



Analyst
 Liang Shibin
 +6565311516
 liangsb@phillip.com.sg

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.

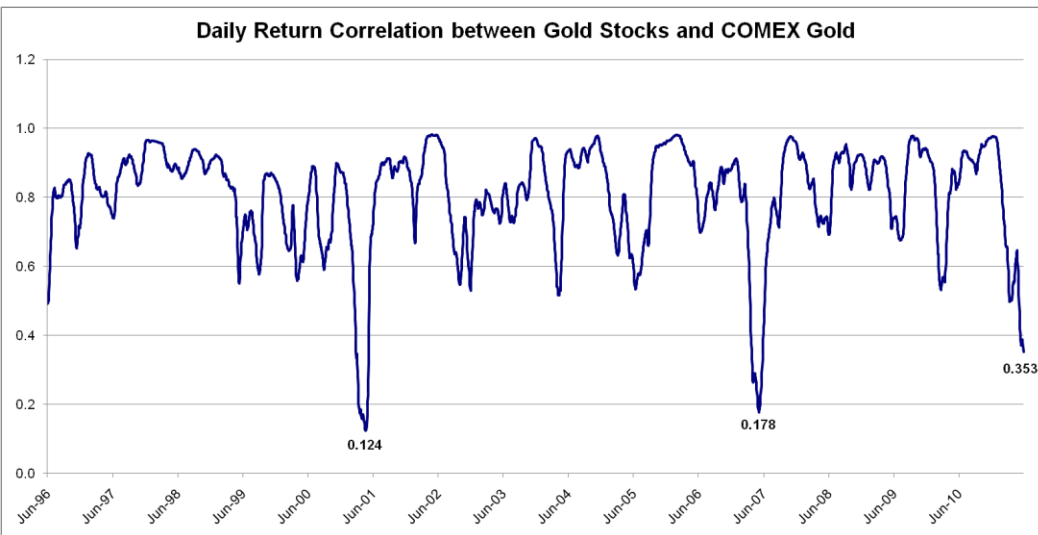
The Gold Bug is Here to Stay

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?

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



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

Source: Bloomberg, as of 09 Jun 2011



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.



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.

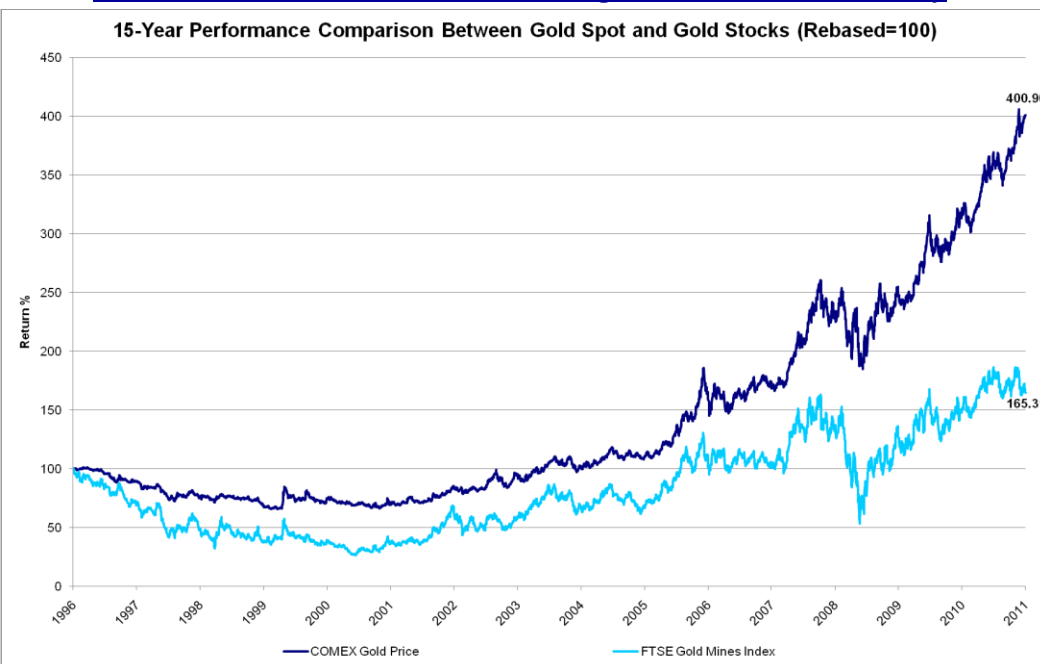
Some proponents also highlighted the potential leverage effects gold stocks may bring to gold investors. The leverage effect is helped by a smaller increase in variable costs when demand drives up production levels. For a similar increase in gold commodity prices, economies of scale will bring about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

Chart 2: Performance of Gold Stocks Lags Behind Gold Commodity



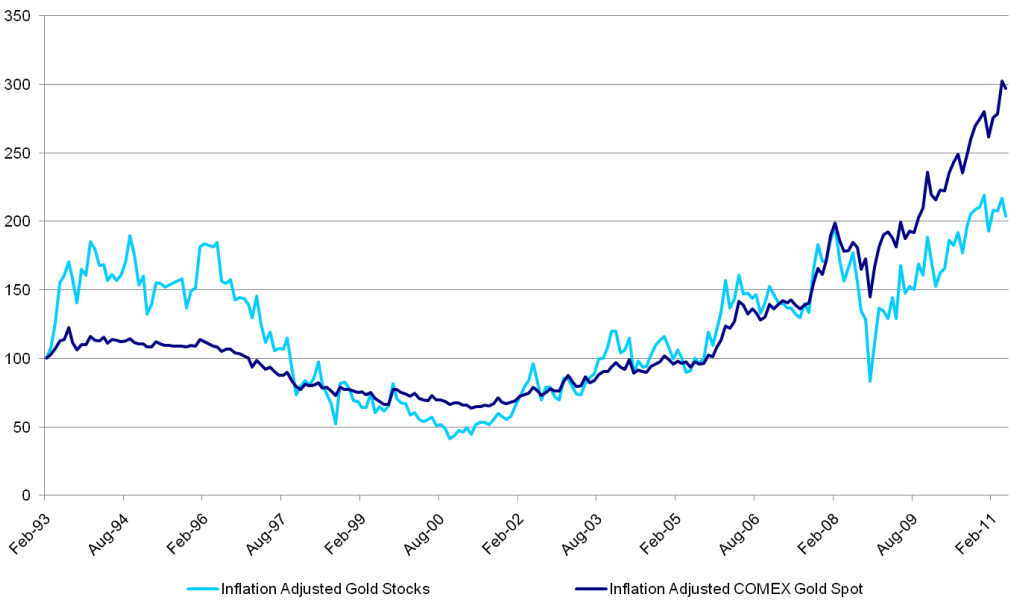
Source: Bloomberg, as of 09 Jun 2011

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



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

Inflation Adjusted Performance (Base Year: 1993)

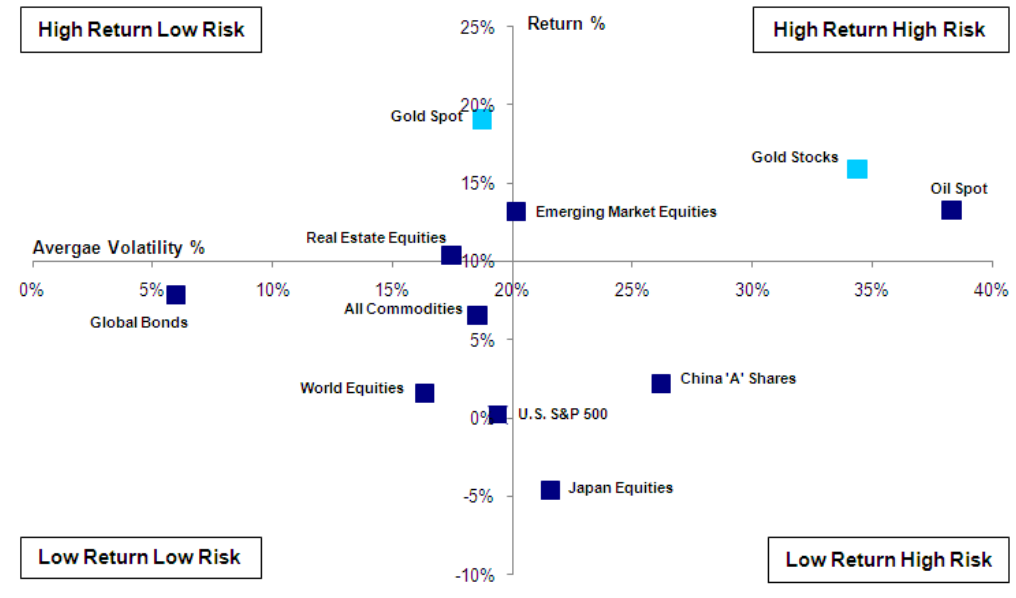


Gold commodity outperforming gold stocks on an inflation-adjusted basis.

Source: Bloomberg, as of 09 Jun 2011

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

10-Year Historical Average Volatility and Return



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

Source: Bloomberg, as of 09 Jun 2011



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.

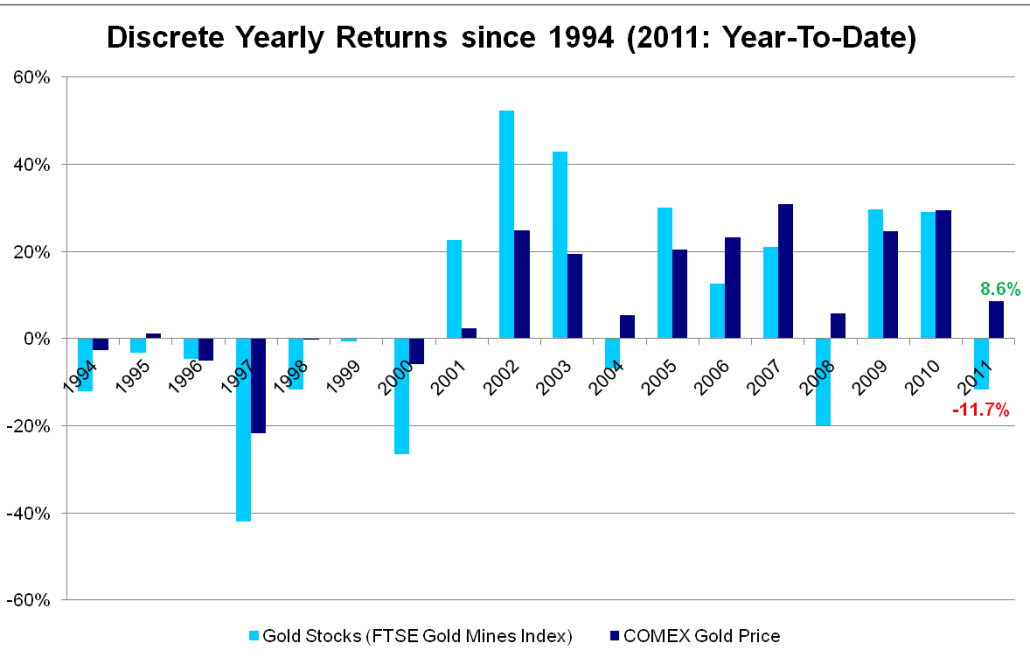
Since 1994, gold commodity outperformed gold stocks in 12 out of the 18 possible years. However, gold stocks outperformed substantially by more than 20 percent per annum during the period between 2001 and 2003 (See Chart 5 below).

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.



GENERAL DISCLAIMER

This publication shall not be reproduced in whole or in part, distributed or published by you for any purpose. Phillip Securities Pte Ltd shall not be liable for any direct or consequential loss arising from any use of material contained in this publication.

This publication is solely for general information and should not be construed as an offer or solicitation for the subscription, purchase or sale of the securities, and specifically funds, mentioned herein. It does not have any regard to your specific investment objectives, financial situation and any of your particular needs. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of any person or group of persons acting on such information and advice. Unit Trusts distributed by Phillip Securities Pte Ltd are not obligations of, deposits in, or guaranteed by, Phillip Securities Pte Ltd or any of its affiliates. No action should be taken without first viewing the details in a fund's prospectus. A copy of the prospectus can be obtained from Phillip Securities Pte Ltd or online at www.eunittrust.com.sg. Past performance is not necessarily indicative of future returns. Investments in unit trusts are subject to investment risks, including the possible loss of the principal amount invested. Investors should note that the value of the units and income from the fund may rise as well as decline. Investors should also note that there are limitations whenever performance is stated or comparison is made to another unit trust or index for any specific period as no funds or indices are directly comparable.

This publication should not be relied upon as authoritative without further being subject to the recipient's own independent verification and exercise of judgment. The fact that this publication has been made available constitutes neither a recommendation to enter into a particular transaction nor a representation that any investment product described in this material is suitable or appropriate for the recipient. Recipients should be aware that the investment products described in this publication may involve significant risks and may not be suitable for all investors, and that any decision to enter into transactions involving such products should not be made unless all such risks are understood and an independent determination has been made that such transactions would be appropriate. Any discussion of the risks contained herein with respect to any product should not be considered to be a disclosure of all risks or a complete discussion of such risks.

Whilst we have taken all reasonable care to ensure that the information contained in this publication is accurate, we do not guarantee the accuracy or completeness of this publication. Any advice contained in this publication is made only on a general basis and is subject to change without notice. We have not given any consideration to and have not made any investigation of the investment objectives, financial situation or particular needs of any specific person or group of persons as we are not in possession of any such information. You may wish to seek advice from a financial adviser before making a commitment to purchase the investment products mentioned. In the event you choose not to seek advice from a financial adviser, you should consider whether the investment product is suitable for you. Any unit trusts mentioned in this publication is not intended for U.S. citizens.

DISCLOSURE OF INTEREST

Statement pursuant to section 36 of the Financial Advisers Act - Phillip Securities Pte Ltd, its directors and employees may have interest in the securities recommended herein from time to time, and its associates and connected persons may also have positions from time to time. Opinions and views expressed in this report are subject to change without notice.

PhillipCapital is a group of companies who together offer a full range of quality and innovative financial services to retail, corporate and institutional customers. Member companies in Singapore include Phillip Securities Pte Ltd, Phillip Securities Research Pte Ltd, Phillip Financial Pte Ltd, Phillip Futures Pte Ltd, Phillip Trading Pte Ltd, Phillip Capital Management (S) Ltd, CyberQuote Pte Ltd, International Factors (Singapore) Ltd and ECICS Ltd.

Information on any and all independent PhillipCapital members and the respective financial services they offer can be obtained through the following website – www.phillip.com.sg. Members can otherwise be identified by their authorised use of PhillipCapital brand name along with their own name in their documentation and literature.