

## **How to capitalize on the junior gold rally**

The nuclear winter endured by junior gold companies since the Bre-X fraud destroyed their market six years ago is over. Reawakened by a robust gold price, the sector is enjoying a wave of investor enthusiasm not seen since early 1997.

Now comes the tricky part for investors. There are hundreds of junior mining companies listed in Canada. Only a few will find a mine. But on a wave that lifts all ships, how can investors determine who will sink and who will sail to riches? What qualities should a junior gold explorer possess in order to have the best chance of success? The following criteria will separate the potential winners from the many losers, assuming the gold bull continues to rage.

### **People**

This is the most important criterion. Because mines are made and not found, as the saying goes, the quality of management will determine if a property advances from discovery to feasibility. The management team needs both a strong technical component and a track record of rewarding investors. "Management must be playing with a full deck," says Eric Zaunserb, a mining analyst with Raymond James. "All of the different characteristics – technical, financial, promotional – have to be there. Maybe they're embodied in one or two people, or maybe they're in a team of four or five."

A clear philosophy, often overlooked by investors, is also crucial to success. "What does management want to do? Do they want to build a mining company (Barrick Gold, for example) or do they want to dress something up, put a bow on it and sell it to a senior company?" asks Zaunserb. Are they "closeologists" – those who seek to boost their market value by staking ground around discoveries - or are they more inclined to test original geological concepts? The latter two strategies can be risky. Closeologists rarely replicate the discovery, while originators (such as Dia Met Minerals) usually toil in obscurity until they hit the jackpot.

Investors should also evaluate the team using more subtle indicators such as profile on the street, insider trading history and passion. "It's in the qualitative items where professional judgment comes into play," says analyst Glenn Brown, vice-president of research at Haywood Securities.

### **Property**

Properties can be difficult to evaluate because there are so many unknowns in the early stages of exploration. But it's no coincidence that the best properties are often held by top-rated management teams. For starters, the overall geological concept used to select the ground must make sense and the deposit type be recognized and understood by the market. Just like other types of real estate, mineral properties are all about form and location. A near-surface deposit with consistent mineralization is more likely to advance than a deep deposit with narrow, irregular veins. Similarly, a property far from infrastructure such as roads, ports and hydro must be extraordinarily rich to warrant development.

Look closely at claims of tonnage and grade, and beware companies that report gold reserves in "millions of ounces", a regulatory no-no. If that million-ounce bonanza is contained within hundreds of millions of tonnes of rock, the deposit is essentially worthless.

### **Paper**

The company's share structure can mean the difference between participating in a robust market run-up or being stuck on the sidelines. Thinly-traded stocks are vulnerable to extreme swings in market value and may be difficult to offload. They can seem like winners if a few buyers move in at higher prices, but the appreciation is artificial and usually unsustainable. "These stocks are illiquid so the pricing by the market is often inefficient. If there's a lot of want they go through the roof," says Brown. Likewise, if the stock has overhang, meaning a block of shares has become, or is about to become, free trading, the price is vulnerable to sudden collapse as the new shares hit the market.

Another factor to consider is market capitalization (the share price multiplied by the number of shares outstanding) in relation to the company's assets. "If the market cap outweighs the liquidation value, there may be a rat in the feed bag," warns Rick Rule, a respected stock picker and senior analyst for San Diego-based Global Resource Investments, in his report *How to Pick a Junior Gold Stock*. Absurdly inflated market capitalizations were a common feature of the last junior bull market, which contracted by 90% when share prices collapsed.

### **Promotion**

"You can have the greatest geologists out there, but if they can't promote themselves out of a wet paper bag, it's not something we're likely to recommend," says Zaunserb. In order to raise capital, companies must be recognized by the street, both in Canada and abroad. Promotion is especially important for new companies trying to establish a name, but every junior needs to sell its message to the investment community, senior producers and the media on a consistent basis.

Good promotion can increase liquidity and help reduce dilution in financings by boosting the share price. Rule recommends companies invest at least \$150,000 per year to market themselves, including taking their show on the road to investment conferences in Toronto, London and New York. He believes "companies that don't appear at the gold shows are almost automatic losers."

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While paying attention to these four key criteria, keep in mind the underlying reason for the rally: a rising gold price. In this type of market, the accepted wisdom is to buy stocks with leverage to the gold price, a risky strategy Zaunserb cautions unsophisticated investors against. "Think defensively. Be exposed to growth stories that mitigate commodity risk. When the market does turn down, the growth stories will vastly outperform the leveraged stories."

And keep in mind that companies determined to perpetuate a fraud can still succeed, despite new regulatory constraints. Without meticulous due diligence on the part of analysts and investors alike, another Bre-X looms.