

# ArthaNITI

The Layman's guide to Financial Freedom

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FINANCIAL PLANNERS

## 'Gold prices will gain further momentum'

*Investing in gold mining companies as against buying gold bullion gives the investor an opportunity to benefit from the growth potential of equities as well as the strong fundamentals of gold. There is a multiplier effect on the profitability of gold mining companies with rise in gold prices.*

*Of all the gold-related mutual fund products flagged off recently, DSP Merrill Lynch's World Gold Fund has had the most promising debut, having notched up a 27 per cent return since its launch in August. The fund is also different from the other Gold ETFs, in that it does not invest in physical gold but takes exposures to gold mining companies worldwide. Rising consumption demand for gold, renewed interest from central banks and the possibility of a weaker dollar suggest that gold prices will gain momentum over the next 3-5 years, says Mr S. Naganath, President and Chief Investment Officer of DSP Merrill Lynch Fund Managers, in an interview to Business Line.*

*Excerpts from the interview:*

***With international gold prices close to a three-decade high, is this really the right time to buy gold?***

From the perspective of fundamentals, gold has shown strong signals to support its recent price rise. With a steady fall in production and a corresponding increase in demand, the demand-supply gap is widening. There has been dual demand in the recent past with central banks steadily increasing their exposure to gold as a hedge against the weakening dollar and strong consumption demand for gold jewellery and ornaments being generated from the Middle-Eastern countries, India and China.

Historic price trends show that the last bull-run for gold was between December 1969 and 1981. One can divide this cycle into three phases, where Stage 1 (1969-1972) saw

gold prices move up gradually as the US dollar weakened. In Stage 2 (1972–1978), the price gained momentum as global investment demand witnessed a rise. In Stage 3 (1978–1981) as a result of speculative trading, gold shot up quite rapidly.

We are now witnessing the second phase in this cycle for gold. Increased demand from central banks, as well as consumer demand for jewellery indicates that we are currently in Stage 2. Taking these indicators into account, we believe that although there may be some short-term volatility, gold prices will continue to gain momentum over the medium to long term.

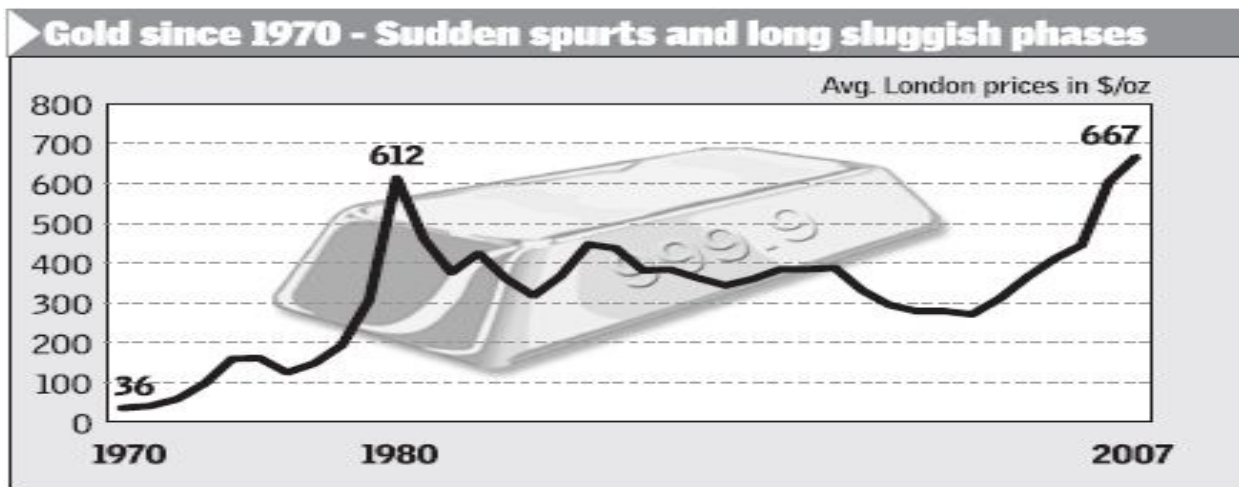
<b>How gold fared versus Indian stocks</b>				
	<b>Gold prices S/oz, Ldn</b>	<b>Sensex Points</b>	<b>Gold Returns(%)</b>	<b>Sensex Returns(%)</b>
1996	369.2	3085		
1997	290.2	3659	(21.4)	18.6
1998	287.8	3055	(0.8)	(16.5)
1999	290.2	5006	0.8	63.9
2000	274.4	3972	(5.4)	(20.7)
2001	276.5	3262	0.8	(17.9)
2002	347.2	3377	25.6	3.5
2003	416.2	5838	19.9	72.9
2004	435.6	6602	4.7	13.1
2005	513	9397	17.8	42.3
2006	632	13787	23.2	46.7
2007	725.5	17773	14.8	28.9
10 yr returns (%)			9.6	17.1

***What is your outlook on gold prices over the next 3–5 years? On what do you base this?***

Gold prices have witnessed a sharp uptrend recently, gaining nearly 10 per cent over a 3-month period. Reports published by gold analysts suggest that in the next 3 to five years, supply-and-demand dynamics will undergo substantial change, caused by a decline in supply and increased demand from India, China and the investment community. This, we feel, would result in gold prices continuing to rise.

***The recent upsurge in gold prices appears to be backed by a flight to safety on the weakening of the US dollar. Economists over the past two years have often been wrong on their predictions of a sharp depreciation in the US dollar. Is the recent weakening, in your view, the beginning of a trend reversal, where the dollar will really begin a secular decline?***

The fallouts of sub-prime lending have begun surfacing in different segments of the US economy. According to a report from a leading financial institution, the construction sector has lost 36,000 jobs in the past two months. Such reports raise doubts about forecasts for slow but steady economic growth in the US. Analysts fear the housing slump would lead to a full-blown recession in 2008 and result in a negative impact on the dollar.



*One of the key arguments for investing in gold is pegged to rising jewellery demand. Yet jewellery demand, especially in regions such as India, is quite price-sensitive. Will higher prices reduce demand and what will this mean for the demand-supply equation?*

Although there should be one-to-one correlation between jewellery demand and price of gold, in India jewellery is bought not only for adornment and investment, but also for other sentimental and traditional reasons — be it marriage or other family functions; there are even auspicious days when buying gold and/or gold jewellery is considered to bring good luck. In our opinion, the increase in gold prices may somewhat impact buying behaviour, but social traditions will continue to generate demand, even at higher price levels. According to a recent report from World Gold Council, India has witnessed a vibrant demand for gold this year and jewellery accounts for 70 per cent of this demand. Manufacturing and designing significantly add to the price of jewellery, making jewellery less price-sensitive to the actual movement of gold bullion.

Earlier, India was the primary contributor to consumption demand for gold but the wealth effect witnessed in other regions such as West Asia (higher oil prices bringing in

more petro-dollars) and China (fastest growing economy) is also driving demand for gold.

***Selling by central banks has been one of the key fundamental dampeners on gold prices in recent years. Do you see signs of a shifting central bank stance on gold as a reserve asset?***

Central banks are the largest holders of gold reserves worldwide. Emerging markets have international reserves of approximately \$2.7 trillion.

In the last 15 months, China and India have seen an approximate increase in international reserves of \$500 billion and \$80 billion respectively. Continued dollar depreciation makes gold an attractive investment alternative for central banks.

***An analysis of 10-year gold price trends suggests that while gold does deliver outsized returns during times of crisis, it has not delivered much for buy-and-hold investors over a 10-year period, with annualised returns of about 9 per cent. Thus, do you advocate gold or gold stocks as an investment for long-term investors?***

We agree with you that gold bullion in its physical form has not delivered smart returns and that is why we recommend investing in gold mining companies through a mutual fund.

We have highlighted the benefits of investing in gold mining companies *vis-à-vis* gold bullion or ETFs earlier. While bullion has delivered a 147 per cent return (absolute) in rupee terms over 10 years, the Merrill Lynch World Gold Fund has delivered 615 per cent over the same period! The outperformance has also been sustained for 5-, 3- and one-year periods.

***Investors now have different routes to invest in gold- ETFs, physical gold in coin/bar form as well as funds such as yours. What advantage does DSPML World Gold Fund carry over alternative investment routes?***

Let me answer this by asking a question. If you had a positive outlook on any commodity... say, copper, are you better off buying a tonne of copper or investing in shares of a copper mining company? An investor can expect better returns by buying

shares of a good copper mining company as the profits of the company will tend to increase much more than the increase in the price of copper.

If costs are contained and increase to a lesser extent than the sale price of the end product, profits expand, driving share prices of such companies. Of course, the converse can happen if commodity prices decline.

Investing in shares of gold mining companies as against buying gold bullion/ETFs gives the investor an opportunity to benefit from the growth potential of equities and also the strong fundamentals of gold. Gold mining companies can grow organically or through the M&A route, while gold bullion/ETFs cannot. There is a multiplier effect on the profitability of gold mining companies with rise in gold prices, due to operating leverage.

Merill Lynch World Gold Fund is also helped by the stock selection skills of a well-respected Natural Resources Team at BlackRock Merrill Lynch Investment Managers. This team manages the largest gold mining fund in the world and has a great performance track record.

By investing in DSP Merrill Lynch World Gold Fund, the investor gets the dual benefit of access to fund manager expertise and active portfolio management.

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