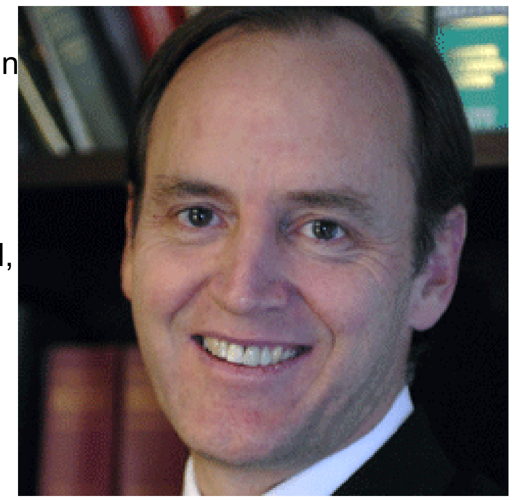
Midas Fund scouts for smaller gold producers with favorable ratio of share price to cash flow

(Kitco News) - With share prices of gold producers having already rallied sharply in the last three months, the Midas Fund (MIDSX) is increasingly looking toward smaller producers in its efforts to find companies with the most upside potential, the fund's managers said.

They also described themselves as upbeat on gold's prospects in general, particularly due to the potential for inflation as the economy recovers after massive fiscal stimulus and monetary accommodation.



Thomas Winmill

William Winmill

Thomas Winmill, portfolio manager of the Midas Fund, and his son William, an analyst with the fund, spoke with Kitco News Monday on their approach to stock picking and their outlook for the gold market. Midas is a mutual fund focused on precious-metals and natural-resources companies.

Gold-mining stocks – like the price of gold itself – has soared from the mid-March lows. So in their efforts to find mining stocks with more upside to go, Midas Fund has been scouting smaller producers that still have a low ratio of share prices to free cash flow, the Winmills explained.

“Some of the biggest companies – the Barricks and Newmonts – have done very well,” William said. “They're strong companies. But in terms of valuations, they're a little bit stretched. So we've been looking for...smaller companies.”

There is some risk since a producer with one or a small number of mines is less diversified, they acknowledge. So the Midas Fund tries to offset this by looking for companies with healthy free cash flow and low levels of debt.

As an example, William listed Hummingbird Resources, which has a mine in Mali, and Caledonia Mining Corp. Plc, which has a mine in Zimbabwe. As of this interview, Hummingbird was trading at roughly six times cash flow with several more years of mine life and ongoing exploration, William explained. Caledonia was around seven times free cash flow, with the company building a new mine shaft to increase production, the analyst continued. Yet another company William cited was Western Australian producer Silver Lake Resources, with its shares less than 10 times free cash flow.

The Midas Fund tends to look at companies' long-term prospects rather than focusing heavily on the last round of earnings reports or some of the temporary mine closures that occurred this spring as countries sought to slow the spread of the COVID-19 pandemic, William said.

"We take a longer term view in which, even if they have to stop mining for a little while, it doesn't impact the overall value of the company," William said. "We also don't want to get involved with companies where the debt situation is ominous enough that a shutdown would cause them to default."

The Midas Fund uses a philosophy that the overseers refer to as the "three Ps" when picking mining stocks – projects, people and price.

"We like to see good projects, meaning the mines themselves," William said. "As for people, a lot of mining is personality driven to a certain extent."

In particular, the Midas Fund favors companies that have leaders with a good track record of accomplishing their objectives and which have not had to make major negative revisions to mine plans.

The focus on price helps guide the Midas Fund when to buy and sell a stock, William continued. The managers do not have ironclad rules but tend to look at longer-term averages for various valuation methodologies. Also, the fund tends to be wary of companies that aggressively bid on another during merger attempts.

Inflation seen underpinning gold prices

Thomas described the fund managers as "starting to get kind of excited" about the outlook for gold, commenting that an eventual return to full employment will be coupled with deferred demand, meaning inflation potential. He looks for the economy to be "back to full stride" by the end of the first quarter of 2021.

"We are pretty constructive on the market," Thomas said. "The stimulus program is at epic levels. I was reading that one analyst put it at about 11% of U.S. GDP [gross domestic product]….That's a significant one-time shot in the arm."

Furthermore, strength in the U.S. dollar and weakness in oil prices has contributed to a lower level of inflation, Thomas continued. However, "we think that's all going to go away."

Whenever inflation is high, central banks hike interest rates, which can hurt gold. But until then, gold is likely to rise alongside inflation, since the Federal Reserve typically takes its time hiking interest rates in an effort to combat rising prices, Thomas explained.

"The Fed tends to be a little reactive and behind the ball," Thomas said. "People tend to say "the genie is out of the bottle' when they start going."

This was the case when “inflation was going wild” back around 1979 and1980, when gold hit what was at the time was a record high price, he said.

“Our view is inflation starts to come back in, and the gold price starts to reflect that,” Thomas said. “Euphoria gets going and the gold price overshoots. About that time, historically, the Fed...raises rates to contain inflation. And in the case of the gold price, it collapses.”

However, even when gold did fall back in 1980, the metal remained well above where it was in the mid-1970s, Thomas pointed out.

A recovering economy should boost demand for all commodities, he said. And, he added, silver is one of the metals that could really take off.

“Silver has such a larger industrial component to it,” Thomas said. “We think when things get really under way, in maybe nine months, it may be the right time to start rotating toward some silver-mining companies.”

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