market. In fact the gains can be astronomical and it is that fact that first brought my interest to the gold market. That should be no surprise because when the profits of a company increase rapidly stocks almost always follow.

The Gold Industry

In 2002 I came to the conclusion that the opportunities to profit in the new gold bull were going to become a once in a lifetime opportunity that I had to take advantage of. I decided that I needed to make contacts with gold analysts, newsletter writers, and management teams. I wanted to know what makes the gold community tick so that I could build off of their advice and get access to the private market place.

I started to travel to mining industry shows across the United State and Canada. Most of them were organized in the same fashion. They rented out a conference center and divided it up in two sections. In the first section there are speaker panels and smaller workshops where you can get one on one attention with experts and in the second section there is almost always an exhibition hall with booths.

These booths were made up of brokers, trading software, and small cap companies trying to attract investor interest. Despite the dozen or so major gold conferences a year, in reality the gold community is small.

When I first started attending these conferences, very little money was actually flowing into gold companies, even though the stocks were going higher. The simple fact of the matter is that gold and the gold stocks are only a small segment of the financial world. At the start of 2001 the combined market cap for all publicly traded gold stocks was less than the market cap of Disney. As I write this Wall Street is still shunning them. Mainstream investors and CNBC talking heads did not accept the fact that gold has been in a bull market until recently. Many still think that the gold rally will fail and are afraid to commit money. This is why the small gold companies still use private investors for financing and depend on newsletters and investment conferences for exposure.

On one hand this is a good thing. You can make contacts with the leaders of the gold industry and most gold companies are very compliant with individual investors. This is a virtual impossibility right now in sectors such as technology. You would have a difficult time trying to meet Bill Gates or Larry Ellison at an investment conference, but you can meet Robert McEwen, the CEO of GoldCorp, a company with a market cap of over $3 billion, at a gold conference.

On the other hand, many tiny gold companies are nothing but pieces of paper and their reliance on small newsletter writers for exposure is a sign of their lack of investment merit. In fact many of them border on being outright frauds. When I started to go to investment conferences that featured gold companies, I made it a point to have private conversations with the gold CEO's to get a better feel for the industry. I spent one night with one of them on a $3 1/2 million dollar yacht watching football and drinking beer. Loose lips are more revealing.

I have never had a position in this man's company and don't now. I took a liking to this guy and he seemed straight to me. Of course he believed that gold will go up, but warned me that 80% of the small cap exploration companies are "fake." He had a 15-year background in the industry and knew most of the key players. I asked him who can the small investors rely on? The analysts don't follow the stocks so all you have are newsletter writers. He laughed and said that most of them are bought off with stock. He told me of one or two that were good, but then added, "you need to understand that they need to make a living."

He went on to tell me that when it comes to exploration companies it is all about promotion. His words made comments that I heard from another CEO of a small exploration company earlier that day bounce in my head. During a conversation with this man he made a side remark to the effect that gold companies are the best companies to run, because the balance sheet doesn't matter. Earnings don't matter. People don't know how to value your properties and it is all about its unknown potential and the ”psychology” of gold, he claimed.

The last time I heard CEO's say that their earnings didn't matter was during the Internet mania. Those stocks flew and crashed to nothing. When the gold bull is over most of small cap gold stocks will go back to nothing too. However, they are still in the 1st quarter of their bull run and just like Internet stocks back in the bubble days you will eventually see bunches of new companies appear out of nowhere and have their moment in the sun.

I got the impression from both men that stock promotion is central to the junior and gold exploration stocks. The man on the yacht point blank told me that it is not the shares of companies with good resources that go up the most, but the ones with the heaviest promotion that does. The way he put it if you have good properties and no promotion the stock will lag, but if you have crap properties and heavy promotion it will fly as gold goes higher. And if you have both then you have a rocket.

The easiest way for people to promote a gold stock is to get newsletter writers involved, especially those that specialize in the gold market. They are the people who can directly reach potential investors. Promoters get them involved by allowing them to buy stock at steep discounts on the private market, paying them money, or by simply giving them shares.

One of the most popular ways to promote a stock is to send out mass mail flyers to investors. These fliers almost always will feature a newsletter writer, who supposedly has earned his subscribers unbelievable profits, and a write up for the company that it should go up 1000% or even more. That write up is the real purpose of the mailing. The newsletter writer is just there to give it credibility.

The problem is that more often than not the investor who buys on these mailings is buying in near a top. The promoter, the newsletter writer, and everyone else involved in pumping the stock already got in way before the flier is sent out. After the last sucker gets in the stocks always goes back down. With no earnings or real prospects they have nowhere else to go.

For the record I do not engage in any of these promotional activities. I am not paid to promote stocks. In the gold industry, it is rare to find a newsletter writer who isn’t involved in this sort of activity. I’ve even heard of one writer calling the gold companies himself and asking them how much they will pay him to write up their stock! Luckily there are ways that you can determine whether or not a newsletter writer is doing real analysis or is just giving you a sales pitch. And there are indeed a few top-notch analysts out there.

There is a simple way to separate the wheat from the chaff. Anyone who recommends a stock must put a disclosure with their recommendation if they already own shares or were given stock or paid cash by the company or a third-party. Read the writer’s disclaimer very carefully to see this disclosure. If they simply own shares that they bought that is one thing, but if they are being compensated to promote the stock be very wary of what you are reading. It is not an unbiased piece of research.

As time goes on I expect these conflicts of interest to become a big issue. Investor awareness will increase. I just hope that it won’t take a scandal for it to start. For now you must carefully choose which newsletters that you follow and make sure they are being written by real independent analysts and aren’t just tout sheets.

I learned from talking to these CEO’s that I needed to be careful in what I invest in. I needed to learn for myself what is the best way to evaluate a gold company. I put lots of my own money into work in the market and I want to buy the best stocks, not just ones that are going up because everything else is, or because they are being promoted. If you are going to buy into a basket of gold stocks you should just buy the best ones.

Types of Gold Stocks

The trick is how to determine which gold stocks have real potential. The safest gold stocks are the large producing gold companies. Every gold portfolio should revolve around a core holding in a few of the largest producers. These companies include Anglogold, Barrick Gold, and Newmont Mining among others. They are the stocks that become institutional favorites of mutual fund managers. In fact if the gold bull market continues the way that I expect it will then Newmont will become a must own stock, much like Cisco Systems was in the 1990's.

Generally speaking the higher the potential gain the higher the risk that an investor takes in a stock. Higher returns are available to gold investors from mid-tier producing gold companies that mine anywhere from 100,000 to 1,000,000 ounces of gold a year. These stocks have smaller share floats so it takes less money flowing into the stock to make it go up in value. The companies have at least one producing mine and often own several mines, some of which may have higher production costs and were closed during the last gold bear market. As the price of gold advances these mines reopen, to provide a boost to the company's profits. A lot of these companies end up getting bought out. Bema Gold, Wheaton River, and Cambior were all mid-tier producers who got bought out at huge prices.

Mid-tier mining companies can become takeover targets and often engage in gold exploration activities. Often they join smaller exploration companies in developing potential mines. Mid-tier mining companies are very dependent on the price of gold and often take on debt to develop mining properties. As a result if the gold price drops they often have to scramble to raise more capital, which means diluting shareholders or floating more debt, and some of them often become insolvent during gold bear markets.

Below the large and mid-tier producers are exploration and junior mining companies, which make up most of the gold companies on the Canadian exchanges. Exploration companies consist of only a couple of employees, most of whom are geologists, who search for new gold deposits in hopes of finding the next big discovery. They raise money to purchase claims on properties and drill them to define their potential. Their shares are penny stocks and are akin to lottery tickets. Only one in a thousand pay off in the end. Of course the reward when one of these companies hits pay dirt is enormous.

Junior mining companies try to transform exploration properties into producing mines. Some junior mining companies have mines in production, but most of them are only a step above exploration companies. Those that do have mines usually have ones of a lower quality and need to open new ones to replace them when they run out of ore. However, when a new mine comes on line earnings for these companies go through the roof so these stocks have huge potential and are less risky than pure exploration plays. Both the exploration and junior mining sectors are riddled with stock promoters and are high-risk speculations. There is a reason why penny stocks are worth only pennies.

Choosing Gold Companies as Investments

I invest in a core position of large producers and usually build the rest of my gold portfolio around a basket of stocks in mid-tier producers or emerging producers. I believe they give me a good risk to reward ratio for each dollar I spend, as many of the shares of mid-tier companies double during rallies in the gold bull market. Most of them also trade over 1,000,000 shares a day. That is enough volume to allow me to build substantial positions and prevent any liquidity problems.

I look for mid-tier companies whose gold production is slated to increase over the next few years, enabling their earnings to grow exponentially even if the price of gold does not rise. They may be planning on reopening mines that have been out of production or have purchased mines from junior gold companies.

In special cases I do invest in junior and exploration companies, but only after a full study of their projects. Most of these companies eventually either get bought out or go out of business. When you become one of their stockholders you become a shareholder and partner in their venture. You are making a bet not only that management can succeed, but that they are on your side and are interested in enhancing shareholder value by building a successful operation and aren't just trying to pad their pockets through stock jobbing. You need to know who the people are behind the company and understand their business model. Do they have properties worth exploring and developing and will they have the resources to execute?

There are simple questions that you can ask. Whose money is already in the company? How much of the company's financing is from insiders and the management team and how much of it came from brokerage houses and individual investors? Is the management team paying itself in large salaries or do they expect to make money from gains in the share price along with their investors? If they are making stock transactions are they buying or selling shares?

What is the background of the management team? Have they built successful companies before? If they made mistakes in the past were they fooled themselves or did they fool their stockholders? Have the geologists involved in the company made successful discoveries in the past? What type of experience does the chief engineer have?

If you ask these simple questions then you'll invest your money with the top people in the industry. The other thing you need to know is how exploration and junior mining companies develop. This will help you evaluate whether or not an exploration company has a viable property or not and if a junior mining company is going to be able to develop a mine.

How Mining Companies Are Developed

Exploration is the first stage of development. Many exploration companies go to hot areas of the market where gold has already been discovered and mined. At some point in a gold bull market area plays develop and exploration companies appear out of nowhere to play off someone else's success. You need to be wary of a company whose only selling point is the area that it is in.

An exploration team will have its engineers survey its properties. Once they determine that there is likely a solid gold deposit, they will need to raise money in order to prove it. The company then drills holes on the property far apart from each other to get an idea of where the gold may be concentrated.

If the first drill results are successful, the company will carry out another drill test, called an "infill drilling" test. This test consists of drilling new holes in between the first ones in order to get a rough idea of the deposit size and ore grade. The drill results are then taken and the gold deposit is classified. You need to understand the classification system so that you can understand how viable the project is.

A deposit classified as a geological resource is the lowest grade deposit. Gold or silver has been found and a rough estimate has been made to its size and grade based on limited evidence. Further evaluation is needed. This classification is also called inferred, estimated, or drill-indicated. This level of resources has the lowest chance of ever being mined and it is best to stay away from exploration companies that tout such properties.

Most deposits are classified as a possible, probable, or proven reserve. Proven reserves have the highest confidence level and were measured with 50 feet drilling spacing. Probable reserves often used 100 feet drill spacing, while possible reserves uses even wider drill spacing.

The SEC does not allow companies to include possible reserves when they total their ore reserves. Canada accepts them and allows mining companies to include them with their proven and possible reserves in press releases and shareholder reports. In reality they are very low-grade properties and should not be counted as strong assets on a company's balance sheet. Be wary of Canadian mining companies whose portfolio is made up of possible reserves.

If the exploration company's survey of a property is promising then it will go the next step, which is a feasibility study. This study further examines and defines the ore reserve and its size, identifies mining methods, estimates capital costs, and projects profitability and return on investment. A feasibility study can take up to three years to complete and once it is finished costs are calculated within a 15% margin. The process of going from exploration to a feasibility survey is what turns exploration companies into junior mining companies.

The next stage of development is the construction of the mine. This can cost a hundred million dollars, which is way more money than junior exploration companies have. If they can’t finance the operation then they will try to attract a larger partner to assist in the project or buy them out. If gold is in a bear trend then the project will sit idle until a new bull market in gold begins, a fact that causes many idle projects to sit in waiting.

The costs and time it takes to get the mine in operation can vary widely. A lot depends on the location of the property and the country that it is in. Stringent environmental laws and bureaucracy can drag out the process and raise costs. Once construction begins and the mine is in operation more knowledge about the size and grade of the ore is obtained.

Even though a company that goes from exploration to production can be a bonanza for shareholders, it won’t necessarily last. All mines run out of ore eventually and the company will have to one-day find new gold reserves, if not at the current mine then at another property. If it doesn’t then it will likely go bankrupt.

In the end exploration and junior resource stocks can make profitable speculations, but they are almost all poor long-term investments. You have to know when to get in and when to get out. This is something that charting and technical analysis can help you with.

Inter-Market Analysis and Gold

Gold has a tendency to be counter-cyclical to the economy and stock market.

There is more to the financial markets than the stock market. There are also the currency, bond, and commodity markets. Each of these markets has their own relationship to the economic cycle and influences one another.

Understanding this can help you see where each market is going and in what stage of the business cycle the economy is in. This is a handy tool for forecasting the long term direction of the stock market . Grasp this and you no longer will you have to rely on the guesses and predictions of people Wall Street analysts and the talking heads on TV to know where the markets are going. You will be able to see the big picture for yourself.

The economy moves in a business cycle that consists of 4 stages: peak, recession, trough, and expansion.

The bond, stocks, and commodities markets move in 6 Inter-Market stages that follow the business cycle:

1 - As the economy enters a recession stocks and commodities fall. At the same time bonds go up in value as interest rates drop.

2 - as the recession hits bottom and the economy troughs, stocks bottom out and rise. Commodity prices continue to drop as inflationary pressures remain tame.

3 - as the economy enters an expansionary phase stocks and bonds continue to rise. However, commodities lag and bottom out and turn up as demand increases.

4 - the bond market tops out, while stocks and commodities continue to rise. A peak in the bond market signals an inflationary environment and a rise in interest rates and is a warning that the economic expansion and bull market are about to end.

5 - the expansion reaches a peak as bonds continue to drop, while stocks top out and follow. Commodity prices continue to rise as inflationary pressures remain. Interest rates rise.

6 - the economy enters a recession and a drop in consumer and business demand causes commodity prices to drop. Now stocks, bonds, and commodities all drop. Soon bonds bottom as the Federal Reserve begins to lower interest rates and the cycle enters stage one.

As you can see the bond, stock, and commodities markets are all sensitive to inflation, interest rates, and the business cycle. I will now break down each market, including the currency market, so you can understand why they move like they do.

1)The Commodity Markets

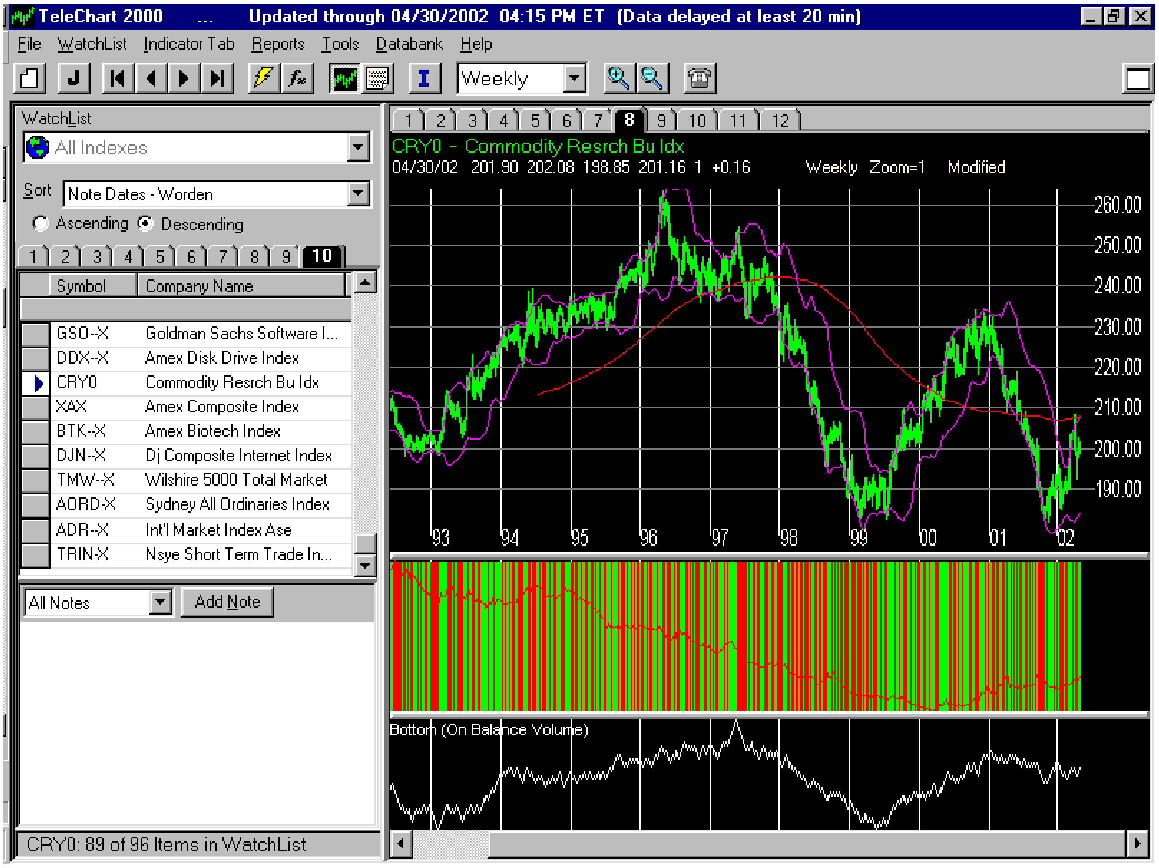
The simplest measure of the commodity markets is the Commodity Research Bureau Index(CRB Index). It is an index just like the DOW or S&P 500. What is important for you to know is that the CRB index is inflation sensitive. In fact the CRB index leads other inflation gauges such as the Consumer Price Index or the Producer Price Index by months.

The CRB index tends to be in bull phases while the stock market is in a bear market and vice versa. That is because the CRB index rises when inflationary pressures increase. That causes interest rates to rise and makes stocks less attractive.

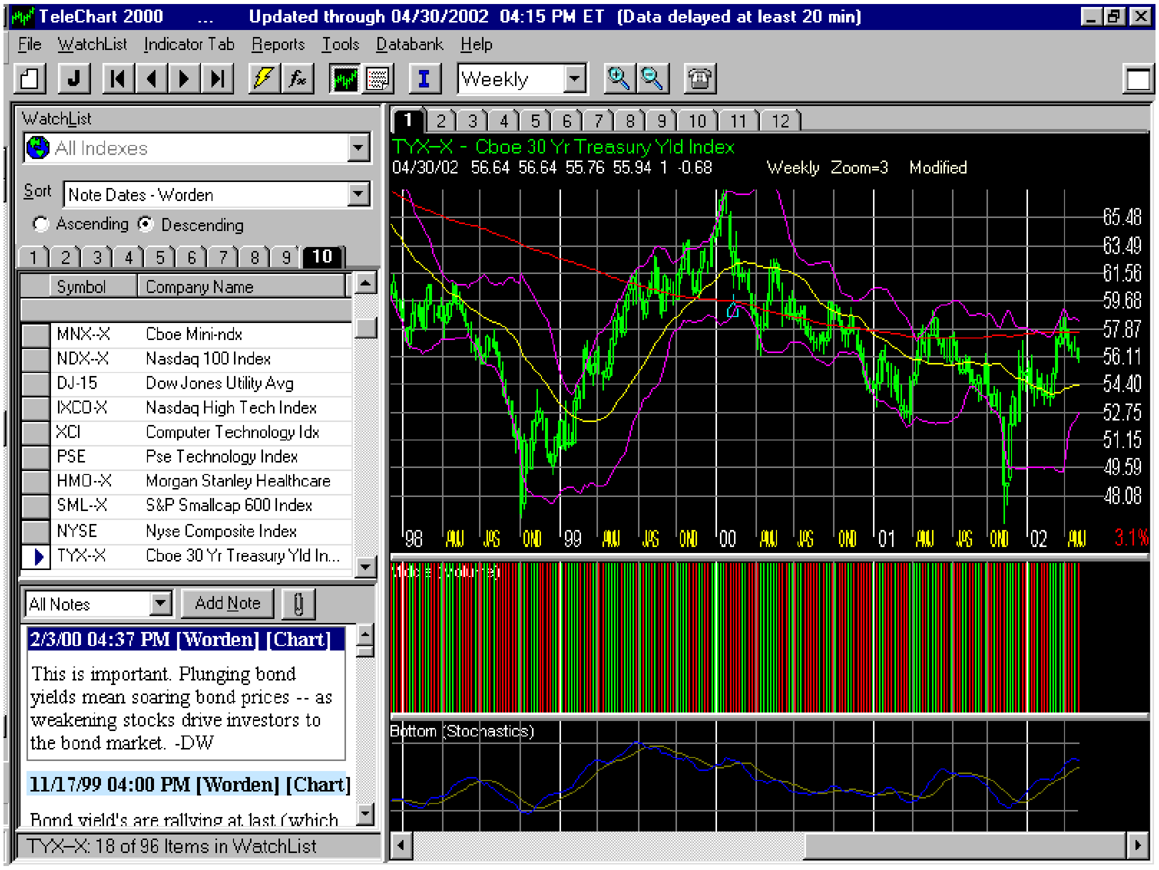
Inside of the commodity markets gold and silver lead the index. Gold is even more inflation sensitive than other commodities. This is because people use gold as a safe haven against inflation. As a result, when the CRB index is in a bear market gold will bottom and enter a bull market before the rest of the index does. Gold will also usually top out and decline before a CRB index bull market comes to an end.

2)Bonds

Bond prices and bond yields trade opposite of one another. When interest rates rise bonds drop and vice versa. Bonds trade completely with interest rates which are sensitive to inflation. Since commodities prices lead inflation the CRB index moves in an opposite direction to bond prices. When inflation is hot and the CRB index trends up bonds drop as interest rates rise.



CRB Index 1993-2002



The yield on the 30-year Treasury bill 1998-2002

To relate this to the business cycle, as the economy expands the demand for raw materials increases. That causes commodity prices to rise. Eventually as the economy gets hot the rise in commodity prices will work its way into economic indicators such as the Consumer Price Index and the Producer Price Index. Once the Federal Reserve begins to raise interest rates to combat inflation, bond yields rise while the bond market tops out and begins a decline. Eventually the rise in interest rates will take a toll on the economy and cause it to slow up or enter a recession. By then stocks will have topped out and entered a bear market. Eventually the Fed will lower interest rates. Bonds prices will begin to rise and soon the stock market will follow and both will enter simultaneous bull runs. Then cycle repeats itself.

BONDS AND STOCKS TRADE TOGEHTER

To summarize: bonds lead stocks while the commodity markets trade opposite of bond prices. At the same time the gold market leads the broad CRB index.

3)The US Dollar Index

The US dollar does not have a solid repeatable relationship with the stock and bond markets, because of the long lag time between moves in the currency markets and their effects on the bond and stock markets. However, the value of a dollar has a more immediate impact on the commodity markets which in turn affects the bond and stock markets. A highly valued dollar lessons the impact of inflation. A dollar that is highly valued can purchase more overseas and in turn makes imports into the US cheaper. Conversely, a dollar that is falling in value causes inflation by making the costs of imports - may they be resources or consumer goods - more expensive.

The dollar and the price of gold are closely tied to each other. When the dollar falls in value investors often sell dollars and buy gold as a safe haven and vice versa. As a result the dollar and the price of gold tend to trade opposite one another. Since gold leads the CRB index, the dollar and gold also lead the rest of the commodity markets. A rising dollar is a bearish sign for commodities while a dollar that has topped out and a gold market that has bottomed signals the beginning of a bull market for commodities and an eventual rise in interest rates. This of course has eventual bearish implications for stocks and bonds.

After advancing for years the US dollar index made a double top in January of 2002 and began a stage four bear market. It broke a support trendline that went back for years and is fell towards its 150-day moving average. By the end of the year that moving average began to slope down and show the characteristics of being in a full blown stage four bear decline.

Gold has a tendency to trade opposite to the dollar. While the dollar was strong through the late 1990's gold dropped and made a bottom in 2001. It broke out of its downtrend in the beginning of 2002 and has been in a bull market every since. Notice how this move also took it above its 150 and 200-day moving averages, which had been trading flat as gold completed its stage one consolidation phase. Within months those moving averages began to turn up and have formed support for the price of gold during its secular bull market that began at this time. We made note of this at the start.

WSW Power Picks

If you want to know more and are interested in discovering individual gold stocks you may want to consider taking a risk-free trial to my WallStreetWindow Power Investor. As part of the Power Investor service you'll receive WSW Power Picks, in which I identify the best stocks to invest in, many of which include gold stocks. I look through literally a thousand stocks a month and pick out a few of the best stocks out of these thousands to bring to your attention.

If you join drop me a note in our members' only forums. I'll be looking for you there. - Mike Swanson

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