



Why Franco-Nevada Corporation Should Be the Only Gold Company in Your Portfolio

Description

When it comes to gold, I cede to the wisdom of the world's greatest investor, billionaire Warren Buffett. Here's what he has to say about the yellow metal.

Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.

Like Buffett, I'll freely admit that there are certain points in the economic cycle where investors should hold gold. From the end of 2008 to 2012, the price of gold more than doubled, eventually peaking at \$1,800 per oz. Other times, like during the tough economic times that immediately followed the burst of the dot-com bubble in 2001 to 2004, it's been advantageous to hold gold in your portfolio. In fact, over the past 15 years, investors have generally done pretty well when investing in bullion.

Yet when it comes to gold stocks, it's been a world of pain, at least lately. That's because most companies aren't really a play on the price of gold. Rather, they're leveraged plays on the price of the metal.

Here's how most gold companies work. They identify a piece of land with a whole bunch of gold underneath it, raise a bunch of money to build a mine, and spend the next five to 25 years mining it, depending on the size of the operation.

Because of all the capital invested in each project, management is looking for a huge margin of safety between the mine's cost and the price of gold. If it costs \$1,000 per ounce of gold to get it out of the ground, there's plenty of money to be made if it can be sold for \$1,500.

Unfortunately, a couple of things tend to happen. The price of gold won't cooperate, and management tends to get too bullish about the future. This leads to projects that are only sustainable at gold prices that are above today's level of \$1175/oz., eventually leading to billions in write-offs, wasted capital, and missed opportunity costs.

Essentially, you're taking two risks by investing in a traditional gold company — gold price and operational risk. A company can do everything right and still get hurt by the price of gold going down. Or it can overspend by millions to get a mine operational.

Investors would be smart to avoid these risks. There aren't many opportunities to avoid gold price risk (besides, most people investing in gold tend to be bullish on it), but there are a few opportunities to avoid operational risk. The best way to do it is by investing in **Franco-Nevada Corporation** ([TSX: FNV](#)) ([NYSE: FNV](#)), which doesn't actually operate any mines.

Here's how the company works. It swings deals with gold miners by providing capital in exchange for a cut of the profits. The other company takes all the operational risk, while Franco-Nevada collects a royalty on every ounce taken out of the ground.

It's been immensely successful. Check out this chart comparing it to **Barrick Gold**, **Kinross**, and **Goldcorp** over the past five years.

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That's some huge outperformance. And there's no reason why it shouldn't continue, either. The company just made a huge deal, acquiring the rights to buy gold for \$400 per oz. and silver for \$4 per oz. from the Candelaria Project in Chile, up until certain production levels. Based on current targets, the deal should deliver approximately \$50 million per year in pre-tax income. Plus, upside exists if the mine turns out to be more profitable than first thought.

That's the big kicker for Franco-Nevada. If the mine expands, the company has a free option on all that additional production. And even if the mine doesn't do that well, it still has a predictable income stream.

This stability makes Franco-Nevada the only gold miner you should own. Taking away the operational risk is a huge benefit. It's that simple.

CATEGORY

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