

Gold: The Pause That Refreshes

By Adrian Day

Last year was a particularly rewarding one for gold and gold stocks, as the sector rebounded sharply from the end-2008 credit-crisis sell-off. While gold itself was up 24% in 2009, the stocks, as is typical, leveraged that performance, with the XAU index of major companies up 36%, and the average gold mutual fund up just over 50%. Many managers did much better, of course.

<u>Metals</u>			
	YEAR AGO	CURRENT	
Gold	\$899.70/oz	\$1,108.50/oz	UP
Silver	\$13.21/oz	\$16.14/oz	UP
Platinum	\$1,085.00/oz	\$1,535.00/oz	UP
Palladium	\$221.00/oz	\$427.00/oz	UP

The strong recovery of 2009 should be seen in the context of sharp declines in 2008. So what now? Should investors sell in order to protect the rally gains, even though many stocks are still well down from their highs and selling at reasonable valuations?

We think not. Despite hitting yet new highs near the end of the year, there is much further to go for gold and gold stocks. We should therefore look at the conditions that led to this move.

Gold certainly was helped by the weak dollar, but it's much more than an anti-dollar play. Gold is up in terms of all currencies, boosted by concern about inflation and extraordinarily low interest rates. Mostly, it's a vote of no confidence in the world's paper monies, and skepticism of central bankers' abilities to effect stable money, and specifically to exit stimulus programs in an orderly manner. Nothing has changed, and gold is becoming a new de-facto alternate currency. There is a lot further to go.

Most significant perhaps, central banks have switched from net sellers to net buyers. Banks of newly emerging countries that built up their reserves in the last couple of decades tend to have among the highest levels of reserves but the lowest proportion of gold (India, China, Korea and so on). Overall, the proportion of gold held in central bank reserves has declined from 30% a decade ago (and that followed a period of heavy bank selling) to just over 10% today. China, Korea, Japan and many others hold well under 5%, and the ease with which India scooped up half the IMF's gold for sale shows clearly that demand overhang is not a problem. Central banks are likely to be net buyers for years to come.

The gold stocks remain inexpensive, with the major stocks selling at historically low prices relative to bullion, and at the lowest price-to-earnings and price-to cash flow ratios in over 20 years. Even better values can be found among the exploration companies, where some trade close to their cash holdings. So we are buying both, the seniors for more certain exposure to a rising market and the juniors for greater profit potential. An exploration company that actually makes a discovery is likely to be snapped up by the resource-hungry seniors, so we are patient holders.

The recent pull-back in gold and gold stocks is nothing to be concerned about. Such corrections are not unusual and can be nerve-wracking. But the lesson is not to panic and ride out the decline, provided you own good-quality companies. Think how quickly the gold

stocks made back all of their 2008 losses; those who panicked and sold surely rue the day. A correction such as we are experiencing is a time for astute investors to add to positions, and there are many good quality companies selling at low valuations.

The key is in stock selection. Once you have your physical gold, start your stock portfolio with a core of good quality senior companies, with good balance sheets and with growth profiles that will ensure they will participate with gold. And then look for juniors and exploration companies, again with strong balance sheets and sound strategies. If things go wrong with the company, then move out quickly and wait for another opportunity. There will always be more, and the key is to have the discipline to wait for great opportunities.

Adrian Day is president of Adrian Day Asset Management, a firm managing segregated accounts for high net-worth clients and companies, with a specialty in gold and resources. For more information, visit www.AdrianDayAssetManagement.com or call 410-224-2037, assetmanagement@AdrianDay.com and mention ASI. □