streetwise The Gold Report®
Featuring investment coverage of precious, base and rare earth metals

Steve Palmer: Rare Earth Opportunities

Source: Tim McLaughlin and Karen Roche of *The Gold Report* 04/09/2010

New technologies are pushing up the demand for rare earths. Steve Palmer, president and CEO of AlphaNorth Asset Management, says the rare earth space is currently his favorite place to invest in the resource sector. In this exclusive interview with The Gold Report, *Steve also talks about where he sees the markets headed in 2010, and shares how he tries to limit the downside when investing.*

The Gold Report: Your fund finished 2009 with gains of about 160%. What's the outlook for 2010?

Steve Palmer: It's unrealistic to expect a repeat of 2009 this year. However, we're seeing many attractive opportunities still and we're optimistic that 2010 will also be a strong performance year.

TGR: Can you talk about some of the attractive opportunities you're looking at?

SP: We buy a lot of private placements. We like to get in on situations that have minimal downside with lots of leverage to the upside. When we buy a private placement, we usually get a half or a full warrant, and if the company executes on the business plan we can have significant gains. We're still seeing lots of attractive private placements.

TGR: And you think that there are still some of those opportunities at this point?

SP: I'm trying to focus my new investments a little bit more away from the resource space. Our fund is relatively balanced between resources and other setors. The "other" would include technology, special situations and biotech, mostly. Given the strong returns that the resource sector has had in the last year versus some of the other sectors, I just prefer looking at the other sectors at this stage.

I'm not implying that we're not making any new investments in resource companies. I have just kind of skewed my interest level to the non-resource sectors at the moment.

TGR: Why have you chosen biotech as opposed to several other sectors? What's unique about this sector that you see upside potential?

SP: In the small cap space in Canada, outside of resources and technology, there are not many opportunities in the other sectors such as financial, telecom, real estate, etc. I prefer companies that have more return potential than a typical financial company would have. The high-return potential is usually in some of the technology names and biotech. The resources obviously have big potential, too. Of sectors in the middle, there are not that many names in those sectors, and they typically don't have the same return profile.

TGR: Are you restricting all your investments to Canadian-based small caps?

SP: Not all of them are Canadian-based. The majority are. There are enough companies in Canada to look at without having to look at other countries.

TGR: In your February commentary for your fund's investors, you said you thought it was unlikely that equities would be able to make any significant gains over the summer months. There was a bit of a pullback in late January/early-February. Do you expect that to happen again in the near term?

SP: It's quite possible that a pullback like that would happen sometime in the summer or late in the spring. Summer's generally not a good time for small caps. Some people use the saying, "sell in May and go away." It didn't apply last year, but it may this year.

TGR: If there was that sort of a pullback, do you think things would start to pick up again in the fall?

SP: If there was a pullback I would be a buyer.

TGR: Do you see it as a summer doldrums sort of thing?

SP: It could be a little worse than summer doldrums. The markets have been quite strong over the last 12 to 16 months, so it wouldn't be unusual to have a 10% or 15% setback.

We could go higher in terms of the TSX before there is a meaningful correction. It's at 12,100 right now. Last year it was up 35%. It's up 3% or 4% so far this year. It could go to 13,000. I only say 13,000 because I do some technical work and to me that would be a strong resistance level and right now we have a lot of positive momentum in the markets. We could see for the next couple of months the Canadian markets continue to go up, but I think they'd be hard pressed to go much farther than 13,000 this year.

TGR: So you're thinking it won't hold that 13,000 level if we get to that point?

SP: Correct. Because with the 35% return last year and another strong year this year, the odds are against it going higher than that in 2010.

TGR: Do you see any scenarios that it might move beyond that 13,000 level?

SP: Move beyond? I don't know. There are lots of things that unfold that we can't foresee. We have another nine months to go. Most of the news on the economic front has been fairly positive over the last few months. It's not always going to be positive.

TGR: We talked earlier about some of your moves to more biotech and technology companies. In your January 2010 fund review, you said your current bias was toward non-resource companies. Can you highlight for our readers the reasons that you felt it was necessary to rebalance the portfolio?

SP: The relative weighting of resources in the portfolio actually hasn't come down that much. In March, we had a couple of resource names that had very significant price appreciation, which is kind of making it difficult to reduce the resource weighting.

TGR: Is that a problem?

SP: Well, it's a good problem to have. We had Cline Mining Corp. (TSX:CMK) go from $.30 to $1.75 in the last two months. This contributed to the increase in our resource weighting. One I've mentioned before is Colossus Minerals Inc. (TSX:CSI), which has been very strong lately also. We have a sizeable position in both of those companies. Even though our new investments have been more in the non-resource side, our existing investments are more than making up for that. So the relative weighting hasn't really changed that much, which is fine.

TGR: When you're looking at resource companies, do you look at primarily at Canadian resource companies?

SP: Yes, primarily Canadian. The TSX is the primary exchange for resource companies in the world. The TSX Venture [index] for the juniors and the TSX composite as the broader index. When I do look at the resources, I have a bias to some of the more obscure areas like the rare earth space. That's probably my favorite place to invest in the resource sector at the moment.

TGR: That seems to be a hot topic for many people. What caused you to look at rare earths and where do you see the primary opportunities there?

SP: There's a very strong demand for rare earths in all the new technology, whether it's related to solar, wind, batteries and so on. China produces the majority of the rare earths. China recently put some restrictions on what they export. The rest of the world has to scramble now to ensure that they have supply because China will likely put further restrictions on exporting their rare earths in coming years. There's a huge demand for them and the price has gone up fairly substantially for many of these rare metals.

There are not that many companies that have rare earth assets. I see the opportunity for significant gains in that space. It's similar to uranium several years ago. There was an investment thesis being made about all the nuclear reactors being built and how much uranium demand there was going to be and there wasn't enough of it around. All these companies started up with uranium exploration projects and assets. Before they imploded in 2008, there were well over 100 juniors pursuing uranium assets.

If you look at the rare earth space, you have a similar thesis in terms of fundamentals, yet there's nowhere near that many companies with rare earth assets. I have only 17 companies on my watch list in the rare earth space.

There have been several uranium companies that have refocused and now they're rare earth companies.

TGR: In another interview we did recently, it was suggested that those who come to the market first with rare earths will quickly satisfy most of the demand. Consequently, the real key in investing in the sector is investing in one rare earth property and in one that can be brought into production quickly. Do you have the same observation?

SP: That's partly true, but the demand is growing fairly significantly. China produces more than 80% of the world's rare earths. If they shut that off to export, we would have to find a lot of rare earth production outside of China to make up for that.

TGR: Do you see that mostly coming from Canadian companies?

SP: Primarily Canadian companies. Not necessarily with a Canadian rare earth asset, but many of the junior rare earth companies are listed in Canada.

TGR: Do you have anybody in particular?

SP: My favorite one is Stans Energy Corp. (TSX.V:RUU). Their asset is in Kyrgyzstan. I like that one because they've acquired a property that has a proven resource of rare earths. It's worth $2 billion in the ground. It's the former mine that made up 80% of Russia's rare earth production. It's been shut down and under care and maintenance for many years. They've acquired it very cheaply and they're going to do some confirmatory work on the resource. They've also got an option to buy the old processing facility. So not only do they have a resource, they could have a processing facility and known metallurgy.

One of the biggest challenges in mining rare earths is separating all the various elements out or the metallurgy. This operation has proven metallurgy, which is a huge step. Most of the other juniors will have to figure this out and it's quite tricky.

It's quite often very different for each deposit. Each deposit has different mixes of these metals and it's quite a challenge to effectively separate them all.

TGR: Is Stans in production?

SP: No, they're not in production yet. They just acquired the asset in December, so not many people even know about it. They're just starting to do some IR now and get the story more widely known.

TGR: Do you have other rare earth companies that you're looking at?

SP: There's another very early-stage company that has a rare earth interest as well as interests in some other assets like molybdenum and a gold-copper exploration property. It's Bolero Resources Corp. (TSX.V:BRU).

There is also a private company called Spectrum Mining with a property in British Columbia. They had some very good drill results for rare earths. Bolero was quick to stake some ground around that property. In the next couple of weeks, they're going to be sending a team of geologists up there to do some initial work. Hopefully they'll be in a position to drill it later in the year.

I like that company because it's got a very low market cap of about $7 million. They have a very prospective rare earth play. They've got a very prospective copper-gold play that is also in B.C. alongside Imperial Metals Corp. (TSX:III), which has had very good results on their property. They have this molybdenum asset in Montana. It's 360 million pounds of moly. So it's got multiple chances of success, each of which could be a company maker.

TGR: Are you looking at primarily exploration companies or producers or a combination of both?

SP: I prefer the exploration companies. With producers you don't generally get as high a return potential and the commodity price becomes more of a significant factor. When you start introducing the macro factors, it makes it harder to predict. It's harder to predict where the commodity price is going to go month to month.

TGR: Is there anybody in the energy sector that you're watching at this point?

SP: There hasn't been a big focus on the energy sector. It's been more on the metals side. Although we do have a few investments in the energy sector. Quetzal Energy Ltd. (TSX.V:QEI) is one that I like. They're drilling a property in Colombia. They also have very small production in Guatemala. One of the properties in Colombia is surrounded by producing oil properties. It's very prospective ground.

Colombia has been a very hot area to invest in recently. There have been many big wins over the last year with companies with gold properties and oil properties in Colombia. So it's a very hot area. A lot of investors are looking for the next big winner in Colombia. I think this could be one of them.

TGR: You mentioned earlier buying warrants. Is purchasing warrants a big part of how you look at these companies?

SP: With the private placements, they are usually structured as a unit that you buy. It's a share and half-warrant or sometimes a full warrant. So I like to buy those because if it works, you have additional leverage to the upside. If it is a full warrant, it effectively doubles your leverage and thus your return if it works out.

TGR: In your November fund review you stated, "It remains unclear how much further the gold bubble will inflate before the gold bugs are silenced yet again." What's your feeling about gold and the precious metals in general at this time?

SP: I'm not as negative now on gold as I was when it made that parabolic move up to $1,200. I'm somewhat indifferent at this point. It'll have a hard time getting past $1,200 again in 2010. I don't necessarily think it's going to decline that much either from current levels. My previous comment was a result of the euphoric sentiment by almost everybody that gold was going materially higher. Anytime you get a situation where everyone is just in total agreement on something, it's usually time to go the other way. My technical indicators also pointed to a short-term top which proved correct, and we executed a very timely trade shorting gold. We have since covered with a nice profit.

TGR: We talked to somebody recently who was saying because of inflationary pressures and additional demand worldwide for gold that he could see scenarios where gold would approach possibly $1,375. Are you thinking that's beyond where gold might head this year?

SP: I don't see much in the way of inflationary pressures. The U.S. CPI was up 0.2% in both December and January. Core prices fell by 0.1% in January. The last time core prices fell was in 1982. I don't know where the inflation is. I've heard that argument for the last 10 years about inflation around the corner. That argument has been wrong for 10 years. At some point it will be right, but I don't see it being right in the near term.

TGR: Isn't the big hubbub around it now the fact that the U.S. specifically has done all the big bailouts and is trying to re-inflate the economy to an extent it has not done before? Do you see that causing the inflationary pressures?

SP: The bottom line is I don't see how you can have inflation if you have excess capacity everywhere, and you have people that have no capacity to spend. Inflation results when everybody tries to buy stuff and you can't make enough of it, so the prices are going up. That's not at all the situation right now in the U.S. The primary driver of gold prices is the correlation with the U.S. dollar.

TGR: Do you expect the dollar to decrease because of the fact that the U.S. is increasing their money supply?

SP: Yes. Over the long term, I expect the U.S. dollar to trend lower. However, a lot of countries are increasing their money supply also so the U.S. will have many periods of strength.

TGR: Steve, your approach to making money is looking at the small caps. These are the companies that have opportunities to increase in size. Can you give our readers your viewpoints on what you're looking for in a small cap? Is it specific properties? Is it management? Previous successes?

SP: Management is important. I'm looking for opportunities where I can invest where the downside is fairly limited and the upside is significant. I'm always trying to optimize the risk versus reward.

TGR: How do you limit that downside? Is it price per stock that limits the downside or something else?

SP: A couple of things. One of the biggest risks of investing in small cap companies is having the company run out of cash. That's a particular risk in the junior resources because they have to spend a lot of money on exploration, etc. Then they have to get back to the market for the next round of drilling or whatever. If it's a time when it's very difficult to raise money, it could be a lot of dilution that occurs for the company to move forward or they may not be able to raise money at all. That's why I buy a lot of private placements, because not only do I get the leverage of a warrant with the deal, but I'm also purchasing at a time when the company is raising money. This eliminates the risk in the short term of the company running out of money. Quite often, private placements are done at a discount to market price, which is another benefit. Another factor I use is technical analysis. This helps time my entry and exit points.

TGR: Thank you for your time.

Steve Palmer and Joey Javier, an investment team since 1998, took three key assets—their excellent track record, their experience and their belief that exploiting inefficiencies in the Canadian small-cap universe would produce superior long-term equity returns—to AlphaNorth Asset Management, launching the Toronto-based investment management firm in August 2007. AlphaNorth currently manages the AlphaNorth Partners Fund, a long biased small cap focused hedge fund and the AlphaNorth 2010 Flow-Through LP.

Steve, who is a Chartered Financial Analyst, earned his BA in Economics at the University of Western Ontario. After starting in the investment community as a research associate, he moved to a major financial institution in mid-1998, where he met Joey and built his career. As Vice President of Canadian Equities, he managed assets of approximately $350 million, including a pooled fund that focused on small-cap companies.

DISCLOSURE:
1) Tim McLaughlin of *The Gold Report* conducted this interview. He personally and/or his family own shares of the following companies mentioned in this interview: None
2) The following company mentioned in the interview is a sponsor of *The Energy Report* or *The Gold Report: Colossus Minerals.*
3) Steve Palmer: I personally and/or my family own shares of the following companies mentioned in this interview: None. Funds managed by Steve Palmer at AlphaNorth Asset Management own shares of all of the companies mentioned in this interview. I personally and/or my family are paid by the following companies: None.

PRINT THIS PAGE

SHARE

Related Articles:

An Interview with a Long Wave Master
ETF Trading Setups for Gold, Silver, Oil and Nat Gas
The Bong of Forced Risk