GOLD & GOLD EQUITY INVESTMENTS

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GOLD

Why is Gold "Golden?"

Physical Properties:

Gold is one of the rarest and most coveted elements on earth. It is not gold's scarcity alone though, which makes it such a covetous commodity. There are four chemical properties of gold, in addition to its rarity, which have made it so desired and sought after for millennia. These properties include its malleability, its anti-corrosive nature, its density, and its luster.

These physical properties of gold make it divisible, indefinitely storable, easily transportable, and identifiable.

Medium of Exchange:

Gold's unique qualities have allowed for it to be the preferred medium of exchange for centuries. In fact, gold (and to a lesser extent silver) has been the legal basis for exchange of goods (legal tender) throughout most of history. Gold only became officially demonetized in 1971 during the Nixon Administration. (Please see: Brief History of Gold Standards in the United States, published by the Congressional Research Service, June 23, 2011 http://www.fas.org/sgp/crs/misc/R41887.pdf)

Gold legal tender coins of the late 19th and early 20th centuries from the US, Britain, and Switzerland

Liquidity:

Despite the fact that gold is not presently the basis for legal tender, it is always liquid. One ounce of gold could be exchanged for approximately 138,000 yen in Japan, 1,090 euros in Germany, 7,900 renminbi in China, or $1200 in the United States.

No One's Liability:

Gold has characteristics which differentiate it from paper or electronic (fiat) money, which is currently used as legal tender. Gold is unique in that it is not replicable and is no one else's liability.

If you place $1,200 (the current market value of one ounce of gold) in a money market fund or in an FDIC insured bank deposit, you own an obligation of the United States government or of the bank in which you deposited your cash. You are taking on a risk that the United States government or the bank will make good on its obligation to pay you back. Gold is the liability of no one.

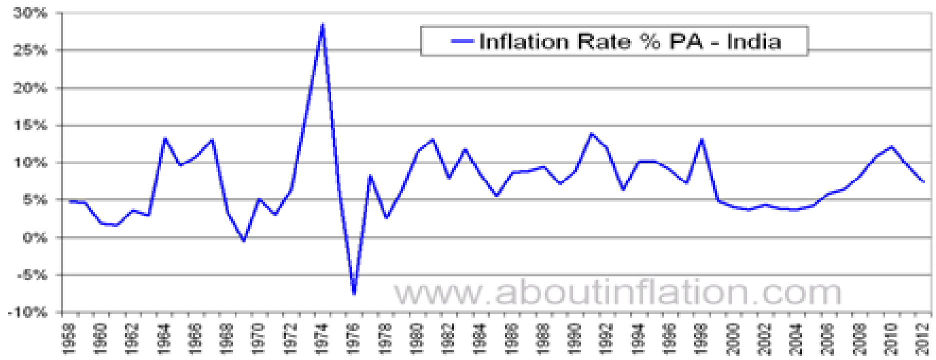
In a similar way, a foreign holder of US Treasury Bills, Japanese Government Bonds, or German Bunds is accepting the risk that the US, Japanese, or German governments will pay them back in full. In holding gold instead, there is no "repayment risk" as such. It might be for this reason that central banks around the world own gold as part of their currency reserves.

Not Replicable: Gold or Rupees (or Dollars)?:

In holding fiat money you are also taking on the risk that the government might repay the money you've lent to it with newly created money, making your currently held money worth less. No one can create more gold.

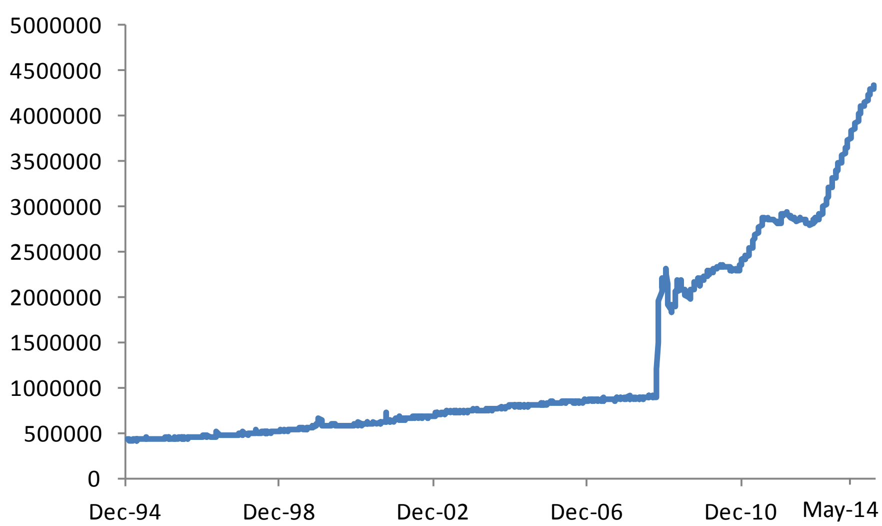
The largest consumers of gold in the world are Indian and Chinese individuals.

Indians largely choose to own gold over rupees as a savings instrument. They have been rewarded for doing so over time as inflation (currency debasement) has degraded the purchasing power of the rupee. It takes 100 rupees today to purchase 1.5% of the goods 100 rupees could have purchased in 1958.



Indians choose to hold their savings in gold to protect against rupee devaluation and the subsequent inflation of asset prices. Gold is essentially a hedge against the rupee losing its purchasing power.

Currency debasement can happen here too. Since the Global Financial Crisis of 2008, the central banks of the United States, the Eurozone, the United Kingdom, and Japan have created a combined $6.5 trillion of fiat currency in order to buy financial assets. This amount of global money creation is without parallel in history, and the eventual consequences of this undertaking are as of yet unknown.



Bloomberg

Above is a graph of the Federal Reserve's balance sheet. The Federal Reserve has grown its balance sheet by purchasing assets with newly created money.

How to Own it

Savings Instrument:

Gold can be owned in a variety of forms. Whereas most Indians and Chinese choose to hold physical gold in the form of jewelry and small bars and coins, Westerners tend to buy and sell gold through market exchanges in the form of exchange traded funds (ETFs).

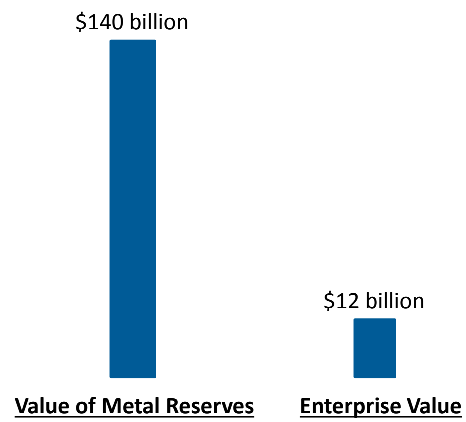
An Investment in Gold:

Physical and exchange traded gold are savings instruments. Gold equities are investments. Gold equities represent ownership stakes in operating businesses. In owning the best gold mining or gold royalty companies in the world, one gets the gold in the ground at the mine sites while also getting the benefit of cash flow produced by the mines and the opportunity for accretive growth.

Why Gold Equities

Gold in the ground at a discount: Newcrest Mining owns $185 billion worth of proven and probable mineral reserves (gold and copper) in the ground compared with its current enterprise value of $12 billion.

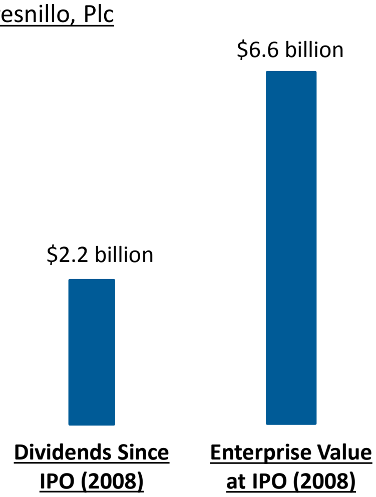
Newcrest Mining



Source: Company Reports

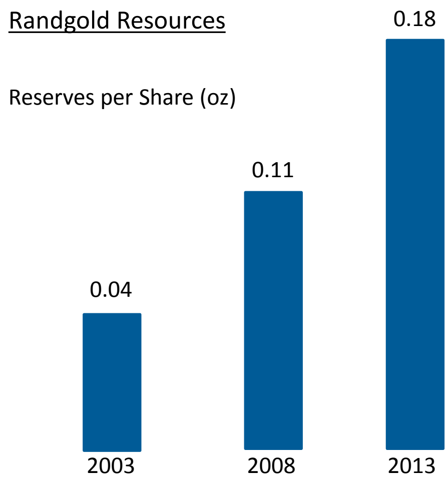
Dividends: Fresnillo, Plc has paid over $2 billion in dividends to shareholders since its initial public offering in 2008 compared with its initial market valuation of $6.6 billion.

Fresnillo, Plc



Source: Company Reports

Growth in reserves per share: Randgold Resources has consistently grown its reserves without having issued new shares. It finds more gold using internally generated cash flow.



Source: Company Reports

Assets, Management, Valuation

The Gabelli Gold Fund (GOLDX) uses a research based approach to invest in what we believe to be the best gold mining and royalty companies in the world. The fund assesses a potential investment based on three characteristics: the quality of the asset (operating mine or mineral deposit), the management of the company, and the valuation being paid in the market to acquire a stake in the company. Risks associated with a potential investment are weighed against valuation.

Assets: Quality – the 3Gs:

There are three qualities which define a good mineral deposit.

These are:

1) The Grade of the deposit, or the amount of metal contained within one ton of rock.

A high grade ore sample

2) The Geometry of the deposit. A deposit's geometry will determine how costly it is to extract this deposit from the ground on a unit basis. The bigger, the wider, and the more uniform a deposit's geometry, the less labor is needed to mine the deposit.

3) The Geography of the deposit. A deposit located near infrastructure (electricity, rail, roads) and a population center will be cheaper to mine than a remote deposit. Whereas an accessible deposit can benefit from relatively low costs of grid powered electricity, transportation, and labor, the remote deposit might have to generate its own power from diesel fuel and transport labor and supplies to site by air.

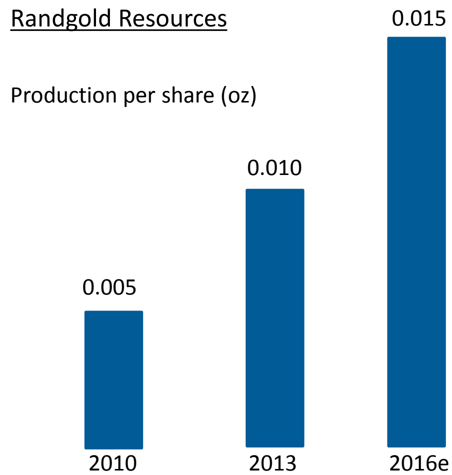
The Malartic mine (left) is near a town, highway, and cheap electricity in Quebec, while the Pascua Lama project (right) is in a remote location in the Andes at an elevation of 15,000 ft

Management: Can they get it out of the ground, and if so, what do they do with it?:

The first quality Gabelli Gold looks for in the management of a gold mining company is its ability to extract the gold from the ground in the most cost-efficient manner possible. If the senior management of a company has the right operational team in place and has imbued its organization with a sense of operational excellence, then a deposit should be mined at the lowest unit costs allowed by the deposit.

Execution is only half of the management equation, however. If the metal has been successfully and profitably extracted, processed, and sold, the management then has to make the appropriate decision as to how to allocate this newly created capital.

A good way to measure a company's capital stewardship is by assessing its ability to grow its metrics on a per share basis. If a company can use its capital to grow its reserves per share and then its production per share, shareholders should benefit in the long run. If opportunities do not exist to grow these metrics on a per share basis, then capital should be returned to shareholders in the form of a dividend.



Based on historical data and Gabelli Gold's 2016 estimate for production

Randgold Resources has grown its reserves per share and is now growing its production per share. This growth is being accomplished using internally generated cash flow.

Valuation:

Once a basis for investment has been established, the question becomes the price that's being paid to make that investment. When valuing a potential gold mining investment, Gabelli Gold focuses on the potential future cash flow generation of the gold mine. We analyze how much free cash flow could be distributed to shareholders or reinvested in value accretive exploration or development projects. We place a high value on companies which have managements who have committed to pay dividends to shareholders and which have proven track records of growing on a per share basis.

We also evaluate a company based on the amount we are paying per ounce of proven reserves in the ground. This valuation methodology addresses the option value inherent in owning gold ounces which might be mined many years into the future. This "gold in the ground" could eventually be mined at a much higher future gold price.

What Could Go Wrong?

The Gabelli Gold research team is always cognizant of the risks involved in investing in a gold mine. From an underground narrow-vein mine at 18,000 feet elevation in the Peruvian Andes, to one two miles beneath the surface in South Africa's Witwatersrand Basin, we've seen it all at Gabelli Gold. We know that gold mining is not an easy business.

We assess various risks when evaluating a gold mining investment. These include:

1) Political risk: What is the likelihood that a mine will be nationalized or that the tax rate on a mine might change? For a pre-development project, what is the risk to getting the project permitted?

   We keep in mind the fact that developing countries are sometimes the best mining jurisdictions given the desire amongst developing nation governments to attract foreign capital and create new jobs in their countries.

2) Operational/technical risk: how technically challenging is it to mine the deposit? A great deposit with a good geometry and competent host rocks limits operational or technical risks associated with its extraction.

3) Geological risk: this applies more to exploration projects than to operations. What's the risk that more (or no more) gold is found at the deposit.

4) Financial risk: Gabelli Gold prefers a company with no debt on its balance sheet and can finance its future production through internally generated cash flow. We are always cognizant of the potential need to raise additional funds through equity issuance.

The ideal mining investment has world class assets with a great value-enhancing management which trades at a cheap valuation relative to its future cash flow and has few risks associated with bringing its gold to account. Please let us know if you would like to discuss any particular investment in greater detail.

Conclusion

We believe that gold is simply an incorruptible store of value. Although not currently classified as such, gold has been the default basis for exchange of goods and services (legal tender) for much of recorded time. Holding gold serves as a hedge against the potential diminution of purchasing power of fiat currencies.

The very loose monetary policy adopted by the world's leading central banks since the global financial crisis is unprecedented. This has included asset purchases made with newly created money. This has helped asset prices, but their long term effect is unknown. Gold is a hedge against an adverse outcome.

Whereas gold is a savings instrument, owning gold miners is an investment which can provide an investor with income, growth, and optionality.

The Gabelli Gold Fund has been applying a proven investment methodology for 20 years. This investment methodology focuses on asset quality, company management, valuation, and risk.

We believe that if you hold cash it might be prudent to hold gold as well. Owning some of the best gold mines in the world through an investment in the Gabelli Gold Fund might be a prudent way to own gold in the ground while benefiting from cash flow generation and accretive growth.