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MAY 2020

Investing in gold in the Coronavirus crisis

It's probably not a surprise to most investors that gold has been one of the few assets whose value has held up well in the Coronavirus market sell-off, having gained 8% in the past three months to 30 April 2020 and nearly 34% over the last year. As a safe-haven asset, its price has risen from around US$1,280 per ounce at the start of 2019 to trade around US$1,717 per ounce at 30 April.

In another example of its defensive nature, during and after the Global Financial Crisis gold recorded an exceptionally strong performance, rising by over 150% from around US$750 per ounce in 2008 to around US$1,900 per ounce in 2011 amid elevated market uncertainty and low interest rates.

Gold as a diversifier and defensive asset
Gold bullion can prove to be a good diversifier in a balanced portfolio: historically it has demonstrated almost no correlation to

equities. So its price will not necessarily fall in a stock market crash, and its value is likely to rise as interest rates fall. At lower levels of interest rates, investors have a lower cost of carry (or opportunity cost) for holding gold.

As in the examples above, history has shown that the best time to own gold bullion as an asset class is usually during periods of macroeconomic stress (such as in low growth/high inflation conditions), geopolitical disruptions (e.g. wars) and financial contagion (banking crises). Rising levels of investor uncertainty generally fuel a rising price, and vice-versa. It is considered to be an “unanchored” asset as, unlike most other commodities, its price is not driven by fundamentals like traditional supply and demand, or changes in its production cost, and it does not have a zero bound (like interest rates).

Investing in gold mining companies is trickier, however. They are less defensive (being slightly more correlated to equities as an asset class) and require much more in-depth analysis before including them in a portfolio. These companies (in South Africa and elsewhere) do not have a good track record of being able to sustain their profitability through global economic cycles that bring rising and falling gold prices. This makes the window for investing much narrower than that for gold bullion, and timing the investment more critical. There have been many periods in history in which the gold miners underperformed the market even as gold bullion outperformed.

Between 2000 and 2011, for example, gold equities substantially underperformed gold bullion for several reasons, including: above-inflation increases in operating costs; declining production volumes; capital raising that diluted shareholder value; and a de-rating in their price-earnings ratio premium. They spent capital inefficiently and did not sufficiently benefit from the periods when a weaker rand and higher rand gold price gave them lower input costs and a higher sales price.

Subsequent to this period, gold mining companies have improved their capital allocation, demonstrating much more discipline in their capital spending and engaging in cost cutting and other measures to improve efficiencies. Many have also strengthened their balance sheets. These measures have arguably been forced on them by their low market ratings, but have made them more resilient and capable of better exploiting gold price upturns.

This has created an environment where shareholders can now benefit from the current high US$ gold price and the weak rand (as well as weak Australian dollar and other producer currencies), offering the potential for higher corporate profitability and above-average share price gains over time. However, this is also contingent on how much production is curtailed in the national economic shutdowns amid the crisis, and how quickly operations normalise. Another headwind on the horizon could be potential inflation arising from the 25% depreciation of the rand.

Prudential's view on gold

At Prudential, we don't use commodity price forecasts In managing our clients' portfolios, as this often leads to mistakes in picking stocks and understanding the conviction behind the equity idea. The top international experts have been proved wrong time and time again (as recently demonstrated by the performance in the oil price). Nor do we employ macroeconomic forecasts. Instead, we base our gold exposure on our fundamental, bottom-up analysis which incorporates a long-term valuation framework and careful risk parameters.

Because the value of gold bullion is unanchored, and fundamentals are not relevant in determining a "fair value" for it, where possible we prefer to invest in gold mining companies to attain gold exposure for our equity funds rather than directly via gold exchange traded funds (ETFs), for example. Despite the more complicated nature of their analysis, we have considerable expertise and experience in assessing mining company valuations and prefer to rely on this method for making our investment decisions.

We do take time to analyse what factors are driving the macroeconomic environment and company fundamentals, in order to understand what will support and detract from commodity prices. We conduct extensive research on commodity supply and demand as well, to determine whether the market for each commodity is in surplus or deficit and how that is likely to change over the medium term. We also study each company's cost curve, determining its marginal cost of production to understand what commodity price is necessary for the company to break even and operate sustainably.

Currently, despite having outperformed the broader resources sector and the FTSE/JSE All Share Index in the past year, we believe gold mining companies (and those with more diversified commodities including gold) still have good prospects to continue to outperform, and are trading at attractive valuations. This assumes, however, that operations normalise in the near term. The companies are currently rated lower by the market than they were in the 2000s (as measured by their P/E ratios), even after having improved their operations, and they are better positioned to benefit from the higher rand gold price now than ever before.

We believe the gold price is likely to be well supported going forward by not only the ongoing uncertainty over global growth, but even more so by the sheer quantum of monetary stimulus now in place that is likely to keep interest rates very low for some time to come – i.e. below 1% in the US.

On this basis, over the past year we have increased our exposure to gold miners. We prefer to gain exposure through a diversified mix of holdings including AngloGold Ashanti and Gold Fields. We are currently holding more gold exposure as a percentage of our overall Resources exposure in our portfolios than the longer-term average. However, with the global growth environment so uncertain and many mining operations still under various levels of lockdown, we are very conscious that there are more risks than usual and we are keeping a close eye on developments at the various miners. This makes us cautious over the short term but positive about the medium-term outlook. Active management is key going forward.

For more information, contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.