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South Africa

Is it time to switch from gold to gold shares?

Moneyweb chats to analysts amid the global debt crisis.

Sasha Planting | 22 August 2011 12:42



CAPE TOWN – As financial markets bolted on Friday one stand-out winner on the JSE was Absa's exchange traded fund (ETF), NewGold, which gained as the price of gold remained fixed at record level of \$1 850 an ounce and the rand stayed above the R7/1\$ threshold.

NewGold rose as investors continued their flight to gold with the fund rising 1.18% to R129.01/ share on heavy volume. At the same time the gold index, reflecting listed mining stocks, fell by 0.6%.

There is no doubt that for gold bulls the place to be in recent months, and years, has been in physical gold or gold proxies like Absa's ETF. The price of gold has outperformed the performance of gold shares by about 250% in the past seven years.

But has a tipping point been reached? Should gold bugs now be considering those unattractive gold shares whose prices have under-performed the gold price so badly?

Stanlib fund manager Herman van Velze laughs. "I would be loathe to say that today is the day that the gold price swings back. I like the ETFs, they are less risky. I sleep well at night."

Another fund manager who may not be named believes now may be the time to look at gold shares. "The gold price has run so hard and delivered great returns. This makes it a less attractive if you are not already in."

SA gold shares may present an opportunity for those with an appetite for risk. "Yes, shares have failed to keep pace, but I believe we must be close to a tipping point. The high gold price should start to feed through to the bottom line – enough to generate a good return and solid dividends," he says.

Stanlib mining analyst Kobus Nell is firmly in this camp. "The almost straight-line movement up of GLD [Absa's gold backed ETF] should be treated with caution. This is panic buying at its best. It could still continue for some time, but the tremendous gain in a short period makes the rand/gold price vulnerable for a pull back." When it does correct, he says, it is likely to happen quickly. "Everyone thinks they are clever enough to get out at the top."

Nell argues that the fundamentals are shifting in the SA gold mining industry. "Gold is structurally at a higher price level. It will potentially stay at these levels for longer, supported by strong macro drivers. This means you will likely see earnings upgrades coming through – assuming the gold companies can manage their costs better." He believes blue chips like AngloGold and GoldFields have made good progress to mine profitable ounces and not chase volume at any cost. This should start to bear some fruit. Most of the local gold mines enjoy strong cash flow at the current gold price. "Take AngloGold for instance. Its free cash per ounce of \$375\$ last quarter is almost double that of the same quarter a year ago". The current gold price of \$1 850/oz would imply a free cash-flow figure that is again almost double that of the last quarter, all else equal.

The picture also starts to look much better for local gold stocks if the rand sticks above R7/\$.

This is not to say that investing in gold shares is a sure bet. Investors need to understand the unique characteristics of each company, as each have their strengths, and there remain many well documented risks. For instance GoldFields rose 1.5% on Friday, while Harmony fell 5% on the back of poor quarterly earnings and nationalisation fears around their Wafi / Golpu project in Papua New Guinea. "You need to pick the shares that can capitalise through operational leverage based on this gold price; whose costs are under control and whose exploration pipeline is healthy."

For Hilton Davies, founding director of SA Bullion, a gold bullion asset manager, the choice should not be about gold shares or unit trusts or the precious metal itself. All have a place in a balanced portfolio, he says – though he leans towards physical gold and ETFs. What is important is that one appreciates the future role of gold in the global economy. The period 1982 to 2005 was one of good times – times defined by the lowering of inflation and interest rates, he says. All asset classes appreciated – except for gold. "In a big expansionary world gold is a commodity and not a currency."

But since 2007 the world has entered a long and painful period of credit contraction. "Gold now presents a compelling investment proposition, not as a competitor to shares, bonds or property, but as a competitor to the dollar, the euro, the pound, the yen and other leading currencies."

Sovereign debt levels of the leading industrialised nations have passed the point of no-return. While these countries face a classic liquidity trap, they do have an escape hatch, he says. This lies in inflation, monetary depreciation and negative real interest rates. "The upshot of all this means that currencies, and by extension cash-in-the-bank and savers, are going to be punished for many years to come – and gold will assert itself as the hard currency."