

The IRS Report

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Green, rosy, black or golden?

It's déjà vu all over again. Politicians argue about whether or not there are green shoots. UK GDP growth of 0.1% in the final quarter of 2009 means we are officially out of recession. Manufacturing industry is rebounding, and so it should given a 25% fall in sterling over the past 18 months. The US economy is steaming ahead, albeit without generating any new jobs. Corporate earnings surprises are almost all on the upside. The market outlook might even be rosy.

Hang on a minute. The huge imbalances that caused the crisis are still there. The



Editor's view

Chinese are holding down the value of their currency to generate exports and continue to accumulate more dollars than they want. I'm told they're now running TV ads encouraging citizens to buy gold and silver – one of the few ways they can think of to

shrink their trade surplus.

Millions of Britons are better off because they work for the government, have secure pensions and jobs, and are paying much less on their mortgages than they were a year ago. But there's only one place rising living standards come from: investment, which remains at a 30-year low in the UK. Until investment and productivity increase significantly, the UK economy will stagger on like an unreformed, overweight couch potato in a Primark shell suit. There's certainly a risk of a heart attack in the form of a debt funding or exchange rate crisis.

The rubber-band stockmarket rebound from the March 2009 lows has probably ended. More fund managers are switching to defensive stocks, which outperformed by a mile in Japan's "lost decade". But why not buy a bit of insurance? Gold offers protection against inflation and deflation. Both John Snowden and I feel it's worth adding to our portfolios.

Chris Gilchrist

Peter Shearlock

A chance to buy bricks-and-mortar at a discount

One positive effect of the recent market pullback is that it has brought a number of shares back into sensible buying territory. Granted, judgments of this kind are highly subjective but, as a value investor, I do have a number of yardsticks by which I can test my gut feeling. One of those is price-to-book, or the relationship between the share price and the underlying net asset value.

For Ben Graham, the father of value investing, a discount to the bricks-and-mortar break-up value of a company was essential if he was going to get interested in a share. He preferred to buy stocks trading at no more than half their net worth. Well, the market has moved on and, partly because of Graham's contribution, there are very few shares offering even bare discounts these days – though there are certainly more than there were a couple of years ago.

One that has grabbed my attention is mid-range housebuilder **Bovis Homes Group**. The shares are now firmly in the bottom half of their 12-month trading range, despite a bullish statement from the company as recently as mid-January. Most importantly, they are valued at a discount to net worth of between 25% and 30%.

Now there are plenty of reasons why the market should be wary of any housebuilder right now. Wind the clock back a year and several were teetering on the edge of bankruptcy. A

Bovis Homes Group

Recent price:	404p
52-week high/low:	571p/341.75p
Market cap:	£525m
ICB sector:	House, Leisure & Personal Goods
EPIC CODE:	BVS

number had to raise new funds and renegotiate their loans. Then came a dramatic reassessment. A big run-up in share prices followed as the market priced in a steady recovery in the housing market.

Negative views

In the past two months, however, sentiment has shifted. Growth in mortgage lending has stuttered to a halt and both the Royal Institute of Chartered Surveyors and the House Builders Federation have come out with negative reports. For all that, the latest Nationwide Building Society survey showed prices continuing to rise at over 1% a month.

While several competitors still look like the walking wounded, this is not true of Bovis. In January, the company said it had achieved completions on 1,803 homes in 2009, more than 1,200 of which were to private buyers, as opposed to housing associations or partnerships. That was a big improvement in the mix, and therefore in margin. Nearly 60% of legal completions came in the second half. At the

recent rise from \$750 to over \$1000 per ounce. But you don't buy an insurance policy to make money – the aim is to avoid losing money. A research paper from the WGC – "Gold as a strategic asset for UK investors" – showed that gold has very low correlation with any other major asset. For example, its correlation with UK equities was 0.055 as against a gilt-equity correlation of 0.315, and gold has mildly negative correlation with gilts. So the paper concluded that for moderate risk investors, a 6.7% holding in gold was optimal. Personally, I take these figures with a pinch of salt because I am deeply skeptical of portfolio theory, but the fact that gold has tended to move quite independently of other assets is clear from the history.

Scope for a boom

So there's the case for gold as an insurance. Now there is also a potential case for a gold boom and even bubble. Ian Williams, manager of the new Way Charteris Gold Fund, says there is good evidence for a 40-year gold cycle, in which case the next peak isn't due till 2019. He thinks we haven't really started yet. The last peak in 1979 was \$2,000 if

Table 2 UK funds for gold investment

Funds investing in gold mining shares	Funds investing in physical gold*
BlackRock Gold & General	ETFS Gold Bullion Securities (GBS)
Ruffer Baker Steel Gold	ETFS Physical Gold (PHAU)
Investec Global Gold	ETFS Swiss Physical Gold (SGBS)
Smith & Williamson Global Gold & Resources	
Way Charteris Gold	

These are LSE-listed funds denominated in SUS but sterling-denominated versions are also available.

you adjust it using the US CPI inflation data, but you can argue that the real rate of inflation was much higher, and that the equivalent price peak was nearer \$5,000 in terms of today's money.

I can certainly imagine the Chinese and Indians getting either scared – of bank busts or inflation – or enthusiastic enough to buy many times the amounts they have bought in recent years.

The extent to which you believe in the possibility of a price surge should determine how you buy gold. If you see a purchase as pure insurance, then stick to ETFs. The physical price has low volatility and low correlation. But if you think the price will go higher, the gold mining funds will make a truckload more money because of the gearing factor. As all the gold mining fund managers have pointed out, gold mining shares have underperformed the gold price for several years, which is

historically unprecedented. On this basis, gold shares are cheap in relation to gold.

I have hedged my bets and gone 50-50 with a gold mining share fund and a gold ETF. But if I top up, it will be with more gold shares.

Of the share-investing funds, BlackRock's is too large at £2bn, and its performance has lagged over the past year. Its long-term manager has recently left.

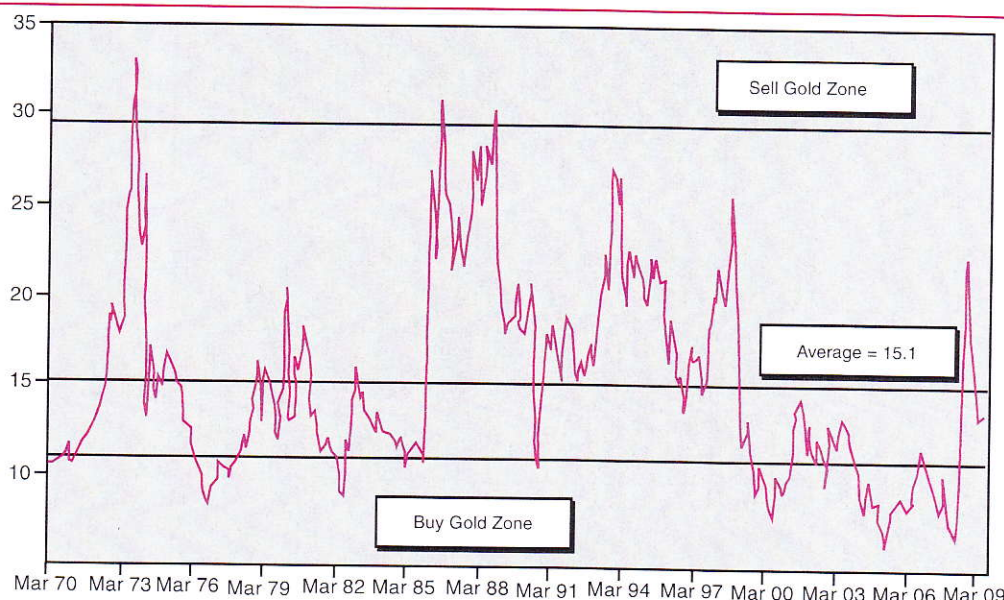
Ruffer's Baker Steel Gold, Investec's Global Gold or Way Charteris's Gold would be my current choices.

All the London-listed gold ETFs are backed by independently audited gold bars. They are the cheapest way to own gold with TERs of 0.4% or less.



Chris Gilchrist is editor of The IRS Report.

Gold bugs shoot for \$5,000



*This is a favourite gold bug chart showing the ratio between the oil price in US \$ per barrel and the dollar gold price. Though there is no reason to expect any particular ratio to be achieved, it does suggest more upside potential.