Primary Silver Producers Are the Best Hedge Against Volatility

Where to focus your due diligence when evaluating silver producers.

Ask any precious metals analyst to describe the silver market, and "volatile" is bound to be one of the first words off their lips. Extreme ups and downs in the silver price are nothing new to seasoned investors, but for those just wading into silver mining stocks it can be intimidating.

However, armed with the tools analysts use to determine which companies will weather the inevitable storms, investors can move forward with more confidence.

"You must be emotionally prepared for silver's higher volatility," points out longtime precious metals analyst Jeff Clark. "In fact, as an investor, this volatility can be your friend. Historically, silver has fallen more than gold in bear markets, but has risen more than gold in bull markets."

According to Clark's research, over the last peak and trough in the silver market cycle, the price of silver gained 448 percent between 2008 and 2011 compared to gold's 166-percent rise. Meanwhile, silver fell 71.8 percent between 2011 and 2016 compared to gold's drop of 44.6 percent.

The health of silver mining stocks is tied considerably to the ups and downs in the price of silver, and even more so for junior exploration companies. In a stalled market, the specialized precious metals investor has little interest in an exploration-stage company unless it has a stellar asset that might catch the eye of a major producer.

“Most of the interest of the precious metals investor will be directed at producers, and within that the less risky producers,” Chris Thompson, senior vice president of equity research — metals and mining at Raymond James told the Investing News Network.

But which producers?

Low-cost producers

“Silver is without a doubt the most volatile commodity within the precious metals complex,” notes Thompson. “For silver producers, this paints a very complicated and challenging production scenario in many respects — one that’s very sensitive to economics and metals prices. Even a $2 or $3 move in the silver price can make a huge impact for certain producers.”

Most analysts, Thompson included, will tell you that the silver producers most likely to survive these fluctuations are those with high-quality assets and the ability to maintain a profitable operating mine in a low-price environment.

Running a low-cost operation — where the total cost of production per unit is less than the unit price of the commodity — is the goal for any resource producer, but in a volatile market like silver, managing costs is crucial if a company wants to survive a downturn. Miners that can still generate cash flow in a weak market are less likely to dilute their stock by seeking additional financing. Profitable, low-cost producers give investors a more solid position as they ride out the lows in anticipation of the upswing.

“Industry-wide, silver-mining costs are one of the most critical fundamental data points for silver stock investors,” says Adam Hamilton, financial market researcher and founder of Zeal Intelligence. “As long as the miners can produce silver for well under prevailing silver prices, they remain fundamentally sound. Cost knowledge helps traders weather this sector’s fear-driven plunges without succumbing to selling low like the rest of the herd,” he added.

The most common metrics are the traditional total cash costs per ounce and the new all-in sustaining costs (AISC). Hamilton calls cash costs “the acid test of silver miner survivability” as they show the lowest silver price at which a mine can remain in operation. All-in sustaining costs — which include direct cash costs, as well as costs associated with maintaining and replenishing an operation — show the silver price levels required to maintain the current level of production.

Other figures that can help an investor identify a silver producer’s production efficiency and potential for future growth are quarterly and yearly revenue growth and net income growth, along with three-year growth forecasts. And of course, a strong balance sheet is important regardless of commodity, as it reveals whether or not a company has the cash to drive further growth and generate returns to investors.

“It’s important to look at a producer from many angles when evaluating investment potential,” emphasized Thompson, who is also an experienced geologist and mineral economist. In 2011, he was awarded the StarMine Top Analyst award for stockpicker in the metals and mining sector. “When I’m evaluating a company, I’m looking at the quality of the asset — the ounces in the ground, grade, mine life and exploration upside — as well as the operation margin, and let's face it, jurisdiction as well."

Disciplined management is key to controlling costs

The majority of seasoned resource investors would agree that the linchpin in all of this is a fiscally disciplined management team with a track record of production success. "I would say management is key. And I'm talking about management that has delivered prior success with a history of making money in the sector," said Thompson.

The largest and highest-grade silver resources don't amount to much if management can't effectively control costs and maintain profitable production. Skin in the game is also a good indicator that a management team is dedicated to the long-term growth in the company, so look at share structure and how many shares management holds.

Primary silver producers offer the best leverage to the silver price

The producers with the most leverage to the silver price are the primary silver producers; however, these are a rare breed. For many, silver may be their primary product, but they may also produce by-product credits for other commodities such as gold, zinc, lead, copper and molybdenum — and that has as much to do with economics as geology.

Yes, "most of the world's silver ore formed alongside base metals or gold," acknowledges Hamilton. But gold has more value, and base metals are generally more predominant in a deposit than silver, making it a "challenge for miners to derive the majority of their revenues from silver."

If your goal is to add silver stocks to your portfolio that will give you "leveraged exposure to silver-mining operating profits to silver's upside," said Hamilton, your best option may be a silver producer that generates more than 50 percent of its revenues from silver production, otherwise the "stock price won't be very responsive to silver itself."