
CONTRARIAN RESEARCH REPORT

COMPENDIUM

June 2010

Featured Companies

U.S. Gold (UXG)
Wesco Financial Corp. (WSC)
Fair Isaac (FICO)
Loews (L)



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The Contrarian Research Report*

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Murray's Musings

Gold Bubbles

In the not-too-distant future, I believe that there will be a gold bubble. What follows are some objectively verifiable facts that form the basis for making that statement. The first is that according to State Street Global Advisors, the SPDR Gold Trust (GLD) holds at the moment 42,902,000 ounces of gold at a value somewhat in excess of \$52 billion. The second is that according to the Federal Reserve, the total assets of aggregate U.S. households and nonprofit organizations were \$68.5 trillion at the end of the first quarter of 2010. The table with that figure can be viewed in the appendix at the end of this report (Table B.100). That figure includes only the assets of households and nonprofits. After subtracting the aggregate debt for all the households and nonprofits, the net worth still comes out to be \$54.6 trillion. That's a lot of money.

The third fact is that according to the World Gold Council, the total amount of gold ever mined since the beginning of history is 165,000 metric tonnes. Each ton is equivalent to 32,150.75 ounces. Therefore, it follows that all the gold ever mined in history amounts to 5,304,873,750 ounces. Though it may be obvious, it's worth stating that all the gold ever mined is clearly not available for trading, because some of it is in jewelry, works of art, has been lost or is unavailable in some other way. More importantly, however, is that to this very day the central banks still hold huge amounts of gold. For example, also according to the World Gold Council, the United States Treasury Gold Reserve amounts to 8,136.5 tonnes of gold, which equates to 261,594,577.4 million ounces. One could also say that the United States government owns, in principle, 4.93% of all the gold ever mined. Similarly, the SPDR Gold Trust owns 0.81% of all the gold ever mined.

According to the U.S. Geological Survey, annual world gold production is 2,260 tonnes.¹ That's equivalent to 72,660,695 ounces, which is not a lot when you think of the size of the SPDR Gold Trust. Another point is that according to the Chicago Mercantile Exchange (CME), the most active gold future at the moment is the August 2010 contract. On Friday, June 11, 2010, that contract traded 132,228 contracts. The specification is for 100 troy ounces per contract; therefore, it is the equivalent of 13,222,800 ounces, which is about one-seventh of the world gold production. That's an extraordinary number.

It's interesting that the next most liquid CME gold contract is the December 2010 contract. On Friday, June 11, 2010, the number of contracts it traded was 3,668. This contract is far less liquid than the one for August 2010. After the December 2010, the next most liquid contract contract is the October 2010 contract. On Friday, June 11, 2010 it traded 1,683

¹This figure can be confirmed on the U.S. Geological Survey website: minerals.usgs.gov

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contracts. One can conclude that there is essentially one very liquid contract in gold, which is the August 2010 contract, and there are a few smaller ones.

Given that the gold price is about \$1,230 per ounce, the notional dollar value of the August 2010 contract equals \$16.266 billion dollars. It's important to understand that the futures contract is trading with a tremendous amount of leverage, so the amount of equity in the contract is much less. Nevertheless, if you think about \$16.2 billion in relation to world wealth, even in relation to American wealth, it's actually a very small sum. To understand how small that sum really is by comparison, the value of the shares of Exxon that trade on an average day is \$1.9 billion. The daily trading value of the SPDR Gold ETF is \$939 million, or almost one-half that of Exxon. That is a very interesting thought if you think of gold as an asset class rather than as merely another ETF in the vast panoply of ETFs.

After the SPDR Gold ETF (GLD), the next-largest in the United States is the iShares Comex Gold Trust (IAU), which has 2,731,385 ounces of gold in it. That amount is much smaller than that of GLD. Europe has the ETF Securities Gold Bullion ETF (GBS), which has about 3.8 million ounces.

Given the previously stated aggregate assets of U.S. households and nonprofits of \$68 trillion, let's assume that those households, on average, wished to have gold as an asset at a 2% weight. If that were to happen, those households, in aggregate, would need to purchase \$1.37 trillion worth of gold. At current prices, that would equal over a billion ounces—or 1,113,640,059 ounces, to be exact—which is 15.3 times annual production, assuming no gold consumption for jewelry or industrial purposes, and no gold purchases by any investment firms, hedge funds, sovereign wealth funds, central banks, or foreign nationals.

Gold is being recognized, because of the risk that nations might print up a lot of money as a way to escape from their massive debt burden, which could cause their currency to become devalued. The logical answer to that would seem to be investing in gold. Even a small weight in gold would be an enormous move.

Industry Thoughts

The Gold Industry

Most world equity indices do not include companies involved in the gold mining industry. For example, China, Japan, Germany, Sweden, Italy, Taiwan, India, and many other indices have no gold exposure. The gold exposure, such as it is, in the S&P 500 is Newmont Mining, which has a 0.28% weight and is clearly a rounding error.

The ten largest market capitalization pure gold firms are listed below. The combined market capitalization of all those companies is \$172 billion, which equals 59% of the market capitalization of Exxon. The largest gold company, Barrick Gold, has a daily trading value on the New York Stock Exchange of \$485 million, which is about 25% of the trading value of Exxon.

Table 1: Top Ten Gold Companies by Market Capitalization

	Market Cap <i>(\$ in billions)</i>
Barrick (ABX)	\$42
Newmont (NEM)	27
Goldcorp (GG)	32
AngloGold (AU)	15
El Dorado Gold (EGO)	9
Buenaventura (BVN)	9
Kinross (KGC)	12
Lihir Gold (LIHR)	9
Gold Fields (GFI)	9
Randgold (GOLD)	8
Total	\$172

The junior gold companies are worth pondering because, if there ever were a large increase in the price of gold, the junior gold companies would probably outperform the senior gold companies. Since the junior gold companies have projects that are often either not financeable or, even if they are, would not be very profitable at current gold prices, they might become very profitable if gold prices rise much higher. It's arguable that there's more operating leverage in the junior gold companies than in the senior ones.

The ten largest junior gold companies are listed below. Their aggregate market capitalization is \$15.7 billion. Even if they were all merged into one company, their combined weight in the S&P would be much less than the weight of Newmont Mining.

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The amount of market value equity they supply would clearly be inadequate to enable the global investment community to establish a 2% gold industry weighting.

Table 2: Top Ten Junior Gold Companies by Market Capitalization

	Market Cap (\$ in billions)
New Gold (NGD CN)	\$2.6
Semafo (SMF CN)	1.9
Alamos Gold (AGI CN)	1.8
Silver Standard Resources (SSRI)	1.4
Hecla Mining (HL)	1.3
Allied Nevada Gold (ANV)	1.4
Coeur d'Alene (CDE)	1.3
San Gold (SGR CN)	1.2
Detour Gold (DGC CN)	1.7
Silvercorp Metals (SVN CN)	1.1
Total	\$15.7

Canada is the only developed market that has an important gold exposure within its index. The iShares MSCI Canada Index (EWC) has the following gold exposure: Barrick, Goldcorp, Kindross, El Dorado, Yamana, IAM Gold, and Franco Nevada, for an aggregate market capitalization weight of 10.51%. If one wished to have an index with important gold exposure, that's the only one that exists. Australia doesn't have pure gold exposure, despite being home to some large mining companies that have important gold divisions, including BHP Billiton and Rio Tinto. At the end of the day, they are still diversified mining companies, not gold companies. The iShares MSCI South Africa Index (EZA) has slightly more gold exposure as a percent of its total than the iShares MSCI Canada; however, it's concentrated in three firms: Anglo Gold, Gold Fields of South Africa, and Harmony Gold. Those companies are available in the Market Vectors Gold Miners ETF (GDX), which one presumes would be the vehicle of choice for individuals or institutions seeking gold exposure.

One of the problems with gold production in the world is that the companies themselves don't have sufficient capital resources to dramatically increase gold production at current prices. For example, Barrick Gold, the world's largest gold company, will produce between 7.6 million and 8 million ounces in the current year. According to the latest Barrick Gold presentation, the total financial assets in the world are \$117 trillion. Think of a 2% weighting in gold in the context of \$117 trillion of assets.

Barrick Gold, the largest gold company, discovered 135 million ounces of gold during the period from 1990 to 2009, which is about 7.1 million ounces a year. At the moment, the company only has two properties under construction: Pueblo Viejo and Pascua-Lama.

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Pueblo Viejo is in the Dominican Republic, and Pascua-Lama is on the border between Chile and Argentina. The only way that Barrick could meaningfully affect global production on its own would be to have more projects of scale to deploy far more capital than currently.

To demonstrate the scale that Barrick Gold operates upon, it recently brought public on the London Stock Exchange the so-called African Barrick Gold (ABG LN). This company has a market capitalization of 2.57 billion pounds sterling. Barrick still retains a 74% interest in it. African Barrick production is going to be about 710,000 ounces of gold per year, which is clearly a de minimis amount in the context of world production. One can only presume that Barrick Gold brought it public because the cost of equity capital in the context of raising money through Barrick Africa Gold was lower than for the company itself. If there were an increase in the price of gold, and a demand for gold equities, there aren't very many gold equities that could really serve the purpose, which is worth reflecting upon.

Facts & Figures

The Weight of Gold

According to the U.S. Geological Survey, world gold production in 1980 was 1,220 tonnes. Despite a falling gold price throughout the ensuing 10 years, by 1990 world gold production had risen to 2,180 tonnes. That fact illustrates the inertia in gold production, because it appears that once the projects are on-stream, they produce gold almost irrespective of the price. It's uncommon to close the mines, because the cash cost of production is so much less than the total capital cost of production.

By 1995, with the price of gold still falling, gold production had increased to 2,230 tonnes. By 1998, it was 2,500 tonnes. Gold production kept increasing until the year 2001 when it peaked at 2,600 tonnes. Since that peak in 2001, despite an absolutely enormous increase in the price of gold, world gold production has been declining. In 2008, the last year for which the U.S. Geological Survey has reliable data, total world gold production was 2,260 tonnes.

Table 3: World Gold Production

	Tonnes		Tonnes
1980	1,220	2002	2,550
1990	2,180	2003	2,540
1995	2,230	2004	2,420
1998	2,500	2005	2,470
1999	2,570	2006	2,370
2000	2,590	2007	2,360
2001	2,600	2008	2,260

Source: U.S. Geological Survey

World gold production has been in a smooth decline since the nadir of gold prices. That's an amazing fact, which illustrates the long lead-time and the amount of capital necessary to bring gold projects online. The gold properties that are producing today were developed in the 1980s when costs of development were much lower. Development costs today are much higher. As a result, the expense of large-scale increases in gold production would exceed the financial capabilities of the large gold companies.

Table 4 lists gold reserve holdings of the central banks of several countries. It's startling how much they hold. The United States is the leader in the world, Germany is the second largest and the International Monetary Fund is the third largest. Between the first quarter of 2000 and the first quarter of 2004, China increased its gold reserves from 395 to 600 tonnes. Since that time, the Chinese have bought no gold; however, imagine what the

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impact would be if the Chinese central bank, or that of any of these countries, decided to buy gold.

Gold (Tonnes)	Q1 2000	Q1 2004	Q1 2009
United States	8,138.8	8,136.3	8,133.5
Germany	3,468.6	3,439.5	3,412.6
IMF	3,217.3	3,217.3	3,217.3
Italy	2,451.8	2,451.8	2,451.8
France	3,024.6	3,024.6	2,452.8
China	395.0	600.0	600.0
Switzerland	2,590.2	1,561.0	1,040.1
Japan	753.6	765.2	765.2
Russia	422.6	389.8	531.9
Netherlands	911.8	777.5	612.5
India	357.8	357.8	357.7
ECB	747.4	766.9	536.9
Taiwan	422.1	423.9	423.6
Portugal	606.7	517.2	382.5
Venezuela	311.0	356.8	356.4
Saudi Arabia	143.0	143.0	322.9
United Kingdom	588.3	312.9	310.3
Lebanon	286.8	286.8	286.8
Source: World Gold Council			

Another interesting fact is that on February 9, 2010 *Business Week* magazine reported that the China Sovereign Wealth Fund, to be distinguished from the Chinese Central Bank, had taken a \$155.6 million position in the SPDR Gold ETF. In the context of China's resources, that amount of money represents a very small position.

Returning to the subject of household assets in the U.S., included in the Appendix of this report are three tables from the Federal Reserve that contain data for the balance sheets of households (Table B.100, referred to in the *Musings* section), non-financial corporations (Table B.102) and for businesses that are not incorporated (Table B.103). You could look at the figures in terms of net worth or in terms of total assets, but any way you look at them, there's an enormous amount of capital that needs to be deployed just in the U.S. The figures are absolutely extraordinary, and gold is a de minimis asset class. Therefore, even a small weight in gold, should it become desirable, would have a large effect.

As a group, investors frequently adopt a common mindset. Since the portfolio weighting of gold in portfolios is de minimis at the moment, if investors were to look at gold as a viable

asset class that belongs in portfolios, even a tiny shifting of weight could have an enormous impact on gold.

How They Did It

The California Gold Rush and Other Bubbles

This section features a person who is historically insignificant in the business world, but is included to illustrate a point about bubbles. When bubbles are viewed at a granular level rather than a fiscal level, that is, when they are observed from the perspective of individuals, it becomes obvious that bubbles are much more complicated than the statistics would suggest. The bubble in question is known as the California Gold Rush and we'll examine it from the standpoint of Johan Suter, known in the U.S. as John Sutter. He was an immigrant from Switzerland who became famous after the discovery of gold on his property in 1847 precipitated the California Gold Rush.

Sutter arrived in the area of what is today Sacramento in about July 1839, when California was part of Mexico. He became a Mexican citizen in 1840 and was granted title to 48,827 acres of land in the Sacramento area, which is almost 200 square kilometers. His goal was to build an agricultural settlement known as New Helvetia.² In the course of building his settlement, he hired a workman named James Marshall to build a saw mill, which is a very logical action, since a certain amount of wood would be required to build the dwellings and farm structures of an agricultural settlement. About the time the settlement was being developed, the United States seized the territory of California from Mexico, and it became American territory.

In 1848, while working on the settlement, Marshall found gold, the discovery of which Sutter wished to keep quiet. Sutter had no interest in developing gold, because he feared, correctly, that a gold discovery in that area would cause it to be overrun by squatters. However, since news of that type cannot be kept secret, Sutter's land was overrun. The great California Gold Rush of 1849 had begun, and the people who flocked to California in that period of time are known as the 49ers.

The following facts refer to the consequences of the California Gold Rush rather than on that period itself. They illustrate the effects of a bubble, which are infrequently limited to the initial subject of the bubble. One fact is that the population of the nearby city of San Francisco increased 25-fold in one year which, obviously, had an impact upon property values. The discovery of gold in California did not go unnoticed by the rest of the world. A gentleman by the name of William Aspinwall saw that immigrants to the area would need

² Helvetia is the Latin name for Switzerland.

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a means of transportation to California. He was not necessarily interested in developing the gold himself, but saw an opportunity in providing transportation to potential prospectors. In addition, he engaged in an initial public offering in 1848 for the Panama Railway. Before the Panama Canal was built, travelers had to use land transportation across Panama when en route to the West Coast of the United States by ship. As an aside, in that same year, Aspinwall organized another venture called the Pacific Mail Steamship Company, which became a charter member of the Dow Jones Transportation Index.

Getting back to Johann Sutter, he wanted to defend his gold claim, but he was essentially pitted against tens of thousands of immigrants. He wrote a letter asking his son to join him in defending the family holdings. The idea was to defend the Mexican land grant, but it was not clearly defensible under U.S. law. Under the treaty by which the United States and Mexico ended the war, the United States was obligated to honor Mexican land grants. However, California was a newly organized territory that had no legal mechanism for enforcement, so it had to be defended in a different manner. Sutter's property became known as El Sobrante, which in Spanish means "leftover." It was an apt title, because Sutter found it very difficult, if not impossible, to defend his claim. In point of fact, in 1858, the United States Supreme Court invalidated his land grant.

When Johann Sutter Jr. arrived in the U.S. from Switzerland, he realized that a person could get killed defending a land grant against an American mob that was suitably enraged with gold fever. However, he observed that the Sutter property was on the American River, which joins the Sacramento River and eventually flows into the San Francisco Bay. Sutter Jr. realized that the many settlers overrunning the city of San Francisco would need another place to live. He thought that the confluence of the Sacramento River and the American River would be a good place for another real estate development, and thus was founded the city of Sacramento.

Another interesting fact about this period in time concerns a certain myth that Levi Strauss made a lot of money in the California Gold Rush by selling picks and shovels to miners. It turns out to be completely false. Levi Strauss did not arrive in San Francisco until March 1853. By that time, the gold fever was somewhat exhausted. He did, however, operate a successful dry goods store. His big success, however, came in 1873 when he met a tailor by the name of Jacob Davis who had developed the idea of reinforcing the textile strength of denim work pants by using copper rivets. Davis had patented that process and received patent number 139121 but, being a poor tailor, he was afraid that he would be unable to afford the legal fees for defending his patent against the inevitable challenges. He and Levi Strauss became partners, and that was how Strauss's wealth was created: in the blue jeans market. It was really an accident.

Returning to the consequences of the Gold Rush, in 1854, the capital of the California territory was moved from San Jose to Sacramento. San Jose had been the historical capital of California under Mexican rule and during the first years of U.S. rule. It was the capital

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because, historically, it had been the site of the largest mining complex in the State of California. That complex was called the New Almaden Mine. It mined quicksilver, otherwise known as mercury, which was used in the then-current technology used to separate pure gold from gold ore. The New Almaden Mine was the largest mercury mine in North America.

However, the California Territory Legislature, in its search for revenue—and here we see that the California revenue crisis is nothing new—saw the vast influx of immigrants as an opportunity. It passed a law in 1854 that imposed a tax of \$20 per month on any foreign miner, of which there were many. In 1854, \$20 was a great deal of money, and the miners, of course, did not want to pay it. Therefore, to facilitate collection of that tax, the state capital was moved to Sacramento. Here it's worth noting that to this very day the local newspaper of San Jose is called the *San Jose Mercury News*. Now you understand the reason for that publication's name: the city was home to the largest mercury mine.

The anti-foreigner tax ultimately drove many of the foreigners from the mining properties, but there were many Americans as well who, in the bubble and the inevitable scramble for resources, found themselves unable to stake a claim or, if they staked a claim, were unable to find any extractable gold. One of those failed California Gold Rush miners, who was nothing more than a victim of the bubble, was a man by the name of William Greeneberry Russell. He married a Cherokee woman whose relatives lived near the South Platt River at the foot of the Rocky Mountains in what is now known as Colorado. It happens that these Cherokee relatives told Russell that there were gold deposits in the area, which was apparently of no value to the tribe.

Russell took a party of 107 prospectors to what is today known as Pike's Peak, and they found gold there in 1858. That discovery started the next gold rush. Pike's Peak is located not far from what is today the city of Denver. That city was built as a mining town. As a matter of fact, the first incorporated county of Denver was known as Auraria, from the Latin word for gold. Today, if you drive on Colfax Avenue in Denver, also known as U.S. Route 40, you will pass by the Auraria Campus of the University of Colorado. That's a reminder that Denver was built on yet another gold bubble. Those three cities, San Francisco, Sacramento, and Denver, were built as a result of financial bubbles. I should tell the readers that I have left out a great amount of economic activity that wouldn't have occurred if not for these bubbles. For example, there was a Sacramento Railroad built to carry the gold to the port of San Francisco. That's just one of many examples that I could give.

The point of all this information is that among the many people attracted to the area by the 1858 onset of the Pike's Peak Gold Rush was a named William Cody, better known in American history as Buffalo Bill. He wrote an autobiography, but some of the stories can't be authenticated, including one that says he was a prospector. However, it's not unreasonable to believe that he was attracted to the area by gold fever, like so many others.

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If he was a prospector and his autobiography is believed, he was a failed one. As such, he became a scout for the U.S. Cavalry, and he fought in the Plains Wars against the Indians. He was a scout for nearly 14 years, and he won the Congressional Medal of Honor in 1872.

While in the U.S. Cavalry, he met another cavalry veteran by the name of Texas Jack Omohundro, who was a veteran of the Confederate Cavalry, and had served as a scout under Jeb Stuart. The two heroes, Texas Jack and Buffalo Bill, liked to entertain the troops by the campfire in the evenings by telling of their many adventures and exploits. Though some of the stories may not have been true, the other soldiers found them so amusing that the two decided to go into business together. They formed Buffalo Bill's Wild West Show.

At the end of the Civil War, Texas Jack had found a child whose parents had been killed—in other words, an orphan—and he raised him as his own son. Naturally, he called that son Texas Jack Jr. When Texas Jack Sr. died in 1880, his son did not wish to remain partners with Buffalo Bill, so he started his own Wild West show. Over the course of some years, Texas Jack Jr. changed the format of the show to a rodeo/comedy format. In 1902, Will Rogers got his start as a comedian in the Texas Jack Jr. Wild West Show.

Buffalo Bill took his Wild West Show to Britain in 1887 to celebrate the Golden Jubilee of Queen Victoria. At some point in his travels, he met an Italian novelist known as Emilio Salgari, who was very impressed by the tales told by Buffalo Bill. Salgari became a bestselling Italian novelist by writing books that were inspired by the various Buffalo Bill adventures. If the following people can be believed, Salgari was the inspiration for Sergio Leone and the old “spaghetti westerns” that were made some years ago. Federico Fellini claimed to have been influenced by Salgari. In the world of Italian and Hispanic literature, many of the leading figures claimed to have been enchanted and mesmerized by Salgari, and that he had strongly influenced their works. These writers include Pablo Neruda (a Nobel Prize winner), Carlos Fuentes, Gabriel Garcia Marquez (also a Nobel Prize winner), Jorge Luis Borges, and Umberto Eco, who is probably one of the bestselling novelists writing in the Italian language in the world today.

The point of these remarks is to illustrate that, while bubbles may be commonly understood as irrational actions resulting from rational actions taken to unsustainable economic extremes, when they are examined in their granular, human form, they appear in a very different light. Many times, they begin as irrational economic activities, but they bear fruit that transforms them into rational and useful products. Bubbles are very complex, and I don't think they are necessarily understandable exclusively through pure time series analysis.

Featured Companies

U.S. Gold (UXG)

Naturally, the first company in this section would have to be a gold company. Since the price of gold is as high as it is, it's not possible to find any gold companies trading at lows. However, U.S. Gold is a development stage gold company with a \$514 million market capitalization. It is run by a gentleman by the name of Rob McEwen, who is himself worth studying. Formerly, he was head of Goldcorp, a company that has been the subject of many *Contrarian Research Reports* over the years. McEwen made that company one of the most successful gold companies of all time, if not the most successful. McEwen joined Goldcorp in 1990 and began restructuring the company in 1993. During his 15 year tenure, the company's share price increased at a 40% compound annual growth rate.

Since 2005, McEwen has been the largest shareholder of U.S. Gold. He currently owns 21% of the company and is the chairman and CEO. Given U.S. Gold's current \$514 million market capitalization, McEwen claims in each and every one of his presentations that by the year 2015 the company will have a market capitalization of \$3.5 billion, and not all of that will be achieved by share issuance. The company has two very large deposits: one silver deposit called El Gallo that is located on the Gulf of California coast in Mexico, and one gold deposit in Nevada known as Gold Bar, which is next to the Barrick Gold property.

The silver deposits in Mexico are in a very shallow open-pit mine, which has allowed the company to be very aggressive in exploration drilling. During the last four and a half months, it has drilled 100 shafts, which is very unusual for development-stage silver mining. It's said by the company to be one of the best ore grades found in many years. Should this property become productive, it will have annual production of 5.3 million ounces of silver annually at a cash cost of \$4.51 per ounce. The price of silver is nearly four times that cost. The estimated reserves on the property are 40 million ounces, and U.S. Gold has many other claims in the El Gallo area, so there may be many more ounces of silver there.

The Nevada property is a different type of investment. Nevada is the second-largest gold-producing area in the world. The U.S. Gold property in that state is in the so-called Cortez Trend, which is still in development-stage. The Cortez Trend has produced, at least as far as its reserves are concerned, 65 million ounces already. The U.S. Gold property, if the company can be believed, should have resources of 2.5 million ounces of gold at a cash cost of production of \$557 an ounce. The project itself should have, if it comes to production, a 60% annual internal rate of return.

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U.S. Gold has no debt. As stated above, McEwen owns 21% of the company, he bought his stock at \$2 per share, and he takes no salary. It's worth mentioning that McEwen resigned from his position as CEO of Goldcorp, a multibillion-dollar market capitalization company, to assume this position at U.S. Gold.

The balance sheet is not adequate to develop these properties. It has \$33 million in cash and \$4.1 million worth of gold on its balance sheet. McEwen believes in the practice of keeping gold on the balance sheet as a liquid asset. During the time when the *Contrarian Research Report* was following Goldcorp, the company frequently did not sell the gold that it mined in the Canadian properties; instead, it retained the gold on its balance sheet. At one point, the company could state with complete sincerity that its gold holdings qualified it as the equivalent of one of the central bank gold holdings of the world. It actually proved to be a sensible investment.

Wesco Financial Corp. (WSC)

Wesco Financial is a company controlled by Berkshire Hathaway, and its chairman is Charlie Munger. Wesco Financial is not similar to Berkshire Hathaway in that it is nowhere near as well-diversified. Nevertheless, it does trade at a discount to its book value, despite its excellent record over many decades of producing a return that is not inferior to that of Berkshire Hathaway. The bulk of the Wesco Financial assets are in marketable equity securities that include Procter & Gamble, Coca-Cola, Wells Fargo, Kraft, U.S. Bancorp, and a variety of miscellaneous equities. There are also a number of operating businesses, including ownership of a furniture rental business known as CORT Furniture that has \$380 million of revenue, and which operates, at the moment, at break-even. It might be one of the explanations for why the company trades at the value of its marketable securities.

In addition, Wesco Financial owns a steel business known as Precision Steel, which also operates at break-even. However, in 2009 the revenues of this business were \$38 million and in 2008 they were \$60 million. This business can be very profitable in a better economy. There are also various insurance operations that work in conjunction with Berkshire Hathaway. In the last fiscal year, the insurance businesses generated \$339 million in premiums and \$11 million in underwriting profits, which has no relation to the investment income. On the balance sheet, there is also \$300 million-plus of cash, \$223 million of bonds and only \$30 million of debt.

The question is, why should this company trade at a discount to what is obviously its liquidation value? It might be that people believe Charlie Munger doesn't pay attention to his businesses, given his advanced age. To address that point, it's worth looking at a company called Daily Journal (DJCO), which is occasionally the subject of the *Contrarian Research Report*. Daily Journal is the other company for which Charlie Munger serves as

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chairman. This company publishes legal journals, which are used in most states as a vehicle in which attorneys publish legal notices.

For many years, this business has neither grown nor declined. It is nothing other than a stable source of cash flow, which the company has been accumulating on its balance sheet for about a decade. During the period from late 2008 to 2009, a large portion of that cash was invested in equity securities that have probably doubled in value. The equity securities of Daily Journal became material to the value of the enterprise to the extent that the U.S. Securities and Exchange Commission actually wrote a letter to Daily Journal requesting that disclosure be made about the nature of its investments, apart from the disclosure that had been made that these were nothing other than equity securities. The SEC correspondence and the company's answer are available on the EDGAR website. The company chose to merely reiterate that it has investments in presumably liquid marketable equity securities, and it cares to say nothing further on that subject. It appears, at least as far as the filing is concerned, that the SEC accepted that answer.

As a stock, Daily Journal was unchanged probably from the year 2000 to late 2008 or early 2009. Then the stock itself proceeded to double in value. Obviously, Mr. Munger still pays attention to his financial affairs and therefore, we might make similar inferences in the case of Wesco Financial.

Fair Isaac (FICO)

Fair Isaac provides software for credit scoring, which is used by companies to aid them in deciding whether or not to issue credit to consumers. It has a \$1 billion market capitalization and trades at 14x earnings. Obviously, most banks and financial institutions are loath to grant additional credit to most of their customers. Given that situation, the banks are less likely to buy increased quantities of credit scoring software. However, 79% of the revenue is recurring and stable, since it is generated from services that the company provides.

Given a \$1 billion market capitalization, the free cash flow recorded by this company in the last quarter was \$34 million. If the free cash flow were to remain constant over the next year, the company would have \$136 million of free cash flow. Given its \$1 billion market capitalization, and the fact that it also has \$342 million of cash on the balance sheet and \$570 million of debt, it would be trading at 7.35x free cash flow, which is a very low valuation.

Realizing that its business is not likely to be robust any time soon, and that it has no use for \$342 million of cash on its balance sheet, nor for more cash its balance sheet in the form of the free cash flow it is currently receiving, Fair Isaac has embarked upon a \$250 million share buyback program, which is very substantial in the context of a \$1 billion company. In the last year, prior to the announcement of its share buyback program, the company

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bought back 2.4 million of its shares, or 4.9% of its outstanding shares. A much more aggressive stock buyback program could cause this company to trade at a more reasonable valuation, given its fundamental characteristics. Ultimately, banks will once again issue credit in increasing amounts, because that is their business. However, it's not likely to happen anytime soon; therefore, Fair Isaac is in a position to acquire its own shares at a low valuation. For that reason, it is recommended.

Loews (L)

Loews is a large company with a \$13.62 billion market capitalization that is trading below book value, which is not its ordinary condition. This firm is essentially a holding company, and its holdings can be broken into five different parts, three of which are publicly traded companies. It owns 90% of CNA Financial, 66% of the Boardwalk Pipeline Partners and 50.4% of Diamond Offshore. The value of the holdings of those three companies combined totals more than the market capitalization of Loews. The company also owns two other assets: 100% of a private company called High Mount, which is involved in oil and gas exploration, and also it owns the Loews Hotel chain. In calculating its book value, the company values the Loews Hotel chain at its own book value. However, since some of its properties have been owned for many years, it's unlikely that their realizable value is equivalent to that book value. It's likely that the value is much higher.

In any event, the stock trades at \$32 and the book value is \$41.80, which is a very substantial discount to book. Over many years, and particularly recently, the company has been aggressively repurchasing its shares. For example, during the most recently reported quarter, the company bought back 5,387,600 shares out of the 419.7 million shares outstanding. That's a lot of shares to buy back in one quarter. We also know that during the period from April 1, 2010, to April 28, 2010, the company repurchased another 1,245,900 shares.

Part of the reason for the Loews decline in value rests on its holding in Diamond Offshore. Though Diamond Offshore is not a participant in the BP oil spill in the Gulf of Mexico, like every offshore drilling company, it is influenced by that event, since the Federal government has placed a moratorium on new offshore drilling projects, which can only have a deleterious impact upon the earnings of Diamond Offshore. If the United States government were to relent at some point and allow offshore drilling on its territory, it's likely that Diamond Offshore would rise in value. If the United States government does not allow it, at least the current moratorium is more or less reflected in the share price.

Since the company has net cash of \$4.95 per share, apart from its cash flow, it has the resources to buy back shares for a very long period of time. There are two possible outcomes. First, the company might influence its value by repurchasing a great quantity of its shares, because the purchasing power of its cash is now enhanced. Second, it's possible

that Diamond Offshore might once again appreciate in value, in which case the company would be dramatically undervalued.

From the Readers

Exchanges: Chicago Mercantile Exchange (CME)

Q: What is your strongest exchange pick right now?

A: I would say the Chicago Mercantile Exchange (CME), because it clearly has a higher valuation than the New York Stock Exchange or NASDAQ, and it has the interest rate futures business. Over the last several years, the interest rate futures business has been depressed, because no one much believes that interest rates have the possibility of rising. One day, however, they will rise, and with that will come a greater need to hedge against interest rate increases. That need will cause the interest rate futures business to become more robust.

Failing that, the raw material necessary for an interest rate hedge is issuance of bonds. Interest rate futures are used for hedging Treasury positions. What asset, one asks rhetorically, is increasing faster than the total outstanding issuance of United States Treasuries? Nothing is, with the possible exception of various European sovereign debt securities. The amount of sovereign debt being issued in the world is clearly growing; therefore, the futures business is likely to be very robust.

The Chicago Board Options Exchange went public earlier this month, and the CME is likely to make a bid for that company. The CME is probably in a position to get more economy of scale from that business, because it's already in the derivatives business, the options business, and it's co-located, at least geographically, with the CBOE. The VIX contract owned by the CBOE would be a welcome addition to the futures business of the CME, especially since the contract volume of VIX futures may be growing faster than any have ever grown in history. Since the CME trades at a higher multiple, it is in a position to bid very aggressively for the CBOE, and it is anticipated that it will probably do so.

AutoNation (AN)

Q: The price to book value of AutoNation (AN) doesn't seem enticing enough. Are there any assets on the balance sheet for which the assessed value may be higher than stated?

A: Auto Nation requires very little in the way of capital investment to maintain its business. At the end of the day, it's only a series of auto dealerships. There aren't really many assets to be valued, though there are some. The real value of the business is the

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franchise value. As a huge auto dealer, the elimination of auto dealerships during the last two years is likely to give it greater market share. The automobile business is cyclically depressed. If one assumes that there will be a concomitant cyclical recovery, it could result in a much higher stock valuation for Auto Nation. The company does not need to invest its cash flow in its own business, so it is using it to very aggressively buy in its own shares. If the company records much higher revenues, and records nothing other than a modest profit margin on those revenues, the profit per share will be much higher than in years past because it will have fewer shares outstanding. Auto Nation should be viewed as a company that invests in itself by retiring its own shares.

Reports of Mineral Wealth in Afghanistan

Q: *What are your thoughts on the announcement in various newspapers that there is vast mineral wealth in Afghanistan?*

A: To begin with, I have no way of verifying whether that information is true or not. Let's presume that it's true. Wherever vast mineral wealth exists, one can reasonably forecast that large enterprises will seek to exploit it. Here we enter the world of geopolitics because, at the moment, the United States occupies Afghanistan. One can have no doubt that if this alleged mineral wealth exists, other nations would like to exploit it as well. There would come the inevitable struggle that we've seen over these many centuries for control of those resources, if they indeed exist. One can read many articles on foreign affairs that have been published over the last several years in which it was presupposed that Afghanistan itself has no strategic value to the U.S. That perception would change if there is truth in this announcement. It would presumably then have strategic value. Past situations of this type have been known to influence the foreign policy of many nations.

Though I'm certainly not a foreign policy expert, nor am I by any stretch of the imagination a military expert but, if my advice were asked, I would strongly recommend to the U.S. Military that if \$1 trillion dollars-plus of mineral wealth exist in that country, that they not allow it to fall into the hands of the Taliban.

The VIX: A Mathematical Abstraction

Q: *When you buy the VIX, what exactly are you buying?*

A: When buying the VIX, you are buying a mathematical abstraction. That's all it is; it's a formula—a calculation. It's truly a derivative in the understood sense of that word because, traditionally, derivatives derive their value from an asset. For example, the value of an interest rate swap is based on the value of real securities. An asset swap is based on the value of gold or equities. The VIX is based on the value of options, which themselves have their value derived from something else, so it's a pure abstraction. When buying the VIX, you are essentially making a bet on a number. If you're long, you obviously want that

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number to go higher. If you're short, you want that number to go lower. That number can change in value by extreme quantities; for example, in late April, the VIX was at a level of 15-plus and, in the next month, was at a level of 45-plus. For one who is merely trading securities, as opposed to investing in companies, any security can be thought of as just a number on which a bet is being placed.

When you talk about the valuation of securities changing, in a sense, you're talking about an abstraction, because the valuation accorded any security by the marketplace is an abstraction; it's entirely subjective. Is the company worth 12, 10, 14 or 20 times earnings? What you'll find over the course of several years is that the answer to that question is that it has all of those valuations. It's really a question of people's moods.

In the case of the VIX, the valuation changes are far more extreme than you would see in P/E multiple changes, whether applied to an individual stock or applied to an index. It is perhaps inevitable that the extreme nature of those changes attracts trading interest. Volume on the VIX futures has increased over the last year by several-fold, which is logical. Let's say that a trader was very astute at trading an individual stock and believed that it trades within a certain range. Let's say that this trader has mastered that range and all of the variables that influence that security's valuation. He or she might still be concerned by the possibility of a variety of exogenous events.

The company could be found to be fraudulent, or it could lose its business or gain a business. Its valuation could change for many different reasons. The industry in which the company operates could become more popular. In the case of the VIX, however, you can be sure that it can't go bankrupt. It can be affected by its own exogenous events, but it will continue as long as there are underlying securities to price and thereby create the arithmetical abstraction that is the VIX. In that way, you can always live to fight again another day. A trader could trade XYZ company, and it's theoretically possible that one day it would stop trading. In that scenario, the trader would have no possibility of recouping any losses, because the company would have filed for bankruptcy. It has happened. That is not a possibility with the VIX.

In pure mathematical theory, I suppose there's no reason why the VIX couldn't fall to some infinitesimally small number, but it would still exist. As long as the VIX contract is traded, it's always possible to make more money. Ironically, the lower the VIX falls, the higher a return it can have, because we know the highs of around 80 that were recorded in the fall of 2008 could happen again. All it would take would be a sufficient quantity of volatility to be experienced in the marketplace.

When you buy the VIX, that's what you're buying. People prefer to trade the VIX. The idea is that trading is about an attempt to anticipate changes in human behavior. Ultimately, if you think of it in that sense, the VIX is a very logical trading tool for one

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who wishes to engage in that activity. I myself do not wish to do so but, if I did, I would choose the VIX.

Q: Does more money in the various derivative securities change the ultimate valuation of the VIX?

A: In principle, options are efficiently priced through the Black-Scholes model. All option values that trade on the CBOE and the other options exchanges are created algorithmically, as people inform me. In principle, it shouldn't matter. They shouldn't depart radically from their Black-Scholes value. If the underlying securities become more volatile, which is what happened in the last month and a half, that volatility probably impacts the options. You might convincingly argue that a lot of money coming into an underlying security could ultimately make it more volatile. I think there's truth in that. In principle, it becomes more liquid. However, it will be volatile as long as there's a base of people who are willing to withdraw their money from that security in quick order. I would think that situation would be reflected in the option price, and the aggregation of the option prices would be reflected in the VIX.

Q: You don't necessarily think that money flowing into or out of the VIX in any significant way drives the volatility?

A: I don't know. I once asked that question of the CEO of the CBOE, and he himself didn't know the answer. He said that they were studying it. All I can tell you is that they must have reached a conclusion in one sense of the word, because I noticed about a week ago that they permitted the two VIX Exchange Traded Notes, which you will observe get more volume almost every week, to list options. If you think that the VIX has high volatility, one should look at the premiums on the VIX VXX options. They're really quite extraordinary.

I wish I could give you a better answer to your question, but I don't really know the answer. In an investment sense, my personal experience is that when many people enter an investment, I would rather not be with the crowd. Similarly, had I been living in the area into which tens of thousands of people swarmed at the time of the California Gold Rush, I think I would have moved somewhere else.

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Money Manager Index																
From Jan 1983 to May 2010																Annualized return
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly return	(since inception)
1983								1.00	0.81	0.76	0.87	0.75	1983	0.75	(60.5)%	(50.2)%
1984	0.75	0.71	0.70	0.66	0.67	0.67	0.61	0.83	0.79	0.76	0.67	0.65	1984	0.65	(13.5)%	(26.5)%
1985	0.92	0.93	0.99	0.95	1.20	1.30	1.32	1.38	1.28	1.50	1.86	2.02	1985	2.02	211.8%	33.7%
1986	2.46	2.78	2.47	2.31	2.36	2.33	2.03	2.23	1.98	2.37	2.34	2.34	1986	2.34	15.9%	28.2%
1987	3.21	3.27	3.16	2.55	2.37	2.30	2.39	2.47	2.22	1.56	1.44	1.52	1987	1.52	(35.0)%	9.9%
1988	1.80	1.87	1.78	1.79	1.69	1.94	1.92	1.96	2.01	1.97	1.95	2.07	1988	2.07	36.0%	14.3%
1989	2.42	2.37	2.54	2.63	2.64	2.64	2.93	3.12	3.07	3.05	3.23	3.26	1989	3.26	57.8%	20.2%
1990	3.12	3.15	3.53	3.06	3.47	3.45	3.30	2.70	2.68	2.40	2.52	3.02	1990	3.02	(7.3)%	16.1%
1991	3.08	3.49	3.70	3.68	3.71	3.61	3.86	4.05	4.07	4.69	4.47	5.72	1991	5.72	89.4%	23.0%
1992	5.76	5.61	5.30	5.12	4.98	4.99	5.93	6.06	6.19	6.56	7.25	7.36	1992	7.36	28.6%	23.6%
1993	8.06	8.04	8.20	7.94	8.15	8.57	9.05	10.00	9.99	9.31	8.97	8.90	1993	8.90	21.0%	23.4%
1994	9.52	8.73	8.05	7.85	7.81	7.53	7.66	8.31	8.15	8.52	7.88	7.95	1994	7.95	(10.6)%	19.9%
1995	7.74	8.38	8.72	8.77	9.20	9.35	9.93	10.78	11.22	10.53	10.89	10.40	1995	10.40	30.8%	20.8%
1996	11.12	11.50	11.33	11.62	11.86	12.53	11.91	12.36	13.32	14.03	14.42	15.02	1996	15.02	44.4%	22.4%
1997	16.04	16.81	15.32	17.27	18.42	20.29	22.28	21.39	25.31	24.95	24.95	25.50	1997	25.50	69.8%	25.2%
1998	25.67	29.00	29.89	30.60	28.90	30.44	27.67	21.33	21.74	25.16	27.27	25.41	1998	25.41	(0.4)%	23.3%
1999	26.00	23.71	23.92	26.77	28.94	29.74	28.78	26.74	25.89	27.73	28.54	30.55	1999	30.55	20.2%	23.2%
2000	31.07	31.19	36.01	35.60	35.20	40.32	43.58	45.75	45.62	48.69	44.05	49.84	2000	49.84	63.1%	25.2%
2001	50.23	46.41	44.27	46.96	48.90	49.98	50.67	49.70	46.47	44.81	48.04	51.91	2001	51.91	4.2%	23.9%
2002	53.62	53.74	55.11	52.52	52.83	50.48	42.58	44.92	41.54	42.66	45.78	43.17	2002	43.17	(16.8)%	21.4%
2003	42.72	41.18	42.36	45.98	49.02	50.71	53.47	53.97	53.46	56.12	55.83	58.49	2003	58.49	35.5%	22.1%
2004	64.38	65.08	64.63	61.68	60.86	62.30	58.71	64.08	65.73	68.86	73.53	78.16	2004	78.16	33.6%	22.6%
2005	76.46	77.94	74.06	72.83	77.02	80.25	83.59	83.07	86.03	89.19	96.58	97.35	2005	97.35	24.6%	22.7%
2006	107.62	111.44	110.75	111.88	101.89	100.61	100.62	104.98	114.61	116.64	113.78	118.05	2006	118.05	21.3%	22.6%
2007	125.73	123.77	122.62	127.58	133.57	134.68	126.61	124.07	133.57	148.09	135.13	135.56	2007	135.56	14.8%	22.3%
2008	127.53	115.76	115.94	121.58	130.51	115.68	119.94	120.55	109.69	72.70	62.95	67.91	2008	67.91	(49.9)%	18.1%
2009	57.51	51.76	65.63	79.49	85.67	90.79	99.97	101.69	107.32	107.36	110.94	115.01	2009	115.01	69.4%	19.7%
2010	106.84	110.32	118.13	114.91	100.179									100.18	(12.9)%	18.7%
Name	Amount Invested			Name	Amount Invested											
Affiliated Manager	\$ 22,947			Pzena Investment Mgt	\$122,426											
Alliance	\$ 7,633															
BlackRock	\$ 23,205															
Waddell & Reed	\$ 27,513															
Eaton Vance	\$ 2,641															
T. Rowe Price	\$ 2,423															
Franklin resources	\$ 908															
Legg Mason	\$ 1,000															
Federated Inv	\$ 26,381															

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International Money Manager Index																
From Jan 1983 to May 2010														Annualized return		
Year	31-Jan	28-Feb	31-Mar	30-Apr	31-May	30-Jun	31-Jul	31-Aug	30-Sep	31-Oct	30-Nov	31-Dec	Yr. End	Index	Yearly return	(since inception)
1986											1.00	1.02	1986	1.02	10.0%	10.0%
1987	1.25	1.37	1.48	1.48	1.37	1.33	1.39	1.40	1.33	0.81	0.76	0.73	1987	0.73	(27.7)%	(23.3)%
1988	0.75	0.92	1.02	0.95	0.80	0.89	0.88	0.82	0.86	0.88	0.89	0.93	1988	0.93	26.4%	(3.4)%
1989	1.03	1.02	1.06	1.17	1.19	1.18	1.25	1.16	1.17	1.20	1.21	1.28	1989	1.28	37.8%	8.1%
1990	1.24	1.24	1.18	1.19	1.22	1.24	1.26	1.26	1.23	1.24	1.25	1.33	1990	1.33	3.7%	7.0%
1991	1.34	1.52	1.56	1.58	1.57	1.47	1.52	1.64	1.81	1.89	1.94	1.92	1991	1.92	44.8%	13.5%
1992	2.01	1.93	1.88	2.14	2.19	2.13	2.08	1.99	1.95	1.77	1.76	1.96	1992	1.96	1.9%	11.5%
1993	1.98	2.03	2.20	2.39	2.42	2.45	2.54	3.05	3.01	3.07	3.01	3.30	1993	3.30	68.7%	18.1%
1994	3.72	3.39	3.17	3.04	2.99	2.89	3.01	3.14	3.13	3.19	3.15	3.15	1994	3.15	(4.7)%	15.1%
1995	3.07	3.12	3.28	3.41	3.56	3.59	3.87	3.76	3.76	3.77	3.70	3.73	1995	3.73	18.6%	15.4%
1996	3.76	3.85	3.70	3.79	3.96	3.90	3.75	3.96	4.16	4.47	4.90	4.86	1996	4.86	30.3%	16.8%
1997	5.11	5.37	4.99	4.96	5.43	5.94	6.57	6.32	7.45	7.24	6.80	7.19	1997	7.19	47.9%	19.3%
1998	7.12	8.05	8.78	9.25	8.95	8.74	8.91	6.67	6.08	7.01	7.51	7.71	1998	7.71	7.3%	18.3%
1999	7.99	8.21	8.68	9.07	8.71	8.61	8.63	8.43	8.47	8.79	9.80	10.79	1999	10.79	39.9%	19.8%
2000	11.23	12.27	13.95	13.50	13.73	15.39	15.85	16.82	17.07	16.31	14.43	16.76	2000	14.43	33.8%	20.7%
2001	17.42	15.88	13.46	15.14	15.84	15.15	14.21	13.61	10.77	11.43	13.90	14.12	2001	14.12	(2.2)%	19.1%
2002	14.74	13.78	15.09	15.11	16.38	14.14	12.92	12.10	11.23	11.06	11.33	10.50	2002	10.50	(25.6)%	15.7%
2003	10.18	9.52	9.69	10.62	12.17	13.04	13.98	15.38	16.67	17.88	18.16	18.07	2003	18.07	72.1%	18.4%
2004	20.00	22.41	29.98	35.46	26.68	30.80	25.37	25.20	23.67	23.34	27.56	31.48	2004	31.48	74.2%	20.9%
2005	32.19	32.57	31.88	27.79	27.36	29.05	30.38	31.49	33.39	32.24	32.95	37.18	2005	37.18	18.1%	20.8%
2006	41.01	40.97	43.69	46.45	42.39	41.58	40.60	43.32	43.55	43.70	44.58	49.38	2006	49.38	32.8%	21.3%
2007	50.95	51.18	53.59	56.09	58.16	56.37	53.90	48.65	50.96	57.03	48.21	45.75	2007	45.75	(7.3)%	19.8%
2008	38.71	39.71	38.59	40.18	39.25	35.10	34.59	33.33	26.09	18.72	14.50	15.79	2008	15.79	(65.5)%	13.3%
2009	14.62	13.24	14.96	19.63	22.82	23.73	26.14	27.05	28.41	28.53	28.69	29.83	2009	29.83	89.0%	15.8%
2010	28.50	27.58	29.90	29.58	25.53									25.53	(14.4)%	14.7%
Name	Amount Invested			Name	Amount Invested											
IGM FINANCIAL INC	\$1,000			HENDERSON GROUP PLC	\$14,447											
F&C ASSET MANAGEMENT PLC	\$1,203			RAB CAPITAL PLC	\$24,603											
INVESCO PLC (PREVIOUSLY AMVESCO)	\$1,357			AZIMUT HOLDING SPA	\$21,908											
SCHRODERS PLC	\$1,208			EVEREST FINANCIAL GROUP LIMITED	\$23,437											
RATHBONE BROTHERS PLC	\$1,208			CHARLEMAGNE CAPITAL LTD	\$36,848											
ABERDEEN ASSET MGMT PLC	\$1,208			PARTNERS GROUP-REG	\$36,848											
CI FINANCIAL INCOME FUND	\$2,585			INVISTA REAL ESTATE INV MNGT	\$36,589											
MAN GROUP PLC	\$2,862			ASHMORE GROUP PLC	\$36,688											
A GF MANAGEMENT LTD-CL B	\$3,343			BLUEBAY ASSET MANAGEMENT/UNI	\$37,469											
SPARX GROUP CO LTD	\$11,762															