

Bullion or equities?

The choice between gold bullion and gold equities depends on how aggressively investors are prepared to trade. Those with a longer-term perspective should favour the physical gold alternative over gold-related equities.

John Robertson* | 01 Jun 2017 | 8:21 | Opinion



Gold bullion is a superior bet for investors looking for long-term gold exposure

Long-term investors, such as those managing superannuation money, may wish to maintain a permanent gold exposure to take advantage of its portfolio diversifying characteristics.

Investors looking to use gold to reduce portfolio risk can choose between holding gold bullion or retaining gold-related equities.

Long-term investors will judge the contribution of gold-related equities by how well they replicate the investment performance of gold itself or, if returns do diverge, the extent to which holdings of gold-related equities add value to a portfolio.

Investors choosing between bullion and equities to achieve their gold market exposure have seven reasons to prefer direct bullion exposure.

Related content

- [Resolute's bullion balancing act](#)
- [Seasonality dominates holiday returns](#)
- [Where's the cash?](#)
- [Achieving that golden brand](#)
- [Investors flee as Blackham grows](#)

TOPICS (select for more information):

[Investment case](#) [Gold](#)

1. Physical gold brings certainty. Investors buying an ounce of gold today know what they will have in 15-20 years. They will still have an ounce of gold. Put the same amount of money into a gold stock and what will they have in two decades? Who knows? There are simply too many variables in play to permit a confident prediction no matter how big or robust a company might appear today.
2. The diversity in stock returns within the sector raises tough questions about what to buy and why. So far in 2017, returns from the stocks within the ASX All Ordinaries gold index, for example, have ranged between minus 44% and plus 146% with a median of 2.6%. Since 2010, the annualised performance gap between the best and worst of the stocks currently in the index has been over 120 percentage points. Investors can avoid having to choose by buying a mutual fund or an exchange-traded fund but funds fail to solve other shortcomings from the use of equities as gold substitutes.
3. Investors are uncompensated for equity price volatility. The short-term leverage of equity prices to gold price movements is often cited as one of the strongest arguments for holding gold equities. Since the start of 2010, a 10% change in the gold bullion price over the course of a month has been associated with an average 19% variation in the price of the VanEck Junior Gold Miners ETF, for example. Of course, leverage works in both directions. The VanEck fund may have risen by 40% or more on four occasions since the start of 2014 but, at other times, has given up all those gains. Between the beginning of 2014 and late-May 2017, the net change in the fund price has not been significantly different from the movement in the gold bullion price. Actual market outcomes suggest equity exposure through a diversified fund of gold stocks does not provide an adequate enough return to compensate for the volatility.
4. Trading agility is needed if investors are to take advantage of the potential offered by volatility to enhance portfolio performance. Succumbing to the temptation to trade may compromise realisation of long-term investment objectives. By definition, investors trading around differences between equity and bullion price movements have lost their long-term perspective.
5. Sector investment returns reflect the industry's propensity for long-term value decay. The gold price is more than four times higher than it was at the beginning of 2000 but the Philadelphia gold/silver sector index is only up 26%. Since 1990, the gold price is up threefold but the index is down over 30%. Other equity price indices display the same tendency to undershoot gold bullion price returns over the longer term. The disparity in performance is unsurprising as companies face the prospect of higher costs and resource depletion. Steps to avoid these outcomes may delay their impact but the nature of the industry makes value decay more likely than not.
6. Equity investors face market risks unrelated to gold price movements. Equity price effects may overwhelm even positive bullion price influences. A reappraisal of inflation expectations may be good for gold, for example, but the consequentially higher bond yields may have a detrimental effect on equity prices across all sectors.
7. Gold mining companies may fail to achieve their operating goals. Negative investor reactions, sometimes exaggerating the impact of even temporary operational shortcomings, may cause stock prices to undershoot gold bullion price movements.

Being able to take advantage of splits between share prices and underlying value may suit an investor with a longer than average decision making horizon but, in any event, instances of undervalued assets will complicate investment decision making. Value identification typically requires more time spent on research to understand what is happening, the extent of the investment damage and why the market is likely to adjust.

So, the arguments against long-term investors using equities as bullion substitutes are strong, if not overwhelming.

The choice of a bullion substitute from within the equity market does not preclude gold-related investments for reasons other than portfolio diversification.

Companies making new mineral discoveries or undergoing value reappraisal are among the more exciting investment opportunities in the sector whose event-driven returns may be uncorrelated with bullion price movements.

Among companies operating within the gold sector, the largest number depends for their investment impact on exploration success rather than directly on the gold price. Higher gold prices may be beneficial but, as in recent years, may have a negligible effect on the share prices of those companies without a resource to show for their efforts.

Temporarily mispriced companies are another group with the potential for unusually large share price gains (or losses) independent of the gold price as the market moves to realign their prices with those of their peers.

The companies benefitting from non-bullion related events are valid investment targets but should not be viewed as long-term portfolio holdings able to replicate the diversification benefits of gold in a portfolio.

**John Robertson is the chief investment strategist for PortfolioDirect, an Australia-based equity research and resource stock rating group. He has worked as a policy economist, business strategist and investment professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia*

