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Keep Digging

By Peter Lynch

So your Krugerrands haven't panned out. It's still possible to uncover good gold-mining companies.

Let's try this again. back in June 1995, I made my pitch for gold in the pages of Worth. It seemed like the right time: Inflation was showing signs of life, and world gold demand was on the rise. Annual fabrication demand alone--for gold destined for actual use, primarily in jewelry and the electronics industry, as opposed to gold to be held in coins and ingots as investments--exceeded the amount being taken out of the ground. Simply on a supply-and-demand basis, it all seemed like a promising recipe for gold prices and hence for gold stocks and funds.

Well, I was right about the demand side of the equation but wrong about supply. Like most gold analysts and gold-fund managers, to say nothing of the long-suffering goldbugs, I didn't see some things coming. And therefore I didn't anticipate the way the price of gold would stagnate for a while, pop nicely higher for a while, and ultimately collapse like a central banker at the end of a long, hard week. In mid-1995, gold traded at a spot price of about $385 an ounce. It climbed in 1996 to $416. It dropped nearly $100 an ounce, to $318, by early this summer, and as I write, it's at $323.

The trend has been ugly, I know, but I think things may begin looking up for gold--and, more important for our purposes, for gold-mining companies. The best news is that if you buy the right companies the commodity price doesn't have to jump for the stocks to show a nice increase.

In the broadest sense, the problem with gold is that it is undergoing a re-evaluation. The central banks of many countries are wondering if gold's traditional role has any meaning in the modern global economy. For centuries, a country's gold reserve has been the representation of its wealth. The very definition of a devalued currency has been one that isn't backed by gold. But in some places the men with their hands on the levers are weakening in their faith. Maybe the best measure of economic strength, they're saying, is something less physical--purchasing power in the world's markets, perhaps. Maybe gold is just a metaphor--a metaphor that doesn't pay dividends or go up in value. The heck with it.

I've talked with people who think this reassessment of gold is savvy and long overdue and with people who think it's foolish, perhaps catastrophic. It's not important to take a position here. What's important is that in the past two years a number of central bankers have decided they didn't particularly care whether their vaults held gold anymore, and they sold (in some cases because they needed to raise cash). I said I had messed up the supply side of the scenario two years ago. That's a large part of what went wrong: Central banks unloaded gold at an accelerated pace.

The amount of gold dumped by the central banks wasn't enormous--they still hold 97.6 percent of the gold they held at the end of 1994. But that's not the point. Gold, much more so than any other commodity, is about sentiment and psychology. There's a sense that central banks aren't playing by the old rules.

Australia, for example, sold two-thirds of its reserves this summer--the government said it would rather buy foreign bonds, which at least pay some interest. Investors have seen this sea change and have asked a pretty fair question: If banks don't want gold, who the heck does? Gold has traditionally been regarded as an inflation hedge, but that is dependent on the same metaphor, the same set of assumptions. (Not to mention that inflation has been quiescent more or less worldwide.) To some people it has begun to appear that, as Jim Rogers said in Worth earlier this year, gold just doesn't work anymore.

I should touch on the infamous Bre-X Minerals scandal. You remember that: The company announced that it had found an enormous reserve in the jungles of Indonesia. And then it announced that there had been...a...mistake. There was no gold. Recriminations followed, to say nothing of lawyers. A company geologist leaped from a helicopter. The company itself has disappeared.

In real terms, this shouldn't have mattered very much. It was even possible to see the bad news as good news: No huge new reserve meant less new supply to dilute demand. But investors saw the scandal in the context of a market that had become odd and unpredictable. They saw it as just another thing not to like about gold. Bre-X didn't cause the collapse of gold prices and gold stocks, but it darkened an already negative atmosphere.

So where do I get the nerve to suggest that you look into gold stocks? I'd like to humbly point out that I was correct two years ago about the demand side of the gold equation. Every year since 1991, in fact, demand has outstripped what is known as the mine and scrap supply. Last year, the gap was about 8.4 million ounces, about 2.3 times the gap in 1994. Much of the demand comes from Asia--in particular India and China. The economies in those countries are increasing rapidly and producing a growing middle class. What are these people going to do with their wealth? They tend to live a long way from a Circuit City. Cars are still out of the question for many of them. If Indians and Chinese can't convert their money to stuff, as Americans so vigorously do, they're going to save it--and they still like to do that, in part, by buying high-karat gold jewelry. A lot of people think this demand, though it has proved price-sensitive, provides a bottom for the market.

The supply issue is probably better under control now, too. Beginning in 1980, when the price of gold shot up to $850, mining companies reacted as you might expect: They explored frantically, sunk new mines, re- opened old mines. They spared no expense, and why should they have? If you can get $850 an ounce, you can make a profit at almost any production cost.

Some of those mines are playing out now; they've had their eight or ten years of production. Others are too expensive to operate in a $330-an- ounce market. According to Gold Fields Mineral Services, a London-based research firm, the industry-wide total cost of getting an ounce of gold out of the ground has risen to an average of $317--a dollar less than the recent low spot price.

Even the great mines of South Africa are finally winding down. They've had amazing runs--100 years and more--but now the gold isn't coming as easily. Or as cheaply: Labor costs have gone in the opposite direction as gold prices. South Africa is not what it used to be as a gold producer. As for central-bank sell-offs, they probably won't be as numerous or have the same kind of impact in the future. Investors now understand that banks can sell. They also know there's a limit to how much they can sell. Australia's sale a few months ago was dramatic symbolically, but in relative terms the country never had much gold to sell. In dumping two-thirds of its reserves, Australia put just 5.9 million ounces of gold into circulation. The U.S., by comparison, has 44 times that much gold in reserve, 262 million ounces, and law requires us

to hold on to it. Germany, Switzerland, and France, the next-largest holders of gold (95 million, 83 million, and 82 million ounces, respectively), aren't likely to destabilize the world economy by emptying their vaults either.

What I'm describing is a fairly delicate balance. Demand is healthy but price-sensitive. Supply is limited (if not in theory, then in practice) but not so limited as to drive prices up.

This is a welcoming environment for investors? Yes, I think it might be. That's because, first, the price of gold doesn't have to rise for the best mining companies to produce respectable profits. And second, if the price of gold is currently at a bottom and does eventually rise, these companies will make huge profits.

I mentioned that the average company is now spending $317 to get an ounce of gold out of the ground. Let's say you're investigating a company that's a little better than average, because of economies of scale or cheaper labor or simply because its mines yield more gold per ton of rock. Perhaps this company produces gold for 10 percent less than the average, or about $285 an ounce. Even with the price of gold limping along at $330, the company can earn good money.

There's ample proof that good companies can do well for investors even when gold itself is a bad investment. I asked Lipper Analytical Services to give me a list of all the gold mutual funds that have been around for 17 years. Seventeen years ago, of course, gold was at a peak. If you filled your dresser drawer with Krugerrands then, at $850 an ounce, you have lost 60 percent of your money. But of the seven gold funds that have been around that long, five show positive returns. The best, Franklin Gold Fund I, has gained 257 percent. The next best, Van Eck International Investors Gold Fund, is up 166 percent. Three more funds managed to stay in the black during these dark days for gold, and even the worst of them has done better than gold itself.

And what if the spot price of gold actually rises? Again it becomes clear that the best way to own gold is not to hoard Krugerrands but to own shares in the best mining companies or in the gold funds that invest in them. Let's say the spot price manages a 25 percent rally: It rises to $412.50, a little below where it was in mid-1996. Your Krugerrands are worth 25 percent more. Not bad. But the company's profits have almost tripled. Where once it cleared $45 an ounce, it now clears $127.50. When a company's profits jump like that, you can imagine what happens to the stock price--and gold stocks consistently pay modest dividends. Gold bars, obviously, don't pay anything.

I'm going to run contrary to the general pessimism and do one more exercise: Let's imagine that gold hits $500 an ounce. When it comes to investing, and especially when it comes to gold, I tend to believe that nothing is impossible, especially if it has happened before. So gold goes to $500 an ounce. If you bought your Krugerrands at $330, you've cleared 52 percent. You're a genius; maybe you should start a newsletter. Our imaginary company, however, is now clearing $215 an ounce. Profits have nearly quintupled. (This bit of leverage, by the way, explains something you'll notice when you look up gold stocks in the newspaper: They trade at extraordinarily high price-to-earnings ratios. A p/e of 50 is not considered out of line for a well-run gold- mining company at today's gold prices.)

Peter Ward, gold-mining and precious-metals analyst at Lehman Brothers, is among those people who think that gold is becoming just another commodity, that more central banks would sell if they could

only find a decent price, and that, with the possible exception of brief spikes downward, the spot price isn't likely to go much of anywhere in the next 12 months.

Nevertheless, he's excited about a couple of mining companies that have the right qualities to thrive in the current environment. His favorite is Barrick Gold (NYSE: ABX; recent price, $21.69), a Canadian firm that is the world's third-largest producer. The central fact is this: Barrick gets gold out of the ground for a cash cost (the actual cost of extraction) of $200 an ounce and a total cost of $265 an ounce. Barrick is also the industry leader in hedging: It has contracts that guarantee it a price of $420 an ounce for much of the gold it produces over the next three years.

Ward also likes Placer Dome (NYSE: PDG, $16.13), because it has some of the same qualities as Barrick. It gets gold out of the ground cheaply (a cash cost of $215 an ounce and a total cost of $280), it has a good hedging program, and it has a clean balance sheet. Victor Flores, senior mining analyst at Marleau, Lemire Securities of Toronto, thinks the long-term average spot price of gold is going to linger in a range of $350 to $385. He, too, sees good things for Barrick Gold.

Flores also likes some medium-size companies. One is Meridian Gold (NYSE: MDG, $4.25), formerly known as FMG Gold. Another is Crown Resources (Nasdaq: CRRS, $6.50), a Denver-based exploration company that is involved in a joint venture in Washington State with Battle Mountain Gold. Finally, Flores mentions a company in which I own shares, Boston-based Pioneer Group (Nasdaq: PIOG, $30.50). Pioneer is actually a money-management firm--you've probably heard of the Pioneer Family of Funds--but it also has mining interests. Among these is a 90 percent stake in Teberebie Goldfields Limited in Ghana. In Flores's opinion, Pioneer is fairly valued even without Teberebie figured in. So when you purchase Pioneer, it's like getting a $500 million gold company for almost nothing.

Let's return for a moment to Barrick Gold. In the spring of 1985, you could have picked up shares in this company for about 50 cents apiece, adjusted back for splits. Gold stood at almost exactly the same price then that it does now. By the spring of 1996, despite a miserable environment for its industry, Barrick traded at $32 a share--it had become a 64-bagger. Even if you didn't buy until 1990, and you're still holding on through a recent drop, you've tripled your money and been paid a small annual dividend for your pains.

Barrick is the kind of company that too few investors are looking for today. It has an old-fashioned business that anyone can understand. It's not the next big anything. All it does is consistently make a couple hundred million dollars a year.

No company, including Barrick, is a sure thing, of course. Say the price of gold begins to rise. The hedging contracts that are now making Barrick so profitable could become, in the short term, an albatross. If the spot price rose above the hedging price, Barrick's profits would hit a ceiling, which would suddenly make it less attractive than some rivals. But don't miss the larger point: There are great companies in just about every industry. You don't have to understand cutting-edge trends to identify these companies. You don't have to have an inside position and buy at the initial public offering. You don't even have to peg the direction of the world's most psychologically freighted commodity. You just need to keep your eyes and ears open and understand what makes a company worth owning.