Why is Bullion Outperforming Gold Stocks?

Important distinctions between the 1970s and today

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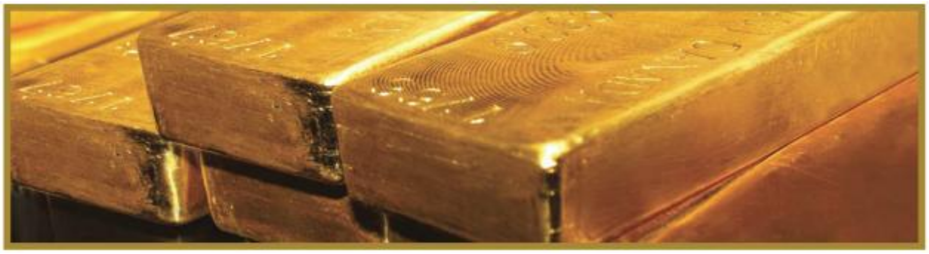

by Nick Barisheff

Gold stock investors, primarily Westerners, are frustrated. Despite the yellow metal's record rise, most gold stocks are trading as if gold was less than half its current price. Some have waited decades for a repeat of the spectacular gold stock performance of the late 1970s. Unfortunately, economic and geopolitical conditions are quite different today from what they were 34 years ago. To prosper in today's unique gold market, with a well-balanced portfolio in bullion and stocks, it is important to understand these differences.

Some of the distinctions are obvious. Others are more difficult to see. Let's start with a few of the obvious differences. In the late 1970s, gold stocks were the most popular way to play the gold market. Today we have SPDR Gold Shares (symbol GLD), the second largest ETF in the world, with a market cap of $58 billion dollars. The total market cap of all the gold stocks in the world is only $262 billion. GLD trades like a stock yet it tracks the price of gold and therefore, like bullion, it has outperformed gold stocks since its inception in 2004. It is fair to assume that GLD has played a major role in diverting significant resources away from gold stocks.

In the 1970s, there were around 200 hedge funds worldwide. According to Hedge Fund Research, there were 715 new hedge funds launched in the first three quarters of 2010 alone. Many of these funds employ sophisticated computer trading programs and complex "market neutral" hedging strategies that restrict the trading ranges of gold shares. For example, one well-known strategy is a pairs trade that goes long gold and GLD while shorting gold stocks. The trade works because the gold futures market is much larger than the gold stock market. When gold corrects, often because of profit taking on the long side, the smaller gold stock sector falls faster and harder, making the short side of the trade profitable as well.

The retail investor hopes for those 10 percent breakout moves that were common with gold stocks in the 1970s. The large funds count on tight trading ranges, as they would rather make money day in and day out on the long and short side of the market through high-frequency trading. A tight 5 percent trading range that lasts years also opens the door to institutional profits through call writing, financing and a variety of other esoteric strategies that are incomprehensible and inaccessible to those outside the hallowed halls of Wall Street and Bay Street.

Higher commodity prices, lack of new 10-million-plus gold ounce discoveries, rapidly depleting resources, environmental pressures and the potential for nationalization of resources are other important differences that distinguish the 1970s gold market from today's. Yet all of the above may only be secondary influences. The most significant cause of the disparity between bullion and gold shares is the most difficult to understand: mindset. Two entirely different mindsets exist about gold. One trusts paper gold products—the other shuns it. This difference became patently obvious to BMG's team last year as members visited Central America, the Middle East and the Far East.

The gold rally of the 1970s was essentially a North American event. Today, it is global and the Chinese, Russian, Indian and Middle Easterners who are buying gold bullion have their own gold mindset. To them gold is a wealth-preserving asset, not a wealth-gaining asset. They buy it to secure their family's wealth for generations. They buy gold because the destruction that currency crises cause is still fresh in their minds. They have little difficulty understanding that in the past decade, the US dollar, the Canadian dollar, the euro, the British pound and the Japanese yen have all lost an average of over 70 percent of their purchasing power against gold. They understand, as does anyone who owns physical bullion long-term, that gold is not going up in value; currencies are losing purchasing power against gold. This is an important perspective, because it implies that gold can rise in price as far as currencies can fall.

So what is the best way to play the gold stock market in this environment?

Picking the Right Gold Stocks

A logical first step would be to adopt the gold mindset of those who are buying physical gold. This means holding about 17 percent bullion in one's core portfolio, a number arrived at by Ibbotson Associates as appropriate for a portfolio heavily weighted in stocks. This does not mean owning gold stocks representing gold in the ground, and it certainly does not mean owning GLD. Neither of these represents direct ownership of bullion. We can protect this core bullion position from temporary downturns with put options, but it should never be traded. For the gold stock portion of the portfolio, investors will likely gain the best performance from a choice of profitable, undervalued mid-tier producers with good reserves located in safe countries.

As fewer large gold deposits are being found despite the higher gold price, major producers will have no choice but to acquire smaller companies with infrastructure in place. There are probably less than a few dozen gold stocks that meet these criteria. Successful explorers are less desirable because of the uncertainty expected in the next five to seven years, the time it will take to put their deposits into production.

Currently, the US dollar, the world's reserve currency, is progressing rapidly along a well-trodden historical path to destruction. Gold, the anti-currency, will act as a counterbalance and continue rising. The major long-term trends that are putting upward pressure on gold (movement away from the US dollar, central bank buying and buying by the Chinese public) will continue for years.

Although North Americans may not remember the destruction a full-blown currency crisis can bring, we should follow the lead of those who do and change our way of thinking about gold. Hold physical gold bullion as one's portfolio foundation, and trade gold stocks or paper bullion for short-term adjustments.

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