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Gold Stocks or Gold Spot?

Executive Summary

- The Case for Gold – Gold investment will continue to be relevant as long as global uncertainties remain at the back of investors' mind.
- Historical Performance and Risk Comparison – Over the past 10 years, investors who took on extra equity risks associated with gold stocks were not compensated with higher returns.
- Active Management – Investors should not write off the gold stocks just yet. By historical measures, there are periods whereby gold stocks significantly outperform gold commodity.

The Gold Bug is Here to Stay

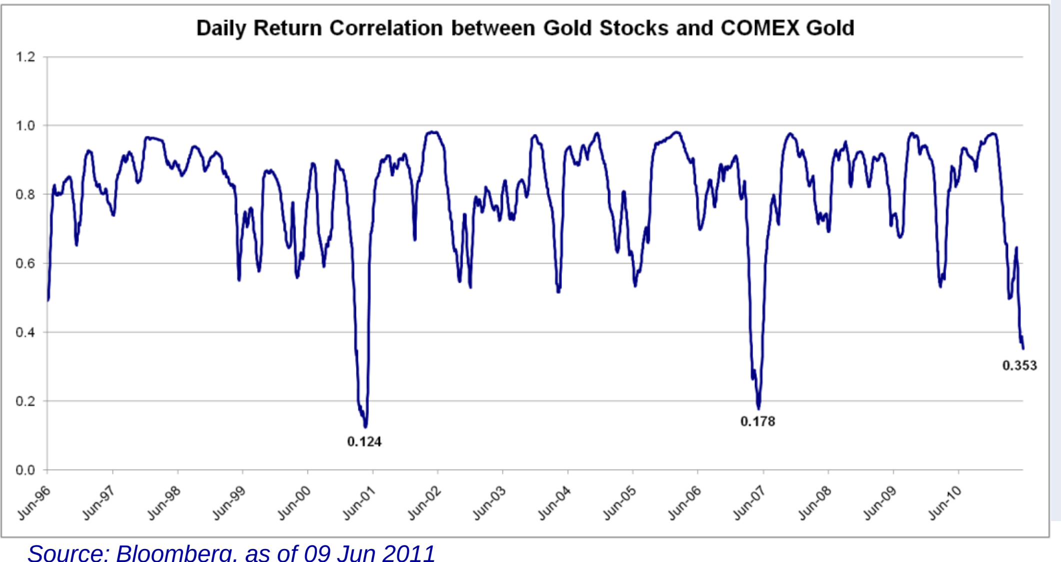
Since the financial market turmoil in 2008 and 2009, investors are appreciating the role of gold in today's sophisticated, computerized, paper-based monetary system. From a low of US$680/Oz. in late October 2008, gold prices hit a historical high of US$1575/Oz. in May 2011. The allure of holding gold as a safe haven asset is brought on by increasing investment and physical demand for the precious metal.

However, not all gold investors were better off. Since the start of this year till date, gold stocks, as measured by the FTSE Gold Mines Index, were down 10.8 percent while gold commodity prices were up 8.6 percent. In exact terms, it was a 19.4 percent return differential.

Historically, this is a rare event but is anything but new. Over the past 15 years, the daily returns between gold stocks and gold commodity prices have been in tandem for most part of the period (See Chart 1 below). However, in 2001(0.124), 2007(0.178) and today (0.353), this correlation seems to have broken down. Does gold stocks still represent attractive investment opportunity?

The correlation breakdown between gold stocks and gold commodity is rare but nothing new over the past 15 years.

Chart 1: 15-Year Rolling Correlation between Gold Stocks and Gold Spot



Source: Bloomberg, as of 09 Jun 2011

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Not a Gold Fan Yet?

The allure of gold as a safe haven asset does not necessarily justify that gold commodity prices will go up indefinitely. But in our view, gold investment will continue to be relevant as long as these questions remain unanswered.

1) Is the sovereign debt woes in Greece, Ireland and Portugal the last piece of the puzzle? How about Italy and Spain? Uncertainty over the long term future of the Euro paper currency prevails.
2) When is the earliest investors can expect a rate hike from the Federal Reserve? Loose monetary policies point to low opportunity costs of holding gold assets given that gold does not pay any dividends or interest.
3) Is the U.S. dollar dominance as the world reserve currency coming to an end? The U.S. dollar has depreciated by more than 17 percent against the major currencies since June 2010. The developing nations, in particular China, agree that the end of U.S. dollar dominance is near.
4) Has the inflation-bug die out? Food and energy prices are still at uncomfortably high levels. According to the United Nations' Food and Agriculture Organization, world consumers may be entering an era of high commodity prices. Gold is widely perceived as an inflation hedge.
5) Finally, can we trust the Chinese government that China's economy will have a soft landing despite all the tightening measures? A property downturn could affect the finances of local governments. With a pending property bubble implosion, the Chinese population turns to gold hoarding.

From a regional perspective, gold asset has also been a good investment hedge against the decline in value of the paper currencies. In Singapore dollar terms, it appreciated almost 94 percent since the start of 2007 (See Table 1 below).

Table 1: Return of Gold Commodity in Asian Currencies (since Jan-07)

Gold in Different Currency terms	% Gain since Jan-07
US Dollar	141.2%
Chinese RMB (Yuan)	99.9%
Hong Kong Dollar	142.4%
India Rupee	144.8%
Indonesia Rupiah	128.5%
Malaysia Ringgit	107.4%
Philippines Peso	112.8%
Singapore Dollar	93.7%
South Korean Won	182.4%
Taiwan Dollar	113.6%
Thai Baht	107.0%

Source: Bloomberg, as of 09 Jun 2011

Since Jan-2007, gold has been a good investment hedge against the decline in real value of paper currencies.

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Gold Stocks – Historical Performance and Risk

Investment in gold may present itself in different vehicle forms. One popular way is to invest in companies which mine, process or deal in the gold commodity. These companies are commonly classified as gold stocks and the underlying assumption is that the performance of these stocks will be tied closely to the gold commodity prices.

Some proponents also highlighted the potential leverage effects gold stocks may bring to gold investors. The leverage effect is helped by a smaller increase in variable costs when demand drives up production levels. For a similar increase in gold commodity prices, economies of scale will bring about a higher percentage increase in profitability.

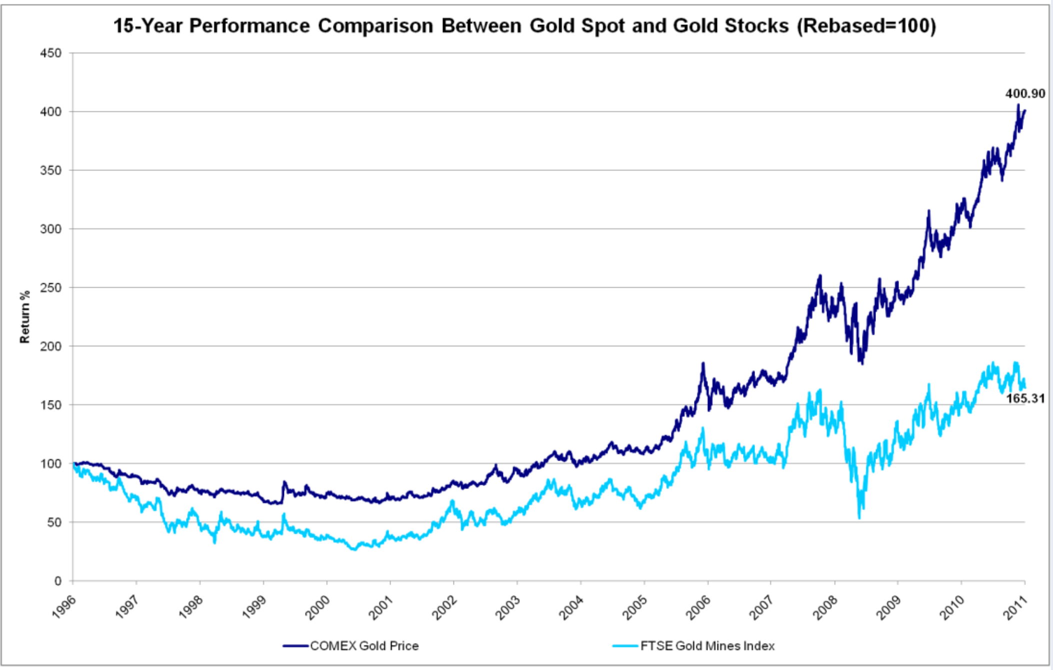
However, gold stocks do not always outperform the gold bullion. Gold stocks are subjected to numerous equity risks which may be overlooked by investors. Operational risks such as development of unproductive mines and inability to generate cash flows to fund projects are common among the gold stocks. Broad market risks associated with macroeconomic factors may result in gold stocks underperforming even though gold commodity prices were rising.

Gold stocks and gold commodity prices do not always move in tandem (See Chart 2 below and 3 on the next page). The FTSE Gold Mines Index (benchmark for gold stocks) underperformed the COMEX gold commodity over the past 15 years by a stunning 230 percent. In fact, the underperformance was especially pronounced in recent years after the implosion of the credit bubble.

To sum up, investors who took on extra equity risks associated with gold stocks were not compensated with higher returns over the past 10 years (See Chart 4 on next page). Gold commodity has been the top performing asset class with an annualised return of 19.0 percent while gold stocks (15.8 percent) lags.

Gold stocks are underperforming gold commodity in recent years after the implosion of the credit bubble.

Chart 2: Performance of Gold Stocks Lags Behind Gold Commodity



Source: Bloomberg, as of 09 Jun 2011

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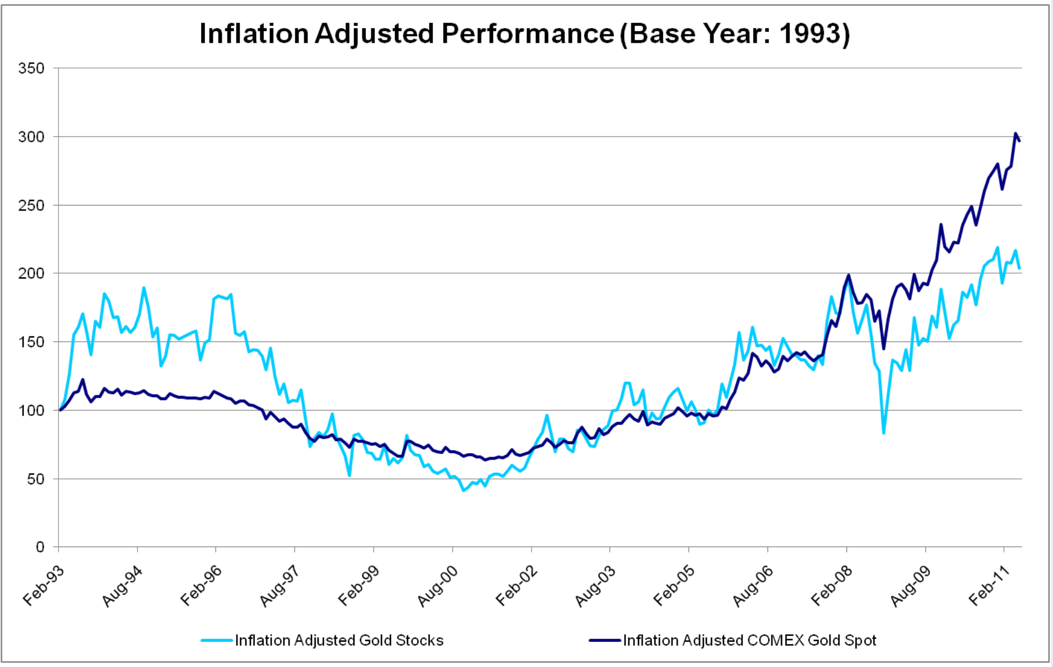
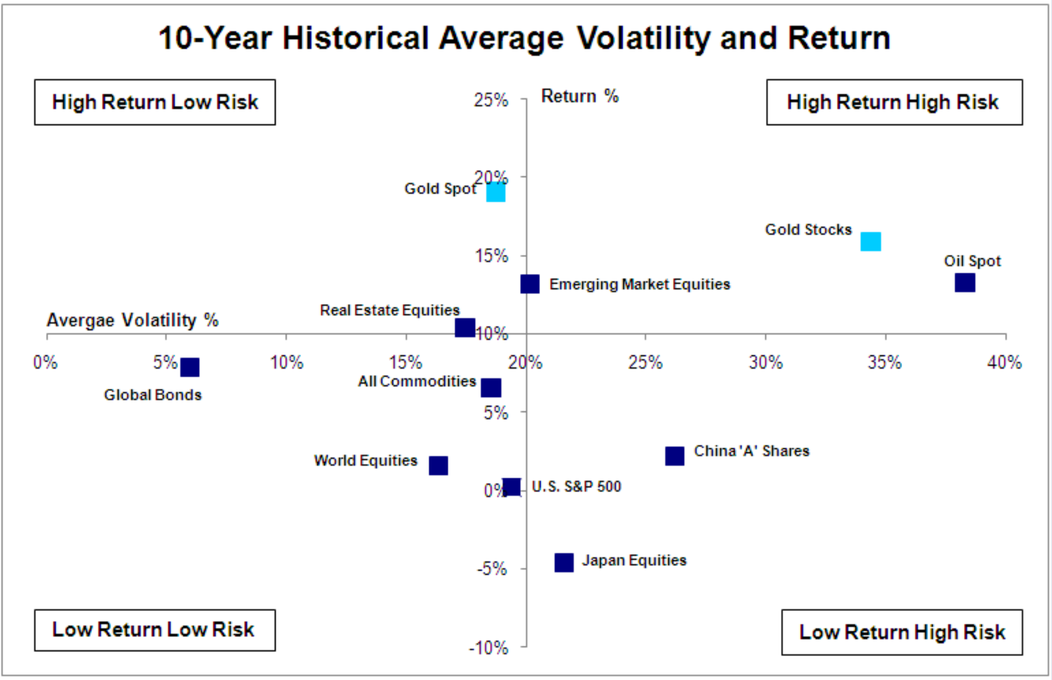
Chart 3: Inflation-Adjusted Performance for Gold Stocks and Gold Commodity



Source: Bloomberg, as of 09 Jun 2011

Gold commodity outperforming gold stocks on an inflation-adjusted basis.

Chart 4: Risk and Return Trade-off Among Various Asset Classes



Source: Bloomberg, as of 09 Jun 2011

Gold stocks are historically of higher risk nature than gold commodity. Both have outperformed over the last 10 years.

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Conclusion – The Case for Active Management

The overall outperformance of gold commodity against gold stocks does not necessarily justify the claim to write off the gold stocks just yet. There are periods whereby gold stocks significantly outperform by historical measures.

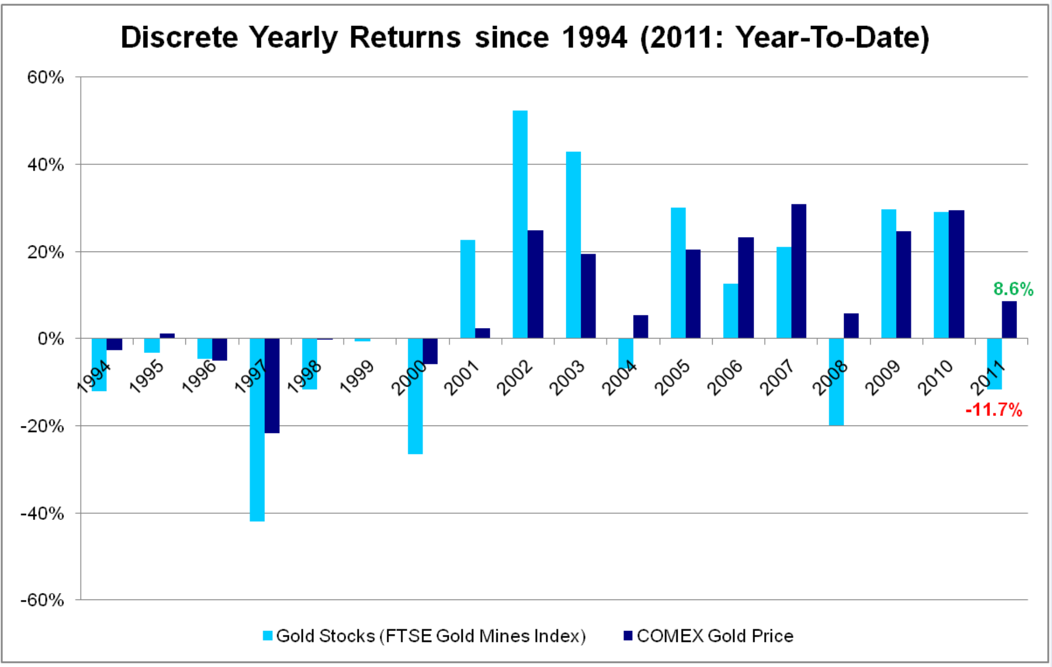
Since 1994, gold commodity outperformed gold stocks in 12 out of the 18 possible years. However, gold stocks outperformed substantially by more than 20 percent per annum during the period between 2001 and 2003 (See Chart 5 below).

We feel that volatile market conditions at the moment may not justify a total exposure to gold stocks. Also, it is not an easy task to gauge when gold stocks will outperform the gold commodity again. As such, a diversified active portfolio approach may make sense whereby portfolio managers actively manage and monitor the broad asset allocation and security selection between gold stocks and gold commodity.

For example, the earlier-mentioned correlation breakdown between the returns of gold stocks and gold commodity may be a rare form of market disequilibrium. This form of market disequilibrium may create opportunities for active managers to generate superior returns as dynamics of the market tend to be mean-reverting.

In conclusion, the economic rationale for gold investments is appealing. However, it is important to take on the right form of risk at the right time. At the moment, the market looks to be underweighting gold stocks. We also show that the historical positive correlation between gold stocks and the gold commodity may suggest that this anomaly may reverse soon, bringing the correlation coefficient closer to its historical average. In periods where gold stocks and gold commodity are trending down together, actively managed portfolios have the flexibility to increase its cash holdings for capital preservation purposes as well.

Chart 5: Gold Stocks Outperformed Gold Commodity Spot during 2001-2003



Source: Bloomberg, as of 09 Jun 2011

So far this year, the performance of gold stocks has been disappointing relative to the rise in gold commodity prices.

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