

95/06-Golden Years

You don't need your own ingot, but the time may be coming when we'll all want to own a little gold

By Peter Lynch

No less a personage than Alan Greenspan once said that gold was the only refuge against profligate governments that are forever debasing their currency. He should know, I guess. These days we've been seeing a lot of debased currencies, including the good old U.S. dollar, and there's a whiff of inflation on Wall Street.

I won't try to predict when the whiff will turn into a rank breeze, but I'm sure about one thing: If it does happen, interest rates will rise and stocks and bonds will fall. In the high-inflation scenario, the only investors who get a good night's sleep are those whose money is parked in a money market or deployed in hard assets such as gold. Some people keep 5 percent of their portfolios in gold at all times, as a kind of insurance policy. For years they haven't needed it, but the case for owning gold is more compelling today than it was a decade ago.

When the price of gold hit \$800 an ounce in 1980, it was a signal for every would-be prospector on earth to grab a pick and shovel and head for the nearest Sierra Madre. No glint in a rock or fleck in a stream escaped attention: Creaky, old shafts were reopened; new holes were dug. South African gold production was in decline, but new mines in the U.S., Canada, Brazil, and Australia took up the slack.

Today, South African output continues to decline, and miners there are scraping the bottom of what was once the mother of all mother lodes. But the big news is that the newer mines that have opened up around the world are beginning to run out of gold as well. Many of these latter-day projects involve small deposits of ore, and they have short life expectancies. Moreover, 14 years of catatonic gold prices have dampened the enthusiasm of prospectors, so the search for new sources has been limited. There's been a definite sag in the supply line.

About 3.6 billion ounces of gold have been extracted from the earth since the time of the pharaohs. That may sound like a sizable haul, but if you took all the gold in circulation today—jewelry, bars, ingots, coins, fillings, crowns—and melted it into one big bullion cube, the entire world supply would easily fit onto the basketball court at the Boston Garden. The whole lump is worth about \$1 trillion at today's prices, or only one quarter of the U.S. national debt.

If you divided the lump equally among the 5.6 billion inhabitants of the earth, everybody would get less than an ounce. But that's hardly enough to satisfy the growing demand for jewelry in Asia and India, where billions of fledgling capitalists have money to spend and not much to spend it on. They can't buy a Winnebago, because the roads are too narrow, and where would they park one? In remote areas, they can't buy electric appliances, because there's no electricity. The last thing they want is to be stuck with the local currency, as long as their governments can operate a printing press. So they're buying as much gold as they can.

Jewelry sales have nearly doubled in the past decade, and 75 percent of the world's gold output now ends up as baubles, bangles, and beads. The U.S. is still the world's largest customer, but Chinese jewelry lovers are buying so much gold these days that China is running a close second. This surge in retail

buying would surely have driven up the price if it weren't for the central banks. They've been on a selling spree.

Since the days of the gold standard, when nations settled their debts with metal, the various central banks have kept stacks of gold bars in repositories such as the Federal Reserve Bank of New York, which has the largest supply of gold on earth more than any South African mine. From 1989 to 1993, central banks have been net sellers of gold, giving their governments something to live on while they watered down their own currencies. The governments are like their citizenry in this respect: They've been buying gold because they know the local money can't be trusted.

The Russians have been the most active sellers of gold, drawing down their stockpile to pay their international bills as they flood the country with worthless rubles. As much as the Russian selling has depressed the price of gold, the idea that they will continue to sell has depressed it even more. By one popular guesstimate, the Russians still have 2,000 tons to unload, while the Russians themselves have pegged their supply at a more modest 240 tons. Apparently, there is no way of knowing the exact amount, but in any event, the Russian selling has subsided.

Selling by central banks in general has subsided, from 500-plus tons in 1993 down to an estimated 46 tons in 1994. This, coupled with the growing popular demand and the dwindling supplies in existing mines, has lifted the spirits of the gold bulls, more commonly known as gold bugs. These people have been waiting for a rally long enough for their children to grow up and leave home.

As to when we'll actually see an extended rally, your timetable is as good as mine, but I've got an idea of how you can get the most out of it when it happens. In the last big run-up in gold, the one that carried the price to \$800 an ounce, the most popular way to play the rally was to buy gold coins and gold bars. People lined up at the coin stores to purchase the one-ounce Krugerrand. In those days, there was a widespread fear that the financial system was about to collapse, which is why so many investors opted for owning the metal, as opposed to shares of mining companies that traded on the stock exchanges.

I've never understood the apocalyptic theory of investing. If the world really does collapse, is it really going to do you any good to have a few Krugerrands in your pocket? And if it doesn't, you're much better off buying shares and not the metal. Gold coins and bars are heavy and take up space in the bank vaults, and there's always the chance they'll be stolen. If you buy them through a company that offers storage, they charge you for it. Physical gold never pays a dividend, the way shares routinely do. And the arithmetic of corporate earnings strongly favors investing in the stocks.

The back-of-the-napkin explanation is as follows: You buy an ounce of gold at, say, \$360 (a little less than gold's selling for as I write this), and the price does a high jump and hits \$500. So you've made \$140. That's a 39 percent profit from owning the metal. But look what happens when you buy shares in a mining company instead. Let's say for argument's sake that the mining company is making a profit of \$20 an ounce on production when gold is at \$360 an ounce. When gold hits \$500, the company's profits suddenly jump to \$160 an ounce. That's an eightfold increase in earnings.

When a company's earnings go up eightfold, even when Wall Street analysts are skeptical that the bonanza can continue, the stock price will double or triple. And if euphoria sets in and people start believing the price of gold can rise to \$1,000 an ounce and beyond, the stock price of our would-be

mining company may well increase as much as eightfold, right along with the earnings. Even if it doesn't, you'll get a far better return than the 39 percent you'd get out of the Krugerrand.

Now we arrive at the usual problem: Which gold stocks do you buy? Mining companies are tough to figure out, so this is one of those cases where Lynch's everybody-can-do-it theory of stock selection doesn't apply. How sad it would be if you were right about gold, but then missed the benefit because you picked the wrong company.

It's smarter to go with a gold mutual fund. You'll get a diversified portfolio managed by somebody who knows more about mines than you do. There are 38 or so gold funds or gold-related funds, including 13 with ten-year records (see the table on the nextpage).

Looking over this latter group, I'm struck by two things. A few have done remarkably well, given the fact that the price of gold is stuck at the same place it was at the beginning of the period. If you owned Oppenheimer Gold & Special Minerals, you got a 228.56 percent total return over a decade. The average fund with a ten-year history gave you a 96.90 percent return, which doesn't beat the stock market but certainly beats the zero return from owning a Krugerrand or a gold bar.

The second striking thing about these funds is the wide range of performance. With the minus 22.59 percent return from Lexington Strategic Investments, you were better off owning the gold bar. Obviously, all gold funds are not alike. From what I can gather, the two losers on the ten-year list (Lexington Strategic and Untied Services Gold Shares) were heavily invested in South Africa. For a variety of reasons, South African shares fare worse than their North American counterparts during periods when the gold price languishes. On the other hand, South African gold funds give you a big pop and outperform the others when gold begins to rise. Lexington Strategic Investments has recently done just that. It's been the top performing gold fund for the past two years.

Of the 38 gold funds, 7 are no-loads. One is an index fund (launched in 1988 by Benham) that tracks the total return of the Benham North American Gold Equities Index. So the usual homework you have to do when picking an individual stock, you need to do when picking a gold fund. I leave it to you to explore the details, but one thing is certain. If gold funds were able to give a mediocre performance in the years when gold went nowhere, they'll be spectacular performers if the metal takes off.

GOLD MUTUAL FUNDS

Fund Name 10-year return

Bull & Bear Gold Investors

91.95%

Fidelity Select Precious Metals

115.20%

Franklin Gold Fund

151.96%

Invesco Strategic Gold

21.74%

John Hancock Gold & Government; B

88.88%

Keystone Precious Metals

128.44%

Lexington Goldfund

136.34

Lexington Strategic Investments

-22.59%

Oppenheimer Gold & Special Minerals

228.56%

United Services Gold Shares

-16.44%

USAA Investment Trust Gold

29.85%

Van Eck International Investors Gold

133.48%

Vanguard Specialized Gold & Precious Metals

172.36%

AVERAGE

96.90%

Lipper Gold Fund Index

99.76%

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