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No room for gold big guys

The largest gold companies fulfil a liquidity role for the biggest investors but may not contribute anything to improved portfolio performance.

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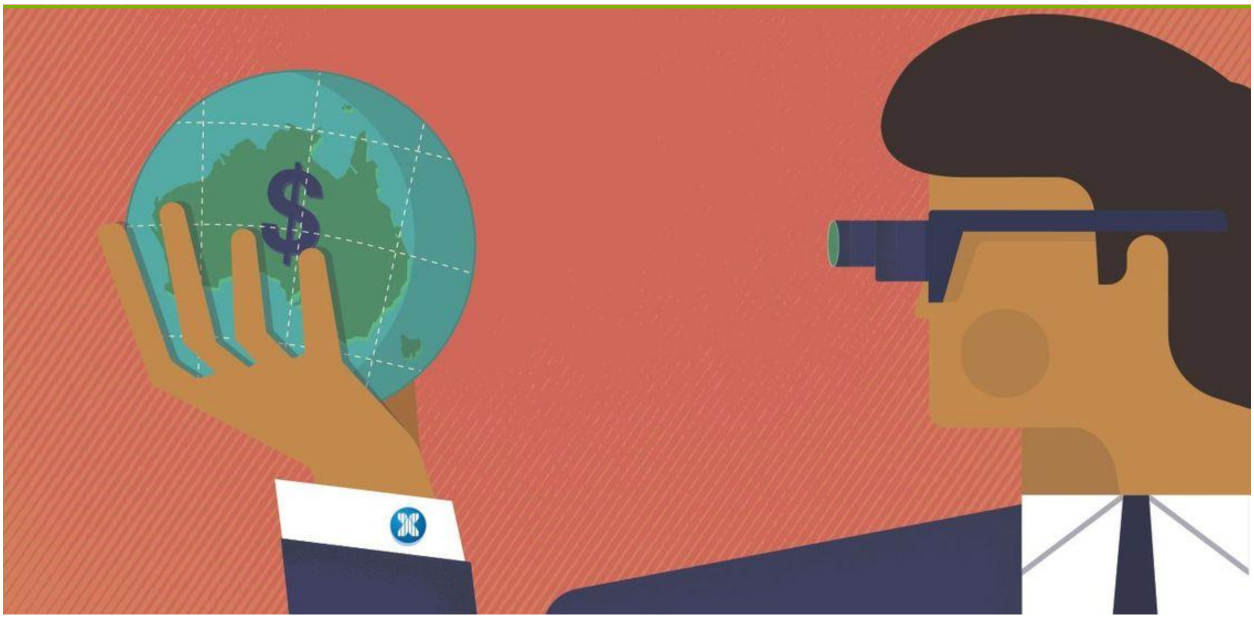

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Picking winners is at the heart of the gold mining investment culture. While the potential for large winning bets attracts some of the most risk tolerant investors, more conservative types are deterred by the prevalent win or lose overtones.

Companies making their investment pitches try hard to show how they could be the next De Grey Mining or Chalice Gold Mines. And yet, pursuit of triple or even quadruple digit investment returns might not be in the best interests of their investing audiences.

Basic financial theory shows that investors may be better off with combinations of stocks rather than trying for the single winner. The precise choice depends very much on individual goals and risk tolerances.

The S&P/ASX All Ordinaries Gold share price index currently includes 28 stocks. This group of stocks should include the biggest, the most consistent and the most dynamic of what is on offer from the Australian industry.

The index includes companies such as De Grey and Chalice which have benefitted from recent mineral discoveries as well as the largest companies in the sector such as Newcrest Mining and Evolution Mining, those with aggressive growth strategies such as Northern Star Resources, and less well performing but well-established names such as Resolute Mining and Regis Resources.

Anyone thinking about owning gold-related stocks has a diverse range of corporate styles and return characteristics from which to choose.

Investors would be foregoing value adding portfolio opportunities if they ignored the contribution from diversification.

An insightful investor could have opted for a position in De Grey at the start of 2015 for an average annualised monthly return of 37%. As well as having the strongest return, the Pilbara region miner also had the largest standard deviation in returns among the index stocks. The company's investment performance was episodic rather than sustained over the duration of the investment.

> **"The apparently inconsequential impact of the major companies in portfolio construction is pertinent to an assessment of the proposed A$18 billion merger between Northern Star and Saracen**

At the other end of the risk spectrum was Newcrest. Unsurprisingly, given its sector leadership, Newcrest displayed the lowest volatility of the index stocks. The return was among the three lowest in the index but, risk adjusted, was in the top half.

The classic mining investment dilemma - a choice between a market leader and the discovery-driven newcomer - was very evident in the performance profile of the sector.

Just as evident were opportunities from portfolio construction. A combination of stocks could have produced a lower variance portfolio than Newcrest with a higher return than the market leader. Any investor would have been better off choosing the portfolio approach over the single leading stock.

Within the minimum variance portfolio, four stocks would have contributed two-thirds of the investment return. The largest of them will have been Regis Resources (31%) followed by Catalyst Metals (16%), Tribune Resources (10%) and Alkane Resources (8%). Another five will have had weightings ranging from 5% to 7%.

The portfolio with the highest risk adjusted return would have comprised 10 stocks. In this instance, the top five holdings would have been Catalyst (20%), Chalice (13%), Saracen Mineral Holdings (13%), St Barbara (12%) and Bellevue Gold (11%). Another three stocks would have had weightings between 5% and 8%.

Over this medium-term investment horizon, the industry's propensity to promote winners ignored other feasible investment objectives. More often than not, the big winners did not warrant a prominent place in the portfolio mix.

Of course, an investor looking for gold market exposure can also choose a direct bullion holding, or some relevant proxy.

Including physical gold holdings as an investment option changes the conclusions about portfolio composition. The minimum variance portfolio, for example, will have been made up almost entirely of gold. No equity matched the gold risk profile.

As risk tolerance rose, the amount of gold in the optimal portfolio could decline. The portfolio with the highest risk adjusted return would have contained 11 stocks but no physical gold. Bellevue and Catalyst had the highest weightings with 16% each followed by St Barbara and Chalice each with 14% and Cardinal Gold with 12%. Another three stocks contributed between 3% and 9% to the portfolio return.

The portfolio had similar returns to St Barbara, Chalice and Cardinal, but with less than half the volatility.

Investing with hindsight is relatively straightforward. Looking ahead, variations in business and market conditions will change optimal portfolio compositions. Nonetheless, the preceding analysis does prompt two inferences about investing in the sector.

The modelling results show that a range of companies with widely differing returns could be sought by investors, depending on their objectives. Companies looking to attract interest could present themselves as making a value contribution without needing a high-profile discovery or prolific news flow to warrant attention.

The second feature of the modelling, with possibly greater significance, is the absence of the highest profile names in the industry such as Northern Star and Evolution Mining, from optimal portfolios. Once physical gold is admitted as an option, not even Newcrest has a potential role.

The apparently inconsequential impact of the major companies in portfolio construction is pertinent to an assessment of the proposed A$18 billion merger between Northern Star and Saracen, announced this week.

Size matters for larger institutional investors. The largest firms in the industry will find a home in their portfolios. Whether that symbiotic relationship can enhance portfolio performance over a medium-term investment horizon is another matter. Nor should it be a pointer to how others invest.

Those fund managers needing investments to match the size of their asset bases will go in one direction. For those investors whose return profiles are the dominant influence on stock selection, the largest producers have been of limited help in building value.

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