Which Is a Better Investment: Gold or Gold Shares?

Description

I never had been able to convince myself that gold or gold shares are good investments. The unpredictability and volatility just never appealed to me.

Some simple statistics may prove the point. Over the past 20 years, a portfolio of global gold shares, as measured by the NYSE ARCA Gold Miners Index, returned an abysmal 1% per year. In addition, the volatility of the returns (read “risk”) was exceptionally high with a worst rolling 12-month return of -58% and a best return of 107%. In 50% of all rolling 12-month periods, investors would have lost money. This is, to my mind, indicative of an investment only suitable for high-risk investors.

Gold, on the other hand, has been a better investment vehicle over the past 20 years. A bar of gold as an investment would have yielded a 6% investment return per year over the full period, while the volatility was much lower than for gold shares. In addition, an investment in physical gold would have lost money in about one-third of the rolling 12 month periods – much better than for gold shares.

The statistics for the past 20 years would clearly favour gold over gold shares as an investment – higher returns and lower risk!

However, gold shares have substantially underperformed gold over the past few years and this may have contributed to a somewhat skewed picture of the real investment profiles of gold and gold shares. The graph below indicates this poor relative performance of gold shares, which started in 2007 and despite a brief rally in 2009, continued into 2015.

There are several reasons for the poor performance of gold shares over the past few years, including high-cost capacity expansions during the gold bull market, overpriced acquisitions, highly leveraged balance sheets, and bloated cost structures. This all had to be worked out over time – a process that affected the profitability and viability of many gold producers. In addition, investors became increasingly wary of the high risk involved in gold mine investing, especially after the 2008-09 market crash.

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Gold Shares Relative to Gold

Another point of interest from the graph is that gold shares normally performed better than gold during periods when the gold price increased. This happened in the early to mid 1990s and again between 2001 and 2007 although the gold price continued to move up until 2012. The opposite was also true with the price of gold in decline between 1996 and 2001, and again from 2011 onwards – during these time periods the gold shares performed poorly relative to the price of gold.

Noticeable is the fact that the ratio between gold shares and gold generally moved between 1 and 2 until June 2011. The ratio is currently at its lowest level for at least the past 20 years, which implies that gold shares are now exceedingly cheap when compared to physical gold. This will correct at some point, most likely when investors become confident that the next bull market in gold has started.

From this analysis, it would be reasonable to conclude that investors who believe that the next bull market in gold is underway or will start in the near future, should emphasize quality gold producers such as **Goldcorp Inc.** (TSX:G)(NYSE:GG), **Newmont Mining Corp** (NYSE:NEM), and **Eldorado Gold Corp** (TSX:ELD)(NYSE:EGO), or gold streaming companies such as **Franco Nevada Corporation** (TSX:FNV)(NYSE:FNV) rather than adding gold bullion to their portfolios.

CATEGORY

1. Investing
2. Metals and Mining Stocks

TICKERS GLOBAL

1. NYSE:EGO (Eldorado Gold Corporation)
2. NYSE:FNV (Franco-Nevada)
3. NYSE:NEM (Newmont Mining Corporation)
4. TSX:ELD (Eldorado Gold Corporation)
5. TSX:FNV (Franco-Nevada)

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