One Stock to Consider Owning if Gold Rebounds

Description

Take Stock *is the Motley Fool Canada's* ***free*** *investing newsletter and is distributed weekly. This edition was sent to our followers earlier this week. To have future editions delivered directly to you, simply* ***click here now****.*

Dear Fellow Fools,

It's been quite an eventful couple of weeks for gold — a onetime market darling — and essentially all of the companies that mine it.

Gold hasn't seen these levels in four years, and the carnage is widespread (just glance at the list of 52-week lows of the Toronto Stock Exchange!).

According to Capital IQ, 50 out of the 123 gold-related companies on the TSX currently trade within 10% of their 52-week low. Additionally, the average return for the entire collection of 123 over the past month has been -19.5%.

This figure looks bad on its own but even worse when we consider that the S&P/TSX Composite is down by just 1.2% over this same period (a decline influenced by gold stocks, no less).

Any time a decline of this magnitude occurs, it's natural for investors to wonder whether the fall is over.

The answer is a resounding "maybe"

On Monday , futures for December delivery dropped to $1,169.90/oz, which is in fact an improvement over the $1,160.50/oz level that was touched on Friday, but still a touch below the current spot of about $1,170/oz.

At the very least, a quick bounce-back for gold does not appear to be priced into the cards.

What happened?

By no means do we Fools consider ourselves macro mavens when it comes to the markets and how the various forces that exist may impact gold.

What's being reported, however, is that gold's recent weakness has coincided with strength in the U.S. dollar. This strength has been buoyed by several variables: (1) Recent U.S. economic data has been reasonable, (2) the Fed's indication last week that quantitative easing (QE) is now complete (within its jurisdiction), and (3) the Japanese government's indication last week that QE is alive and well in theirs.

These central government moves have led to an outflow from the Japanese yen with the destination of choice being the U.S. dollar.

Got it?

Here's my take. (Warning: In some — many? — corners, the following views might be considered incredibly naïve and unsophisticated.)

Money flows are very likely an issue, but that's exactly the sort of rationale that can be used to explain gold's decline on any given day (and gold's possible rise on any given tomorrow). It is very difficult, if not impossible, to isolate these variables and quantify how each has actually impacted the price of gold.

In my opinion, the bigger-picture reason for the decline is that there is very little in the way of natural demand for this commodity. You and I do not need gold to get through the day. We need oil, we need natural gas, we need copper, zinc, potash, etc. *We don't need gold*.

Without a real, natural source of demand, gold's "intrinsic value" is essentially a figment of the market's imagination. The price of gold is truly a case of whatever the next person is willing to pay for it. There is little in the way of fundamental data that can support any kind of valuation for this metal.

Perhaps none have illustrated this dynamic better than (who else?) Warren Buffett. In his 2011 Letter to Shareholders, Buffett described gold as part of a category of assets that "will never produce anything, but that are purchased in the buyer's hope that someone else – who also knows that the assets will be forever unproductive – will pay more for them in the future."

To Buffett, gold is essentially a Ponzi scheme.

In the same letter, Buffett expands on gold:

"This type of investment requires an expanding pool of buyers, who, in turn, are enticed because they believe the buying pool will expand still further. Owners are not inspired by what the asset itself can produce – it will remain lifeless forever – but rather by the belief that others will desire it even more avidly in the future."

"What motivates most gold purchasers is their belief that the ranks of the fearful will grow. During the past decade that belief has proved correct. Beyond that, the rising price has on its own generated additional buying enthusiasm, attracting purchasers who see the rise as validating an investment thesis. As "bandwagon" investors join any party, they create their own truth – for a while."

Should've listened to Buffett

I read this letter when it came out in 2012 (and several times since) and, of course, am a big Buffett believer. Yet still, I personally own some gold exposure and we have in fact recommended a gold-related entity in our *Stock Advisor Canada* service, which I lead.

Needless to say, both my personal holdings and our gold-related recommendation are suffering along with the rest of the sector.

In a moment of weakness (make that a couple of moments), when gold was plummeting back in early 2013, I couldn't stop myself and picked up a few shares in several of the bigger gold mining companies that were, so I thought, being unjustifiably punished.

Looking back, and replaying the words of Buffett over and over again in my mind, I've come to realize that the punishment was entirely justified.

In my opinion, mining for gold is just a bad business.

Not only are you dealing with a commodity with an imagined value, but mining for this (or any) commodity is incredibly difficult.

I'm proud to say at least that I've not been adding to any of these positions as they've continued to fall. Time will tell if I remain proud of this decision to stand pat.

Not all bad

In our view, there is at least one bright light in this sector — the company we've recommended for our *Stock Advisor Canada* members (full disclosure: I own it personally as well).

This is not a mining company per se, but what's known as a "streaming" company and one that, as long as the industry keeps producing, should perform quite nicely over the next five years. You see, unlike mining companies, this company's costs are fixed at a level that is well below current market prices.

What this means is that even though it will make a lot more money if the price of gold (and silver) rebound, even if a floor is found below current levels, our recommendation is still going to be very profitable — as it's been throughout this decline. Fixed costs help to ensure this, as does the fact that its "production" is set to grow dramatically. Provided there is not an outright collapse in this space, beyond what has already occurred, we continue to believe in this company as it arguably operates under the most sound business model in the entire space.

Bottom Line

Personal experience and Buffett's wisdom aside, I'm still not adverse to a portion of one's portfolio being allotted to gold. It's demonstrated over the past decade that under the right conditions, it can produce rather spectacular returns — ideally when other assets aren't. This diversification angle, and the relatively small allocation that I've made, are what have kept me sane as the entire sector has been battered by the market.

As things stand, I also believe that — even though they are terrible businesses — the miners probably offer a more attractive risk/reward scenario than the commodity. Should the commodity rebound, which may or may not occur, the producers are poised for a potentially astounding move higher.

In our opinion, though, shining brightly above them all, because of its superior business model, is the company that we've recommended for our *Stock Advisor Canada* members.

Because it is a members-only service, I can't reveal the name of this company at this time, but we'd love to have you join us and learn all about it by simply clicking on this link.

Notice that this is a risk-free proposition. Sign up, poke around, learn about this company and the 22 others that we’ve recommended, and if you don’t like what you see, we offer a 30-day full-money-back guarantee.

As risk/reward scenarios go, it doesn’t get better than that! See you inside!

Foolishly yours,

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