TO BARRICK OR TO BE BARRICKED, THAT IS THE QUESTION

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Dear Mr.Kingston:

Thank you for writing. You ask me whether Barrick is a 'buy' now that it has reached its long-time ambition of becoming the *first*: the largest gold producer of the world. Would it now start moving up from its place of being the *last*: the world's worst large-cap share price-performer in the gold-mining business?

I am a monetary economist and as a rule do not offer investment advice. Having said that, the name "Barrick" touches a raw nerve in me. I used to be a shareholder. In 1992 I took early retirement from my professorship, accepting bribe money (they call it 'golden handshake') from Memorial University of Newfoundland, my academic home for 35 years. At stake was about $50,000 which I invested in Barrick shares and leaps, with the idea of arbitraging one against the other. As the gold price went up, I would sell leaps and put the proceeds into shares, and *vice versa*. Most of this investment has gone up in smoke as a result of Barrick's 'Brave New World of Hedging'. I decided that, in reply to your kind letter, I would tell my story.

The Godfather

Barrick's founder and godfather, Peter Munk, like myself, grew up in Budapest. Truncating the original 'Munkácsy', a name his family shared with one of the most famous Hungarian painters Mihály Munkácsy, Munk got himself a new name when he landed in the New World. We did not know each other but, as schoolboys we had the same experiences, spoke the same street jargon, and trod on the same cobblestones. Above all, gold loomed large in our lives, making an indelible impression. In 1944 Munk's father bought their exit visas from German-occupied Hungary to neutral Switzerland, along with a train-load of other Jews, all paying for their escape with gold. The Swiss government agreed to play the role of go-between.

I learned about the life-saving properties of gold a few months later in a different context. When the Red Army placed Budapest under a siege those who had gold ate; those who didn't went hungry. My family did not have much gold, but there was a heavy gold chain that used to hold the gold pocket watch of my grandfather in better days. The watch itself had been bartered away in hard times for food before I was born during the hyperinflation following World War I. During the next hyperinflation, following World War II, dentists refused to take paper money for professional services rendered. My mother paid for dental work needed by my sister in gold. I still remember the dentist's delicate hands: he clipped off an agreed length of the chain. And his face: he had the smile of Shylock as he was preparing to take his pound of flesh. My mother gave me the remnants of that gold chain, thus abridged, before she died. My wife has it now. It has been fashioned into a pretty bracelet.

Munk came to Canada to study electrical engineering at the University of Toronto. During the pre-Christmas shopping seasons, as a student he was arbitraging Xmas trees between the parking lots of various supermarkets. When I came to Canada in 1957 I already had my university degree and settled down to a teaching career in Newfoundland. Munk as an electrical engineer went into producing high-end stereo systems and met his first Waterloo in Nova Scotia. He had made the bad decision of accepting government financing for his factory.'Never again!' he vowed after his business deal with the provincial government unraveled and he lost his entire investment. (This did not prevent him, years later, from courting retired politicians such as former Prime Minister Brian Mulroney of Canada, and Ex-President George Bush, both of whom took their seats on the 'Advisory Board' of Barrick.) The next bad decision was to design luxury hotels (never actually built) in the shadow of the Egyptian pyramids, an idea about as brilliant as setting up a pork-chop stand in Jerusalem.

A little bit of etymology

Munk initially conceived American Barrick in 1980 as a junior oil and gas company. In 1983 he reconstituted it as a gold mining company, renaming it Barrick Gold. I have an avid curiosity about the origin of words and I could not resist the urge to research the word 'Barrick'.

At an early brain-storming session, as described in the authorized biography of Munk, the question was raised how to name the fledgling company. Munk, who was obsessed with big and quick success had no patience with such trivial details, exclaimed: 'Call it Baszik, Szarik, Barrick, as you will; I couldn't care less'. The name Barrick stuck. Knowledge of the Hungarian language helps the etymologist. The first two words' English equivalents are 'f...ck' and 'sh...t'. In Hungarian four-letter words have six letters to sport and, as verbs, they are also distinguished by their '-ik' ending, forming a special conjugation class of their own.

Gold mining and hedging: killing the goose laying the golden egg?

As a shareholder I was concerned about Barrick's preposterous ideas on hedging. Munk was fond of using innovative financing techniques and Barrick boasted that its credit standing is second to none, due to its unique hedging policy. I realized that the word 'hedging' as used by Barrick was a misnomer. It is not hedging at all, any more than a shill is winner at the poker table. The appearance is that she is winning big; in fact she has to surrender every cent of those gains to the casino owner at the end of the day. Barrick was simply selling its production forward, at one point as far as five years out as measured by current output, with settlement postponed, at the option of the 'hedger', for as long as fifteen years. Imagine, no margin calls for fifteen years, no matter how much the price may move against your position! Barrick justified this insane policy by the statistical Principle of Mean Reversal asserting that all economic indicators, including prices (however volatile) ultimately tend to return to the mean. Fifteen years was considered sufficiently long for even the most 'absurd' spikes in the gold price 'to correct'. I demurred. Gold was an exception to mean reversal. In a hyperinflation, after the 'dead cat bounce' of paper money, you could wait till doomsday for the gold price to correct.

I wrote a paper with the title *Gold mining and hedging: killing the goose laying the golden egg?* In it I explained that forward selling must be carefully distinguished from hedging. A proper hedging strategy would require that the mine channel production into a fund, which would then buy gold in the open market when the price was low and falling, and sell when the price was high and rising. The income from this arbitrage would more than make up for lost revenues from the outright sale of mine product. Above all, such a strategy would not impart a bearish sentiment to the market. Speculators knew that the gold mine would sooner or later step in as a buyer whenever the gold price weakened, and they would try to preempt it. They would want to buy first. And conversely. The chips could fall where they may.

But since Barrick had an established policy of selling forward, and never buying forward, speculators would abandon the long side of the market in droves. They would move to the short side *en bloc*, in trying to forestall Barrick. They would want to sell first. Under these circumstances the chips could no longer fall where they may. Fall they did alright, together with gold. The gold price was effectively capped. Worse still was the long-term effect. Just as you cannot 'cap' an active volcano, you can't cap the gold price forever either. It is bound to erupt and, when it does, you can kiss good-bye to the Principle of Mean Reversal. In the end Barrick could be saddled with a king-size liability that it may never be able to live down.

Shareholders do not need to have a PhD in vulcanology to find this out. As soon as they do, they will vote with their feet.

Shareholder-proofing corporate governance

Indeed, they have no alternative. After the Nova Scotia fiasco Munk decided that he would construct a corporate structure that would be 'shareholder-proof'. He developed the 'perfect poison pill'. Not only will Barrick never be the victim of a hostile take-over bid, shareholders will have to eat from his hands. The corporate governance of Barrick epitomizes this. Shareholders are pariahs, sacrificial lambs on the altar of high management policy. They have the right to vote with management. But that's about all. In case of a disagreement they can go and fly a kite. Management lives in its own world of an unassailable bunker.

In 1994 I did not know this. I was naive. I wrote a letter to Munk asking him for a meeting. I wanted to present to him a copy of my paper with my compliments. In reply Munk told me that I had to show my paper to his Senior Vice-President and CFO, Jamie Sokalsky first. By the time I could see Jamie company headquarters were moved from Yorkville, a bohemian district of Toronto, to the Royal Bank Towers downtown, projecting an entirely different corporate image. The significance of this move was lost on me at the time. I believed that I could convince Sokalsky of the errors of Barrick's ways.

The meeting lasted for two hours. I could see from his occasional remarks that Sokalsky understood everything I have said. He did not argue with me. He said that what I was talking about was all very interesting and promised that he would read my paper carefully and give me a written answer. I have never heard from him since, nor have I heard from Randall Oliphant, the President of the company. Both men were fired later by Munk as shareholder dissatisfaction with the company's hedging policies, and with the low-altitude flight of the share price, could be heard inside of the bunker, sound-proofing notwithstanding. Scapegoats had to be thrown to the wolves to keep them away from the door.

I sold my shares and leaps, as did thousands of others. And I went back to my own den to lick my wounds.

If forward sales, why not forward purchases, too?

Barrick never explained to the world what has happened, or how they would fix the flawed policy. Even today, the new guy at the helm President Greg Wilkins defends the policy of 'a reasonable level of hedging' as an 'essential risk-management tool for the company'. It is supposed to 'stabilize revenues and satisfy banks that finance its projects'. But if this were true, then the policy should be made even-handed. Barrick has never admitted that its one-sided forward selling was responsible for the bearish bias in the gold market for the last decade of the century and the millennium.

In my paper I suggested an easy way to repair this bias. The company could complement its forward sales by *forward purchases*. These are triggered whenever the gold price is low and falling. Just as the gold mine lifts its short hedges as production is delivered into the hedge book, it can lift long hedges as deals to buy new gold properties are being closed out. In this way the mine can acquire new gold properties at the best possible price. I have evidence that Sokalsky understood my point perfectly well, the point being that the bias against the long side of the market would be removed as speculators would be coaxed back to it. Quite possibly my paper was in the hands of the top brass when they discussed the dismal failure of their policy of unilateral hedging, as it dawned on them with the new century and millennium. For all I know, Sokalsky could have proposed my idea of 'bilateral hedging' as a face-saving measure which, for him, could have been a 'skin-saving' measure as well.

Is Barrick a front to cover up gold-laundering?

That is, unless Barrick was a front to cover up gold laundering by governments, in which case unilateral forward selling was not a mistake but a deliberate policy. I couldn't help but believe that the company had a vested interest in suppressing the price of gold. Its ambition to become No. 1 also points that way. It is not about vanity. It is about pricing power. The suspicion that Barrick is a front to cover up a gigantic gold-laundering operation, presumably on behalf of a government (or governments) that need more time to complete a gold-acquisition program in the order of thousands of tons of gold, is hard to escape. Incidentally, if you interpret 'gold laundering' as a polite expression for 'stealing shareholder gold', no harm done.

Unfortunately, such a conspiracy theory will be very difficult to prove or disproof. I was not the only one who suggested it. GATA and Golden Sextant named Barrick as a co-conspirator in the illegal scheme to suppress the gold price.

When in the early 1990's Barrick sued the United States Treasury over a user-fee issue and, implausibly, won in the court, I failed to smell the rat. Only later did this lawsuit appear like a whale-size red herring to me, dropped to deflect suspicion away from Barrick lest someone think it was a front. "Behold, little David conquering the towering Goliath! What rubbish it is to suggest that David was bribed by Goliath to do it!" At about the same time Barrick moved its headquarters to shed its image as a maverick, to assume the image of a 'responsible corporate citizen'. No longer did it want to rub shoulders with hippies. Its credentials were established beyond the shadow of a doubt.

ACHILLES heel, or noose around the neck?

One analyst has called its hedge book Barrick's Achilles heel. But to others it looks more like a noose around the neck that no amount of 'creative book-keeping' or 'off balance-sheet financing' can hide forever. It has been stated publicly that Barrick would be bankrupt if it marked to market its liabilities. Wilkins gave himself till the end of 2009 to clean up the mess and reduce the hedge-book from 14,3 million ounces of gold to 9,5 million. But by that time the gold price could be well into four digits. The question is whether the kindly and gentlemanly bullion bankers will honor their 'no margin calls for fifteen years' pledge at those lofty prices. If shareholders can't throw the rascals out, maybe the bullion bankers can, and will.

Maximize life, not profits

In the meantime an even larger business challenge is confronting Barrick in the shape of a cost-of-production squeeze. Under a gold standard, the gold miner typically mines his property most conservatively. He goes after marginal grades of ore, the most expensive to exploit, where a base metal miner would go after the highest grades, the least expensive. The gold miner is not interested in maximizing profits as is the base metal miner. And for a very good reason, too. The marginal utility of a base metal declines. The miner wants to extract it from the bowels of the earth before the price may drop even more. By contrast, the marginal utility of gold is constant. There is no rush to dig it up only to bury it again in bank vaults. Therefore *the gold miner wants to maximize the productive life of his mine, not profits*. Barrick threw this wisdom of the trade to the winds as it has been mining the highest grades of ore available, and at break-neck speed to boot. Now it has to face the consequences. Its mined-out properties will have to be closed down prematurely, from which gold has been extracted and sold at what must, in retrospect, appear as give-away prices.

My suggestion of forward purchases of gold combined with the miner's problem of premature exhaustion of gold properties, would have made a perfect fit. Barrick would have been in an extremely strong position to buy new gold properties while lifting the long hedges it had put on when the gold price was much lower.

The Best Little Whorehouse in Nevada

Here is how a reporter described the scene at Barrick's annual meeting of the shareholders in Toronto's Metro Convention Centre last spring:

"The sky is dull grey, but the mood inside is dazzling. Pockets of spontaneous applause break out during the presentations. Standing at a podium emblazoned with the Barrick logo before a cinemascope-sized graphic display of the company's global reach, Wilkins leads shareholders through the past year's triumphs, and hints at a long and prosperous future for a company that now has unprecedented size and clout.

"He is followed by the 78-year old Munk, resplendent in a dark grey pinstripe suit, pale blue shirt and a luminescent pink tie. Munk pauses for effect and then leans over the podium. In a gravelly voice speckled with traces of his Budapest childhood, he delivers a rumination that is both self-congratulatory and self-deprecating, at once a nod to Barrick's humble origins and a prelude to a glorious future. 'I can't help but sit back and say that what we have done here has been spectacular', he says. 'But it's not the mines, it's not the reserves, [and] it's not the credit rating that's the best in the industry. What makes me proud, what makes me exceptionally happy, are the intangibles...those intangible values of integrity from which every decision automatically springs. It's the culture that this company has had in its DNA from the time it bought Camflo Mines'.

"You should give as good as you get. Integrity, as Munk says, means many things in gold mining, including paying people fairly for their work and contributing to local communities. It can even mean, he says puckishly, funding and building housing projects for miners in places like Elko, 'that dusty, miserable Nevada town with one whorehouse'."

Hey, Munk, wait a minute! It's all very well to fund and build posh whorehouses where miners and top brass can Barrick to their heart's content! But what about the share price? What about the patrimony of the shareholders?

Shareholders? They will be Barricked.
Again.
I know it. I have been there.

Yours, etc.

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