MANAGER INSIGHTS

Gold Equities *versus* Gold Bullion: The Case for Gold Shares Amid Rising Costs

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Introduction

Gold equities had positive price performance from the beginning of 2012 up until about mid-March. The drop in the gold price late in the first quarter dragged gold stocks down, leading to overall negative returns for the quarter. This was despite the appreciation of the gold price during the quarter, and the already low valuation levels of the stocks at the beginning of 2012. Year-to-date as of March 31, 2012, gold bullion has gained 6.7%, while the NYSE Arca Gold Miners Index has decreased 4.0%. The Market Vectors Junior Gold Miners Index fared better, down only 0.6% year-to-date. Historically, gold mining stocks have outperformed bullion when the price of gold rises. We believe there are two key reasons for the recent underperformance of gold equities: 1) rising operating and capital costs in the mining industry, and 2) contraction of valuation multiples[1].

Rising Costs

Anyone who follows gold stocks probably knows that mining companies have struggled to control costs (see Figure 1). Many assume that escalating costs reflect poor management. However, miners' rising cost structure has been no different than the inflation consumers experience at the gas pump or grocery store. Generally speaking, mining companies face three types of costs – operating, project capital, and ongoing capital. Operating costs are the direct costs of mining and extracting gold, including energy and labor, which together can account for up to 80% of operating costs at a gold mine. Cost escalation trends date back to 2003, when WTI Crude, currently trading at over $105 per barrel, crossed the $40 per barrel threshold. The correlation between crude prices and mining energy costs is fairly high.

The global mining boom has created a labor shortage due to increased demand combined with a shortage of skilled workers, driving labor costs upward. The modern gold mine is no longer a pick-and-shovel operation but rather a high-tech enterprise that requires increasing amounts of knowledge and skill to run. According to GFMS annual data, total mine operating costs have increased at an average rate of 15.8% annually since 2003. Also, the ongoing capital cost to build and maintain mines continues to escalate. RBC Capital Markets estimates that project capital costs have increased by 25% per year since 2003. Overall, it is difficult to see an end to the cost pressures across the mining industry. However, investors who focus solely on rising costs risk missing the larger picture – the profitability of this sector.

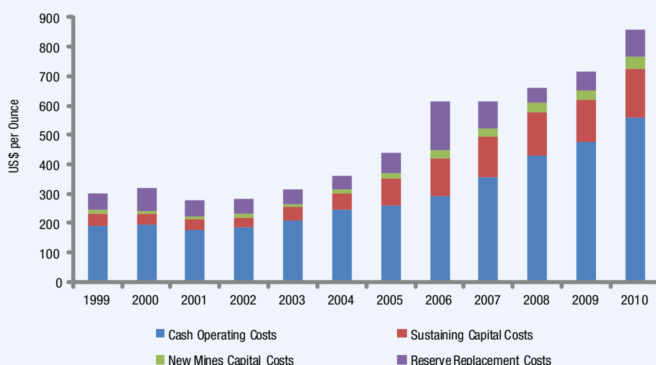
Contraction of Variation Multiples

Another factor that we believe has led to miners' underperformance is a general contraction in valuation multiples assigned not only to the stocks but also to the overall equity markets (see Figure 2). We believe this de-rating of the broader equity sector reflects heightened risk aversion by market participants. It is difficult to say whether the trend is permanent or if the market gradually will assign progressively higher multiples to reflect improving macro-conditions and increased appetite for risk. In our view, further de-rating of gold equities from these levels seems unlikely. Specifically, we believe gold mining equities continue to exhibit benefits in three major ways: 1) leverage to the gold price, 2) rising dividend yields, and 3) currently attractive valuations compared to bullion. As a result, we believe this is a potential buying opportunity for equities.

Leverage to Gold Price

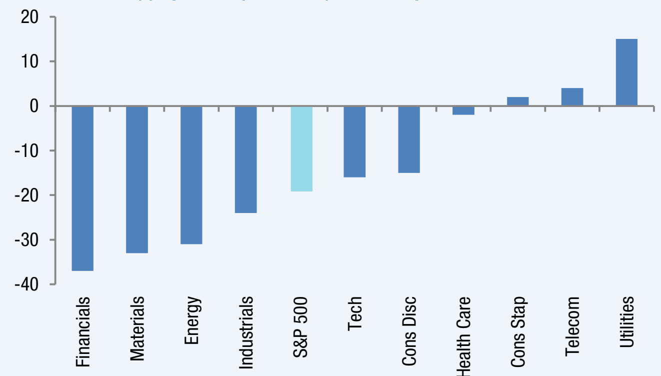
Although costs are a huge issue in the mining industry, we cannot ignore the larger picture, which is the sector's profitability. As operating costs have increased 15.8% per year since 2003, bullion is up 19.8% annually over the same period. We believe that several factors driving miners' costs structures higher are also moving the gold price upward. Factoring in gold's historical role as a safe haven, currency hedge, and central bank reserve asset, it seems reasonable to us to forecast a bullion price that stays ahead of production costs over time. If so, miners' margins will expand, which, in turn, will give gold equities leverage to the gold price.

FIGURE 1: PRODUCTION AND REPLACEMENT COSTS
PER OUNCE OF GOLD



Source: GS Global ECS Research

FIGURE 2: DERATING OF CYCLICAL SECTORS
% CHANGE IN P/E IN 2011



Source: S&P, Bloomberg, Haver, DB, 02/16/11-11/30/11

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[1]Valuation using multiples is a method for determining the current value of a company by examining financial ratios of peer groups.The most widely used multiple is the price-earnings ratio.

To understand this leverage, consider an example: If a company must spend $700 to produce an ounce of gold when bullion is at $1,700/oz it realizes a profit margin of $1,000/oz. If bullion increases by 10% to $1,870, the profit margin increases to $1,170/oz, which represents a 17% increase. In this case, profitability growth outpaces the gold price by 7% (10% versus 17%). All other factors being equal, this should translate into outperformance of the shares relative to gold.

Rising Dividend Yields

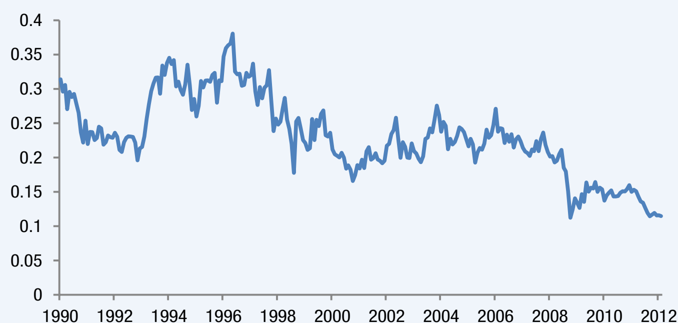
Despite increased costs, miners' profit margins have generally expanded, increasing free cash flow. With yield-hungry investors increasingly focused on dividends, many mining companies have used earnings growth to raise dividends (or start paying them). For example, in 2011 industry leader Newmont Mining Corp (NEM) increased its dividend and linked it to changes in the gold price. This reflected the company's commitment to distribute earnings back to shareholders in a rising gold price environment. Newmont's indicated yield is now 2.5% and carries additional upside leverage to gold.

Other companies have followed Newmont's lead. On average, dividend yields for leading gold miners have grown to about 1.5% currently, from under 1.0% just a couple years ago. We believe mining companies should target yields of at least 2% to further differentiate their equities from other gold vehicles such as bullion exchange-traded funds and physical gold (both of which have no yield).

Attractive Valuations

Key valuation metrics such as equity prices to net asset values (NAVs), cash flows, and earnings indicate that gold shares are trading at historically low valuations. Ratios of gold mining indexes to bullion have moved to levels previously seen during the 2008 financial crisis and the depths of the gold bear market in 2000 (see Figure 3). These were periods of acute financial stress for the gold mining industry. However, the industry is now financially healthy, which makes the current low valuations anomalous; we believe this may represent a buying opportunity for gold.

FIGURE 3: XAU INDEX[2]/GOLD PRICE RATIO
JANUARY 1, 1990 - FEBRUARY 29, 2012



[2]Philadelphia Stock Exchange Gold and Silver Index   Source: FactSet

Conclusion

The market's intense focus on increased costs for the gold mining industry is causing it to ignore positive attributes of increasing cash flows, expected higher dividend yields, and the built-in leverage of gold shares to rising bullion prices. In late-February, markets became unsettled as a result of continued concerns about the sovereign debt crisis in the European Union and reduced growth expectations for Europe and the emerging economies. Relatively positive news about the U.S. economy, combined with the market's perception that further quantitative easing (QE) may be off the table, led to gains in the US dollar and drove down the gold price. We discount this reaction because we believe that for the foreseeable future there remains the risk of an economic downturn strong enough to prompt another QE initiative by the Fed. Given the persistence of the underlying fundamentals, we continue to believe in the longevity of the bull market in gold. We expect gold bullion to retain its role as a safe haven and sound currency alternative, and we expect the valuation gap between bullion and miners' shares to revert toward historic norms.

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