Have investors forgotten about Gold?

“Opportunities come infrequently. When it rains gold, put out the bucket, not the thimble”

— Warren Buffett

There was a time when investors seeking exposure to the gold price, they automatically bought gold mining shares. Gold mining shares offered leverage to a rising gold price and when gold producer shares appreciated, there was a flow on effect to gold explorers. This flow-on effect meant that gold explorers could then raise risk capital for exploration and subsequent discoveries became the new producers for the next cycle!

The attraction of gold has been as a ‘store of wealth’ and when there are economic risks to the major economies, particularly the US and potentially leading to a depreciating US currency. In this scenario the gold price moves higher and is deemed to be an inflation hedge.

Hence, investment in gold exposure at the right time in the economic cycle can generate significant returns. However there are a number of different investment opportunities to gain exposure to an increasing gold price although there individual effectiveness has changed over the years.

Quoting Benjamin Franklin: *“An investment in knowledge pays the best interest”*.

When investing in Gold there are three common investment choices.

Buy bullion, directly from a supplier like the Perth Mint. This can be in the form of bullion or alternatively, gold coins. In addition, there may be storage, insurance costs and transaction commissions. This provides the most direct exposure and any change in the gold price will directly affect the price of the investor’s holding.

In general, the volatility of the gold price has meant fluctuating returns and includes sharp and sudden movements. Since August 2011, the gold price has fallen by 30% from above US$1800/oz but previously experienced a stellar rise over the previous decade.

Buy gold ETFs, these funds either match the gold price through physical gold backing or potential derivative backing or a combination of both. They allow easy entry and exit for investors and they track the gold price in line with bullion with a 5 year or more track record.

A typical a gold security/ETF consists of a gold bullion share of nominal value and a beneficial interest in approximately 1/10th of one fine troy ounce held on trust for the holder of the security. A trust deed establishes a separate trust for each holder of gold so that the holder is absolutely entitled to the gold bullion held in the vaults. Each time a holder transfers gold to a new holder, the beneficial interest in the gold bullion automatically transfers to the new holder. ETFs which are 100% backed by physical gold has gold held in reputable vaults such as the HSBC Bank Vault in London.

There are many funds listed on stock exchanges in the USA, France, Singapore, South Africa, Switzerland, Turkey, and the United Kingdom.

Buy shares in gold-related mining companies, this is the easiest and most common method for investors to invest in gold. In addition to purchasing exposure to gold, an investor is also purchasing a share of the company's assets and growth potential. In an ideal world, this growth can provide addition leverage to the gold price as the company brings more production (and more exposure to the gold price) on stream over time. Similarly with explorers, a new gold discovery may deliver strong shareholder returns in a regime of rising gold price.

However, mining companies also have another set of risks and which range from operational and management risk through to financial and exploration risk. Operational issues have often plagued some of the Australian producers and this can overshadow positive trends in the gold price leading to share price falls, not rises! This company – specific risk has led to disillusionment with investing in gold companies, and investors have tended to look to securities which mitigate this risk – hence ETFs which invest in a basket of gold companies.

Gold Company ETFs provide exposure to a basket of gold shares which means that operational problems occurring in one particular company will not 'drag' the value of the basket significantly lower. This operational risk mitigation has led to these ETFs becoming very popular but also to the detriment of the individual companies – they now have fewer investors and there is more importance on company weightings within say a gold index which itself is driving the level of investment by the ETF.

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Australian Gold Companies

Some of the Australian listed gold companies are pure gold producers while others have additional interests, where gold is a by-product of their mining operations and hence gold price changes hardly affects their bottom line or share price. There are approximately 20 listed large gold producers on the Australian market although not all of them are considered to be liquid enough for traders and investors to be able to buy and sell readily.

Newcrest Mining, is one of the world's top five gold mining companies, operating mines in four countries. Early 2011 its share price stood at $40, today their shares are selling at $9.78*, an almost consistent downtrend with a series of lower peaks and lower troughs have occurred over the last 3 1/2 years.

Bargain hunters will continue to compete with sellers during the current gold price direction uncertainty overlain by operational issues. As a direct comparison one of the smallest gold producing companies, Reed Resources, during this same 3 1/2 year period, its share price has fallen from .56.5 cents to the current asking price of .030*, demonstrating the influence that the size of the company can have on its share price performance when investors leave the sector.

Traditionally September has been gold's best month, did this seasonal trend continue in 2014?

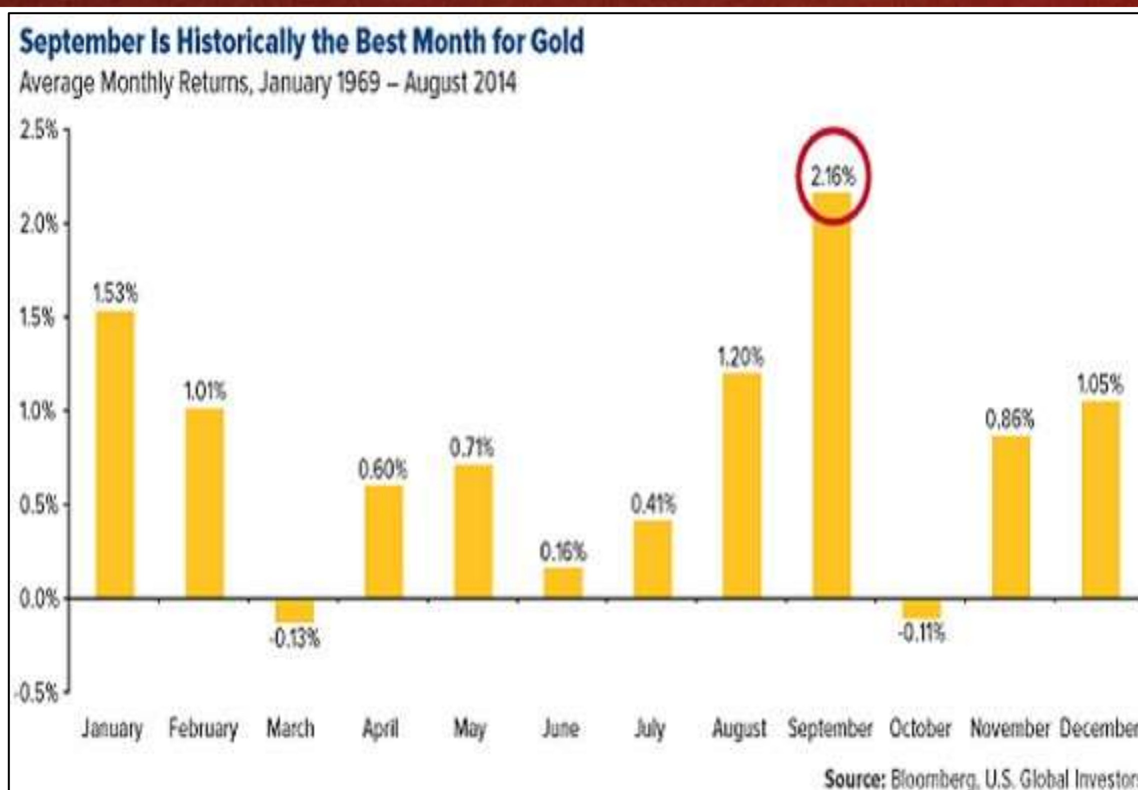
With the wisdom of hind-sight it was not hard to see that September was not going to live up to the high expectations that gold would outperform the market, on the back of jewellery demand.Traditionally the market strengthens in September, through into early October, and then corrects in mid-late October, returning to higher prices towards the end of the year. That's how it has historically worked!

"September is historically gold's best-performing month of the year, returning 2.16% on average since 1969," said Frank Holmes, chief investment officer of US Global Investors. And no other month is close, as you can see from the following chart:

He says some of this has to do with consumers. "Demand rises in India ahead of Diwali (Oct. 23 this year) and the wedding season, while retailers elsewhere restock ahead of Christmas and all the gold-giving that happened at the end of Ramadan."[a]

And then there's the stock market. "A bad month for riskier assets can be a good one for gold." – Shawn Langlois.[d]

Have investors given up on Gold?



History may be on gold's side, but market watchers said current trends are not. Gold prices are up about 7% on the year, but the metal squeaked by August with only a 0.6% gain and it started the month of September on a down note. When combining the recent price weakness and lack of physical demand this year, gold may experience its traditional seasonal upswing, analysts said.

Ira Epstein, director of the Ira Epstein division of The Linn Group, closely follows the seasonal trends. He said gold should have started bottoming in mid-August if the seasonal trend of higher prices was to develop as it usually does. " What's weighed on gold this year is the U.S dollar strength," he said.

"Additionally, gold has not been able to build any sustainable gains on geopolitical concerns, whether it's fighting in the Middle East or in Russia/Ukraine, he said, nor are there any signs of inflation. Instead, money is chasing a rising stock market," Epstein said.

HSBC Sees Gold Ranging From $1,150 To $1,350 For The Rest Of 2014

HSBC believes gold trading will be in the range of $1,150 to $1,350 an ounce during the remainder of 2014, with the market "searching for a new equilibrium" with a number of offsetting factors. The bank left its 2014 average price forecast at $1,292 an ounce and listed 2015 and 2016 forecasts of $1,310 and $1,345.

"Gold is searching for a new equilibrium after last year's price plunge, which ended the more than decade-long bull run," HSBC said. "The massive gold-exchange-traded funds (ETFs) outflows of 2013 –which were instrumental in driving prices lower – have largely abated. Another positive is that net long positions on the Comex are rebuilding. Other factors supporting prices are that mine production gains are plateauing, scrap supplies are down and central bank demand is steady.

Conversely, expectations for dollar strength are likely to create headwinds for further rallies, HSBC said. Also, the tapering of asset purchases by the Federal Reserve and low global economic growth and inflation rates discourage a return of institutional investment, although these are already factored in by the market, the bank said. (c)

Jewellery, coin and bar demand is down by double-digit percentages from a year ago as the key markets of China and India have softened, HSBC said. However, the bank continued, this comparison is also "misleading" since last year was a record high for this demand.

"Long-run economic and demographic trends argue for increasing emerging-market bullion demand," HSBC said. "Near-term gold consumption would likely be stimulated by any decline in prices to or below the USD1,200/oz level, we believe.

"These factors largely balance out so we are leaving our price forecasts unchanged. We see a broad price range of USD1,150-1,350oz for the remainder of this year, with an average price for 2014 of USD1,292/oz."

Outflows from gold ETFs slowed to a “trickle” this year from a “deluge” in 2013, said HSBC. More specifically, the bank said, investors liquidated 880 tons of gold from ETF holdings last year, a reduction of one-third from the end-of-2012 peak.

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The liquidation so far this year is just 30 tons.

"We believe that many remaining ETF holders have adopted buy-and-hold strategies that will preserve the bulk of current holdings intact," HSBC said. "This should steady gold prices. At the same time, net-long positions on the Comex, which were greatly reduced in 2013, have partially recovered. We forecast a small rebuilding of gold ETF and net-long positions."

The bank looks for net central-bank demand of 400 tons this year after purchases of 344 in 2013. "Although below 2012 and 2011 record purchases levels, this is equivalent to one-sixth of world mine output, making central banks an important source of physical demand," HSBC said.

HSBC said China's demand for imported gold was down 15% in the first half of this year, although the decline comes from unprecedented demand in 2013. "Despite this (year-on-year) weakness, 2014 demand is on track to be the second-best year on record," HSBC said. "We expect China to remain the world's largest importer, consumer and producer of gold this year." HSBC added Indian demand "remains stifled due to high tariffs and burdensome regulations, but is showing evidence of recovering from weak 2013 levels."

The bank said it looks for jewellery demand to reach 2,175 tons this year, which would be an 8% year-on-year decline.

HSBC looks for coin and bar demand of 1,170 tons.

"We forecast that while demand is likely to remain down compared to 2013, gold consumption for both jewellery and investment will partially recover in the latter half of the year," the bank said.

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(a) Frank Holmes, chief investment officer of US Global Investors
(b) Ira Epstein, director of the Ira Epstein division of The Linn Group
(c) Allen Sykora of Kitco News
(d) Shawn Langlois, SAN FRANCISCO (MarketWatch)
* Asking price as at 30/10/2014 12.10 pm(NCM)

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