Is it time to get physical?

Good as gold? It depends

Investment in the precious metal requires some thought

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The usual reason for buying gold is that it is a hedge against risk. However, not all gold investments are equal.

A gold coin or a gold exchange traded fund (ETF) offers direct exposure to the gold price. A gold share brings additional exposure to risks such as market sentiment and social and environmental problems, for example silicosis claims and collapsing tailings dams. But an extra boost to share price performance can come from positive news like new gold discoveries, acquisitions, turnarounds or dividends.

Unfortunately, for long periods gold shares can underperform the gold price, so are not suitable for highly risk-averse investors or those investing only for the short term.

Identifying gold companies that can potentially outperform is a bit more challenging. They range from small, struggling companies like Central Rand Gold (whose shares performed spectacularly well for a few months, when Chinese companies were bidding to take over the company) to diversified and more consistent performers like AngloGold Ashanti.

AngloGold Ashanti is one of the more solid gold shares on the JSE. IM has compared an investment of about R100,000 in the company’s shares over an arbitrary five-year period — January 1 2012 to December 31 2016 — to a similar-sized investment in Krugerrands or the Absa NewGold ETF.

In this period, gold companies were battling to contain costs and pay down debt, with no assistance from the gold price, which fell steadily until the end of 2015. So AngloGold does not come out well from the comparison.

At the beginning of 2012 AngloGold was trading at R360/share, so R100,000 would have bought about 277 shares. By end December 2016 the share price had plunged to R152.58. It paid dividends until the 2013 interim period, and declared a final dividend for 2016 in February, but if the shares were sold at end-December, the 2016 dividend would not have been either priced in or received. Dividends received in this period totalled 550c/share, or R1,523.50 on this investment.

At the end of December, these 277 shares would have realised R43,789, including dividends but before costs. If this was the only investment made through an online share trading platform, the administrative cost would have been about R90/month for 60 months, on top of which were brokerage costs on buying (0.5% or R499) and selling (R211) and a couple of other minor items. Total costs are about R6,110, which means an investor would have come out with R37,679, a 62% erosion of value.

In the same period an investment in Krugerrands before costs with SA Bullion would have returned 23.2% gross, the difference between the purchase price of R12,895.03 per coin, which includes the transaction cost, and the selling price of R15,886.86 quoted by Rand Refinery, which applies to all Krugerrand sales.

All other costs, including storage and insurance, are a maximum of 2%/year for small investors, SA Bullion MD Hilton Davies says, but they are on a sliding scale so proportionately cheaper on larger investments. At the maximum level, costs on a R100,000 investment would come to about R2,000/year, or R10,000, which reduces the return to 13.2%.

Hilton Davies. Picture: FINANCIAL MAIL

Davies says in the chosen five-year period gold's performance was disappointing — if investors had sold on April 7, their gross return would have been 34.3%, not 23.2%.

SA Bullion is licensed as an investment manager by the Financial Services Board, which means it complies with onerous requirements, including insurance and auditing.

Davies says people invest in Krugerrands rather than shares or unsecured debentures because physical gold cannot "go bust". "As with one's home, it should be owned directly and without an intermediating instrument. This way it forms a bedrock investment in one's portfolio that talks to ultimate security, free from the risks of currency debasement, government maladministration, and bank failure," he says.

SA Gold Coin Exchange chairman Alan Demby says gold is a store of value and a currency hedge against devaluation caused by political decisions. But it would be unwise for investors to put all their money in Krugerrands. Normally the exchange recommends holding 10%-15% of a portfolio in gold assets but with the increased political and economic turmoil of the past few years it now advises 15%-25%. The investment should not be made for short periods.

Alan Demby. Picture: FINANCIAL MAIL

A lump sum investment in the Absa NewGold ETF through ETF-SA would have returned 28% in the five-year period, including the total expense ratio of 0.4% but excluding brokerage of 0.08% (about R80 each on buying and selling, so R160) and an annual administration fee of 0.65%/year, which comes to between R3,250 and about R3,450 for five years on a R100,000 investment. These costs reduce the net return to about 24.5%.

ETF-SA MD Mike Brown says Krugerrands and a rand-based ETF like NewGold will give roughly the same investment performance.

"Gold shares, of course, carry a far higher risk, because mining incidents, labour problems and mining rights risk affect the value of the share relative to the gold price. However, gold shares do give some leverage on the gold price and therefore should be considered as an investment option, provided their returns compensate for their higher risk," he says.

Matt Brenzel, joint chief investment officer at Cadiz Asset Management, says Krugerrands appeal to investors taking a view on political or economic risk because they give exposure to the gold price, and are a tangible asset and portable.

NewGold gives similar exposure to the gold price but its advantage is that it can be sold instantly on the JSE.

A gold share also offers exposure to the gold price and the rand/dollar exchange rate, but additionally is an investment in an entity that can generate revenue growth and possibly dividends, Brenzel says. Depending on the timing of buying and prospects for earnings growth, gold companies can generate returns above Krugerrands or ETFs. The most marginal producers, like Harmony Gold, react the most to increases or decreases in the gold price because they have relatively high fixed costs.

At different times it might be better to be in physical gold than shares (when the earnings of gold companies are under pressure), or vice versa, Brenzel says. Gold shares have a place in a diversified portfolio because they are uncorrelated with equity markets in general, tending to outperform when the rest of the market is falling.

One of the problems in trying to do a comparison like this over a specified period is that it does not reflect the behaviour of real investors, who buy and sell for different reasons but would generally hang on to a gold investment until there was a price recovery. It also ignores the fact that investors have different preferences. For some investors, physical gold is much easier to understand than gold shares.

Even traditional equity investors living in a country facing political turmoil, rising debt repayments and an upswell of popular sentiment in favour of land expropriation without compensation may start to see more advantages in gold coins.