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## **Tapping Higher Gold Prices Bullion or Equities?**

**Gold equities are supposed to offer greater leverage to gold price rises than gold bullion. The experience during the current cycle suggests otherwise.**

The US dollar gold price has risen at a 23.3% annual rate over the five years since 30 June 2005. Some analysts are suggesting further rises as a loss of confidence in fiat currencies causes investors to seek safer alternatives in which to hold their wealth. Others suggest the gold trade is simply a momentum play that will exhaust itself in due course ending in tears for those who have joined too late.

Putting those, albeit important, arguments aside for the moment, one of the issues for investors to address is whether they are better off getting their gold exposure by purchasing bullion or whether equities might be a cheaper and better returning alternative.

Equities have been a favoured way for retail and professional investors to get gold exposure because trading was relatively inexpensive and more convenient than holding gold bullion. At the same time, pure gold producers could potentially benefit from their leverage to higher gold prices.

- Previously unprofitable mines can often become profitable as the gold price rises. The resulting change in financial conditions might warrant a rise in the share price which is greater than the rise in the underlying gold price.
- Higher prices might validate mine expansions that permit profits to rise more strongly than the gold price itself.
- Higher gold prices encourage exploration which, if successful, can result in a disproportionate rise in an explorer's share price.

To some degree, equities have lost their competitive edge through the innovation of exchange traded funds such as the SPDR Gold Shares traded on the New York stock exchange. These are cheap ways for the retail investor to effectively buy and sell gold bullion. They count on physical gold backing for each investment as an important ingredient in their success. There is 42.2 million ounces of physical gold set aside for investors in SPDR Gold Shares.

In practice, the leverage from investing in gold equities has been harder to find than anticipated.

The Australian All Ordinaries gold index which has risen at a 20.0% annual rate over the past five years has lagged the rise in the gold price. Within the index, there are 36 stocks of which 29 could have been bought at the beginning of 2005/06. They rose at an average rate of just 17.0%, slightly slower again than the index. The median rate of increase was only 9%.

These numbers suggest that buying randomly would have left an investor well short of what he wanted to achieve. That said, 12 of the 29 stocks did do better than the gold price over this five year stretch suggesting that a closer study might have offered a chance to get the advertised leverage.

Unfortunately, it was not simply a case of opting for the best known stocks. Lihir rose faster

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than the gold price but Newcrest did not.

There are several reasons why investors should be wary about getting their gold exposure through the equity market.

- Execution risk can be high. Miners have to get the gold out of the ground at a cost that is consistent with what investors are expecting. For those mines still in the development phase, company management must be able to demonstrate the necessary skills to maintain confidence among investors that they can meet the goals they have set.
- Gold equities cannot be fully independent of the markets in which they trade. Weak equity markets will adversely affect the performance of gold stocks no matter what is happening to the gold price. Investing in gold equities out of a fear of weakening equity prices may prove counterproductive.
- Gold mines have a limited life. As more gold is mined, the resource base declines eroding the fundamental value of the gold mining company. If the company is unable to find compensating resources for what is mined and sold, its share price should decline over time. A higher gold price might simply compensate for this.
- Currency movements may be unfavourable. A weakening Australian dollar should raise the Australian dollar sales proceeds for the gold miner. However, a weakening Australian dollar is a disincentive for foreign investors. They would normally prefer to wait until the dollar is rising before putting money into the Australian market.
- Some gold mining companies may have used derivatives either voluntarily or as a condition for bank financing. Derivatives will reduce the leverage to higher gold prices.

Picking the right gold stocks is critical. Over the last five years, returns have ranged from minus 43% to plus 88%. The dispersion in returns should make some additional analytical effort worthwhile. However, bullion seems a less risky alternative if an investor is convinced of the investment case for gold but lacks the necessary information to choose the right stocks.

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