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HALLGARTEN & COMPANY

Portfolio Strategy

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MV Rare Earth/Strategic Metals (REMX)
Strategy: Neutral

REMX - Key Metrics	
Price (USD)	$ 23.52
12-Month Target Price (USD)	N/A
Upside to Target	N/A
High-low (12 mth)	$19.25- $27.19
AUM (USD)	$282.6mn
Shares Outstanding (millions)	12.015

MV Rare Earth/Strategic Metals

Sheep in Wolves' Clothing

- + The surge in the super-sexy Rare Earth stocks has made Strategic Metals a craved space in which to be invested
- + This renewed interest has enabled companies in the subspace to crawl out of the bunkers and start to raise money and dust off projects
- + The sabre-rattling (metaphorically and literally) of China has made the scales fall from the eyes of those that blithely felt that cheap strategic metals were here to stay. This has set off alarm bells that have reactivated the West before things were "too late"
- ✘ The ETF that has cast its bread onto the water has been far from rigorous in its search for Strategic Metals representation
- ✘ Various Non-Strategic and Non-Critical Metals are strongly represented in the ETF
- ✘ The ETF holds the three most super-charged names in the Rare Earth space
- ✘ Many of the metals with the most dangerous degree of China-dominance are not represented (in two metals they are represented by a Chinese company!)
- ✘ There is a strong presence of industrial intermediaries that are often first-order losers, rather than winners, in a scenario where the prices of strategic raw materials rise.

All Things to All Investors…

Bull markets produce all sorts of weird and wonderful spin-offs. The last ten years have been the heyday of the ETF as the instrument *du jour*. It was probably inevitable that the interest in Rare Earths should spur an ETF of the stocks in the space however the creature that has been born to meet this perceived demand is not a thoroughbred by any means. Despite that it has shot out of the starting gates with a strong tailwind and achieved a very healthy value move and an even more exponential AUM move.

The MV Rare Earth/Strategic Metals ETF (REMX) is a strange beast indeed and reminds us of the old adage of a "camel being a horse designed by a committee". It comes distantly upon the heels of the physical REE ETF, Dacha (DSM.v) that was launched early in 2010. We can only wonder what the design process of REMX was. Maybe it started out to harvest the enthusiasm for REE and then had Strategic Metals tossed into the mix to hedge the bets on the possibility that the superheated REE space might have a moment of pause. Or maybe it started out as Strategic Metals, a most worthy theme that we have long championed, and was hijacked by the REE boom and restyled. We may never know.

More to Strategic Metals than REE

There is good reason why the Rare Earths were not the words on everyone's lips for so many decades. They were far from being daily occurrences in the everyday consumers' lives and the closest that consumers came to them was with the rise of cellphones, which contain an infinitesimal amount of

REEs. The fact that they would not have had the colour television boom since the 1970s without Europium was scarcely known or acknowledged.

The other Strategic Metals were much more up close and personal for the Man in the Street. Everyone had heard of Titanium (hip replacements, razors), Tungsten registered with anyone who knew about tools and knives (or lightbulbs), Antimony had been used as mascara since the days of Nefertiti.

Defining Strategic

It would be useful to define what we think is truly "strategic" these days rather than using old encyclopedia definitions of the metals that might fall into the group. Our definition could be summed up in two statements. Metals today are "strategic" if:

- China has a grip on the metal and might either withhold for industrial policy or macropolitical reasons
- The West, or a country friendly thereto, has a strong or dominant position in a metal that is in relative short supply

Thus Tungsten is relatively abundant but China still dominates the supply because the West has abdicated control to China. This is repeated in various other metals.

Cobalt on the other hand is a metal the Chinese desperately need but which is not easy to increase production overnight though deposits are known. It is a metal with a large market, but large may not be good enough if the demand is larger. However, it might swing to oversupply also should projects like the Duluth complex come to fruition.

The EU on "Critical Metals"

In a 2009 report (THE RAW MATERIALS INITIATIVE — MEETING OUR CRITICAL NEEDS FOR GROWTH AND JOBS IN EUROPE) a committee of the European Union, on the subject of access to strategic or critical metals, made the following comment:

> "The need for Europe to focus particularly on the critical role of high tech metals is confirmed by the French geological survey BRGM. The work of the French geological survey focuses on the higher degree of criticality of high tech metals based on three criticality criteria:
>
> - possibility (or not) of substitution,
> - essential role,
> - and potential supply risks.
>
> In their analysis they identify short to medium risks to their supply of a number of materials:
> antimony, chromite, cobalt, germanium, gallium, indium, lithium, magnesium, molybdenum, platinum, palladium, rhodium, rare earths, rhenium, titanium, and tungsten.

> This list might be expanded to take in five more materials (chromite, manganese, niobium, tantalum and vanadium) …… for which there is a high degree of concentration of producing countries".

This report published an interesting table showing specialty metals and the degree of concentration in supply and the source of that supply. This data was collected largely from the USGS reports of 2008, but pertained to a snapshot of the state of affairs in 2006. The table is shown below.

Metal	First	%	Second	%	Third	%	Cumulative %
Rare Earth concentrates	China	95%	USA	2%	India	2%	99%
Niobium-Columbium	Brazil	90%	Canada	9%	Australia	1%	100%
Antimony	China	87%	Bolivia	3%	Sth Africa	3%	93%
Tungsten	China	84%	Canada	4%	EU	4%	92%
Gallium	China	83%	Japan	17%			100%
Germanium	China	79%	USA	14%	Russia	7%	100%
Rhodium	Sth Africa	79%	Russia	11%	USA	6%	96%
Indium	China	60%	Korea	9%	Japan	9%	78%
Tantalum	Australia	60%	Brazil	18%	Mozambique	5%	83%
Tellurium	Peru	52%	Japan	31%	Canada	17%	100%
Selenium	Japan	48%	Canada	20%	EU	19%	87%
Vanadium	Sth Africa	45%	China	38%			95%
Titanium	Australia	42%	Sth Africa	18%	Canada	12%	72%
Rhenium	Chile	42%	USA	17%	Kazakhstan	17%	76%
Chromium	Sth Africa	41%	Kazahkstan	27%	India	8%	76%
Bismuth	China	41%	Mexico	21%	Peru	18%	80%
Cobalt	DRC	36%	Australia	11%	Canada	11%	58%
Molybdenum	USA	34%	China	23%	Chile	22%	79%
Cadmium	China	22%	Korea	16%	Japan	11%	49%

From this we would note that a few things have changed over four years and some things have remained the same. Points to note:

- That graphite is omitted, and this is a critical product in more recent commentaries by industrial interests (for example there is 10 times as much graphite in a lithium ion battery than there is lithium). Moreover the main Canadian mine source of the product is nearing the end of its mine-life.
- Zirconium is not on the list but that is strongly present in the US (Wyoming) meanwhile Alkane, the Australian miner, is likely to be enabled in its Zr production by having an interesting REE component in its Dubbo property that will be the tail that wags the dog. As a spin-off of Titanium mining, its fate is intimately tied to mining activity in Titanium.
- The Canadian share of 4% in Tungsten has largely gone away due to the closure of North American Tungsten's facility
- We would beg to disagree that Moly is a strategic metal. It is important but not in any sort of short supply, and there are significant identified deposits and idled capacity (e.g. Freeport's Climax mine) that could be brought into production on any lasting price surge

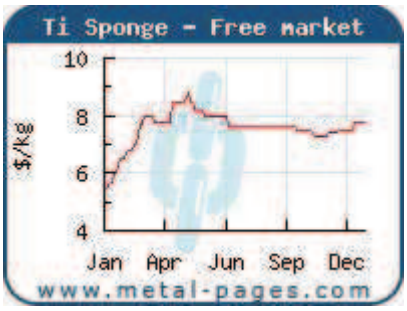
- The US share of Moly production has probably gone down steeply since 2006 with Canada rising in percentage terms.
- Titanium may have high-tech applications but it is present massively in beach sands as well as other mineralization all over the world (including sizably in Wyoming)
- Cobalt is a product which the Chinese need and which is likely to see a strong upsurge in future production from the Duluth complex in the US (Polymet & Duluth Minerals), Ambartovy (owned by Sherritt) in Madagascar, various base metals projects in British Columbia, as well as Geovic in Cameroon
- That while China holds a strong position in REE, Tungsten, Gallium, Indium, Germanium and Antimony, in some other Strategic Metals it is in a weak position. Recent stunts like the cutting off of REE supply to Japan could backfire if it was tried against other countries that have metals that China wants.
- Outside of this core group where China has a (seeming) stranglehold the China percentage is only meaningful in Bismuth and Cadmium and by no means dominant
- In a metal like Indium, China's dominance could be cut back dramatically by just one or two mines debuting. A good example is the Malku Khota Ag-In property of South American Silver (SAC.v) in Bolivia that could provide 25% of global supply at a single stroke
- Likewise, Antimony and Tungsten are both metals where there are stirrings in the West. We recently saw three Tungsten (W) companies through New York in the space of two weeks (Geodex, Playfair and Woulfe). Woulfe should be in production very soon reviving Korea as player in the W space. That company is an interesting amalgam of a Korean property in a Canadian listed company run by Australianised South Africans. In Antimony, we know of several properties that are easily revivable and capable of stealing a lot of China's Nth American and European market share.
- Vanadium is a product where China comes in a strong second to Sth Africa but where Australian production is likely to rise strongly over coming years (the Windimurra deposit and Reed Resource's holdings) as well as Energizer Resources in Madagascar.
- There are a number of up and coming Tantalum prospects, including those of Commerce Resources in Canada.
- Chromium is another product that the Chinese are anxious to have and where their current product is largely irrelevant. There are quite a few chromium deposits (including the famous past producer, Albania) hat could be brought back into production.

We could go on…. There is so much dynamic to the metals in this group that except for Rare Earths, where it is clear that China has a stranglehold (for now), the bulk of the others are subject to fluctuating levels of dominance and concentration.

The constituents of the REMX

Hmmm.. what to say here? Maybe we have unreal expectations that an ETF should be something more than just a pooled investment in a sector with a heavy human overlay. We hope for science and instead get art.

Not surprisingly, in light of its name the ETF is heavy with Rare Earth names, though by our calculation the Rare Earth stocks make up less than 40% of the total.



Titanium (Ti): There is the puzzling overweight in Titanium. While most associate Ti with high-tech space applications and medical devices, a significant portion of Ti production goes into plain old paint. While this metal may be put to strategic uses we suspect that the reasons that investors may be jumping onto the Strategic Metals bandwagon (perceptions of shortages, export boycotts, soaring high tech demand, China dominance) are far from the motors driving Titanium and its producers. There is no shortage of Titanium and nor is their likely to be. Moreover, the Chinese have little relevance to the Ti story and the products that drive Ti demand. Ti demand took a dip with the housing market in 2007/8 due to subdued paint consumption that is not exactly the type of dynamic that those seeking "swinging metals" are looking for.

The chart at the right from Metal Pages shows that the price has been going sideways for the last nine months. In short, Titanium is one of the least exciting Strategic Metals.

REMX - Fund Holdings as of 12/31/2010

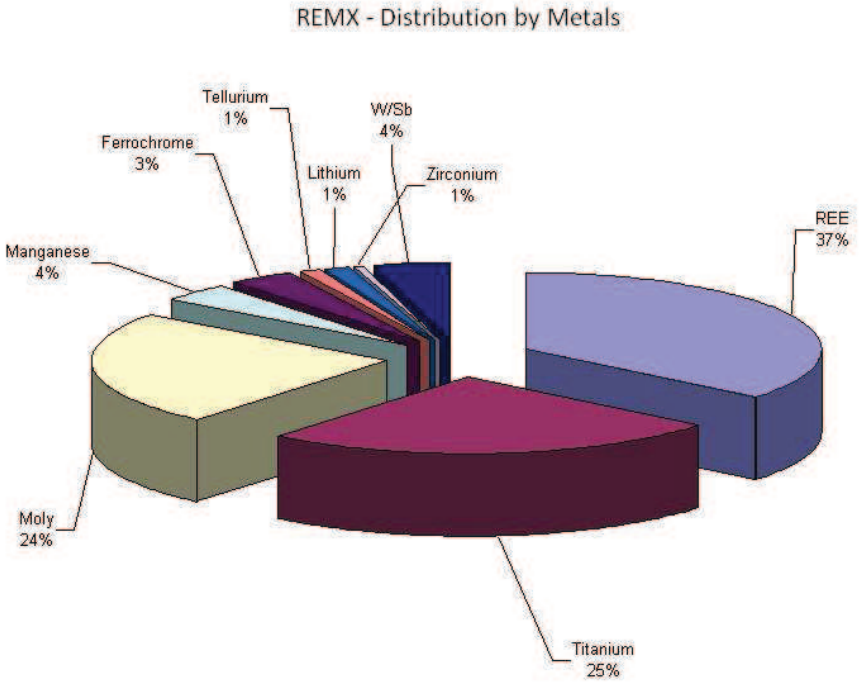
Rank	Holding	Metal	Ticker	Shares	Market Value	% of net assets
1	Lynas Corp Ltd	REE	LYC AU	11,128,219	$23,484,046.09	9.92%
2	Iluka Resources Ltd	Titanium	ILU AU	2,037,664	$19,078,048.56	8.06%
3	Thompson Creek Metals Co Inc	Molybdenum	TCM CN	1,073,536	$15,773,789.16	6.66%
4	Molycorp Inc	REE	MCP US	292,821	$14,611,767.90	6.17%
5	Kenmare Resources PLC	Molybdenum	KMR LN	26,043,239	$13,398,173.12	5.66%
6	China Molybdenum Co Ltd	Molybdenum	3993 HK	14,000,000	$12,864,464.96	5.43%
7	Titanium Metals Corp	Titanium	TIE US	746,454	$12,824,079.72	5.42%
8	Neo Material Technologies Inc	REE	NEM CN	1,316,877	$10,390,294.05	4.39%
9	OSAKA Titanium Technologies Co	Titanium	5726 JP	215,300	$10,132,002.97	4.28%
10	Hunan Non-Ferrous Metals - H	Tungsten/Antimony	2626 HK	22,428,000	$9,602,140.68	4.06%
11	Cia Minera Autlan SAB de CV	Manganese	AUTLANB MM	3,805,250	$9,344,983.18	3.95%
12	RTI International Metals Inc	Titanium	RTI US	334,873	$9,034,873.54	3.82%
13	Avalon Rare Metals Inc	REE	AVL CN	1,423,921	$8,899,058.43	3.76%
14	Toho Titanium Co Ltd	Titanium	5727 JP	356,600	$8,588,066.47	3.63%
15	NORTH MINING SHARES CO LTD	Molybdenum	433 HK	189,420,000	$8,528,133.75	3.60%
16	Rare Element Resources Ltd	REE	REE US	522,688	$8,394,369.28	3.55%
17	China Rare Earth Holdings Ltd	REE	769 HK	17,178,000	$8,014,622.61	3.38%
18	Arafura Resources Ltd.	REE	ARU AU	4,141,070	$6,291,517.69	2.66%
19	General Moly Inc	Molybdenum	GMO US	967,288	$6,268,026.24	2.65%
20	Ferbasa-Ferro Ligas da Bahia	Ferro-chrome	FESA4 BZ	651,400	$5,285,550.38	2.23%
21	Quest Rare Minerals Ltd	REE	QRM CN	822,629	$4,578,210.00	1.93%
22	5N Plus Inc	Tellurium	VNP CN	426,756	$3,006,382.53	1.27%
23	International Ferro Metals Ltd	Ferro-chrome	IFL LN	6,403,743	$2,924,982.75	1.24%
24	Galaxy Resources Ltd	Lithium	GXY AU	1,879,306	$2,798,015.37	1.18%
25	Daiichi Kigenso Kagaku-Kogyo	Zirconium	4082 JP	45,100	$1,815,094.45	0.77%
26	Net Other Assets / Cash			0	$850,906.43	0.36%
	Total				$236,781,600.31	

Molybdenum (Mo): Moly is no-one's idea of a Strategic Metal. It is so common that it is would be better described as a Lesser Base Metal than a Strategic Metal. While it is used strongly in the building of petrochemical plants and oil pipelines because of its sulphur resistant qualities, it is not a Strategic

Metal. The vast bulk of its application is in steel alloys, ranging from the mundane to the high-tech, with a bias towards the mundane. It is not in short supply, and it would be stretching it to claim that it is.

Chrome (Cr): Ferrochrome features in two of the stocks and safe to say Chrome is also more of a Lesser Base Metal than a Strategic Metal. It again does not suffer from any shortage, and supply is not dominated by China either.

Manganese (Mn): This metal figures here in one instance (Autlan, a Mexican Bolsa stock we have spoken favorably upon in the past). Manganese, sad to say, is not a strategic metal, it's a bulk commodity that if memory serves us right is the sixth largest traded metal by tonnage. Its not expensive, its not scarce and it has no high-tech applications of any special note.



This is leaving us with a dwindling pool to justify the word" strategic". Tellurium is certainly in the category but for those who think this is a mining ETF they may be disappointed to find that at least 20% of these companies have no mining or ever intend to (Neomaterials, Daiichi Kigenso, and most of the Titanium stories listed in the fund are industrials not miners). Likewise the Tellurium play, 5N Plus, is a processor with no mining interests. If Tellurium suddenly goes into short supply (a quite likely event in the next five years) then 5N Plus would be a victim of such a shortage not a winner. So much for the ETF being an insurance policy.

Lithium (Li): Our old warhorse, is represented by Galaxy, a stock that we like. Not our favorite in the spodumene mining space but still very well managed and well-positioned. Lithium is actually gearing up for potential oversupply in the next decade rather than shortage. There is a proliferation of new projects

coming down the pike. Many of these we suspect will go nowhere but their mere existence will loom as a counter-balance to a price spike and certainly does not make the metal "strategic" as there are lithium deposits widely scattered across the planet with a particular concentration in North America, friendly states in Latin America and in Australia.

Zirconium (Zr): We might dwell longer upon Zirconium despite its thin presence in the REMX. Zirconium is represented by a processor not a miner, and is found primarily in Australia, Brazil, India, Russia, South Africa, and the United States, as well as in smaller deposits around the world. Over 80% of zircon mining occurs in Australia and South Africa. With known Zircon resources exceeding 60 million metric tons worldwide and annual worldwide zirconium production is approximately 900,000 metric tons there is certainly no shortage looming. We would concede though that its applications are almost exclusively high-tech. It is used in alloys for high temperature situations (with the REE Yttrium). Zircon is joined at the hip (a the risk of using a bad pun) with Titanium as it is frequently a by-product of the mining and processing of the titanium minerals, ilmenite and rutile (as well as tin mining).

Antimony (Sb): This metal gets the heart racing in our circles with Chinese domination said to be north of 90% these days. However, we strongly suspect that Western production is on the verge of a resurgence, with Australia and Canada, for starters, having various past producing Antimony mines to crank back into action. If this happens then the Chinese play that figures here(Hunan) will be a loser of market share rather than continuing to have Western industrial consumers over a barrel.

So where is the **Tantalum** here (Commerce Resources could be conjured with)? Where is the **Vanadium** (quite a number of TSX and ASX plays)? Where is the **Germanium** and **Gallium** exposure? Where is the **Antimony** producer (Mandalay)? Where is the **Tungsten** producer (Malaga) or wannabe (Woulfe Mining) or the revivable North American Tungsten? Where is the Graphite (Emerys)?

To paraphrase the Bard, speaking through Marc Antony, a Strategic Metals line up "should be made of sterner stuff…."

Risks

The prime concerns would be:

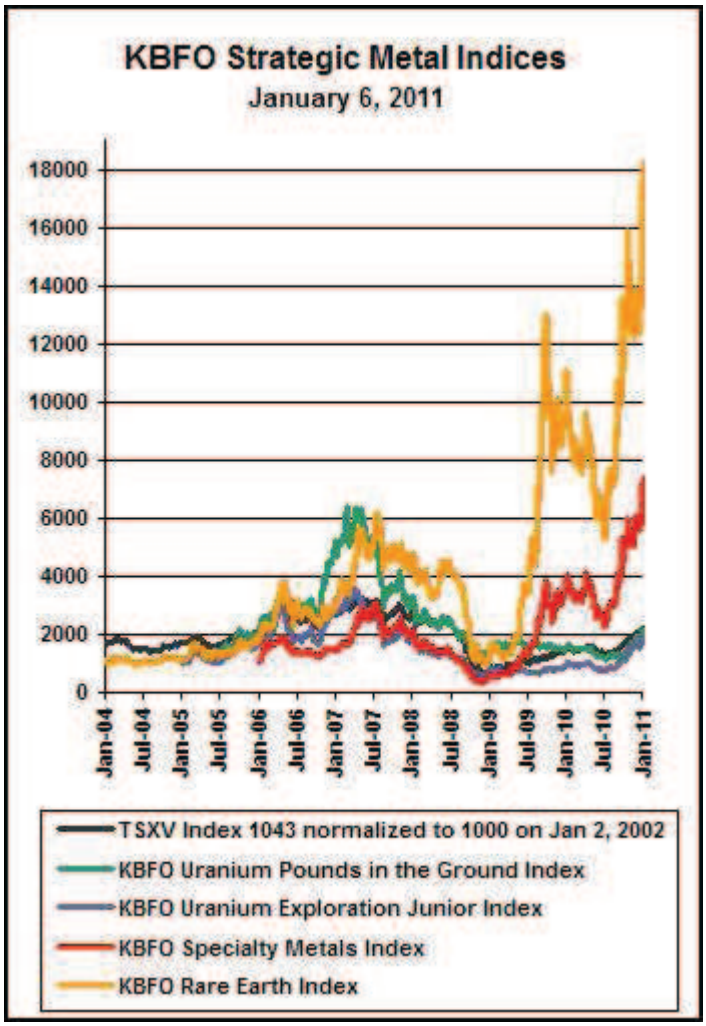
- Rare Earth stocks come off heavily from their stellar run and send the whole ETF to the scrapyard.
- Commodity prices – several of the heavyweight components like Molybdenum and Titanium are not movers, as yet.. with little representation from the sexier (read scarcer) Strategic Metals it is hard to see how the ETF can outperform physical Strategic Metal's prices
- Heavy industrial presence – in a strong market for raw material inputs it is quite frequently the middleman who gets squeezed. The presence of numerous converters/processors in this ETF leads us to think that there are potentially quite a few commodity inflation "losers" in this line up.
- The bigger the ETF gets the more it is likely to drift away from investing in up-and-coming miners of real strategically important metals in short supply and end up with token representations of the "maiden aunts" who knit while Rome burns (excuse our mixed metaphors)

- If this ETF was set up three years ago it would not have included Rare Element, Avalon or Molycorp as "not meeting the criteria"….. think about it..

Conclusion

Evolution is not kind to a specialist ETF, but it is to its managers. As it gets larger the manager collects more fees on a larger AUM, but as the ETF grows it can also outgrow its more interesting constituents. Some would argue that the names that truly represent the Strategic Metals are too small to now find a place in this ETF. All well and good.. so if it is not going to have true Strategic Metals stocks in the ETF, in the interests of truth in advertising, it should be renamed the "Rare Earths, Lesser Base Metals and Titanium Fund".

Maybe we make too much of this. We suspect investors are not buying this fund for its Strategic Metals at all but rather as a Rare Earth sector proxy. They would probably be happier if all the Molybdenum and Titanium just went away to be replaced with the go-go stocks of the REE space. The result though of having all these non-REE stories in the mix (particularly the static – pricewise – Molybdenum space) is that the REMX has massively underperformed the REE space as measured by the best index we know which is John Kaiser's (shown at the right).

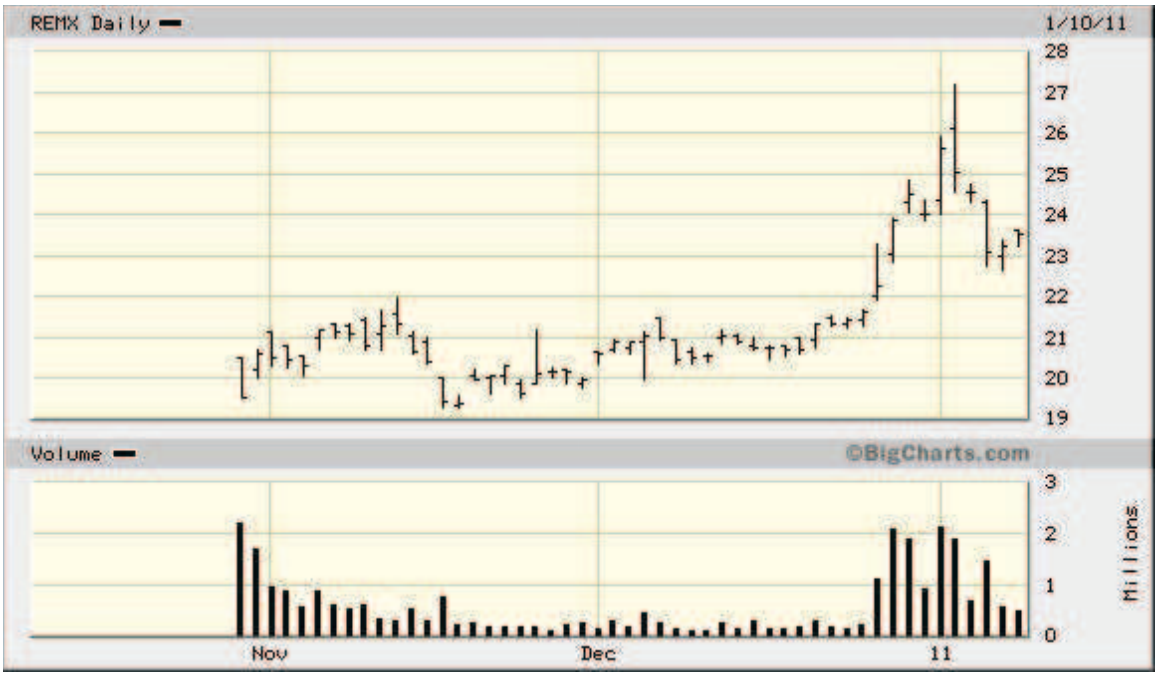


We can see here that REE stocks have massively outperformed Strategic Metals by any measure.

Thus those choosing the REMX over a randomly chosen six REE stocks would have massively underperformed over recent weeks and months.

Our coverage of ETFs seems to be a litany of woes and complaints but we cannot help but see what are glaring defects in ETF construction. Should investors in the mining space be served up ETFs that are patently inferior to those in other sectors.

The REMX fills a gap but fills it poorly. The market remains wide open for a better constructed ETF in both the Strategic and the Rare Earths spaces.



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