MUTUAL FUNDS WORKSHOP

Assessing Gold Funds: It's the Mettle That Makes the Most Difference

By John Markese

Gold fever comes and goes, and when the metal crossed $400 an ounce recently, temperatures started to rise.

There are many ways to invest in gold: bullion, coins, gold mining and exploration stocks, and gold mutual funds. The objectives of gold investors varies, but the most-often mentioned objectives include: hedging inflation, diversification, and speculation. And there are always those who say that if you have held a hunk of gold, you have felt its seductive powers. Whatever its draw, one of the easiest ways to diversify and invest in gold is through gold funds.

One ounce of gold may be interchangeable with any other ounce of gold, but the same is not true of gold funds. Table 1 lists the gold funds covered in AAII's 1996 edition of "The Individual Investor's Guide to Low-Load Mutual Funds" and the performance figures differ significantly, from a high compound average annual total return over five years of 10.9% to a low of –7.9%. What accounts for the differences? Beyond the price of gold, the two critical factors that affect the performance of gold funds are portfolio composition and country weightings.

Most gold funds spread their assets over gold stocks, bullion, cash, and "other" investments, the latter of which usually consist of bonds and preferred stock convertible into gold mining shares.

Gold stocks are the predominate investment of most gold funds. Setting aside the geographical location of the company, gold stocks can be categorized as either mining stocks or exploration stocks. While most mining companies tend to continue with some exploration projects, mining—the production of gold—is far less risky. Exploration—the finding of gold—is far more risky, but requires little capital; small exploration companies abound.

Gold funds primarily hold mining stocks, where gold reserves, production hedging, and production costs per ounce of gold rule. For these firms, small changes in the price of gold can have a big impact on the earnings. Interestingly, while the lowest cost producers are, not surprisingly, the most profitable, mining firms with high costs of production benefit the most from changes in the price of gold—a classic case of operating leverage and the breakeven point. Gold mining stocks are therefore much more volatile than gold itself. If gold were to go from $400 to $500 per ounce, a 25% increase, the earnings of many gold mining firms could rise 100%. The current overriding investment question is, "Does the current price of gold mining stocks already fully reflect an expectation of much higher gold prices?"

The gold funds in Table 1 are predominantly invested in gold mining shares, but a few do take meaningful positions in bullion, and sometimes the bullion is silver or platinum rather than gold. Lexington GoldFund, with 11.4% of the portfolio in gold bullion, leads the funds in percent invested in bullion. Bullion has storage costs and doesn't have the multiplier effect that exists with gold stocks when gold prices move; it rises in value dollar-for-dollar with the price of gold.

The "other" category in Table 1 under percent of invested portfolio includes fixed-income assets such as preferred stock and bonds, both of which are usually convertible into stock and sometimes the preferred is tied to the price of gold. Cash, however, is cash, and large cash portfolio positions usually indicate some attempt at market timing. U.S. Gold Shares, at 9.2%, holds the highest cash position, a financial asset susceptible to inflation.

Country weightings can have a pointed influence on portfolio performance because of geographical considerations including local labor market conditions, the age of mines, the political atmosphere, currency fluctuations and other factors. The four largest gold producing countries are, in order of production: South Africa, the United States, Australia, and Canada. Australia alone produces more gold than all the rest of the world after these big four.

The gold funds can be divided, although not perfectly, into two categories: North American gold funds and global gold

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funds. Fidelity Select American Gold and Benham Gold Equities Index concentrate investments in North America. [Benham Gold Equities Index is now called Benham Global Gold and has recently changed its objective to an emphasis on global investments.]

Oddly, however, South Africa and Australia are missing from some of the global fund portfolios. South Africa most likely is avoided by some funds because of high and rising production costs, declining production, and the volatility of the South African mining shares. U.S. Gold Shares, with the highest concentration of investments in South Africa at 71.0%, is also the most volatile of the gold funds as measured by the three-year standard deviation, a measure of return volatility. An interesting historical note: Half of all the gold ever recov-

Table 1.
Gold Funds: A Comparison

	% of Invested Portfolio in:				Bullion (%)			Country Weightings % of invested portfolio excluding bullion:		Three Largest Stock Holdings
	Stocks	Bullion	Other*	Cash	Gold	Silver	Platinum			
US World Gold	97.7	0.0	2.3	0.0	—	—	—	S. Africa: 0.0 U.S.: 22.9	Australia: 18.7 Canada: 51.5 Other: 6.9	Barrick Gold Corp. 12.8%, Delta Gold N.L. 9.9%, The Pioneer Group 8.3%
Scudder Gold	90.7	4.6	3.6	1.1	3.4	0.0	1.2	S. Africa: 3.1 U.S.: 30.6	Australia: 11.4 Canada: 50.3 Other: 0.0	Stillwater Mining Co. 5.5%, Pioneer Group 4.6%, Hemlo Gold Mines 3.8%
INVESCO Strategic Portfolio—Gold	89.8	0.0	10.2	0.0	—	—	—	S. Africa: 0.0 U.S.: 15.4	Australia: 3.8 Canada: 76.1 Other: 4.7	Diamond Fields Res'cs 13.9%, Franco-Nevada Mining 7.3%, Golden Star Resources 5.5%
Fidelity Select American Gold Portfolio	89.9	2.5	2.9	4.7	0.0	2.5	0.0	S. Africa: 0.0 U.S.: 35.5	Australia: 0.0 Canada: 59.2 Other: 2.8	Barrick Gold Corp. 9.9%, Newmont Mining Corp. 8.5%, Placer Dome 6.3%
Benham Gold Equities Index (Benham Global Gold)	100	0.0	0.0	0.0	—	—	—	S. Africa: 0.0 U.S.: 28.5	Australia: 0.4 Canada: 69.3 Other: 1.8	Barrick Gold Corp. 24.0%, Placer Dome 16.2%, Newmont Mining Co. 9.4%
Blanchard Precious Metals	97.6	0.0	0.3	2.1	—	—	—	S. Africa: 12.3 U.S.: 34.4	Australia: 6.1 Canada: 47.2 Other: 0.0	TVX Gold, 10.3%, Placer Dome, 9.9%, Santa Fe Pacific Gold 7.3%
USAA Gold	94.6	0.0	0.0	5.4	—	—	—	S. Africa: 14.0 U.S.: 38.7	Australia: 10.2 Canada: 37.1 Other: 0.0	Barrick Gold 8.6%, Placer Dome 8.1%, Freeport - McMoRan 6.2%
Lexington GoldFund	84.6	11.4	0.5	3.5	11.4	—	—	S. Africa: 19.3 U.S.: 16.0	Australia: 22.6 Canada: 28.1 Other: 2.6	TVX Gold 4.4%, Newmont Gold Co. 4.1%, Dreifontein Cons. Ltd. 2.8%
Fidelity Select Precious Metals Portfolio	94.5	0.0	0.7	4.8	—	—	—	S. Africa: 42.5 U.S.: 15.6	Australia: 8.5 Canada: 31.1 Other: 2.3	Barrick Gold Corp. 11.2%, Western Areas Gold Mining 4.4%, Newmont Mining Corp.3.9%
Vanguard Specialized Port.—Gold & Prec. Metals	91.7	5.7	0.3	2.3	5.6	0.0	0.1	S. Africa: 33.0 U.S.: 21.4	Australia: 22.8 Canada: 13.7 Other: 3.4	Free State Cons'd ADR 3.1%, Impala Platinum Hold ADR 3.0%, Euro Nevada 3.0%
Bull & Bear Gold Investors Ltd.	84.9	8.6	0.0	6.5	1.9	6.7	0.0	S. Africa: 27.0 U.S.: 25.5	Australia: 18.0 Canada: 20.9 Other: 0.0	Pioneer Group 4.8%, Kloof Gold Mining ADR 4.4%, Placer Dome 4.2%
US Gold Shares	90.4	0.0	0.4	9.2	—	—	—	S. Africa: 71.0 U.S.: 15.5	Australia: 0.0 Canada: 8.4 Other: 5.1	Free State Cons'd ADR 9.6%, Kloof Gold Mining ADR 7.1%, Southvaal Holdings ADR 7.1%
All Domestic Stock Funds										

** Includes: corporate bonds, convertible securities, and preferred stock.*
*** Bull market period: July 1, 1994, through December 31, 1995; bear market period: February 1, 1994, through June 30, 1994.*

Source: "The Individual Investor's Guide to Low-Load Mutual Funds," 1996 edition, American Association of Individual Investors.

ered from the earth was wrestled out of the ground from the Golden Arc, the Witwatersrand Basin around Johannesburg.

As with non-gold mining stocks, mines with large reserves and growth potential pay little or no dividends, while mines with low and diminishing reserves pay high dividend yields. Many of the South African mines fall into this latter category and some have dividend yields greater than 10%.

Exp. Ratio (%)	Yield (%)	Annual Total Return (%) One Year	Three Years	Five Years	Bull Market** Ret. (%)	Bear Market** Ret. (%)	Std. Dev. (%)
1.55	0.0	15.9	22.2	10.9	8.7	–14.4	28.0
1.65	0.0	13.1	18.6	7.1	10.7	–8.8	21.5
1.25	0.1	12.7	11.9	3.6	–4.1	–17.6	27.6
1.41	0.0	11.1	18.8	8.8	5.0	–10.5	25.5
0.62	0.0	9.2	18.1	5.9	5.6	–14.0	29.5
2.49	0.0	4.4	21.1	7.2	–2.5	–7.6	26.4
1.28	0.0	4.0	14.2	5.6	6.0	–11.4	27.0
1.64	0.1	–1.8	19.3	4.8	2.2	–9.7	27.4
1.46	0.3	–3.3	26.4	9.9	3.0	–3.2	27.5
0.25	1.4	–4.4	20.4	7.9	–1.9	–6.5	26.4
2.93	0.0	–5.4	15.2	4.5	–3.9	–13.3	29.2
1.42	3.0	–26.8	16.8	–7.9	–18.2	–3.0	34.6
1.16	1.2	30.9	14.1	17.9	37.1	–7.7	9.6

The largest gold mining stock holdings for each fund are listed and reflect stock selection and also country weightings by the portfolio managers. Fidelity Select American Gold Portfolio has as its three largest holdings: Barrick Gold, Placer Dome, and Newmont Mining, the three largest North American mining stocks. U.S. Gold Shares lists three South African mines, matching their heavy emphasis in South Africa. These three make up 23.8% of the portfolio, indicating that the fund is as concentrated as Fidelity Select American Gold, with 24.7% in its top three holdings. Lexington GoldFund, Vanguard Specialized Portfolios—Gold and Precious Metals, and Bull and Bear Gold Investors are the most diversified by country and by holdings.

For comparison purposes, the bottom of Table 1 reports the average expense ratio for domestic stock funds, which is 1.16%. While some of these gold funds have high expense ratios, two in particular scream, “Look out!”—Bull and Bear Gold Investors, at 2.93%; and Blanchard Precious Metals, at 2.49%. While performance figures include expenses, funds with this high of a drag on performance will have difficulty rising above their peers in the long run.

The dividend yields for gold funds are low. The highest yield is 3.0% produced by U.S. Gold Shares; second is 1.4% produced by the Vanguard fund, a result of their heavy weighting of South African shares. Gold funds have traditionally been purchased for their capital gains potential, particularly when inflation is anticipated to be high, and not their dividend yields.

In Table 1, the funds are ranked by one-year performance; three-year and five-year compound average annual total returns are given for a broader view. Because gold funds are touted as elements to diversify a portfolio, their bull and bear market performances are also reported. Lastly, the standard deviation is given as a measure of total risk—the higher the standard deviation, the greater the risk.

The comparisons to all domestic stock funds isn’t pretty. The best of the gold funds, U.S. World Gold, returned 10.9% a year for five years, while the average stock fund returned 17.9%. But most disturbing is the bull and bear market comparisons—none of the gold funds come within even a third of the bull market performance of the stock fund average, and five of the 12 funds have negative bull market returns. Bear market performance is equally dismal, with eight out of 12 funds returning bigger losses than the average stock fund. The gold funds seem to act like gold when the stock market rises and stocks when the market declines—the opposite of what would be expected from an investment often described as a portfolio hedge. And all of this terrible performance was achieved at three times the risk of the average stock fund.

Of course, 1996 may just be the year of the gold fund, if the gap between gold demand and gold supply ever translates into higher gold prices. But then again, it may not. And not all these gold funds will glitter as brightly as the metal if gold does make a rush—gold funds do differ by composition and performance. Assay a fund carefully before you invest.