

# Metals and mining update

August 2011 (Data as at July 31, 2011)

## **Sentry Precious Metals Growth Fund Sentry Mining Opportunities Class**

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### **Market overview**

*"The best way to destroy the capitalist system is to debauch the currency." – Vladimir Lenin*

One surefire way to fight a strong domestic currency is to print money and buy a weak foreign currency. Japan and Switzerland demonstrated this tactic in early August by aggressively buying US dollars and treasuries. The aftermath was sharp market retreats including a roughly 10% pullback for gold and silver equities in a matter of two days. After the seemingly mandatory but modest profit taking in gold, the no-counterfeit currency reacted properly in our view to the latest salvo in the currency debasement war. By August 8th, the \$1700 price level was breached and three days later the \$1800 marker fell.

Was this a disproportionate response to just the latest of many currency debasing market interventions? We don't think so. We have often spoke of the 'point of recognition' – that moment in time where everyone realizes the Emperor has no clothing and is in fact preening before admirers wearing absolutely nothing. We think the last vestige of clothing was stripped from the US Emperor by the debt ceiling debate. Japan has been losing its garments for years, and the European Union is now doing a country by country strip-tease as well. The point of recognition should be accompanied by acceleration of capital flow to safety. Gold is accelerating, so we are there.

Since very few want to believe the current state of affairs will last, there has been a divergence between the price of gold and the price of gold producers. So, the good news is that gold equities have been held back by disbelief and general market weakness and there is no penalty for coming \$400 late to the party. For those with equity risk tolerance, we think that investors should be overweight gold equities.

### **Portfolio review**

*"The best armor is to stay out of range" – Italian proverb*

In the stock market, this means holding cash to sidestep market weakness. We chose to maintain the 50% base metals component of Sentry Mining Opportunities Class at 20-24% cash early in the year to offset the higher than usual market risk associated with deteriorating sovereign debt. The balance of this tranche was held in gold-base metal hybrids or exceptionally valued non-precious metal/mineral opportunities. We remind readers that we generally look for several criteria before committing to an investment: value drivers to generate 25% annual

return with no help from the underlying commodity; ability to generate free cash flow yield well in excess of cost of capital; a strong balance sheet; located in safe jurisdictions; and skilled management. This year, we were looking for 50% annual return potential as compensation for taking market risk. We highlight four such holdings below.

*"I would rather be first in a little Iberian village than second in Rome." – Julius Caesar*

We'd rather see first-in-class cash flow in Spain than second-class cash flow in North America. Iberian Minerals Corp. fits the bill. The company recently consolidated its financial ownership of the Condestable mine and should be free of a well-below market hedge book starting next year. With full revenue exposure to current zinc and lead prices (around \$1/lb for each metal), we estimate the company can generate a cash flow yield of over 34% and a free cash flow yield of about 31% next year. We expect Aguas Tenidas – Iberian's key operation – to process two million tonnes of ore grading 6.5% zinc, 1.1% copper, 1.9% lead and 37g/t silver. Using current metal prices, the operation should be able to generate almost \$200 million in free cash flow in 2012. As well, elimination of the hedge removes the derivative liability on the balance sheet and working capital automatically increases by \$148MM.

*"Everything has its limits – iron ore cannot be educated into gold." – Mark Twain*

We feel iron ore can be educated into cold hard cash, however, at least in a vehicle such as Labrador Iron Mines (LIM). LIM's assets are located in western Labrador and northeastern Quebec. The 20 Schefferville projects are near previously operated iron mines – the area has been mined from 1954 to 1982 by the Iron Ore Company of Canada. LIM's stage one and two deposits contain almost 40 million tonnes (MMT) of ore, with stages 3 to 5 potentially adding a further 80 MMT. Current production forecasts for 2012 range from 2.5 to 3.0 MMT of direct shipping iron ore. The company had a number of delays this year, specifically securing rail transport and solidifying relationships with native bands, however, these issues are now behind them. We estimate the company will ship 2.5 MMT of iron ore next year. With operating costs of C\$50/T and current sales prices in the \$150/T range, this translates into \$220 million in operating cash flow. This implies a cash flow yield of over 50% (cash flow multiple of 2x). There is additional potential for the company to ramp up production to 5 MMT/yr within the next five years. As of March 31, the company carried no debt, had

cash of over \$7 million, but had negative working capital – we believe this situation will be remedied as soon as payments for iron ore shipments are received (we understand shipments are imminent or may already have taken place).

*“You cannot step into the same river twice.” – Heraclitus*

While true, one can buy Rio Alto Mining shares as often as one chooses. The company recently started producing gold at its La Arena property in northern Peru. The asset came out of the Cambior/IAMGold acquisition and was generally an underfunded (read: under-explored) property in the IAMGold stable. Rio Alto recently cleaned up the ownership structure of the asset and now owns 100% of the property. Production started in May of this year and the company’s guidance for 2011 gold output is 75,000 ounces. At present, La Arena is a simple heap-leaching operation. This can change in the future, however, as the oxide cap currently being mined sits atop a copper/gold porphyry orebody hosting over four billion pounds of copper and 2 MM oz gold. The addition of a sulphide flotation plant for copper production could be funded from operating cash flows and debt, limiting potential share dilution. As well, exploration upside at La Arena and vicinity is encouraging – and very little regional exploration was conducted by prior owners. For the time being, all revenues and profits come from gold. We believe the company should be able to produce over 80,000 ounces of gold in 2012, which should translate to a cash flow yield of 26% – off the charts for a gold producer, where a cash flow yield of about 10% is typical. Rio Alto stands high above the rest of its peers on this measure and you get 20 years of future copper-gold production essentially for free.

*“No matter how advanced our economy might be, no matter how sophisticated our equipment becomes, for the foreseeable future we will still depend on fossil fuels.” – George W. Bush*

The developed world’s dependence on fossil fuels is what drives revenues and cash flows for Sandstorm Metals & Energy (SND). SND is a royalty company that presently owns six coal royalty streams, two oil

streams, and one each of copper and natural gas. The company paid \$112 million for these royalties and the money is being used by the operators to develop production, so there is some startup risk associated with the investments, but nothing unusual. The structure allows Sandstorm to buy natural gas for \$1/mcf, oil for \$15/bbl, thermal coal for \$55/t, metallurgical coal for \$75/t and copper for 80c/lb. The royalty stream assets are located in Canada and the USA – safe jurisdictions for mining and oil and gas operators. The oil streams come from Alberta, natural gas from Utah, coal from Tennessee, Alabama, and Kentucky, and the copper stream is from Quebec.

Since the royalty stream acquisitions were financed with the issuance of equity, the company carries no debt. Operating cash flow (and free cash flow) yield are estimated at 20% for 2012 (based on \$17 million in cash flow, which is expected to rise to over \$30 million in 2013). Sandstorm has over \$30 million in working capital (over \$31 million of it in cash) with zero debt. Royalty companies are not exposed to rising operating costs and typically trade at mid-single digit cash flow yields as a result, so Sandstorm looks quite cheap to us.

#### **Sentry Precious Metals Growth Fund**

##### AVERAGE ANNUAL COMPOUND RETURNS (SERIES A)

3 MONTH	6 MONTH	1 YEAR	3 YEAR	5 YEAR	10 YEAR	S.I.
-0.8%	5.5%	38.0%	32.3%	19.9%	24.6%	15.9%

#### **Sentry Mining Opportunities Class**

##### AVERAGE ANNUAL COMPOUND RETURNS (SERIES A)

3 MONTH	6 MONTH	1 YEAR	3 YEAR	5 YEAR	S.I.
0.4%	3.7%	50.0%	18.6%	12.8%	13.1%

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compound total returns net of fees (except for figures of one year or less, which are simple total returns) including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

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