Good morning. It is a pleasure to be here today with my panel members to talk on this topic. I will make some brief introductory remarks, following which we will listen to the expert panellists. In this session, we examine the question ‘Are precious metals an investment class?’ To the tens of millions of people who own gold and silver in physical form, the answer is ‘yes’, yet I would also observe that there are many different perspectives and strong opinions on what investment means. This panel will discuss several approaches to investment in precious metals, but cannot touch on all manner of investment.

The question of whether precious metals constitute an investment class is important, as the asset class designation pulls them into the ambit of permissible investments for certain types of investors. As all of you know, investors are not homogenous; thus, asset class versus asset class designations are more crucial to some than others.

For example, asset class distinction is not relevant to retail, as a typical small investor is not constrained by structure. The private wealth sector, as represented by family officers, does subscribe to the discipline of modern portfolio theory and asset allocation, but they are less concerned with definitions. For the third broad category of investors – institutions – asset class designation and distinctions are crucial, as these define the framework for the investment decision process.

The distinction has meaning for this category because it bestows portfolio legitimacy to precious metals that can lead to target allocations and long-term holdings. In fact, to date precious metals have not experienced significant penetration in institutional portfolios. This is also true of the broader category of commodities. Some of the obstacles encountered include ignorance and misconceptions, uncertainty over expected returns, and the aggressive marketing of more familiar, mainstream financial products.

The good news is that there is growing evidence that institutional investors’ attitudes are changing, however slowly that process unfolds. The important question of how to accelerate the rate of change, and the most effective means to do so, will have to wait for another day or for another conference.

Today’s panel will touch on the various points of the investment spectrum for precious metals, from the over-the-counter (OTC) trading desk to the new exchange-traded fund (ETF) security that tracks a spot price, to the leveraged and more volatile investment in mining companies. Each is an example of the right way to gain portfolio exposure for this investment class.

I will now turn to our panel of experts, who will present views that are entirely their own. Let me first introduce John Reade, who is a former gold-mining engineer and production manager who went on to be a successful gold equity analyst, and is now a highly-respected precious metal strategist, also responsible for emerging currencies, at UBS Investment Bank.

Our next speaker is Vladimir Nedeljkovic. Dr Nedeljkovic earned his PhD in applied mathematics and has used it to develop derivative strategies and structured investment products, most recently as part of the capital and debt markets team at ABSA Corporate and Merchant Bank.
Our last speaker is Sandy McGregor. As you will note from the biographies, he has the shortest. I asked him how he preferred to be introduced, and he said, “With brevity”. So, here’s Sandy.
UBS is a global bank with more than $2 trillion dollars in assets under management, 70,000 employees across the world, and it is a major player in the gold market. As UBS’s gold analyst for more than six years, I guess I am well placed to talk about over-the-counter – or OTC – gold investment.

But before I move onto this topic, I would like to share some thoughts about commodity investment in general and some concerns that I have about this growing trend.

UBS recently expanded its efforts in commodities. We have had a large precious metals business for fifty years and recently added base metals, expanded our energy trading and exchange traded commodity business and added a commodity index structuring group to create a large team of professionals located in one place on our FX trading floor.

Conversations within this team, together with some recent client meetings during LME week have confirmed a suspicion that I have held for a while.

There is a Wall of Money heading for commodity markets – a Wall of Money that is driven by non-traditional players in commodities, and it is set to overwhelm what have been traditionally small, largely professionally-driven markets that have had only modest speculative and investment involvement to date.

The Wall of Money is coming from real money managers who are looking to diversify into alternative asset markets, due to poor returns from their traditional fields of cash bonds and equities. One of the three key themes from our global economics team in 2004 was the challenge of declining nominal returns across asset markets, and this move into commodities, I believe, is an attempt by fund managers to overcome this low-return environment.

I am concerned about this because asset allocation is a top down process, and too much account may be taken of historic returns and not enough about current valuations. The charge into this asset class has been led by European pension funds, one of which presented to the LBMA conference in Lisbon, explaining this strategy. But the trend is spreading and, according to one client who has monitored these developments closely, is beginning to take off in the United States, which is apparently a couple of years behind Europe in this regard. Once the actuarial consultants become comfortable with a new asset class, it is only a matter of time before pension funds follow their recommendations.

The Wall of Money is on its way and it is coming to a commodity market near you.

Our clients are demanding access to – and more information about – commodity markets, and we have responded to these demands in the following manner:

• Firstly, UBS investment bank’s asset allocation team, headed by our Chief Economist Larry Hatheway, added alternative assets to their more traditional asset mix back in 2004, including an allocation to commodities.

• Secondly, this year UBS Wealth Management, our private bank, added a commodity team and are now recommending a sizable weighting in commodities.

The extent to which this investment has impacted on commodity prices is hard to judge. I am no expert on most of these markets, and copper at an all-time high of $4200/t and oil at $60 dollars a barrel may be justified by fundamentals. But open interest in copper, crude oil and gold has collectively increased sharply over the past couple of years, as can be seen on the following chart.
For precious metals specifically, all four exchange-traded precious metals have seen increases in open interest and larger speculative long positions – as well as the remarkable success of the ETF products in gold.

Another way that the investment in commodities is showing up is in the flattening of commodity yield curves. Markets that have traditionally been in backwardation have seen investors buying and lending – another way of saying buying forward – to take account of high commodity interest rates. In precious metals, the most notable example of this has been in platinum, where three-month deposit rates have fallen from 10% to 2% since the start of 2003 despite high prices and a market in deficit over the whole period.

An interesting example of increased investment in commodities comes from the sugar market, which has seen open interest quadruple over the past few years.

Tim Woodward, our head of exchange traded commodity derivatives business, tells an anecdote about a new client attracted to sugar’s fundamentals who wanted to buy what would have been half the total open interest in the sugar market – clearly this could not take place.

I have not found any reliable statistics on how much money is invested in commodities. Anecdotally I have heard of sums between 50 and 100 billion invested in commodity index products, although that could be more. But this is a tiny fraction of global funds under management. When I presented to the LBMA a few years ago, the market capitalisation of all bond and equity markets was about 50 trillion dollars – and is probably more now.

If real money continues to move into commodity markets in a meaningful way, investor interest could increase by a factor of 10 or more.

So what are the consequences of all this investment? Well, obviously, prices have moved sharply higher, lifting some commodities well beyond consensus estimates of long-term equilibrium prices.

But does this matter? One of the reasons that commodities tend to be mean reverting is that high prices leads to demand destruction and investment into new production capacity, bringing the markets – after some delay – into oversupply, dropping prices. Won’t this happen again?

At the risk of using some of the most dangerous words in the investment world:

We believe this time is different.
Even if high prices return markets to oversupply, the weight of investment money can easily mop up these surpluses; what looks like a large surplus to a commodity analyst is small in the context of real money investment. This will limit or even eliminate traditional cyclical weakness.

The final point I will make about the Wall of Money entering the commodity markets is to analysts of other commodities.

To them I say: welcome to the world of a gold analyst. Classical supply and demand analysis will matter less in the future. Investment flows and speculative positioning may become the dominant drivers of your markets.

And just because prices are going up, it will not make your job easy. As one Alex cartoon from the 1990s said, “You may think my job as a dot-com analyst is easy, but try taking the investment case of 'buy it because it is going up' and turning that into an 80-page report.”

Gold’s position in all of this is rather odd. It has superior depth and liquidity compared to most other commodities – which makes it one commodity that can accommodate substantial investment due to vast above-ground stocks.

But these stocks make gold fundamentally less attractive to commodity investors. Gold is almost always in contango and producer de-hedging and central bank lending look set to keep gold interest rates low. Still, gold is a part of most of these commodity indices and should continue to attract basket-based buying irrespective of these disadvantages.

Aside from the asset allocation argument, gold has traditionally attracted investment interest due to the metal’s supposedly unique attributes. For the purposes of this presentation, please suspend your disbelief about some of these attributes and remember the Keynesian beauty contest.

- In a portfolio of currencies, gold has **diversification characteristics** – and not just against the US dollar.
- Gold is a **hedge against inflation**, especially where investors do not have access to – or confidence in – other usually more effective inflation hedges.
- Gold is the only financial asset that is nobody else’s liability – although other real assets like real estate and commodities fit into this category as well. Real assets give **protection against systemic financial sector risk**.
- Gold returns are **uncorrelated with other asset classes** and arguably negatively correlated with other assets during **extreme negative events**.

UBS’ main investors in OTC gold are wealth management clients – certainly in terms of the number of investors, but also in terms of activity. You will understand if I generalise and draw broad conclusions for reasons of discretion and client confidentiality: UBS is a Swiss bank, after all.

There was a trend during the 1990s for clients to reduce gold holdings. Equities were booming and gold prices were falling, at least in dollar terms, encouraging metal investors to liquidate their holdings and buy tech stocks instead.

But this behaviour stopped in the early years of this decade, and we have seen substantial interest from clients globally to buy gold. The reasons for their purchase were diverse and largely selected from the list above, although from North America we received considerable interest from investors concerned about the US dollar and the wider asset markets.

Our OTC clients invest mostly in gold via **metal accounts**. These accounts are like normal currency deposit accounts and are unallocated – which means that you have a bank account with ounces of gold in it. Metal account holdings of gold allow investors to use their metal via structured products, which I will describe in some detail below.

Some clients hold gold in **allocated, segregated accounts**. Clients hold specific bars of gold in our vault – like keeping dollar bills in a safe deposit box for safekeeping. Since this gold cannot be lent out by UBS, it is more costly, but fractionally safer, for the client to hold gold in this manner.

We do have some clients that **buy gold and remove it from UBS’s vaults** – although as you can imagine, we don’t recommend this. But some clients believe that holding their own physical gold gives them the most security, although clearly there are risks that the gold will be stolen or indeed lost. I know of one client that heads out every weekend in the summer with a metal detector trying to find his stash of buried Krugers on his estate.

In addition to purchases and sales of physical gold, clients also use high gold volatility to enhance the yield on cash deposits.
There are many examples of these products. For simplicity, I will describe only two: The precious metals double currency unit, or DOCU, and the Guaranteed Return on Investment or GROI.

The precious metals DOCU is a combination of a money market instrument and a sold call option on gold, and is suitable for clients that own gold. The premium from the sold gold call is embedded in the interest rate and at expiry the investor receives the interest coupon plus the principle, either gold or in the base currency.

As an example, when gold was trading at $467.20 per ounce, a one-month DOCU with a strike at $480/oz would yield an interest rate of 7.10% per annum.

If at expiry the gold price is below $480/oz, the investor is repaid the initial gold investment plus the accrued interest of 7.10% per annum over the period paid in US dollars. If the price of gold is at or above $480/oz at expiry, the investor receives dollars converted at a price of $480/oz plus accrued interest at 7.10% per annum over the period, paid in US dollars.

Clearly this client has to be prepared to sell his gold under certain circumstances in order to transact a DOCU.

For investors who do not own gold but are prepared to buy gold under certain circumstances, a DOCU can be structured whereby the investor will invest dollars and sell a gold put. If the price of gold at expiry is at or below the strike price, the investor will get his capital back in gold rather than US dollars.

The Guaranteed Return on Investment, or GROI, combines the potential trading revenue of the gold market with that of a money market instrument. It offers a full or partial refund of investment at expiry together with participation in an option strategy. The partial or total capital protection element makes this suited to a more conservative investor who nevertheless is prepared to take some risk to try and increase returns compared to a traditional money market investment.

The example shown here is a Range GROI. Here the investor places dollars on deposit and takes a bet that gold will stay in a range over the entire three-month period. If gold does remain in the range for the whole period, the investor receives his money back plus interest at 5.5% per year. If gold does trade outside of this range, the investors only gets his capital back.

These examples demonstrate some of the ways that OTC gold investments can be structured with gold options to enhance yield on money market deposits.

In conclusion, I have tried to explain some of the interest we get in gold from our wealth management customers, explaining why they buy gold, how they hold it and what they can do with gold once they have it.

I have also explained some of my current thinking about commodities and about the consequences of continued Real Money investment in this new asset classes.

I hope this has been of some interest. I would like to thank my colleagues, Tim Woodward and Cirstie Parker in London, for their help with the non-gold examples in this talk.
The Impact of ETFs on the Gold Market

Vladimir Nedeljkovic
Structured Products, Capital and Debt Markets
Absa Corporate and Merchant Bank

Good morning ladies and gentlemen. The title says it all. I am here today to give you a couple of thoughts on a new trend in the gold investment, the gold-linked exchange rated funds, or ETFs, and their current and potential impact on the gold market. I will first set the scene and show you some well-known facts about gold demand, then zoom in onto the gold investments and zoom in again on the gold ETFs. I will specifically concentrate on the market penetration of the gold ETFs by looking at them in the context of the worldwide investment market. Finally, I will talk about the potential for growth for these products.

You have basically seen the gold supply and demand graph multiple times. Above ground stocks are approximately 150,000 tonnes, and I will come back to that number later. Supply and demand flow is about 4,000 tonnes per annum. On the demand side, the investment is about 13% of the total; to compare, 69% of the demand is in jewellery.

If we go into gold investment, most of it is in gold bars and coins, as well as other retail investment. Securitised gold in the form of gold-linked ETFs is a relatively new development, and this is the one that we will be concentrating on today.

If we look at year-on-year demand for the investments, we see that it more or less bound in the range of 300-500 tonnes. We’ve seen, of course, some growth in the recent years, and I would like to attribute some of it to the advent of the gold-linked exchange-traded funds. Interestingly enough, in the survey we took yesterday, 62% of the participants said that they believe that investment demand is going to drive the gold price going forward. Still investment demand is only 13% of the overall demand for gold. Why not 50%?

There are obstacles to investing in gold. Gold is traded over the counter, which excludes it from the investment universe of certain classes of investors. It is a physical transaction, so one basically has the issues regarding custody arrangements, insurance, settlement, and so on. It is specifically difficult for the retail investors. They do not really have much choice.
Most people cannot buy big bars, costs are significant, liquidity is low, et cetera. Of course, investors can buy gold coins, but there are issues related to that as well.

One important factor is the regulatory environment. For example, in South Africa gold is considered to be a foreign currency and falls under the Exchange Control regulations. In some countries, pension funds are not allowed to invest in gold.

Add to that the relatively lackluster performance of gold price over a period of years and, as a consequence, we get an asset that is really outside of the institution investors’ benchmarks and as such not being followed and researched by them. We market our gold ETF and we talk to a lot of institution investors that invest in gold equities but do not really know about the properties of gold as an asset.

In order to address those issues, we had the advent a couple of years ago of securitised gold in the form of gold ETFs. Gold ETFs, compared to some other structured products, are very simple structures. There is a vehicle that holds gold in a trust, usually fully allocated, so there is no credit risk. On the basis of that, gold securities are issued, listed on an exchange and traded in the same manner as equities.

As a consequence, this type of investment is accessible and simple. It is listed on a stock exchange, quoted in local currency, with no minimum investment. It is very secure because the gold is, as I said, held in an allocated form. It is very cost effective. Depending on the investment size, it can be more cost effective to invest in gold through this channel than by actually buying physical gold. Finally, it is very liquid. Because gold ETFs are open-ended, i.e., their size can vary with supply and demand conditions, the liquidity of the securitised gold is exactly the same as the liquidity of the underlying spot market, which is actually quite high.

So we see that there are some good reasons to invest in gold through gold-linked securities. These securities have been around for a few years now, and it is a fair question to ask: have they made any impact? Consider the asset growth of gold ETFs worldwide. You can immediately see some positives and some negatives. The positive is that we have experienced a rapid growth in assets over a relatively short period of time. At the moment, there is about 300 tonnes of gold in all the ETFs worldwide. That is significant by any standard. The one negative is a trend that is similar to all gold ETFs. Initially, there a relatively sharp growth, followed by a plateau. The question that people ask is, is this it? Has the demand already been satisfied?

If you look at the contribution of different countries to market capitalisation, the situation is quite skewed, in that quite a large percentage of the investments in gold ETFs is basically in one country, the United States. Based on this, one could say that one should not really be bothered by any other country, that US gold ETFs are a success story and that the other ETFs are irrelevant and failures. The problem with that kind of reasoning is that it does not take into account the relative sizes of the corresponding markets.
Taking the market size data from the International Federation of exchanges and the BIS, and expressing the assets in the gold ETFs as a percentage of the overall assets, the penetration of the gold ETFs in different markets is quite similar.

Excluding two Canadian close-ended funds, which are not real ETFs, the biggest market penetration is in the UK, followed closely by the US, Australia and South Africa. The worrying thing is that in all markets, penetration of gold ETFs is minuscule. Overall, average penetration is just 0.009%. Even this is an overestimate, because the analysis could not include all the different investment assets available for the lack of relevant data.

I worked with the World Gold Council on asset allocation studies for different markets, and they show orders of magnitude higher optimal allocations to gold than we have at the moment. Today, we have heard some central bankers discussing optimal allocation to gold in their portfolios of 5-10%. The margin between the current and the desirable is really wide.

So, the potential is here. But how do we quantify it? Let me be very conservative and say, okay, not everybody wants to invest in gold, and so let us say our aim is to try to increase the market penetration, not to 5% but to 0.5%, which is actually quite below what the most optimal asset allocation model tells us to invest. Also remember, I looked at only five countries. I did not look at European countries; I did not look at India; I did not look at China.

What do we get if we increase market penetration to 0.5% in the five markets we are considering? An additional demand of about 16,000 tonnes of gold. Remember, the total above ground stocks of gold are 150,000 tonnes, so we are talking about 10% of the total of above ground stocks. Also, compare it to the total annual demand for gold of some 4,000 tonnes.

We can get a good visual representation of the possible impact if we overlay 2,500 additional tonnes of demand per annum for the next six years over the current demand figures. The topic of my speech is ‘What happens to the gold price?’ Well, I ask you: what happens to the gold price? We cannot exactly say what would happen because we do not really have the proper gold demand elasticity models, but judging by this simple graph, I would think the gold price would react quite positively.

Is it possible? I do not know. I do not see why it would not be possible if we take seriously the case for gold. Everybody in this audience talks about the issues such as diversification, currency hedging, inflation protection. If the central banks think it is prudent to hold, say, 10% of their assets in gold why would not other institutions think it is prudent to hold similar amounts or maybe 10 times less of gold in their portfolios?

How do we get there? Currently, according to the Gold Bullion Securities’ statistics, the largest investors in gold securities are institutions: mutual funds hold about 26%, individuals 11%, pension funds 2%, which is quite low, assurance holdings 6%, stock lending 7%. In the case of South Africa, for our ETF, we have about 90% - 10% split between the institutions and individuals.

What are the obstacles? I think the first one is lack of knowledge, again because of the fact that institutional exposure to gold, compared to other assets, is quite minor. As a consequence, there are not too many analysts that cover gold, which further makes the job of selling gold or gold securities more difficult. Another obstacle is a perception held by many that gold is a marginal and speculative asset with no real intrinsic value. Finally, there are regulatory obstacles in some jurisdictions to be overcome.
There is a very good investment case for gold, dealing with topics such as diversification, inflation protection, currency hedging. That case needs to be aggressively promoted. Secondly, we need to expand the investor base. We need to go beyond traditional gold bulls (after all, they are already invested in gold in one way or another). We need to reach mainstream equity investors, and position gold as another security with all the characteristics they know and like. Finally, we have countries like India and China that are traditionally very big on gold as an investment, but they currently do it in the form of jewellery.

Is there a potential? That is really a question I would like to know the answer to. Is it possible to sell securitised gold to investors in these countries without cannibalising existing jewellery demand? I suppose that is a well-posed question that can be answered by researching the relevant markets and taking into account relevant demographic and development trends.

To conclude, I believe that the potential of gold ETFs is far from fulfilled and that they can become a significant factor fuelling demand for gold and pushing the price of gold upward. Thank you very much.
Where Now for Mining Equity Investment?

*Sandy McGregor*

*Director, Allan Gray Limited*

Although the title of this talk says mining shares, I am going to talk about gold shares; maybe I should have put that in the title. About a month ago when I was preparing the slides for this speech, I asked my friends at Merrill Lynch to calculate the ratio of the market cap of major gold mining companies to their net present values. They gave me this set of numbers, and you can argue about the detail on all of this – different analysts will have different views – but I think you will find that almost everyone who analyses gold companies will come to the conclusion that the shares discount the price very substantially higher than the current price. On this analysis, the US shares are discounting $650, and, in fact, they have gone up since then. If you assume the present gold price for the rest of time, these are what you would call very, very expensive as a class. One always hesitates to say that investors are totally stupid, but that just could be the explanation. When you look at gold mining shares, there are various times, and this is true of all asset classes: people look at asset classes in different ways at different times.

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<th>Price to NPV for Leading Gold Companies at $450 on 14/10/05</th>
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Gold price discounted in share price

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For a long, long time, the way people looked at gold shares – this was really when gold shares were mainly single mine operations in South Africa – these individual mines were priced on a single, which was that the dividend yield equated the S&P earnings yield.

This goes back to 1965. It was a very good rule. What investors were saying more or less is that they did not actually understand what went on in a company, but they did understand what the dividend was. They said, ‘That is what we are getting out, and that is what we are pricing on.’

In fact, I think the investors were saying what Mark Twain said, which is that ‘a mine is a hole in the ground with a liar down at the bottom of it.’ People did not know what was going on in the mines, but they knew what dividends they were going to get. You see right at the end of this series how the dividends have collapsed. The S&P is now at 5%, and these dividends are way, way below it. There has been a change in the way people are looking at things more recently than they have in the past.

One of the interesting features of this market is that investors have paid very little attention to mine life. This is quite interesting. They buy the shares as if the companies were going to go on...
forever. This has been a persistent feature of gold mining investment for as long as I can remember. Investors are very insensitive to the concept of mine life. Mine life is actually the crucial issue in valuing a share.

This graph shows the bottom axis is a life, and the ratio on the other side is the price to cash flow ratio. There is a simple rule here; simple mathematics. Those sets of lines are different rates of return. If you take a 5% rate of return for mines with a 15-year life you should get a 10 times cash flow. An interesting corollary of this is that a mine with a long life is very valuable; this is why we have had a preference for investing in very long life mines. If you have a 30-year life you can justify maybe a 15-times cash flow.

The trouble with this mathematics, of course, is that as your approach life gets shorter, your company rating starts to fall off a cliff. As I say, investors tend to be insensitive to this. You are getting a situation now where the majority of companies are all standing substantially above the top line on this graph. I was going to put them in but then I could not work it out, so I thought I would say that in principle that is where they all are. They would be spread out a bit above it, but they are all above that line. The point is that they are all heading towards nought. As I mentioned, as your life gets shorter, your rating starts to drop off a cliff. While investors are now insensitive to this sort of thing, once they start realising it, you will have a huge downrating in gold shares, which is quite alarming for gold mining companies. That comes back to the basic rule, which I keep telling my friends in the gold mining industry: they have got to get a life, otherwise they have got a problem.

There is another feature of looking at gold shares: growth. This graph shows the astonishing expansion of gold production, starting in 1980, when I think 300 tonnes were produced in the world outside South Africa, Russia and China, and how it went up to 1,700 tonnes about 15 years later. This was a huge growth story, and of course, that is another way to invest. It is quite reasonable to pay a lot of money, a big premium, for a company that is going to grow. The problem is, if you look at the last few years, all these companies have gone ex-growth collectively, and that is the dilemma facing the industry. The valuations of the companies could be justified by growth, but the growth is not happening.

Just to give an example of growth, this is Barrick, which is the best example. There is growth, but then the last seven years have been flat; it has gone ex growth.

There have been other recent examples of companies growing. Newcrest is a good one. It has grown a lot recently and its shares have performed accordingly. The general principle is that all these companies are suffering from an inability to grow their production.
These are two slides I got from David Davis of Andisa. The first is an accumulation of all the production of these mines, working out what total production will look like if they mine what they have. This is the production profile of these companies. There will be additional production to this due to increased resources coming into reserves, by exploration success in new mines, but these companies are trying to run up a down escalator. That is a formidable thing: the amount of gold you have to replace just to stand still. The probability of them achieving it is quite remote.

These are the South African numbers. The South Africans have a bit better situation on life, but again, within 10 years, they start dropping off a cliff. There is nothing in South Africa you can do. In other countries across the world, you may be able to maintain that production better than in South Africa, where once it goes, it goes. It is going to be much more difficult.

You have to replace these things, and one chief executive of a mining company said to me, ‘Well, you know, we all talk about growth, but in fact in gold mining replacement answers are called growth.’

That is the reality. The companies are investing, and there are a lot of interesting new projects around, but in reality, they do not actually compensate for this downward trend in gold production, and, of course, that excites the gold bulls, because they say that the gold is going to run out.

From the shares point of view, that means nowadays these gold shares are not paying great dividends, so that dividend argument does not work anymore. The growth argument is broadly gone. You can, as investors, find some shares which will have good growth situation, and obviously those are the ones you buy.

You come to the third way to look at gold shares, and that is really as a geared way to benefit from higher gold prices. In a way, a gold company is a long-dated option. A lot of the people in the financial markets say, ‘Well, you can just buy an option in the market, what is the difference? Why do you have to go to all the bother of buying a gold option?’ If you start buying 10-year, 15-year options, you are going to pay quite a lot, so from an investor’s point of view it is quite a logical way of getting a long life option. But notice, like in all options, there is time decay. Some companies have more time decay than others. Those are the ones that are going to underperform.

You can see here how a 50% rise in the gold price gave an 85% rise in the shares over the last five or six years, and that is in addition; there was a little bit of income as well. Newmont is the same story, but that gave a better return. That is an important thing to note: these companies can get re-rated. Newmont has been re-rated quite highly now, and it is really very expensive, because it is a great company and people want to buy it. There you have a 90% gearing.
On the South African companies, the gearing is even greater, because it is a double whammy: you actually have a story on the rand as well as the dollar gold price. I think it is a 135% rise over the last five or six years. This explains why gold investors, coming back to yesterday’s debate, do not want you to hedge. If the shares are discounting $650 and the management rushes up to you and says, ‘Look, we have done a wonderful deal. We have locked in $450 for you’ — yes, locked in a $200 loss for the investor, from his point of view. That explains why the investors are so hostile to hedging; they want that upside; that is what they are buying.

When you ask what the future is of gold share investment, I think the critical issue is this one of life. There is decay; the options are decaying.

On every measure which you look at these shares, the life issue is the critical one, and the companies are facing formidable challenges of trying to maintain that life. The reality is that they might do quite a good job in sustaining production, maybe close to present levels, for longer than one would expect. There is quite a lot of interesting exploration going on, but it is running up a down escalator. These shares are all vulnerable to the processes of work and the processes of time. It is a major threat to the gold mining industry.

Are gold shares a good investment? I think you have to choose your shares right. There are shares you can make money on. You can make money in this game, playing these rules, but one has to see it in context of the universe as a whole. There might be a big price rise. Let us say that gold goes to $800: gold shares are going to be the way to make money out of that. That is why you are there, that is why you are buying gold shares, but if you look at it in a longer term context, this investment class faces a formidable challenge as regards life.
Session Six: Investment
Questions and Answers

Q – Philip Klapwijk, GFMS Ltd: With the high contango available on gold, juicy forward prices, do you see any sign yet from your clients in the OTC market of an interest in playing gold from the short side? If so, what ratio do you see between shorts and longs in the OTC market?

A – John Reade: If you are talking about OTC investors, then by far the largest proportion of people who we see have been buy and hold, or maybe buy, hold a core long position and then perhaps try to trade around to take advantage of what have been in the past some relatively predictable short-term moves. We have not seen much in the way of what I would call long-term profit taking, and I am not aware of any substantial investors who are short at the moment, in terms of our client base, with whom I have had communications.

Q – Justin Brown, I-Net Bridge: A question for John Reade. You mentioned in your speech that there is a ‘wall of money’, as you say, coming into the commodity market. Surely quite a bit of money has been put into the commodity market already, how much more do you expect to come?

A – John Reade: How long is a piece of string? It is big compared with what we see in the past, but the point I made is that if you look at assets under management around the world and factor in some diversification flows rather than just the normal historical investor bases that we have seen, then an order of magnitude might be a good starting point. I do not say that is what I am expecting, but that is the potential.

Q – James Burton: John, while you are answering, can you answer this question: what is a Keynesian beauty contest? That eluded me.

A – John Reade: The Keynesian beauty contest is a great thing to use in a debate when you are making comments that people do not necessarily agree with. In a Keynesian beauty contest the idea is that you are trying to pick the winner in a contest of, say, 10 beautiful women – or men, I suppose. The idea is that you are trying to guess who the winner is going to be. Therefore, you are not choosing the one who you think is the most beautiful; you are choosing the one who you think people will find the most beautiful.

The analogy to gold is, even if you do not necessarily believe that gold is a great hedge against inflation, for example, and you can use a case in saying that inflation-linked bonds are a better diversifier or better protection against inflation, it does not matter whether that is true or not as long as there are enough people out there who believe that gold is a hedge against inflation. Hence the Keynesian beauty contest.

Q – James Burton: I am very glad I asked that. I have another question for the panel. One of the questions that comes up frequently relative to the ETF is that it allegedly is taking market share away from gold equities which, according to Sandy, is probably a good thing, but there is this commentary out in the marketplace. Vladimir, have you experienced that? Is it something that you have observed with your product?

A – Vladimir Nedeljkovic: Unfortunately, we have not. As Sandy said, I think that gold equities and gold ETFs are two different things. Gold equities are long-dated options on gold mingled with the company risk, I suppose. Gold is just gold. The risk profiles are completely different, so I suppose the types of investors that would invest in one or the other are different. I also might add that with the advent of ETFs, if you want to have exposure to a specific risk, now you can. If you only want exposure to the gold price, either ungeared or geared, you can do it quite easily; you do not have to look too closely at mining companies.

Q – James Burton: John, let me turn to you. How about the ETF impact on the OTC market, if at all?

A – John Reade: One of the things that has confirmed to me that there is a lot of interest in gold at the moment is the number of enquiries I receive, particularly coming from what used to be called our Paine Webber broker network in the States with tens of thousands of brokers. A typical example would be from somebody who perhaps receives my precious metals commentary and says, ‘Hi John, we have a client who wants to buy $10,000-worth of gold, how can he go about it?’
In the past, that would have been quite a difficult question, because it is not enough to interest the investment bank. They would be forced to go to the physical market and buy coins, probably at a 5% or 7% premium over the spot price of gold. Now the obvious answer to them is, ‘The ETF sounds like just the product.’ I suspect that the availability of the ETF is probably having a small impact on OTC or physical gold investment, but I think the net result is probably for people to buy more gold than they would have done before, albeit indirectly through the ETF, simply because the spreads look a lot more attractive on the ETF than they do for small physical quantities of gold.

Q – James Burton: Thank you. Sandy, do you want to take the same question, please?

A – Sandy McGregor: I think the interesting thing about the exchange-traded funds is how small they are after two years. The important thing about them, I suppose, is that they are there, but they have really had no impact at all on the equity investors. I think this is a reflection that the investor class is very conservative; they continue playing the game that they have been playing. It takes quite a lot to change the way people look at things. If you look at the class of investors in gold, they are the same sort of people, I think – often very much older people, by the way – who are playing the same game they always have done. You have not really seen the ETF game start and, if it does start, it will probably be a different crowd of investors from the one that buys gold shares.

Q – Participant: I have a question about the ETFs. You said that there were some obstacles for the development of the ETF, but you did not speak about liquidity, and I would like to know if it is liquid and, if not, is this not another obstacle?

A – Vladimir Nedeljkovic: The way that ETFs are structured, they are open-ended funds and they can grow or decline in size according to demand and supply. In other words, if someone wants to buy a large quantity of ETFs, basically what will happen is that the market maker will create additional units and purchase gold in the spot market. Therefore, the liquidity of the gold ETF, as with any other ETF for that matter, is exactly the same as the liquidity of the underlying market. Thus, the liquidity of gold ETFs is the same as the liquidity of the spot gold market, which is quite large. That is also the reason, looking in the commodity space, everybody started with gold ETFs and not, say, platinum or silver ETFs, because the gold market is much deeper, much more developed.

A – James Burton: The only thing I would add is that if you look at the United States’ ETF, there is also the daily trading volume, which absorbs quite a bit of both buying and selling, if you will. Hence that is another aspect of the liquidity that has added to the attractiveness of the product.

A – Vladimir Nedeljkovic: And yes, we would like central banks to buy gold ETFs.

Q – Guy Keller, Macquarie Bank: What is being done to educate the equity traders and sales guys as to the availability of ETF? For example, if I rang my guys on the equity desk and said, ‘There is this product’, half of them would not even know it exists. Is there any sort of coordinated initiative to put it out there on the radar screens of equity markets?

A – James Burton: How about if I take that question from a general perspective? A lot of work has been done trying to educate, but it is still astonishing to the teams associated with the World Gold Council initiative how little is known about the ETF. Perhaps we just see it from the perspective of all the news that flows into our organisation. We think it has been quite prominently mentioned in the business press everywhere, yet we continue to run into that problem also.

The US product uses State Street as a distributor, and they are trying to work through their network and also, where they can get cooperation, do some cross-selling through two competitors – a nice way to put it. However, there is an issue about distribution of information and finding different ways to get it out there. In the United States, the effort is further hampered by the fact that the SEC has clearly ruled that the product is in continuous offering, so you cannot use normal methods of advertising that are associated with 1940 Act companies.

For example, the S&P 500 Spider is aggressively advertised and marketed and everybody knows what that is, but the product structure for the US product does not allow that same public advertising. Therefore – long story short – effort is made constantly. In fact, we have just cross-listed in France and brought on Société Générale as a distribution partner. They will be taking on the same initiative in terms of, if you will, advertising and communicating about the product to their customer base and then throughout Europe. However, again, at times it is slow.
A – Sandy McGregor: The interesting thing about this is that what will advertise it is if it starts making people money. In a way, one puts in these assets for people to buy, but if people start making money, they will buy it. If they do not make money out of it, they will not buy it. That is the acid test. If you have a period of a rising gold price, I think you will find that will be the best advert for these products.

A – Vladimir Nedeljkovic: That period is basically now, the period of rising gold prices. I also wanted to say something else. As we saw yesterday, and as I mentioned, 62% of people here think that gold investment – and the ETF is the new kid on that block – is going to drive the demand. In that context I suppose what one should look at is the allocation of resources in marketing. I do not say that people should not advertise jewellery; they should, because it is the mainstay of the overall picture. However, I think that the marketing of institutional and high net worth individual products such as gold ETFs is much more cost effective. In other words, one dollar spent on that probably results in a bigger increase in gold sales than the same dollar spent in a saturated market such as jewellery. Again, that is my personal opinion.

A – James Burton: So noted. In case anybody missed that, that was a pitch for World Gold Council support for the South African product and it is duly noted.

With that, as there are no other questions, we will bring the panel to a close. I want to thank again our experts for their concise and insightful comments about their areas of expertise within the gold market. Thank you for your attention.