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A Golden Opportunity For Investment Portfolios

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Editor's note: This article is for informational purposes and not investment advice.

It appears now is the time to take a very hard look at the value of adding gold, and even gold mining stocks, to investment portfolios.

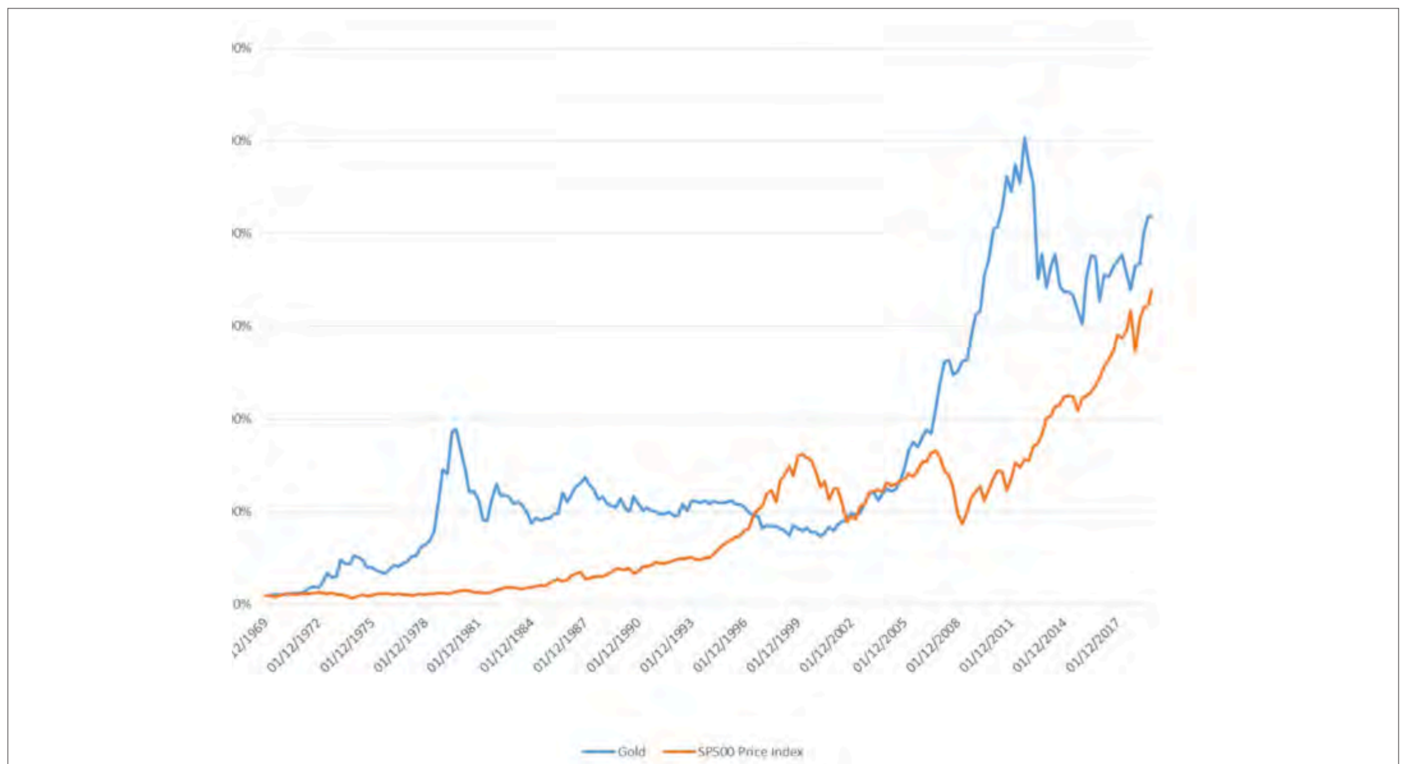
The benefit of adding gold to portfolios is its significant historical diversification benefits. The benefit of adding gold to a portfolio **right now** is the decent potential for a large increase in its price due to current low gold mining industry sentiment and possible central bank actions in the coming years. Furthermore, an interesting aspect of gold mining stocks is that they can act like a long-term call option on the price of gold.

Let's look at each of these factors one by one.

DIVERSIFICATION BENEFITS OF GOLD

While I could show a mean-variance analysis of gold and its correlation (or lack thereof) with stocks, I think the following chart of the performance of gold versus U.S. stocks (SP500 Price Index) over the last 50 years really illustrates how gold can perform very different from stocks. (See Chart 1)

Chart 1
Percent Change—Gold Price Versus SP500 Price Index—Last 50 Years



Source: Bloomberg

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Table 1

Gold	Time Period	Gold return	S&P 500 Price return
Boom	1970 to Jan. 1980 peak	+2317%	+24%
Bust	1980 to 1999 low	-70%	+1057%
Boom	1999 to 2011 peak	+649%	-14%
Bust	2011 to Nov. 15, 2018	-23%	+176%

Source: Bloomberg

Furthermore, I have divided the last 50 years into four periods of boom and bust for gold and how it has done versus the SP500 Price Index in those periods. (See Table 1)

As shown in the chart and table, the price of gold can often move in very different ways from stocks. Also, the table shows gold can have medium-term periods of very high returns and also long periods of no or negative returns.

At the time of writing this article, the S&P500 has just set all-time highs above 3100. Modestly diversifying into something uncorrelated with stocks seems like a reasonable thing to consider at this point in time.

GOLD MINING INDUSTRY SENTIMENT

I grew up in a mining town in Northern Canada and got to see first-hand the big booms and big busts of commodity mining and prices. What typically happens is that high commodity prices cause a lot of expansion of mining operations and exploration for new sources of supply. After a few years of this excitement by the entire mining industry, the large expansion of supply comes online leading to prices then rapidly falling. The lower prices lead to a significant curtailing of mining operations with cutbacks, layoffs, and a focus on cutting costs often through mergers as weaker players can no longer continue to exist with low prices. After several years of this despair, the reduction of supply leads to prices then rapidly rising leading to a renewal of the boom/bust cycle.

You would think that mining companies would learn from this, but it seems that the reality is that it is hard to get people to finance or invest in mines until **after** the commodity price has risen. This dynamic not only leads to cycles in the various mining industries, but it also really **amplifies** the cycles to create very large booms and vary large busts.

The current sentiment in the gold mining industry, eight years after the 2011 all-time high in the price of gold, is one of cutting costs, mergers to consolidate administration, and many years of reduced exploration. For example, one of the most prominent gold mining companies, Barrick Gold, has recently made it clear that it is focused on cutting costs and not on increasing production. In addition, several large gold mining company investors have also put pressure on these companies to focus on large administrative cost cuts and reduce growth efforts.

Furthermore, a recent report from McKinsey Consulting highlighted that in recent years there has been a "70 percent reduction in exploration expenditure as companies sought to preserve cash."

The massive efforts to reduce costs in the gold mining industry and the significant reduction in exploration are actually a sign of the bust getting closer to an end. This long period of retrenchment sets the stage for possible supply shortfalls, and thus increases the potential for a boom and a rise in the price of gold in the coming years.

POSSIBLE CENTRAL BANK ACTIONS—THE "NEXT STEP"

There is a lot of focus right now on low and even negative government bond interest rates and the decisions of central banks on their short-term policy interest rates. But I think it's the central banks' possible next steps not related to interest rates that could significantly impact the price of gold in the coming decade.

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In one of the most important central bank speeches of all time, Ben Bernanke, past head of the U.S. Federal Reserve, in 2002, laid out how his research showed how central banks should deal with deflation caused by a large reduction in consumer demand. The initial steps of cutting the policy rate to zero and then central bank purchases of assets to bring long-term interest rates down have played out (again and again) over the last 13 years. The "next step," according to Bernanke's speech, if needed in a significant downturn, is some sort of coordinated money printing, tax cuts, and giving money directly to consumers to spend. (Technically, the U.S. Federal Reserve cannot print money, but rather, it could coordinate with the federal government to buy very large amounts of the government's debt that is used to allow the government to finance large tax cuts, or even to dispense cash directly to citizens to spend.)

There is no certainty that this "next step" has to happen, but let's look at a few factors that may cause this to happen sooner rather than later.

First, the U.S. Federal Reserve is already lowering its short-term policy interest rate and it currently sits at under 2 percent. This is at a time when things are economically pretty good—the U.S. stock market is at an all-time high, long-term interest rates are at historic lows, and U.S. employment is very good. There is very little room for the U.S. Federal Reserve to adjust interest rates (short-term or long-term) if there was a significant downturn. This puts the "next step" much closer than it has been before.

Second, the European central bank has tested negative policy interest rates. The evidence is suggesting that this is not actually stimulating the economy as much as desired. Furthermore, the head of the U.S. Federal Reserve recently stated that negative interest rates are not something the U.S. central bank would pursue. Again, the "next step" seems to be reasonably possible in the next several years.

What does this mean for the price of gold? If this next step were to occur, it's reasonable to think that investors (individual and institutional) and countries that hold U.S. currency in reserve to stabilize their economies will question the value of holding that asset and will look for an alternative tangible store of wealth. Furthermore, it's reasonable to think that other countries with their own currencies will follow the lead of the U.S. One alternative to currency, that is limited in supply and is tangible, is gold.

Even a small amount of uncertainty around the value of currencies could lead to a large increase in the demand for gold. An increase in the demand for gold at the same time supply is diminishing due to cutbacks and poor sentiment in the gold mining industry could be the recipe for a very large increase in the price of gold.

WHY GOLD MINING STOCKS ACT LIKE A LONG-TERM CALL OPTION ON THE PRICE OF GOLD

There is no guarantee that the price of gold will rise in the coming years. But I have tried to show that the potential for a large rise is there. One way to take advantage of that potential, but also limit downside is through some sort of long-term call option on the price of gold. Interestingly, at this point in time, many gold mining companies through their efforts to reduce costs and be more efficient, have effectively turned their stocks into something like a long-term call option on the price of gold. Let's look at an example to show how a gold mining stock can act like a call option on the price of gold: First, imagine a gold mining company is currently surviving on a gold price of $1400 per ounce and say making a profit of $400 per ounce. Then, imagine what would happen if the price of gold, say, increased by 50 percent to $2100 over the next several years. That could, all other things being equal, increase profit margins from $400 to $900 per ounce. In other words, gold mining stocks have the potential to see their profits increase by several multiples of the percentage increase in the price of gold. This increase in profit margins can lead to a much higher price for gold mining stocks. Hence, gold mining stocks can have a very asymmetric risk/reward relationship with an increase in the price of gold very much like a long-term call option on gold.

Importantly, picking **individual** gold mining stocks is fraught with danger. For example, Mark Twain has been credited with saying "a gold mine is a hole in the ground with a liar on top." So, instead, a broadly diversified approach to investing in gold mining stocks is usually much better—such as ETFs or well-managed mutual funds. In addition, there is a spectrum of risk and reward when looking at large mining companies, smaller companies or companies that focus on exploring.

This current situation allows portfolios to get significant diversification and potential return benefits from allocating only a

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relatively small percentage to a diversified mix of gold mining stocks—say 5 percent to 10 percent of an investment portfolio.

CONCLUSION

The diversification benefits of gold are easy to see. The current potential return benefits are harder to see, but the ingredients seem to be in place. Even a small allocation to gold and gold mining stocks could be enough to significantly benefit investment portfolios over the coming years. It appears to be a good time to take a hard look at this asset class.

But even if gold does not perform well, I can say it is still one asset class that can make your portfolio truly shine. ■

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