MINING STOCKS VS. BULLION — will a rising tide lift all boats?

by Nick Barisheff

Investing in mining stocks or bullion does not have to be an either-or proposition. There are differences between the two and, depending on the investor, one could invest in both, in appropriate percentages, at certain times. Mining stocks and bullion have very different attributes on the risk-reward spectrum; they can perform quite differently.

In 2011, gold performed exceptionally well for bullion investors. Early 2012 saw gains for silver and platinum, as well as gold, while North American mining shares have trended lower as a group.

Platinum prices look positive, as South African production remains strained. On the demand side, global emission standards are driving platinum purchases for catalytic converters. The average age of cars on US roads has reached an all-time high of nearly 11 years and car purchases in China are expected to rise as much as 10% this year.

Silver, the poor man's gold, has been drifting lower for the past six months. Hedge funds in particular have been decreasing their silver positions. Net speculative long positions have been cut drastically on the COMEX by non-commercial accounts, which is a good insight into who has been selling silver and bidding up the S&P 500 by 30% since the October lows.

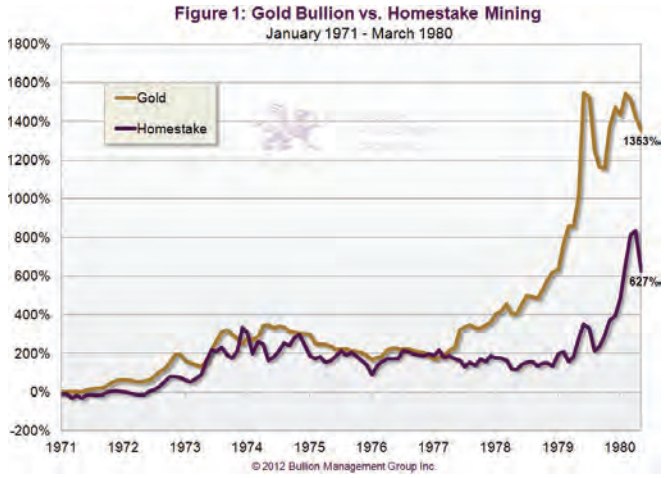
The latest *Barron's Big Money Poll* has 30% of portfolio managers as gold bulls and 39% as bears. This seems fairly neutral and contrasts the near-universal disdain for gold in the media.

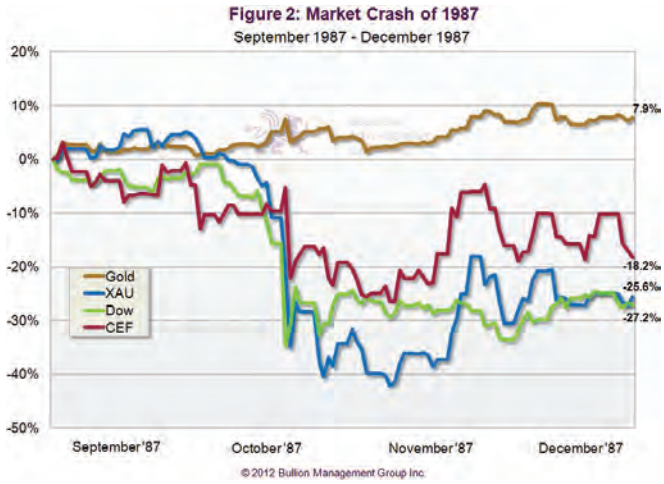
If anything, some of the short-term froth has dissipated for gold, silver and platinum, presenting a long-term opportunity for bullion. Mining equity investors should benefit with rising metals prices as well.

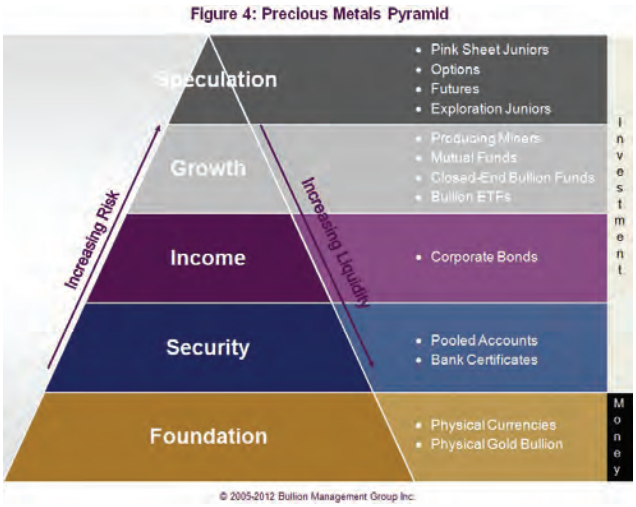
Perhaps Barron's should poll central banks. Their behaviour is likely more important, since portfolio managers are notoriously short-term investors. After many years of selling, central banks have been net buyers of gold since 2009. That is an important signal for long-term investors.

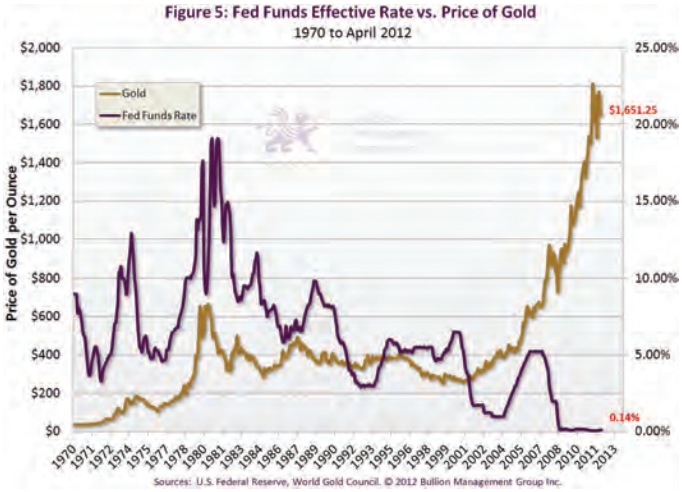
China is an interesting example. Bloomberg recently reported that, while China does not publish gold trade data; mainland China's gold imports surged more than six fold in the first quarter of 2012. This is a good indication that the country's central bank, People's Bank of China, is accumulating reserves.

Sometimes, when making investment decisions, we need to look to the past. During the 1970s, physical gold rose by 1,373%, relative to a respectable but not as impressive 627% increase in the stock price of Homestake Mining (Figure 1), which was, at the time, the biggest producer in North America. Many juniors out-









performed bullion, but many also went to zero (something bullion will never do).

Generally mining stocks and bullion are correlated; however, during broad equity declines they tend to follow the equity markets rather than bullion. During the market crash of October 1987, the price of gold was rising as stocks fell. Mining companies, big and small, fell approximately twice as much as the broad equity markets. Interestingly, shares of the Central Fund of Canada, a closed-end fund that invests in both gold and silver bullion, and trades on the TSX and the NYSE, fell with mining stocks instead of rising with bullion (Figure 2). Under these circumstances, mining stocks can have a negative impact to the entire portfolio.

Most recently, during 2008, gold bullion was one of the few asset classes that posted a positive return. The XAU mining index, consisting of 16 gold and silver mining companies, declined (Figure 3).

Junior mining companies are a speculative investment, but even blue-chip producers act like other equities during stock market declines. Provided your advisor is able to accurately time the market, trading mining stocks could produce speculative gains for investors with a high risk tolerance.

It bears mentioning that daily turnover of physical gold, according to the London Bullion Market Association, is approximately US $34 billion. Volume is estimated at five to seven times that amount. When markets are volatile and stocks are falling, liquidity is a trap that can hurt mining investors with thin trading volume. Bullion is therefore the foundation of a traditional investment pyramid (Figure 4), while mining stocks can provide short term gains during certain periods for investors with high risk tolerance.

A study by Ibbotson Associates found that, "Investors can potentially improve the risk-to reward ratio in conservative, moderate, and aggressive asset allocations by including precious metals with allocations of 7.1%, 12.5% and 15.7%, respectively. These results suggest that including precious metals in an asset allocation may increase expected returns and reduce portfolio risk."

It is interesting to note that only about 0.3% of global pension fund assets are allocated to gold, and privately held bullion represents only about 1.5% of the world's $200 trillion in financial assets.

So what does the future hold for gold? That depends in large part on the past. Baby boomers, after decades of consumption and borrowing, are entering retirement. Their discretionary spending will decrease, while their dependence on various social programs, for which today's taxpayers are responsible, will increase. Lower economic growth, higher unemployment, ever-increasing budget deficits and further increases to the money supply seem inevitable, and not just in the US. Mining stocks and bullion will benefit.

In 2002, four years before he became chairman of the US Federal Reserve, Ben Bernanke said: "Like gold, US dollars have value only to the extent that they are strictly limited in supply. But the US government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many US dollars as it wishes at essentially no cost [and] reduce the value of a dollar… [and] generate higher spending and hence positive inflation." Today, 10 years later, it seems clear that a tiger does not change its stripes.

The US Fed is expected to keep interest rates low through the end of 2014 (at least), in order to keep deflation, Bernanke's greatest fear, at bay. Even if central banks raise short rates in the coming year, long rates in the West seem destined to remain stable after a 30-year decline to almost zero. Politicians seem to believe low interest rates and easy-money policies are one way to assist in the deleveraging process and manufacture inflation (or avoid disinflation).

Investors should note that bullion has a unique ability to thrive in rising or falling rate environments. Just consider gold's ascent during the rising interest rates of the 1970s, as well as the strength it has shown in the recent falling rate environment (Figure 5).

Last summer's political theatre surrounding the enormous US $14 trillion debt ceiling is about to be repeated. The next debate on raising the debt ceiling will likely happen before the November 2012 US presidential election. Official estimates predict that US debt will stand at $23 trillion by 2015 and, based on a tendency to underestimate such figures, it wouldn't be surprising to see US debt double in the next three years. If the correlation between gold and US debt holds up, $3,000 gold in the near future does not seem farfetched.

"It is absolutely inevitable that the US will have to default on part of its existing liabilities, since the long-run trajectory of government borrowing is clearly unsustainable." – Niall Ferguson, Professor of History at Harvard University and author of *The Ascent of Money*

Government debt is spiraling out of control all over the Western world. Reinhart & Rogoff's 2010 study, *Growth in a Time of Debt*, identified a crucial 90% debt-to-GDP threshold, after which point median GDP growth falls by 1% and average growth by even more. Today's policy response of quantitative easing ensures that debt breeds more debt. This does not bode well for fiat currencies, and it is why every investor needs exposure to bullion as well as mining stocks.

One of the key developments that mining stock and bullion investors should pay close attention to is the fallout from the US National Defense Authorization Act (NDAA) signed on December 31, 2011. The NDAA seeks to target those who do business with Iran's oil industry. The act imposes sanctions that will prevent access to the US financial system as of June 28, 2012, forcing a choice between the US capital markets and Iranian oil.

In order to circumvent the NDAA and provide cash for Iranian coffers, countries like China and Iran will likely begin using gold to pay for Iranian oil. Earlier this year, Iran said it would be happy to accept gold in exchange for oil, supporting the idea that gold is money.

In my upcoming book, *$10,000 Gold: Why Gold's Inevitable Rise is the Investors Safe Haven*, I examine several disparate themes that are related to the main theme of gold's rising price. (Or is it just that currencies are falling in value?) Informed investors will reap the benefits of building wealth and protecting principal with bullion. A minimum allocation of 20% to precious metals bullion is necessary today to protect portfolios in the current economic environment. ■

Nick Barisheff is the founder, president and CEO of Bullion Management Group Inc., a company dedicated to providing investors with a secure, cost-effective, transparent way to purchase and hold physical bullion.

Widely recognized as an international bullion expert, Nick has written numerous articles on bullion and current market trends, which have been published on various news and business websites. Nick has appeared on BNN, CBC, CNBC and Sun Media, and has been interviewed for countless articles by leading business publications across North America, Europe and Asia. His first book, $10,000 Gold: Why Gold's Inevitable Rise is the Investors Safe Haven, *will be published in the fall of 2012. Every investor who seeks the safety of sound money will benefit from Nick's insights into the portfolio-preserving power of gold.*