P. ZIHLMANN INVESTMENT • MANAGEMENT AG

Why Junior Gold Mining Stocks

An explanation why Junior Gold and Silver Mining Stocks currently present an extraordinary interesting investment opportunity.

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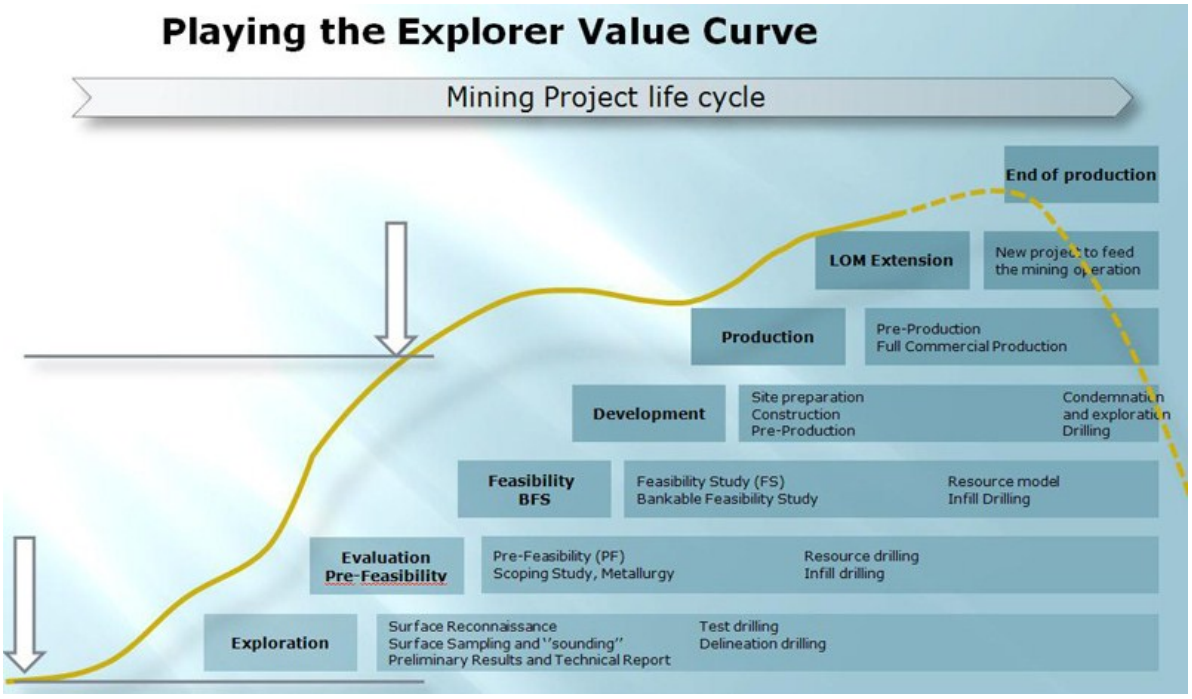
The Definition of „Junior Miners“

Mining companies are defined largely by the way in which they derive their revenues. A senior producer or operator generates its revenues from the production and sale of the commodity it is mining. We define a junior miner as a company which has an early stage or no mining operations and is exploring to expand its resources in precious metals. It must rely almost entirely on the capital markets to finance its exploration activities. The market capitalization of such companies is located in the area of USD 20 million to 2 billion.

Why „Junior Miners“

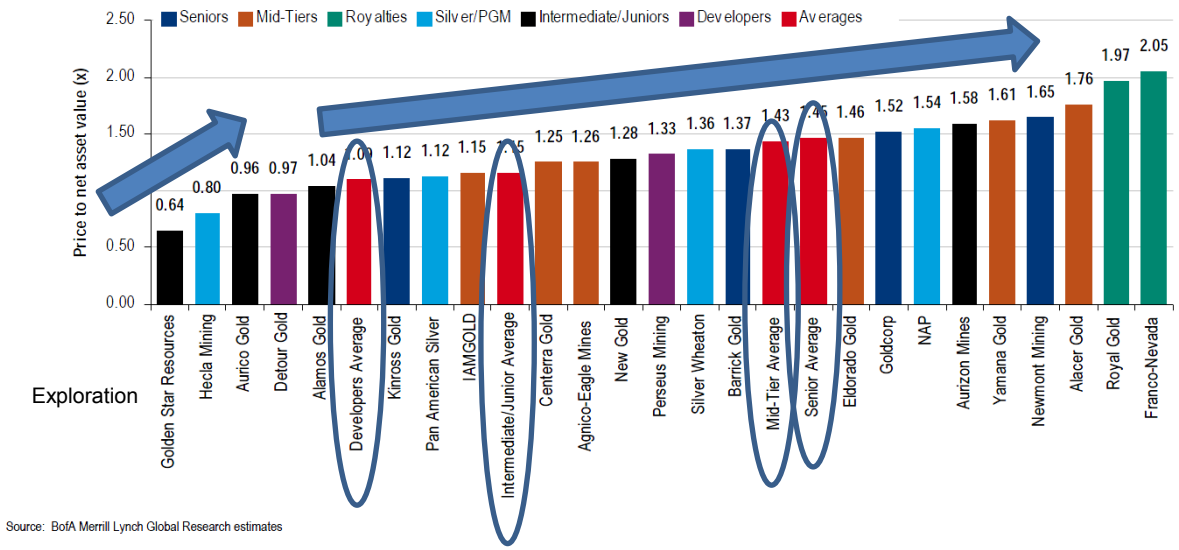
The valuation of a company makes different movements during its development phases. An analysis of the entire sector based on its historic stock prices concludes that the highest potential returns stands in the discovery of promising early stage exploration projects. It is in this area, where we position our fund. The graph below shows exemplarily how the stock price of a mining company develops over its life cycle:



Source: LKConsult

Valuations within the gold mining sector are based to an important part on the analysis of a company's existing resources in comparison with its market capitalization (Price to NAV). The NAV is calculated by discounting future cash flows out of the proceeds of existing resources.

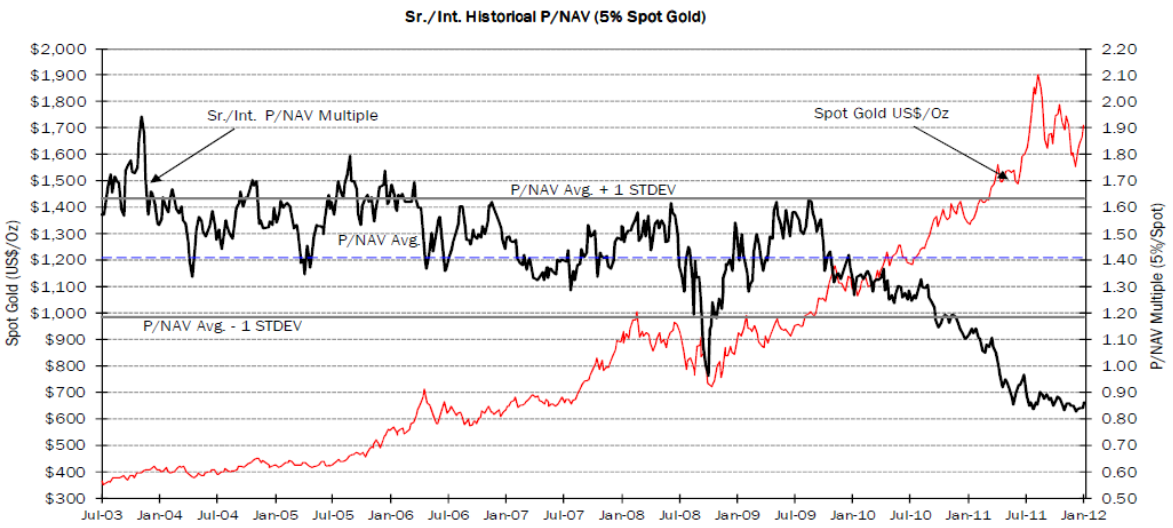
Within the gold mining sector there are massive differences in valuation. Companies which already feature considerable production are valued more dearly than such, which are not producing any precious metals yet. Simply put this means that the gold in the ground of a large producing company is worth more than the "potential" gold of an exploration company. Consequently a company, which progresses on its life cycle from exploration to production (ceteris paribus), will be priced higher. The following chart shows this difference in valuation based on a selection of stocks and their respective sector average:



Why now?

Since the finical crisis of 2008 gold and silver mining equity could not keep up with the development of the precious metals prices.

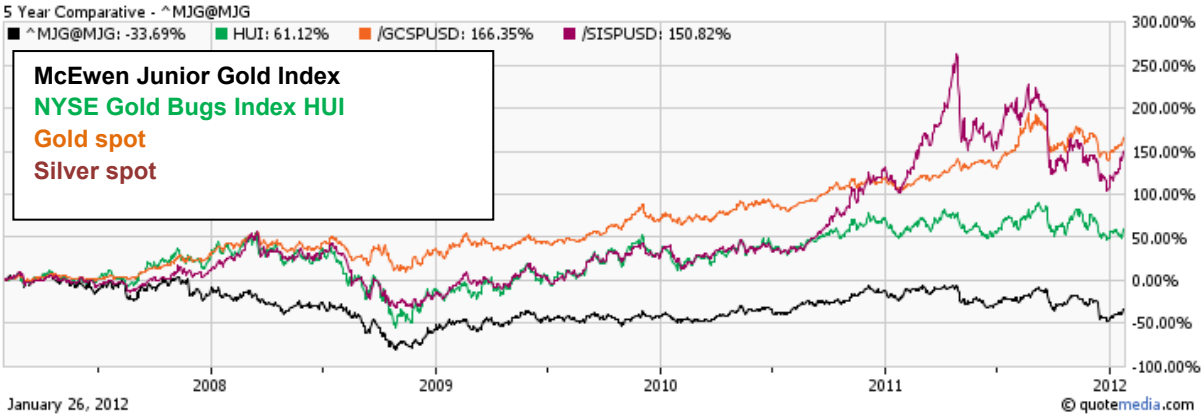
Not only has the goldprice fared distinctively better than gold mining stocks. More importantly, the valuation of these companies has reached a historic low-point. The comparison of the market capitalization of a company to its resource base results in an extraordinary undervaluation. The chart below shows this ratio of price to NAV over the past ten years:



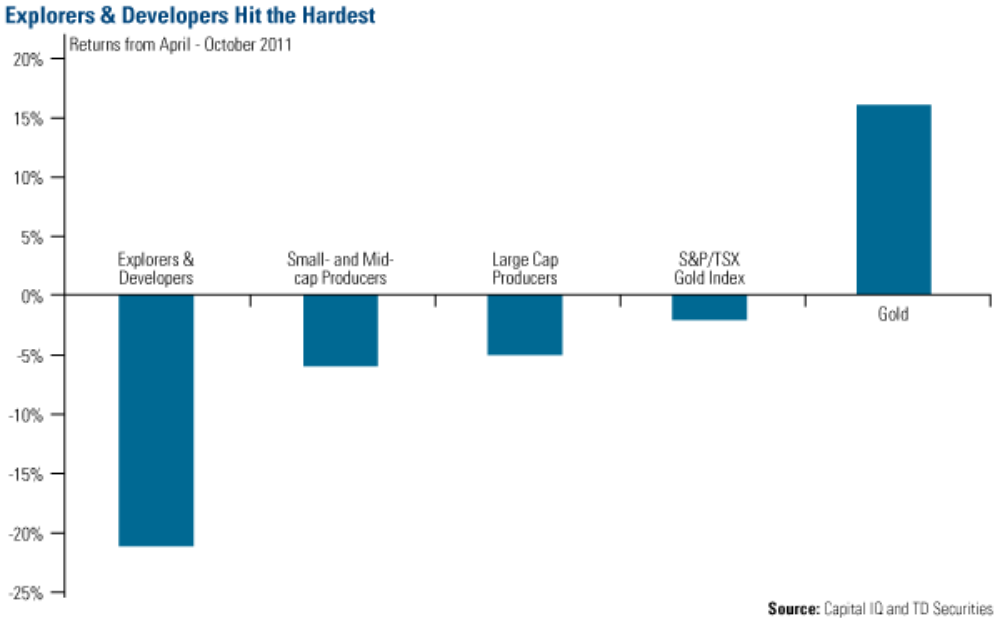
Source: Thomson ONE, Canaccord Genuity estimates

In fact, you can see from the chart that the current price-to-NAV level is sitting on record low levels.

Over the past four years the junior miners have suffered especially hard. The chart below shows the massive accumulated underperformance of the junior sector (McEwen Junior Gold Index) versus gold and silver, but as well against the senior gold miners (NYSE Gold Bugs Index).



After suffering badly from the 2008 financial crises the junior miners could only partially recover in the last three years. The following chart shows the performance differences from April to October of last year. Again the juniors (i.e. explores and developers) suffered most, mainly due to the “small cap” effect and the high risk aversion of investors worldwide. This has now led to an explicit undervaluation.



Because of the dramatic price decline in these early-stage companies, investors have the opportunity to purchase explorers and developers, often referred to as juniors, at **about half of the company's net asset value (NAV)**.

Toronto Dominion Bank (TD) found that in seven of the past 10 rallies, senior gold equities beat gold - averaging a beta of 1.4 times. Looking over the next year or so, we believe the smaller gold miners are especially poised to outperform this time. As TD says, "on a rebound, we expect the best performing equities to be among the ranks of the explorers and developers."

Investment Strategies for the Junior Mining Sector

The stock selection in the junior mining sector is essential for the success of your investment. Operational risk in these micro-cap companies are large and need to be analyzed carefully. Our company selection process contains summarized the following aspects:

1. Exploration Success Plays

- Already getting value – just need to add resource ounces
- Ounces get above a certain threshold (i.e. for economic viability, or to attract interest of established producers, etc.)

2. Re-Rating 1 –Project Advancement / Economic Viability Play

- Shares re-rated as project successfully advances towards development (exploration, feasibility, construction phases)
- Positive economic study results – prefeasibility, full/bankable feasibility
- Receipt of permits (incl. environmental), financing

3. Re-Rating 2 – Tier/Factor/Project Changes as Catalyst Play

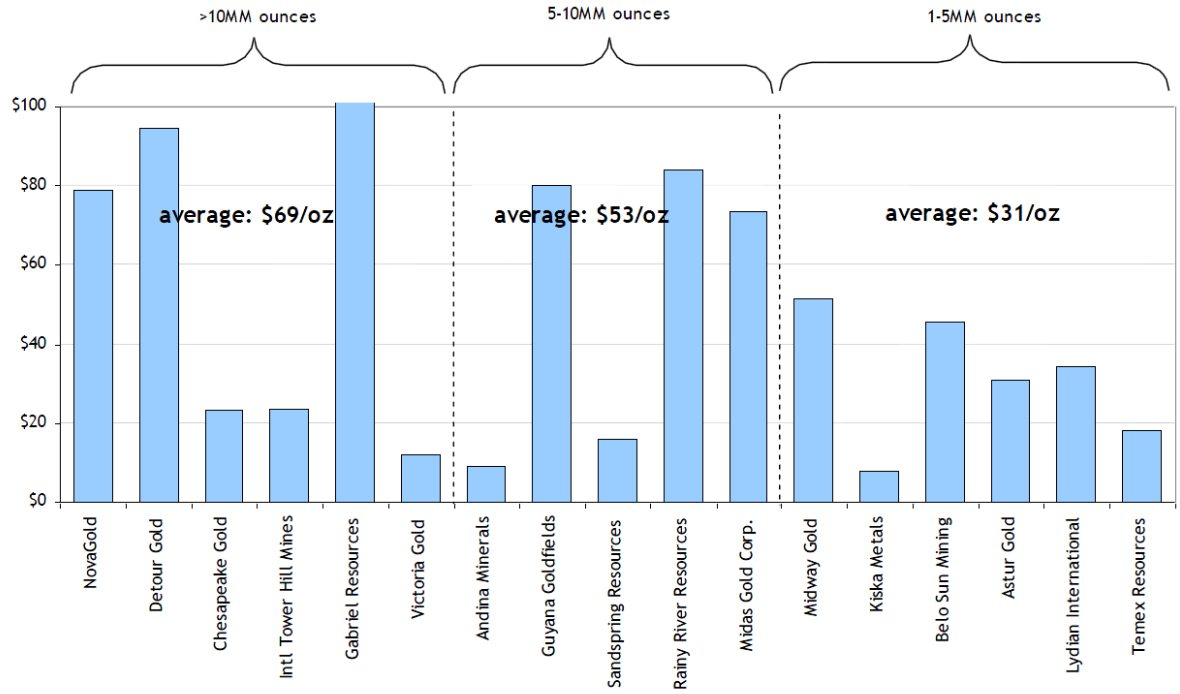
- Deposit Size Increased to Next Tier (+2MMoz, +5MMoz, +10MMoz)
- Announcement/Potential for discovery of higher grade zone mineralization
- Improved Geopolitical Risk for Country - change in Gov., laws, etc.)

4. Takeover Plays

- Synergies with other operations/projects

All these aspects are amalgamated into our analysis. We put a lot of emphasis on the future growth of a company's resources. The valuation of the gold resources of a mine increases significantly (measured in USD/ounce) as soon as they increase over five million ounces. The following graph shows this escalation of valuation from size of resource tier groups:

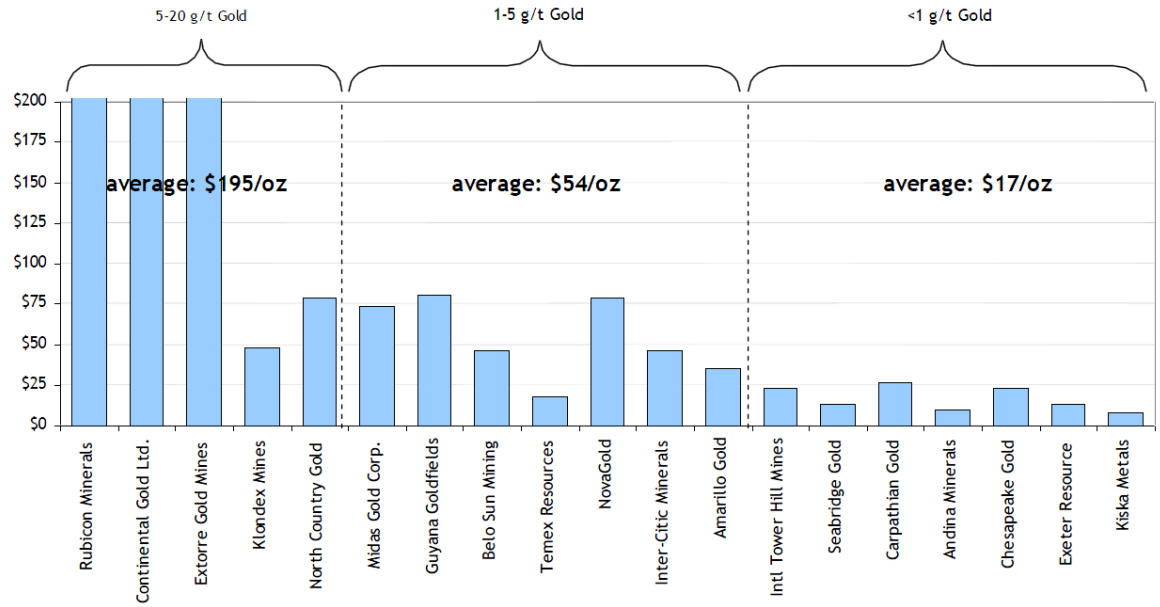
Exhibit 7: Junior Gold Explorers AMC/oz (US$/oz): Factor 1 - Size of Resource



Source: Company reports, RBC Capital Markets

A second crucial factor is the grade of the resource. Resources with higher gold grade mineralization per tonne are valued higher than lower grades. The following graph shows this very nicely. One needs to note that new mining project with gold grades over 2 g / tonne have become rare. We therefore carefully analyze the potential of a project in regards to the quality of its recourses and try to understand its geology.

Exhibit 8: Junior Gold Explorers AMC/oz (US$/oz): Factor 2 - Grade of Resource



Source: Company reports, RBC Capital Markets

The Gold Price

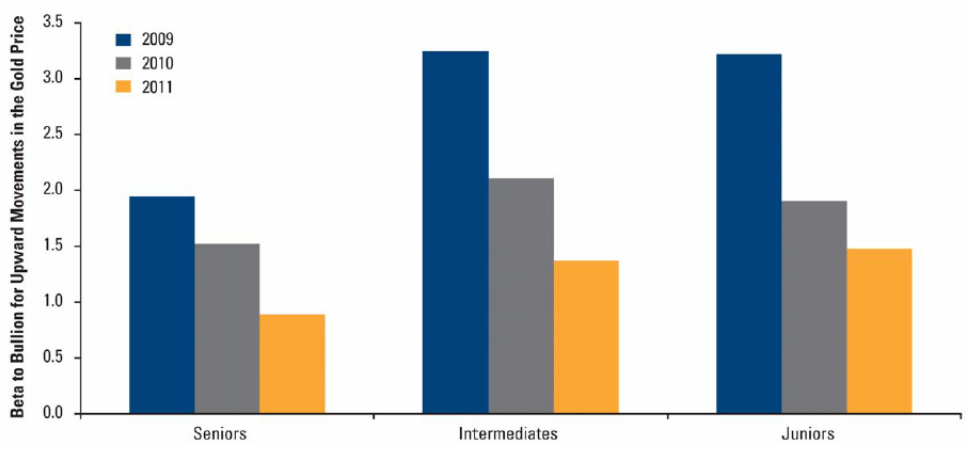
The gold and silver prices, which are used for discounting the resources for the calculation of the NAV have a significant influence on the outcome. The historic as well as the actual valuations of these resources are done with conservative estimates of the gold price, which often are based on a 12-months historic average.

We expect higher gold and silver prices going forward. The reasoning behind rising prices is summarized as follows:

- ✓ Flight to safety by individual investors due to excessive printing of paper money
- ✓ Global imbalances: US and European debt burden and huge US trade deficit
- ✓ Global foreign currency reserves are “excessive” – gold reserves low:
  - ➢ as a consequence central banks have become net buyers of gold
- ✓ Mine supply is flat and cannot satisfy increasing demand
- ✓ Investment demand and jewellery demand are growing strongly, especially in India and China
- ✓ Debt crisis is rapidly worsening. No solution in sight to European sovereign debt crisis

The mining stocks benefit twice from rising gold and silver prices. On the hand the valuation of their resources increases and on the other hand the amount of resources can be expanded. How come? Through higher gold prices mining projects with low grades are now becoming economically feasible. Meaning that a company can as a result increase its resource estimates just through reducing its cut-off grades applied.

This is reflected exemplary in the beta of the mining stocks to gold. In rising markets gold mining stocks go up about twice as much as the gold price.



Source: Bloomberg and CIBC World Markets

Interesting to note in this chart is that the beta – and therefore the price potential – of juniors is significantly higher than that of the senior miners.

Conclusion

The gold mining sector offers exceptionally high profit potential. Due to a historically unique low valuation the risks for lower equity prices are substantially lower than the potential profits.

Within the gold and silver mining sector the juniors offer by far the largest potential. These exploration and developing companies are located on an attractive appreciation curve.

The selection of stocks should be based on several aspects (see above mentioned points). The operational risks of these junior companies remain high and can change dynamically over time. We therefore recommend investing in this sector through a diversified portfolio. For new investors buying a mutual fund represents the most reasonable solution.

Our Products:

The Timeless Precious Metal Fund

THE TIMELESS PRECIOUS METAL FUND invests in listed mining companies of medium or small market capitalization, which have to fulfill the following criteria:

- Companies that are in production on the one hand, and have a high potential of adding new reserves and resources.
- Companies that are set to go into production and that have, at the same time, considerable exploration prospects.
- Companies that concentrate on the exploration for precious metals in commodity rich regions that already have a substantial resource.
- In addition we consider the experience and integrity of the mining company's management as another important investment criterion.
- Emphasis on operations in mining friendly countries and jurisdictions.

Sierra Madre Gold and Silver Venture Capital Fund

The SIERRA MADRE GOLD AND SILVER VENTURE CAPITAL FUND invests in listed precious metal venture capital mining companies with a focus on Mexico and other Latin American countries which have to fulfill the following criteria:

- Companies that are in production on the one hand, and have a high potential of substituting exhausted resource bases, and at the same time, of adding new reserves.
- Companies that are set to go into production and that have, at the same time, considerable exploration prospects.
- Companies that concentrate on the exploration for precious metals in commodity rich regions that already have a substantial resource.
- In addition we consider the experience and integrity of the mining company's management as another important investment criterion.
- Geographic focus is on Latin America but 10% of assets may be invested in other countries.