March 2009

S&A Oil Report

Dempsey's Loophole: How to Generate Double Digits from the World's Best Gold Mines

Stansberry & Associates
Investment Research

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By Matt Badiali

Mining is a sucker's bet…

That's what Stan Dempsey came decided in 2003... After almost 30 years in mining – he started out lighting fuses in his uncle's coalmine as a boy – Dempsey had enough of the roller coaster you ride chasing the big payoff.

He didn't always believe that though.

In 1986, Stan Dempsey was a mining company CEO, and his company scraped bottom. Shares traded for pennies and his gold-mining operations combined for a $2 million per year loss.

He kept the business afloat by buying and selling shares of mines. While that part of the business succeeded, his exploration business kept losing money. It took Stan several years of boom and bust desperation before he stumbled upon the key to owning gold mines – don't do it.

Stan figured out a better way to develop gold projects... to pick the most promising prospects and buy up their gold on the cheap.

The type of gold company Dempsey developed is also an ideal way for investors to profit from the mining industry without subjecting capital to a game of Russian roulette, as with typical all-or-nothing junior mining stocks.

In this report, I'll explain how Stan Dempsey's brainstorm – what I call the "Dempsey Loophole" – works… And I'll show you the best way for us to profit off it. We're going to use Dempsey's Loophole to generate our own double-digit cash flow.

The World's Best Gold… No Mules Involved

Twenty years ago, most folks felt the only way to get rich mining was to, well... mine.

You bought a pickaxe and a mule and headed for the hills. Then, you hoped before long something would start glittering at the bottom of your pan. Modern mining hasn't changed much from Gold Rush days – we just use much bigger "pickaxes" now.

The problem is, the strategy doesn't work out for most miners. The average junior mining company can pour millions of dollars and a dozen years into a project. Even if it finds gold, any number of things can scuttle a project, block a mine, and waste all that investment.

In Stan Dempsey's case, the final straw was Milos...

In 2000, his junior mining company had made a major find. Exploration identified about three quarters of a million ounces of gold on the Greek island of Milos. The geologists thought it might hold much more than that. It was the kind of discovery that launches a penny stock, like his company, into the $100 million market cap club... and makes mining company executives very rich.

The company spent $2.5 million in exploration and applied for permits to continue to explore – only to be denied by the Greek Ministry of Environment, Regional Planning, and Public Works. Those Greek bureaucrats unceremoniously ended Dempsey's business on Milos and sent him from the exploration business for good.

Dempsey learned the hard way that miners are in constant need of cash – especially during the early stages of mine development. These cash-starved miners will happily sign over a percentage of their future production (called a royalty) for cash today. You can negotiate steep terms if you have the cash.

Dempsey figured that out, he dumped all his own exploration operations, and assembled a team of geologists, engineers, and mining economists to evaluate projects and cherry-pick the most promising royalties. Dempsey's goal is to generate at least 5% per year on each royalty.

One of his first deals was a royalty on the Martha silver mine in Argentina. The company I'm going to recommend today gave the mine's developer, Coeur D'Alene, $1.8 million cash. In return, it receives about 2.5 million ounces of silver per year, worth nearly half a million dollars. **That's a 27% annual return on the investment.**

This is probably the safest and most profitable way to make money in the mining business ever. While other mining companies struggle to keep their profit margins in double digits, Dempsey's company converts 80% of its revenue into cash.

Now, let me show you how we're going to invest with Stan Dempsey… and book steady, safe income from only the best gold mines in the world …

An Accounting Firm that's Paid in Gold

The company Dempsey used to develop this model is **Royal Gold (Nasdaq: RGLD)**.

Royal Gold doesn't own any mines, land, trucks, or any of the other super-expensive equipment you need to operate a gold mine. It doesn't have the labor, insurance, permit, or storage costs associated with mining.

Instead, the company owns a portfolio of 25 production royalties and 33 exploration-and-development royalties. Three quarters of those production royalties are gold and silver mines. The rest are copper and other base metals.

It is essentially $1.4 billion accounting firm that takes its payments in gold.

Actually, Royal Gold is a collection of old mining hands like CEO Tony Jensen, with 20 years of experience. Before coming to Royal Gold, Tony ran the Cortez Joint Venture, which includes a huge mine and exploration projects outside Elko Nevada. These are the kind of people I want to evaluate mining projects – which is all Royal Gold does.

Royal Gold owns royalties on some of the world's great mines, like Goldcorp's Peñasquito project in Zacatecas Mexico. The project contains 17.4 million ounces of gold and 1 billion ounces of silver reserves. Royal Gold owns 2% of that reserve, which has grown 76% since the company bought the royalty.

Today, Royal Gold's royalties cover a little more than 53 million ounces of gold reserves at mines all over the world. And remember, **the company converts about 80% of its revenues straight into cash**.

Over the last six months, Royal Gold's royalty revenue was $30.7 million. Net income was $27.1 million, and free cash flow totaled about $25 million – 81% of revenue. It currently has $55 million in cash and no debt. Over a full year, that works out to $54 million in earnings and $50 million in free cash flow... and I think rising gold prices will make the next six months at least as good as the last six.

Royal Gold's market value is $1.38 billion. That means we're paying about 26.5 times future cash flow for this company... Pretty good for a company that turns 80% of its revenues into free cash flow.

The rising gold price puts the wind at Royal Gold's back. This is one company that will post capital gains for investors this year, if you don't pay too much for the shares...

Royal Gold's business model is simple, but it's still a little complicated to figure out a fair value. That's because it involves two moving parts: the share price and the gold price. If we dig back 10 years, we find that, on average, an ounce of bullion gold trades for about 30 times the price of an ounce of Royal Gold's reserves. The five-year average was 29 times.

That's an important number because once we know the average, we can figure out the fair value of Royal Gold's share price. You see, Royal Gold carries no debt and has about $200 million in cash. Plus, as I said, its business is very simple – all it does is collect gold ounces from the mines.

Gold Spot Price	Buy Shares Below::	Gold Spot Price	Buy Shares Below:
$1,200	*$53.04*	$900	*$39.78*
$1,150	*$50.83*	$875	*$38.68*
$1,125	*$49.73*	$850	*$37.57*
$1,100	*$48.62*	$825	*$36.47*
$1,075	*$47.52*	$800	*$35.36*
$1,050	*$46.41*	$775	*$34.26*
$1,025	*$45.31*	$750	*$33.15*
$1,000	*$44.20*	$725	*$32.05*
$975	*$43.10*	$700	*$30.94*
$950	*$41.99*	$675	*$29.84*
$925	*$40.89*	$650	*$28.73*

This table shows exactly how much you should pay for Royal Gold's shares, depending on the price of gold. Here's how it works... Royal Gold's shares currently trade for a little less than $38, and gold trades for $911 an ounce. Let's consult the table. The current gold price falls right between $900 and $925, and we're safe buying shares up to $39.78 if gold is at $900 per ounce.

Since the gold price is more than $900, and Royal Gold shares trade for less than $39.78, then we can buy. Once we know how much to pay for our shares, we can use them to generate cash.

How to Generate Double-Digit Paychecks

Now that we know a fair price for Royal Gold's shares, we can make some money. We're going to do that by selling an "at the money" call. That means, we're going to sell someone the right to buy these shares from us in a month around the same price that we bought.

The Case for Gold

I'm sure many of you expect the *S&A Oil Report* to focus exclusively on petroleum and energy-related investments. But being too narrowly focused on a single commodity can be hazardous to your portfolio… especially when that commodity is wallowing at its lowest price in four years.

In contrast, gold is clearly in an uptrend and in line for huge price increases… The reason is inflation.

Whenever the government goes about printing large volumes of new money – and $1.5 trillion in bailout and "stimulus" packages qualify as "large volumes" – the value of gold spikes. You see, unlike dollar bills, the supply of gold is finite. It can't be created on a printing press. That also means, if you double the number of dollars in circulation, it costs twice as many to buy the same amount of gold.

The money supply increased 10% in 2008, and the price of gold increased 14%. But since the start of 2009, the price of gold is up another 10%. The government doesn't report money data on a daily basis. But between the $700 billion bank bailout the Obama administration will finish distributing and its newly minted $787 billion economic stimulus package, the gold price sure appears to be tracking money supply.

And the price of gold has historically reacted much more strongly to increasing money supply. Over the last decade, the U.S. money supply rose 86%, while the gold price rose 208%. (Of course, the costs of mining – for instance, oil and gasoline – have fallen, too.)

That's why we're going to make a fortune in gold stocks over the next year. The market will continue to react to the ever-growing number of dollars, pounds, and francs… which will drive the price of gold continually higher.

In exchange, the buyer will give us cash, right now. For example, you can sell **Royal Gold April 2009 $40 calls (MJQDH)** for more than $2.25. This option obligates you to sell shares of Royal Gold for $40 on April 17 (the day the option expires).

That's what we want to happen. We want to sell those shares. If we buy shares for $38 and they are "called away" six weeks later for $40 each, we'll make $4.25, or 11%, on the deal ($2 in capital gain PLUS the $2.25 option premium).

That's our goal. We want to buy Royal Gold shares cheap, so they have little risk of falling in price, and sell them to someone else next month to generate cash. The call obliges us to sell the stock if it is trading for more than $40 on April 17. Here's how this covered call trade works:

Today, Royal Gold's shares trade for around $38. So 100 shares will run you $3,800. You should have no problem selling one call option for $225 per contract, or $2.25 per option (each contract represents 100 options). The $225 upfront premium will bring your cost basis to $35.75 per share ($3,800 minus $225 premium equals $3,575 total for 100 shares).

This trade can work out three ways:

1. If the gold price continues to climb, Royal Gold's shares should respond by rising past $40 per share. In that case, our shares will be called away. We will receive $2 per share and keep the $2.25 per share premium. Our total return in just one month would be 11%. *If this happens, we'll to repeat the entire process again in six weeks (assuming RGLD shares remain cheap compared to gold bullion).* If we repeat the process eight times a year (52 weeks divided by six weeks for the trade) we'd book an 88% return this year.
2. If Royal Gold's shares continue to trade below $40 per share in April, we keep the $2.25 call premium. That's a return of approximately 6% on our $38. In this scenario, we'll sell another set of calls on the position and continue to collect income. Here's the key... if we roll this trade over every six weeks, our annual return would total about *48% even though Royal Gold shares are stagnating.*

3. We'll maintain a 25% trailing stop on this position. That means we'll stay in the trade until Royal Gold shares hit $28.50. If Royal Gold shares do fall below our trailing stop, you must first buy back the calls (they'll be trading at a huge discount, so we'll still make a profit). After you've bought the calls, then you can sell the shares. This scenario is highly unlikely without a massive fall in the price of gold.

You must own those shares to sell the call option.

Once you own 100 shares of Royal Gold, sell one of the RGLD April 2009 $40 (MJQDH) calls. (The symbol for these options will vary slightly depending on your broker. The symbol on Yahoo Finance is MJQDH.X).

Actions to take: Buy 100 shares of Royal Gold (Nasdaq: RGLD) and sell ONE RGLD April 2009 $40 call (MJQDH) for at least $2.25.

If you commit $12,000 to this strategy, which is three sets of covered calls, you can make $880 per month with. I can't think of another way to make that much cash so safely. If you have questions about how to sell calls, please consult your broker before putting on the trade. That's why you pay him...

This is not our first time buying into RGLD. We bought it about a year ago, but stopped out in October when the price of gold collapsed to nearly $700. For the reasons I explained earlier, I doubt gold will stage a repeat performance. Instead I think a rally from here is in the cards.

Also, I know many of you may view option trading as risky, but I urge you to consider our covered call strategy with Royal Gold. Our strategy is actually much safer than simply holding the shares. First, by limiting ourselves to short-term (six weeks) trades, we're only investing in RGLD when the value of its reserves is at a discount to the price of bullion. The price of gold is the principle driver moving RGLD shares up or down, so our risk is low when the company's reserves lag the price of gold. Second, by racking up call premiums every six weeks, we're ensuring a healthy return even if the company's stock trades sideways.

Still if you are uncomfortable selling covered calls, Royal Gold shares are a great buy when they are cheap based on the table on page 3. So for instance, if gold trades for $925 an ounce, Royal Gold is a buy at $40.89. At today's gold price of $911, you can safely buy Royal Gold up to $40.26 per share.

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