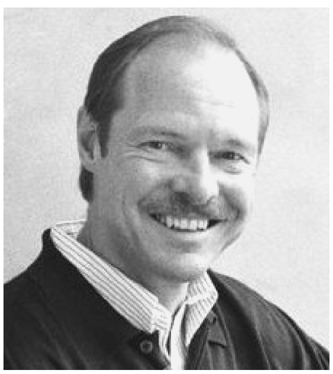
July 16, 2003

Cavelti

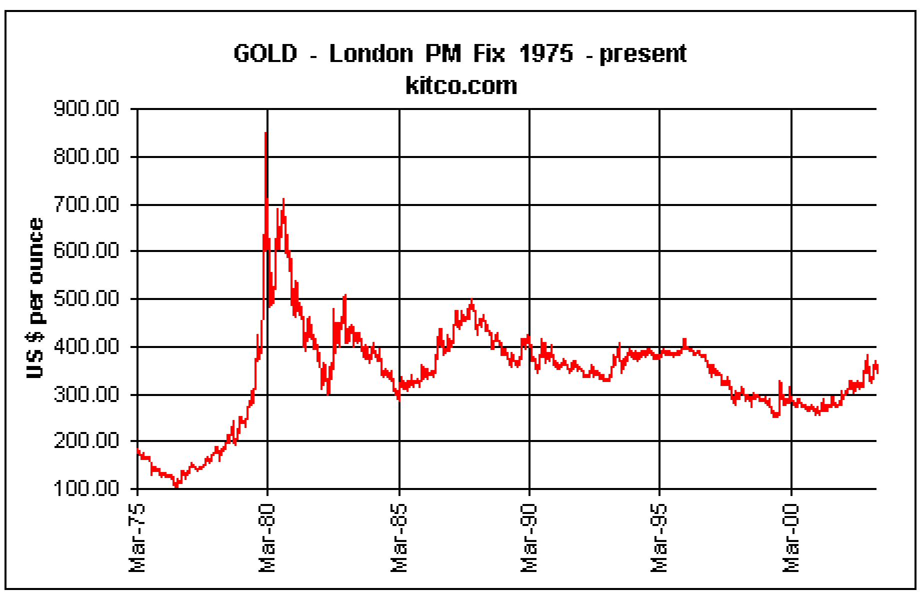
Perspectives

Gold and Gold Stocks:
Another Chance to Get On Board



It's always interesting to analyze investment performance and figure out which portfolio components made the biggest difference. In the case of the Perspectives model portfolio, the "bang for the buck" has typically come from relatively small positions. During the past three years, for example, exposures to gold stocks, energy stocks and the emerging markets helped us post a healthy portfolio return, despite the vicious meltdown in world equity markets.

Today, I'd like to talk about gold. After spending two decades in a protracted downtrend, which pushed the bullion price from its high of US$850 in January of 1980 to just above US$250, the Midas metal has finally ended its bear market. The question now is how substantial gold's upside potential is and when the next major advance will unfold.



All charts in this issue of Perspectives courtesy Kitco.

A number of technical analysts predict a strong rally; some say it's imminent. Tom McClellan, the editor of the excellent McClellan Market Report (www.mcoscillator.com), sees "higher highs for gold later this year, with the upward acceleration especially catching fire in August." McClellan has done a fine job predicting past turning points and correctly foresaw the recent consolidation in the gold price.

Technical correction has run its course; fundamentals are strong

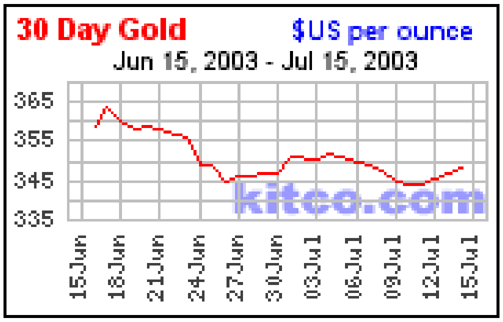
My own technical analysis yields similar conclusions, but I feel even better when I consider the fundamentals. In the current environment, almost everything is moving in gold's favor. Money is cheaper than it has been in over 40 years, which sharply reduces the opportunity cost for holding bullion. Moreover, short-term interest rates are not just low, but actually negative when adjusted for inflation—in other words, if you keep your money in cash, inflation eats up more than you earn. For good reason, low interest rate environments have historically been favorable for gold. Additional encouragement for gold could come from the Federal Reserve's stated commitment to counteract deflationary forces. The money supply in the US has sharply risen, which raises the risk of an eventual return of inflationary pressures.

There are other factors which should support a healthy, multi-year uptrend for the yellow metal. Doubt about the US dollar and the absence of a viable alternative could boost gold's role as a currency proxy. And the ongoing geo-political morass is likely to stimulate investment demand further. Meanwhile, a host of new gold products (more about that later) makes it easier and less expensive for small investors to buy gold--or, for that matter, buy gold at all. China's citizens, for example, have recently been allowed buy gold in physical form or in gold accounts at banks, for the first time. That in itself could significantly boost gold demand.

Then there are the changing industry fundamentals. Production has for some time followed a stable course, but the advance in the bullion price during the past two years has put immense pressure on the mining industry to reconsider its strategy to aggressively pre-sell future production. This practice, which saw many leading mining firms hedge several years worth of output, worked well during gold's multi-year bear market. But with gold rising, shareholders ask themselves why they should own a gold producing company when the upside in the gold price has been neutralized by hedging? The result is that the market has rewarded companies with a declared no-hedge policy and, conversely, punished those which were caught with sizeable hedge positions. As the gold price continues its advance, the pressure on mining companies to "de-hedge" will increase. And as that process unfolds, gold's rally will be fueled further: instead of metal being sold forward, existing forward positions will be bought back. Some analysts expect that process to result in a sharp spike in the bullion price; I personally think it will exert more gradual, but nevertheless noticeable, pressure on the bullion price.

Are there any negatives to the gold story? There are, but the pluses, in my opinion, far outweigh the minuses. One concern is that investor sentiment on gold has remained quite high throughout the recent correction. Some analysts feel that more consolidation or a final sell-off is needed before the metal can continue its climb. More looming in my opinion is the subject of central bank sales. On this subject, gold experts remain sharply divided. Some argue that the higher gold price will attract larger sales from government gold hoards; others forecast stable sales volumes or even a decline. I belong to the camp that expects stable supplies from this source. On the one hand, the 1999 Washington Agreement, under which 15 signatory central banks agreed to limits for their aggregate gold sales, has worked well and may well be renewed after its expiry in fall of 2004. But even if the agreement is not extended, a sudden flood of central bank gold is not likely and the impact of liquidations of bullion is likely to be mitigated by central banks entering the open market to buy gold. Key among these will be the Chinese Central Bank. Beijing's foreign exchange reserves keep swelling at a rapid rate and for some time now, China's central bankers have been steady buyers of bullion.

In short, a host of positive factors is likely to keep pushing gold to higher levels. There are a few potential negatives, but I expect their impact to be relatively minor.



What to do now

Roughly two years ago, I switched from an underweighted position in gold to a fully invested one. In February of this year, with the bullion price probing $385, I trimmed our gold stock holdings back to target, locking in substantial profits but leaving our original positions intact. The Midas metal, at that time, was in dire need of consolidation, a process which now appears completed.

What should you do now? If you've followed my model portfolio, nothing. You already have a meaningful exposure to gold and no additional action is necessary. If you're among the readers who've joined Perspectives more recently or hold an underweighted gold exposure for different reasons, this is in my opinion an excellent time to add to it. I'll discuss our choices below.

Gold or gold shares?

"You've repeatedly warned of holding too many Euros or Yen and pointed to gold as a better dollar alternative," writes a subscriber in Connecticut. "Do you prefer bullion or mining shares?" In my opinion, the two should play distinctly different roles. I've always viewed gold shares as something to be included in the equity portion of a portfolio, mainly because the leverage of gold mining shares can be such that they can help minimize damage during negative periods in the investment cycle. The past three years or so are a case in point. Our model portfolio managed to generated a decent return, largely because we held assets like gold stocks. What's even better, we didn't have to take huge bets—a relatively small inclusion helped a lot. Core holdings such as Newmont Mining and Dundee Precious Metals* have risen 160% and 270% since they made their cyclical lows!

Such gains make bullion's advance of roughly 40% seem paltry, which is why gold in its physical form is ignored by many investors. In the end, gold price movements simply aren't as exciting as those of gold stocks. Since gold related assets bottomed, our recommended gold stock holdings have, in aggregate, outperformed the gold price by more than four times. "So why hold bullion at all?" asked a friend of mine the other day. "If it tanks, I don't want to hold it; and if it rises, I want the leverage." That's an excellent point, but there *is* a role for bullion.

That role is as a crisis insurance of last resort. It's difficult to imagine a world where the value of paper money would disappear, even temporarily. But increasingly many observers are alarmed by the Federal Reserve's dramatic anti-deflation push and see it as a blatant attempt to debase the currency. Others suggest that even if a collapse of the US dollar does not have a high probability, it's still a good idea to insure against it. If that's what you want to do, physical gold bullion—in the form of bars from a major mint or refinery or bullion-type coins, such as the Canadian Maple Leaf or the US Eagle—is the right thing.

What about bullion certificates, shares of funds which hold physical gold, or the new gold-based ETF sponsored by the World Gold Council—the *Equity Gold Trust*? Personally, I don't like any of them, even though I readily admit that they provide a convenient (and in the case of the planned Equity Gold Trust, an inexpensive) way to buy, hold and sell physical metal.

---

*Disclosure: I am a founder and director of Dundee Precious Metals Inc. and hold shares in the company.

What, then, are my reservations? During the late 1970s, I was responsible for launching one of North America's largest bullion certificate programs; and, quite candidly, I wondered why so many people accepted paper in lieu of the real thing. Our certificates were backed by real gold, to be sure. But taking delivery was cumbersome, time-consuming and expensive. And to me, being able to get at the gold is everything. So, my points are these: First, if you feel the need for crisis insurance—something you can put your hands on in an emergency—real gold is what you want! It comes in the form of ingots or bullion type coins, such as the Canadian Maple Leaf or the US Eagle. And, second, if you do buy physical gold, view it not as an investment, but as investment insurance. Your bullion holdings should be viewed as part of your cash position.

For a superior return, look to gold shares

If, on the other hand, achieving a superior investment return is your objective, stick to quality gold mining shares or a fund that invests in them. The gold mining sector looks more exciting than it has for many years and indications are that more sparks are yet to fly. If you haven't already positioned yourself, now seems an opportune time!

What do the gold holdings in our model portfolio look like? At the moment, 8% of total equities are held in gold stocks. Adjusted to their current market price, the positions are as follows:

Newmont Mining	(NYSE: NEM)	3%
Dundee Precious Metals	(TSX: DPM.A)	3%
Meridian Gold	(NYSE and TSX: MDG)	1%
Placer Dome	(NYSE and TSX: PDG)	1%

I will continue to update you on gold and gold equities in future issues of Perspectives. ☐

Publisher: Cavelti & Associates Ltd., Toronto, Canada.