We examined the gold price in detail in 2010 in ‘The Great Gold Debate’ (RE:VIEW Volume 13, July 2010) as a context for our holding in one of South Africa’s major gold producers, Harmony.

We commented then that while the Gold Debate may have raged, since the turn of the century the gold bugs had undeniably had their day in the sun. Over that time, gold had delivered around four times the return of bonds and five times that of stocks.

As valuation-based investors, it’s difficult to value gold using our favoured approach of assessing the intrinsic value of an asset against the current price. Valuing gold on this basis is a dead end – unlike bonds and stocks, the asset produces no cashflow and therefore has no clearly quantifiable intrinsic value.

We therefore have to look at establishing gold’s relative value by defining what one expects to receive by owning gold in the absence of cashflow. Through the ages, gold has served as a store of value and as a form of currency. Gold investors see the asset as a means of protecting purchasing power over time. If they’re right, we’d expect gold to deliver a return equal to inflation over time.

When we wrote the article, gold was around $1,200. A graph of the inflation-adjusted gold price since 1914 showed that gold had only ever once been more expensive in real terms – during the speculative gold bubble in 1980. We also showed the inverse relationship between the inflation-adjusted gold price and the returns you could expect over the 10 years that follow. Unsurprisingly, when the inflation adjusted gold price has been high, returns over the subsequent 10 years have been poor.

While the comparison of gold against oil was inconclusive, graphing gold against a broader basket of commodities and against the MSCI World Index showed that gold looked expensive against both benchmarks. We concluded that gold was clearly expensive in inflation-adjusted terms, in comparison to commodities in general and relative to global equities.

Why then did we own Harmony at the time? Our first point was that our analysis showed the South African gold shares to be very cheap in historical terms relative to the reserve ounces of gold owned. We also saw gold and gold stocks as a form of insurance against financial catastrophes in the world. While this particular insurance policy was not as cheap as it had been, in the context of the rest of our portfolio of generally high-quality businesses, we felt it prudent to allocate some capital to gold. At the time, we were concerned about the tumultuous state of global government finances and the likely longer-term impact of global fiscal and monetary activities over the preceding two years. If the tail risks in the global economy – that most financial market participants seemed to be disregarding – came to pass, gold would probably be the last man standing, as it has been through the ages.

What’s happened since then

Since we published the original article more than three years ago, total returns from the three assets we discussed have developed as shown in Chart 1 on the following page.

Although gold continued to outperform the other asset classes for about a year after the article, it has been the clear laggard of the three asset classes since then. The rout in the gold price in recent months has been the main reason for this.

The inflation-adjusted gold price chart in the original article went back as far as 1913. We’ve subsequently obtained inflation and gold price data going back to the mid-1200’s. But when one starts talking about 750-year averages, famous economist John Maynard Keynes’ quote that ‘In the long run we are all dead’ becomes quite relevant, even for us long term value investors! So we’ve decided to limit the data in Chart 2 to the comparatively insignificant 100-year timespan we showed in the original article.

Nothing much has changed in the strong negative relationship we showed between the inflation-adjusted gold price and the ten-year prospective returns from investing in gold. Buying gold when its price is high in real terms has historically not
been conducive to good investment returns. Despite recent declines, the price is still high today in the context of the longer-term history.

With the oil price increasing from about $70 in mid-2010 to $110 today, Chart 3 shows that gold now looks to be on the cheap end of its historical range against oil.

Relative to other commodities, gold still appears to be expensive, as Chart 4 demonstrates. But, as we explained in the original article, there’s a case...
to be made that gold should increase in value relative to other commodities over time. On that measure, gold appears to be more reasonably priced – the relationship between the gold price and the CRB index is more or less in line with the longer term trend of gold outperformance over other commodities.

We also explained how one would expect stocks to outperform gold over time. Relative to the long-term trend of stocks' outperformance of gold, gold appeared very expensive. While this situation has moderated somewhat, Chart 5 shows that gold is still firmly expensive relative to stocks.

**Chart 3: Gold vs Oil**

![Chart 3: Gold vs Oil](source: Thomson Reuters Datastream, RE:CM)

**Chart 4: Gold vs CRB Index**

![Chart 4: Gold vs CRB Index](source: Thomson Reuters Datastream, RE:CM)
On these measures, the conclusions from our 2010 article broadly still hold. While gold has become somewhat cheaper on some of the measures we explored, it’s still far from cheap. We typically employ a marginal cost/incentive price framework when trying to establish fair value for commodities. This represents the price that incentivises gold producers – gold mines – to continue to produce gold. The incentive price for gold currently appears to be in the $1,300 to $1,400 per ounce region, coincidently just about where it’s trading at present. But because such a substantial portion of gold demand is driven by investment – or speculation – as opposed to industrial or jewellery uses of the metal, we have less confidence in incentive price as an accurate fair value for gold than for most other commodities.

While our clients owned some direct gold exposure and gold shares – primarily Harmony Gold – at the time of the original article, we subsequently sold almost all of this exposure, with most of this occurring well before the selloff in the gold market of recent months. In the original article, we pointed out the ‘insurance policy’ quality of gold, and the value of that in an investment portfolio. Since then, we’ve become less convinced of the value of such an insurance policy, given the price one is paying for that insurance policy today.

As for the shares of gold mining companies – at the time, we pointed out how historically cheap South African gold shares were on an enterprise value per ounce of reserve basis, relative to gold. On this measure, the South African gold miners have become even cheaper. Chart 6 shows the combined enterprise value per reserve ounce for AngloGold, Gold Fields, Harmony Gold and Sibanye Gold relative to the price of gold. The chart shows that on this basis, the gold shares are even cheaper than they were in 2010.

So why have we sold out of gold shares? In short, we revisited the underlying economics of the businesses and came to the conclusion that they were worth less than we initially thought – and less than the price the market has historically paid for these businesses. Our investment in Harmony was, at least in part, predicated on the business transforming itself from a low cost, marginal producer to a better quality business over time. In the more than five years that our clients owned the shares, very little of this transformation came to pass. Our revised assessment of what the company was worth was materially lower than our earlier estimates. This was the motivation behind our decision to sell out of Harmony.
Incidentally, while the overall trend in Harmony’s share price was negative during the time our clients owned the shares, the overall outcome of our clients’ investment in Harmony was a small positive return. That is far from the disaster one may have expected from looking at Harmony’s share price graph for the past six years. This return resulted from the action we took to reduce exposure when the margin of safety was relatively small, and to increase exposure when the margin
of safety was relatively large in the context of the substantial volatility in the share price, as Chart 7 illustrates. Which shows the value of buying only at a large margin of safety and adjusting exposure as the size of the margin of safety changes.

Given the sharp declines in the prices of gold shares in recent months, our assessment is that prices are now much better aligned with the long-term economics of these businesses. But as yet, we haven’t been able to find large enough margins of safety to allow us to allocate significant capital to the shares of these companies.

Wilhelm Hertzog