INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

Gold shares vs. bullion

Gold shares have had higher returns over a 40-year period

September 2011 Print Edition

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With gold share prices badly lagging gold bullion prices, many financial advisors are wondering about their relative merits. To address this issue, my firm, **Tacita Capital Inc.**, analyzed the Canadian-dollar returns of gold shares and bullion. To get a long-term picture of share performance, we spliced the S&P/TSX global gold index, available since October 2000, with the S&P/TSX gold index and the now discontinued TSX gold/silver index.

Despite recent underperformance, over the long run, gold shares have earned a higher return than gold bullion. Since September 1971, just after former U.S. president Richard Nixon closed the gold window, gold shares had an annualized compound return of 10.4% compared with the 9.5% return of bullion. Over the almost 40-year period, this superior return has cumulated into 37% greater wealth for investors in gold shares.

This higher return reflects the impact of operating and financial leverage on revenue growth over time. Although bullion is a unique commodity — supply in any given year includes old gold scrap — mining production is still the sole source of long-term supply growth. While there are lengthy periods, such as 1997-2001, in which bullion trades at prices that provide an inadequate return to shareholders, the long-term equilibrium price of bullion should result in a higher return to shareholders vs. bullion owners to compensate the former group for the higher risk.

The higher risk of gold is evident in its tremendous volatility. The annualized standard deviation of gold shares was an incredible 44.9% — twice the 22.3% standard deviation of bullion. Notably, both assets were more volatile than the S&P/TSX composite index, which had a standard deviation of 18.3%. Gold shares are subject to more frequent and deeper drawdowns than bullion.

Although both gold shares and bullion diversify portfolios, bullion has a greater effect. Bullion had correlations of 0.07 and -0.11 with Canadian and U.S. stocks, respectively, compared with gold shares' 0.44 and 0.12 correlations, respectively. In a series of historical portfolio optimization runs, bullion earned a much larger role than gold shares, especially for more conservative portfolios. Bullion also was a better hedge against falling stock prices. The higher return of gold shares did result, however, in a similar allocation to bullion for more aggressive portfolios.

There are other important differences. Many larger gold companies pay modest dividends; bullion obviously does not. Bullion, even when held through an exchange-traded fund, has storage costs that erode returns; gold shares do not. Tax treatment also may vary. Finally, gold shares seem to have the advantage at this point in relative valuation: from January 2007 to June 2011, bullion has returned 111% cumulatively; gold shares only earned 19%. Gold shares are now trading at near historical lows relative to bullion.

Advisors concerned with income and return should focus on gold shares. Those worried about diversification and extremely adverse market events should primarily concentrate on bullion. Allocations in both cases should be kept modest — a globally diversified equities portfolio earned higher returns over the past four decades at much lower volatility than did either gold asset. **IE**

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