ES Baker Steel Gold & Precious Metals Fund

Investment Manager's Commentary: Q1 2022

bakersteel capital managers

Highlights:

- The precious metals sector made strong gains during the quarter, amid rising inflation and geopolitical risk.
- Large-cap miners outperformed during this early stage of the sector's recovery.
- The Fund is focused on those miners that can best manage rising energy costs and benefit from margin expansion.

Q1 Top performers:

- **Yamana Gold**
- **Barrick Gold**
- **Agnico-Eagle Mines**

Q1 Underperformers:

- **Polyus**
- **Polymetal International**
- **Fresnillo**

2022 has started with a spike in geopolitical tension and uncertainty for investors, following Russia's invasion of Ukraine.

Fund Performance

The ES Baker Steel Gold and Precious Metals Fund ("the Fund") rose +15.1% (B Class) during the quarter compared with the EMIX Global Mining Gold Index ("the Index") which rose +19.0%, while gold rose +9.1% (in GBP terms). Full details of Fund performance can be found here.

The precious metals sector generated strong returns during the quarter, continuing its recovery, against a backdrop of turbulent geopolitics following Russia's invasion of Ukraine, as well as a shifting macroeconomic environment as the US Fed began its interest rate hike cycle. It is our view that the recovery of gold and silver miners is in its early-stages and, as in previous recovery phases, large-cap miners have tended to outperform the mid-cap portion of the market during this period, a key cause of the Fund's lag relative to the Index during the quarter.

The outlook for inflation, interest rates and geopolitics remain core drivers for the precious metals sector. The impact of inflation is already being felt by businesses and individuals around the world, while hawkish rhetoric from the US Fed belies the reality that the scope for rate hikes is limited and the risks to the economy high. These factors, alongside signs that geopolitical tension will persist and perhaps rise further in the months ahead, signal that precious metals may be at the start of a significant and extended upcycle.

Market Update

News of Russia's invasion of Ukraine in late-February upended global markets, casting particular uncertainty over certain commodity markets, amid a fundamental shift in the geopolitical environment in a manner not seen for decades. The gold price returned briefly to its all-time high amid safe haven buying on the news. Gold miners have accordingly made gains since the Ukraine crisis began, demonstrating worthwhile diversification benefits for investors.

The second major theme for the gold sector in recent months has been the start of the US interest rate hike cycle, which began this month. The interplay between heightened inflation and rising interest rates remains an influential factor for the precious metals sector. Inflation has historically been positive for real assets and, as precious metals are the ultimate real financial asset, we believe gold and silver prices will rise significantly during the new era of inflation, once current headwinds abate. Current inflation is driven by supply side factors, as well as demand sided factors, such as supply chain issues, reshoring and demographic factors, which won't be solved by higher interest rates. Precious metals tend to have a close negative correlation with real interest rates (rather than nominal rates), and we are likely facing the shortest US rate hike cycle in history, as the risks posed by rising borrowing costs for heavily indebted economies that are used to low rates, are high.

With regard to gold and silver equities, the sector is largely in its healthiest shape for many years. With relatively strong gold prices in recent years and with capital discipline continuing to prevail, as management teams recall the errors of the last cycle, we identify a good selection of high-quality companies with robust balance sheets and strong margins. Dividends and buybacks have been rising in recent years among gold producers, a trend which appears set to continue. A further bullish market factor for miners is the potential for a rotation back into value by investors, away from the growth theme which has dominated in recent years.

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Performance Attribution

The Fund's portfolio remains concentrated relative to its Index and the investment strategy continues to be focused on identifying value in high quality precious metals miners. Key portfolio themes in recent months have included managing the risks from the Russia-Ukraine conflict, as well as managing the cost inflation underway in the industry at present.

With regard to the Russia-Ukraine conflict, our team had monitored the situation between Russia and Ukraine closely in the weeks leading up to the invasion. By the time the invasion began in late-February, Russian exposure had already been materially reduced, for both risk management, and has since been further divested. We have taken a firm-wide decision not to enter into any new positions or increase exposure to companies headquartered in Russia or with material Russian exposure until further notice.

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A key theme for gold producers at present is rising energy costs. We expect to see energy costs remaining heightened for some time, in line with our broader outlook for inflation to remain persistently higher than forecast. Far from being a surprise, Baker Steel's investment team have been assessing the impact of higher energy prices on precious metals miners for a year now and has incorporated its findings directly into investment decision making and portfolio construction. Given our outlook for energy prices, the Fund is focused on those companies which can best manage higher energy costs. Overall, recent results across the sector showed an increase in costs, with a selection of companies facing material problems, however many high-quality companies, such as Barrick Gold and Newcrest Mining, are proving encouragingly resilient.

Our team has assessed the impact of higher energy prices on miners and incorporated its findings directly into investment decision making.

Top performers during Q1 2022 included Yamana Gold, Barrick Gold and Agnico-Eagle Mines. Yamana Gold (4.6% NAV) gained +32.2% (USD) during the quarter. The company is developing into a leading mid-tier producer, with quality assets and a focus on shareholder returns. The future at the Canadian Malartic mine, including underground development, is promising, while Yamana's recent takeover of the Wasamac gold project offers growth. Significant value potential exists from the Mara copper/gold project in Argentina, with a feasibility study due this year. The project would see 85% of its gold produced using renewable energy.

Barrick Gold (3.9% NAV) gained +29.1% (USD) during the quarter. A high quality large-cap producer, Barrick is on an attractive dividend yield, with excellent exploration upside, and maintains a focus on margins and returns. While there are some expectations by the market regarding potential corporate actions, the company appears disciplined on acquisitions and is seeking high rates of return from large-scale Tier 1 assets.

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Agnico-Eagle Mines (4.5% NAV) gained +13.9% (CAD) during the quarter. Following the company's merger with Kirkland Lake, the company has a portfolio of high-quality Tier 1 assets. Agnico's relative valuation appears attractive and the company has recently increased its returns policy. The company's Detour Lake project is expanding, while Malartic underground presents a promising development asset.

Underperforming positions during Q1 2022 included Polyus, Polymetal International and Fresnillo. Polyus declined -95.6% (USD) during Q1 2022 and the Fund materially exited its position during the quarter. As a Russian-headquartered company, listed in

London, the position had been sold down prior to Russia's invasion of Ukraine, as risks rose. The remaining holding was sold once the news had come out, leaving the position de minimis in the portfolio.

Russian exposure had already been materially reduced, for both risk management and ESG reasons, and has since been further divested.

Polymetal International declined -76.6% (GBP) during Q1 2022 and the Fund has sold out of its position during the quarter. In a similar manner to Polyus, the Fund's position in Polymetal had been reduced prior to news of the invasion, before being sold in its entirety once the conflict began.

Fresnillo (3.0% NAV) declined -17.8% (GBP) during Q1 2022. The world's largest silver company, Fresnillo is trading at a significant discount with the highest yield amongst silver miners and a strong balance sheet. Fresnillo has been struggling recently with COVID-19, new labour reforms and a delay to a key permit. However, beyond these challenges there is significant long-term value and growth potential.

Outlook

We believe the risk-reward opportunity in selected gold mining equities is at an unprecedented positive level in terms of upside potential in the months and years ahead.

The outlook for precious metals equities appears more positive than for some time, amid signs of a revival of investor sentiment and supportive macroeconomic conditions. Our team has positioned the portfolio to benefit from the margin expansion underway in the precious metals sector, as gold and silver prices appreciate under the current inflationary environment. Through focusing on those producers which can control costs, including energy, we are also focusing on those which will protect their margins and have the best chance of increasing their dividends to return this margin to shareholders.

We believe the risk-reward opportunity in selected gold mining equities is at an unprecedentedly positive level in terms of upside potential in the months and years ahead. It appears the headwinds for the gold price may ease in the coming months, as the limited scope of the rate hike cycle and the persistence of consumer price inflation become clear. Furthermore, we expect to see safe haven demand for gold continuing, amid the current volatile geopolitical climate. We see a good chance that the sector will undergo a major upward move in the near future and, as in previous upcycles, an actively managed portfolio of high quality producers with strong cost controls is best positioned to deliver superior risk adjusted returns, relative to a passive holding in physical gold or gold equities.

David Baker, Mark Burridge & Trevor Steel

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