Schroders

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Schroder ISF[1] Global Gold Fund update

February 2020

Fund performance

The fund posted a return of -2.15% for February. This compared to the FTSE Gold Mines Index benchmark return of -7.08%.

I shares gross

US$ %	Feb 2020	2019	2018	2017	2016	Since Inception[1]	
						Cumulative Performance	Annualised Performance
Fund	**-2.15**	**51.09**	**-13.90**	**11.28**	**-17.21**	**16.75**	**4.31**
Benchmark[2]	-7.08	42.68	-10.04	10.23	-23.13	0.40	0.11

Calendar year performance

US$ %	2013	2014	2015	2016	2017	2018	2019
Fund					**11.3**	**-13.9**	**51.1**
Benchmark[2]					10.2	-10.4	42.7

Source for performance: Bloomberg I shares gross USD. Performance is on a NAV to NAV basis. [1]Inception 29 June 2016. [2]FTSE Gold Mines Index. Typical ongoing charges for I shares are 1.07%.

Past performance is not a reliable indicator of future results, prices of shares and the income from them may fall as well as rise and investors may not get the amount originally invested.

Risk Considerations:

The counterparty to a derivative or other contractual agreement or synthetic financial product could become unable to honour its commitments to the fund, potentially creating a partial or total loss for the fund. A failure of a deposit institution or an issuer of a money market instrument could create losses. The fund can be exposed to different currencies. Changes in foreign exchange rates could create losses. A derivative may not perform as expected, and may create losses greater than the cost of the derivative. Emerging markets, and especially frontier markets, generally carry greater political, legal, counterparty and operational risk. Equity prices fluctuate daily, based on many factors including general, economic, industry or company news. A rise in interest rates generally causes bond prices to fall. In difficult market conditions, the fund may not be able to sell a security for full value or at all. This could affect performance and could cause the fund to defer or suspend redemptions of its shares. Failures at service providers could lead to disruptions of fund operations or losses.

Gold and broader market commentary

Gold price performance on a YTD basis remains solid, up 8% and flat for February. As we write, global markets remain gripped by speculation around Covid-19 and the policy reaction to it.

Gold trends have been interesting through this period. Through the China-centric, early stages of the Corona-virus outbreak gold traded as expected. As yields and real yields fell, and uncertainty increased, gold prices rose, reaching US$1,690/Oz a couple of weeks ago, up nearly 15% for the year.

Last week, treasury yields moved sharply lower and real yields have continued to trend lower. The dollar also weakened and equity markets saw very sharp falls, for example with the S&P falling >12% from peak to trough in six trading sessions. Yet, gold prices also fell.

With aggressive Federal Reserve action (the first intra meeting cut and the first 50bps cut since 2008) likely to be followed by a wave of Central Bank easing globally, gold now looks very cheap (relative to nominal and real yields) on a short-term basis.

We received several client questions on why for a brief period gold prices (and gold equities which we cover in more detail below) seemed to temporarily lose their role as a safe haven.

The following factors likely played a part:

- Short term positioning: trend following strategies were close to record long. CFTC money managed positions were also very long, leaving the market vulnerable to short-term corrections.
- Producer hedging (selling) has picked up, particularly from countries where gold prices are at record highs in local currency terms such as Australia
- There have also been reports of large-scale liquidation of gold positions which were bought as a hedge against equity positions and had to be liquidated as equities fell. This is possible, but unverifiable.

[1]Schroder International Selection Fund is referred to as Schroder ISF throughout this document.

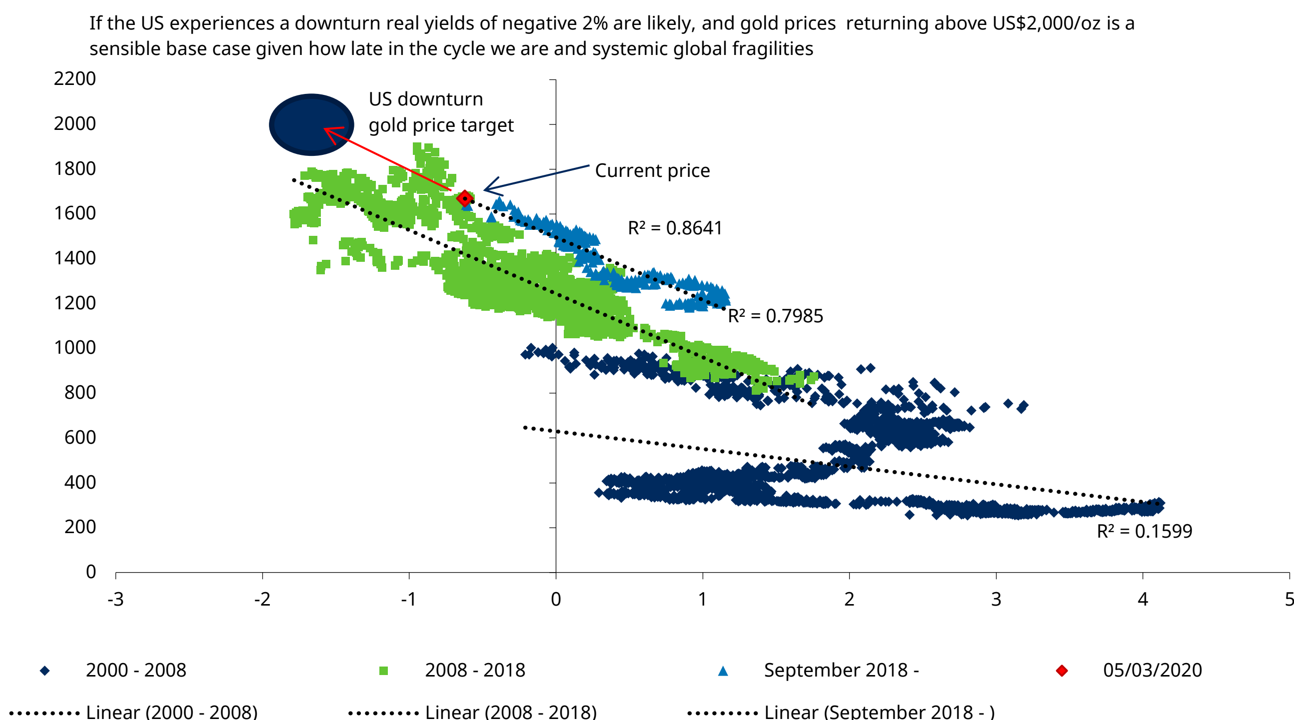
- Jewellery demand (physical consumer demand) has likely been very weak in Asia given growth concerns around Coronavirus. Scrap selling probably increased (it always does when prices are high)
- We can say for sure that the following factors did not cause the sell off:
- Global ETF investors didn't sell. In fact, they have consistently bought and ETF holdings are now above 90Moz.
- Off-exchange retail investors were also buying. Bullion Vault reported their busiest weak since Trump was elected while there have also been reports of aggressive physical buying in Switzerland.

Overall we would urge readers to take a longer-term view of gold's portfolio role and price relationship with key financial drivers. Eventually structurally lower real yields and threats to major currencies will likely be reflected in higher gold prices.

We do not know whether the current Coronavirus outbreak will be sufficient to tip the US and other developed markets into recession. However we do believe that the current panicked reaction which is being witnessed in US treasury markets is a very good indication of the trends we should expect when a downturn does finally hit.

Our view remains the same: when that downturn, either now or later, occurs policy makers are clearly laying the groundwork for a radical shift in the policy mix which will likely mean significantly negative real yields and higher gold prices. Of course that does assume treasuries manage to maintain their "safe haven" status. Given treasuries are currently one of the last remaining sources of positive yield in "safe" jurisdictions, a move towards zero nominal yields on treasuries could have a-symmetric consequences for gold prices. We expect gold prices to move to new record highs over the next few quarters, likely in line with negative US real yields as the chart below illustrates.

Chart 1: Gold prices plotted against real yields (5-year Tips)



Source: Schroders; Bloomberg.

Gold equities

Gold equities (FTSE Gold Miners Index) decreased by just over 7% in February, not a great showing given continued gold price firmness, but significantly better than global broad equity markets. Within the month gold prices and equities experienced significant volatility, particularly into month end. This volatility has understandably worried investors and is worth discussing further.

With regards to sharp moves lower in gold equities into month end our main observations are that:

- In periods when broad equity indices are under pressure indiscriminate selling can hit all equity sub-sectors. This can temporarily dis-connect gold equity valuations from the underlying gold price. One reaction from broad equity investors faced with "Covid-19" threats has been to look to reduce holdings of all "commodity" equities. Gold equities continue to sit within broad "basic material" sub indexes of major indexes and so can be caught up in this type of de-risking.
- There have been no operational issues to explain recent price action. Gold mining companies are less exposed to Coronavirus risks than other sub-sectors. They operate in remote locations and can easily minimise physical contact with the outside world for brief periods. With China now resuming industrial activities we view the chance of a shortage in consumable materials to be very low. In fact, the largest consumable for gold miners is diesel, which is declining in value, further contributing to the very mild cost inflation trends we are seeing.

We believe the highest probability outcome over the next few weeks and months (though to be clear we don't pretend to know for sure and we definitely don't pretend to be able to forecast the very short-term) is that once the market environment becomes more orderly (even if still bearish for broad market equities), gold and gold equity prices will move sharply higher to reflect the lower real yield environment and the increased macro policy uncertainty that now confront global policy makers.

Gold equities will close the large valuation gap that now exists between the producers and the underlying commodity. Indeed recent sessions have seen some of this orderliness re-emerging, with gold equities rebounding significantly from the recent sell-off.

As a fund, while the benchmark is 100% gold producers (the FTSE 100 gold miners index) we have the flexibility to hold significant cash and to hold physical gold bullion. Given current broad equity volatility we have obviously been considering these options closely as potential avenues to preserving investor capital on a tactical basis.

Part of that discussion, looking at historical precedents, is covered above. Another key part of the investment discussion is to look again at the underlying profitability of the industry and how current valuations correspond to that. The contrast could not be more stark. As we show below the industry is producing record cash margins, is maintaining significant financial and capital allocation discipline, and at current prices (or even $200/Oz lower) will be set up to significantly increase shareholder returns via dividends. To us the gold equities, taking a reasonable timeframe view, are far more attractive than either cash or the underlying bullion. The return in recent days to more "normal" correlations between gold, gold equities and key underlying drivers gives us some confidence in that conclusion and in our decision to remain fully invested in the underlying producers.

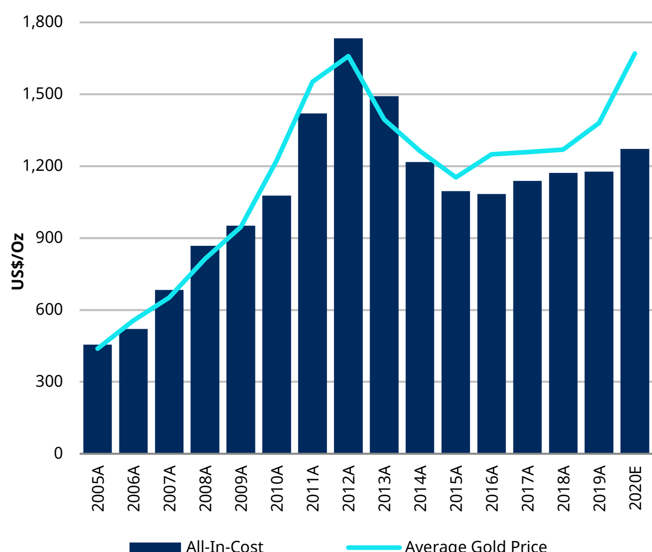
Industry profitability – the best on record

It is worth taking a step back and explaining that last point a little further as it really is key to the case for gold producers in the current macro environment, and core to our longer-term structural thesis.

Put simply, in today's environment (high prices, low costs) gold producers are earning All-In-Cost margins far higher than in 2011 (when gold prices peaked in the last cycle). In our data AIC margins averaged US$29/Oz between 2005 and 2011. In 2010 and 2011 when gold prices were particularly elevated, AIC margins were US$147/Oz and US$132/Oz respectively. At that time producers were trading on very high Ev/Ebitda and P/NAV multiples (even using aggressive gold price forecasts); while at the same time generating negative free cash flow due to massive project capital outlays.

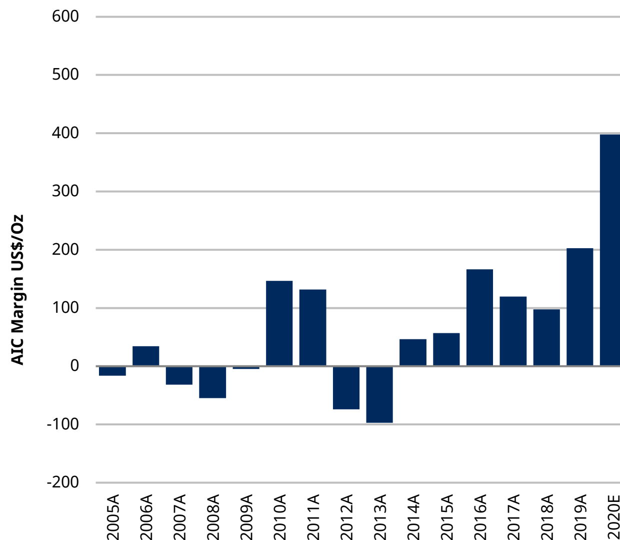
Today the situation is very different. In 2018 AIC margins were US$180/Oz on the data we have (not quite complete as results are still coming in but it will be close). Right now using current spot prices and assuming 8% AIC cost inflation for 2020e, AIC margins are close to US$400/Oz, more than 3x the 2011 level (see exhibits below). Meanwhile producers are deferring capital spending decisions in some cases and in other cases only going ahead when projects generate significant returns on capital using US$1,250 or US$1,300/Oz long term gold price assumptions. Free cash flow yields are extremely high and we expect to see a surge in dividend policy initiations or dividend increases as the year progresses.

Chart 2: Gold industry All-In-Cost (AIC) in US$/Oz plotted against average annual gold prices (current prices for 2020)



Source: CIBC, Schroders estimates

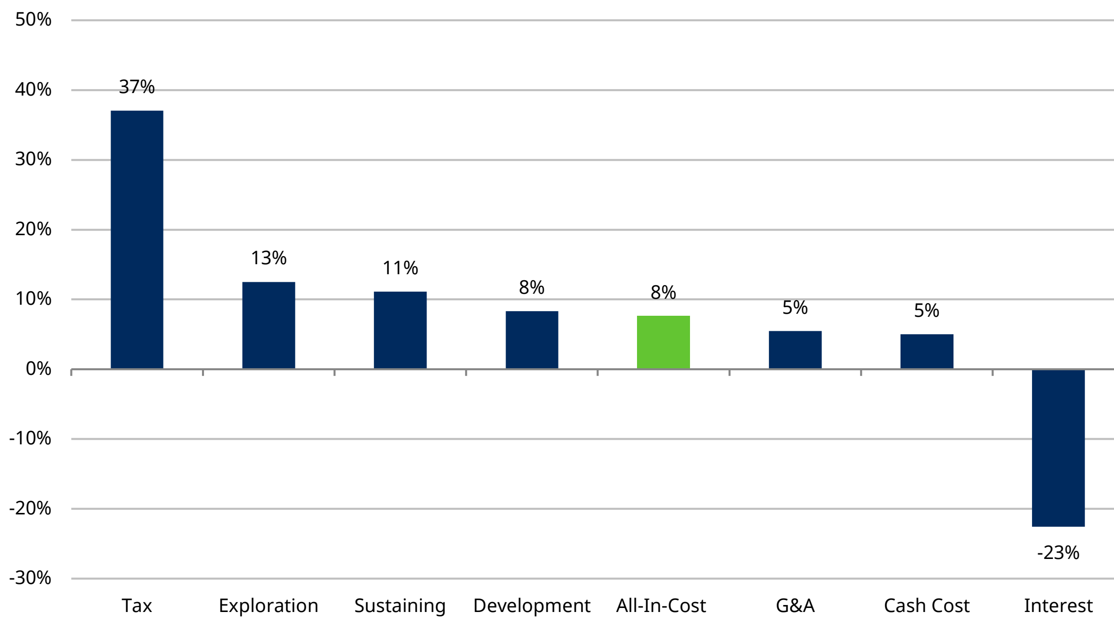
Chart 3: Estimated gold industry AIC margin using average annual spot prices (current spot for 2020e)



Source: CIBC, Schroders estimates

Perhaps we are not factoring in enough cost inflation for 2020 and are overstating AIC margins at spot prices? All In Costs include all production costs excluding major project capital. These include total cash costs (including royalties), exploration, sustaining capital, development capital, G&A as well as interest and tax. The exhibit below lays out the assumptions we have made for each sub sector to drive our 8% growth in 2020 production costs. The biggest increase is tax, this is inevitable when profitability is so strong. We also assume >10% increases in sustaining capital and exploration spend. Cash costs on a unit cost basis are assumed up 5%, though remember a big portion of this increase is royalty payments which again are linked to the gold price. Overall we don't think we are being too conservative at all.

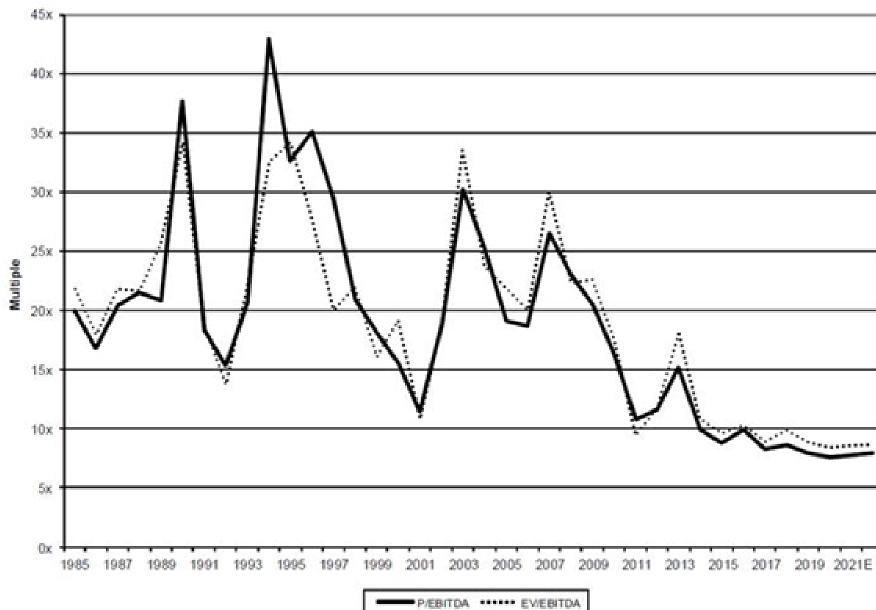
Chart 4: Breaking out cost inflation assumptions for 2020E



Source: Schroders.

Put another way gold miners are trading on depressed commodity valuations, while the monetary asset they produce (gold) continues to rise for completely non-commodity reasons. With very strong underlying operating cash drivers in place, EV/Ebitda valuations of below 8x for North American miners are exceptionally low.

Chart 5: Long run North American Gold Sector EV/Ebitda and P/Ebitda ratios



Source: Scotia, Schroders.

Equity subsector performance and positioning – 28 February 2020

The Australian gold equities (ASX Gold Mining Index) decreased by 7.1% in USD terms during February. At month end, the fund had around 22.3% exposure to Australian listed gold equities. This compared to the benchmark weight of 16.8%.

The South African gold equities (JSE Gold Mining Index) decreased by 6.5% in USD terms in February. At month end, the fund had around 12.9% exposure to South African gold equities. This compared to the benchmark weight of 8.1%.

The North American gold equities (S&P/TSX Gold Index) decreased by 8% in February in USD terms. At month end, the fund had around 50.8% exposure to North American gold and precious metals producers. This compared to the benchmark weight of 69.3%.

Performance attribution and portfolio activity

The fund moderately underperformed the benchmark in February, and was impacted by the sharp sell off in the closing two sessions of the month. Underweights in Barrick and Newmont (5/10/40 restrictions make these inevitable) contributed significantly to this underperformance. Falls in stocks including Centerra and Oceana Gold also contributed. Portfolio activity has included re-establishing a small position in Australian producer Westgold as well as adding to positions in both Harmony and Anglo Gold following the sale of Mponeng to Harmony which carries strategic benefits for both companies.

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