

# Session Four: Debate

## The Importance of Jewellery vs. Investment to the Gold Market

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Not many of my keepers have had the courage to drag me out of retirement to come and speak at a conference. In retirement, one develops a certain degree of immunity and unaccountability, which allows you to say things you might not have said in the past – and this is a wonderful opportunity for me to say some of those things. Time and reflection have allowed me to indulge in some thoughts about what this industry has been doing and even perhaps indulge in a little revisionism. I am the last to speak and nobody yet has framed the debate. Allow me to try for a moment to make this a little more focused.

There is only one statistical bible available to us and that is the GFMS bible that we all read. It says that something like 3,500 tonnes of new gold is produced by the industry and something like 3,500 tonnes or a similar figure is consumed by jewellery each year. A casual analyst and, I think, most people, could easily come to the conclusion that jewellery is therefore vital to the future of the business and that this is a one trick pony business; nobody else consumes gold in any significant amount. Ipso facto it is very easy to come to the conclusion that promoting jewellery should and would be the only business that we can pursue. Indeed I believe there is much more to it than that.

Let me focus you strategically on where we are as an industry. My comments here really go to the leaders of the industry and the sort of behaviour that we have all witnessed over the last few years. It is not difficult in my mind to come to the conclusion that there is only one word to describe the some of that behaviour and that is insane; incompetent is not strong enough. To what I can ascribe it, I do not know. Perhaps it is because the industry has been run by engineers, but maybe it was insane engineers.

Just consider the position we were in. When the Bretton Woods system was withdrawn and gold was declared to be no longer a reserve asset, central banks were sitting on 35,000 tonnes of gold. In addition, I believe there were about a further 25,000 tonnes sitting in bullion form in private hands. Against this, we had a jewellery market that consumed only 3,000 tonnes a year. Now if all those people who held bullion reserves decided to sell, nobody was going to

save our souls. 3,000 tonnes a year of consumption was hopeless. We needed and have always needed a larger supplemental market for gold. Otherwise all of us – you, me, producers, dealers, central banks – could all go home.

There have been a number of ridiculous examples of bad behaviour by this industry. Consider the WGC faced with this strategic crisis for years. The WGC, despite some very noble efforts, have been unable to get the industry together to deal with it. At best today – and today is probably the best performance they have had for years – they have been able to round up something like 40% of the producers to contribute a dollar or a dollar and a half to try to promote their product. Somebody from Coca Cola would be astounded at the low dollar spend on promotion by this business.

Producers of other metals do a much better job than we do and yet we have a much greater

challenge facing us but also one of the greatest opportunities in front of us. Platinum and aluminium are good examples.

Let me give you another example of weird behaviour – the hedging debate we went through several years ago. At a time when central banks were selling gold, when the issue was becoming more and more prominent, the reaction of some companies was to go and sell their gold reserves in the ground in a falling market – and publicly congratulate themselves on how much money they were making on their hedge positions while their stocks tanked, and gold went from \$450 to \$250.

No amount of badgering by some of us who could see it happening could persuade people from doing it. It was only when the central banks stood up and formed the Washington Agreement, and thank God they did, that they stopped this lemming-like rush for the cliffs. If the banks had not done it, quite frankly we would not all be here; this would be a completely moribund industry. It is stunning in retrospect that the industry never got itself together to deal with it. In the meantime, while that was all going on, we were debating – and I do not understand why we are still debating – whether jewellery was going to save the ship. Nobody could realistically think that 3,000 tonnes demand a year could save this ship if everybody decided to sell.

I now have four arguments for why you should think jewellery is not the future. First of all, jewellery is in fact investment. I will not spend a lot of time on this, but somewhere between 65-75% of jewellery sold in the world is sold as high-carat jewellery and is bought and sold by weight, plus or minus a percentage, and is bought by women, a lot of them subject to Sharia law, where the jewellery they obtain becomes theirs and they can retain it in the event of divorce. It is unquestionably a financial asset and has extensive investment dimensions to it.

So only a small part of the jewellery sold around the world really is baubles, where the value of the product far exceeds the value of the gold content. It always amazes and surprises me – and I hark back to the days when we were trying to persuade other producers to join the WGC – how many mining CEOs have in their minds a public perception that the gold and jewellery we sell is the stuff that you see being sold over the counter in Zales in America. That is not what it is all about; jewellery is in fact the stuff we sell mostly through the Middle East and India and other places, where it is sold primarily as investment.

The second issue is slightly more complex, and with it I hope to be able to change some of the thinking in the business. We use entirely the wrong conceptual model for analysing the gold business. Unfortunately, it is the only one that we have, and because of the scarcity of good numbers, it is very difficult to change it.

The best way for me to explain it is by way of a parallel – the US housing market. The US housing market is roughly 120 to 130 million existing units; to which is added about 1.5 to 2 million houses a year. Some houses are torn down and destroyed as others are built; the total grows incrementally in small amounts. Nobody in their right mind would ever try to analyse the US housing market and the price of houses purely by looking at the supply and demand for new houses alone.

Yet we in this business – when there is arguably 80,000 tonnes of gold that is liquid in other people's hands – analyse and focus only on the supply and demand for 3,000 tonnes a year, and that is simply the supply of new gold versus the demand for jewellery. This leads to a mindset and debate that says jewellery is all that is relevant; it is not. There is probably more than 70,000 tonnes out there, all of which is potentially liquid, with some notion of underlying value, some notion of when they might sell or might not sell, and some of which trades below the radar screen and we never see it. That, I argue to you, is the real gold market. Simply to measure jewellery conceptually is unsound.

What then are the possible implications of a business that really is only jewellery? Sometime back when I was CEO of Gold Fields, when everybody was selling all their gold for \$250 and there seemed to be no end in sight, one of the responses we thought of was to integrate vertically. We would go and buy a refiner, buy some fabricators, buy up jewellery retailers and we would become top to bottom a gold producer, producing our own gold and selling at whatever price we wanted through the jewellers. It would at least, in the circumstances before the central banks decided on the Washington Agreement, possibly have guaranteed our survival.

There was no question that there were considerable cost savings through the integration step, and initially it seemed a great idea. In fact, it was a disastrous idea. Let me tell you why. First, if you go back over time, and I invite some of the analysts in the audience to do it, you will see that if you compare the PE ratio of the gold index with the S&P 500 PE ratio since the war through to today, on average gold equities traded

about three times the multiple of the S&P 500 and this was a fairly stable thing. There is a weird phenomenon that we have lived with and know so well, which is that gold equities trade at a substantial premium to their underlying value. It is a mystery, but it became clear to me that the moment we turned Gold Fields into an integrated gold jewellery producer we would have become just like any other industrial company and the gold multiple would disappear. The other reason is that if we all did that and only focussed on selling gold to the jewellers and promoting that business, then all the bullion dealers would be out of business and the central banks would be looking for jewellers to sell their gold to. If we made jewellery the sole focus of our business, it would be the end of the business. The real business of gold is that it is a fiscal asset, it has mystique and it has a future elsewhere.

Let me talk a little about the vision and the prospects for the ETF. The strategic situation is that we have substantial holdings of bullion and a gold market for jewellery and little else. On top of that, for most of the last century there were restrictions on private ownership of gold at least in the US, South Africa and Japan. At the time it was difficult to think of developing the investment business, but at least it had some prospects. If 25,000 tonnes of bullion were owned privately through individuals and institutions at a time when there were severe restrictions, what would happen if we removed those restrictions and made it much easier and cheaper to buy and sell gold?

That intuitively is a very inviting prospect for an investment business. The ETF's foundation point was to try to make it easy for people to own gold. Under US legislation, when the ownership of gold was prohibited, most investment mandates prohibited the ownership of gold and sometimes commodities. The challenge was to create an instrument that was a defined security without being gold which explains why it took so long to get the ETF listed because we had to define through sophistry an instrument that could be treated as a security.

Having done that, the door has opened for much wider ownership and potentially a much bigger market. The challenge ahead is to expand that ownership, because only then, if the central banks no longer have any formal reliance on gold as a reserve asset and can sell it, can we create a market that has a realistic opportunity of absorbing the gold. Even if the process persuades central banks that gold really is a valuable asset – and I think that is happening – then we will be able to restore gold's prominence and prestige. That then is what the ETF is all about. It has only just begun – we are only through 500 tonnes – but the potential, if we can get pension funds to believe and we can get the liquidity levels up, is to make this a really exciting business again. ■

