Gold Stocks, Dividends And Hedging

We all are familiar with the concept of a disruptive technology, something that comes along and puts a previous business in the garbage can of history. I was thinking about this as I was reading a newspaper while watching a videocassette and faxing my order for a tuna salad sandwich over my landline telephone.

The news last week a number of gold miners are considering raising their dividends to combat the intrusion of ETFs onto their turf made me wonder whether the ETF had become a destructive product for those seeking protection against destructive monetary policies. Even though I can and have argued gold futures are a preferred vehicle relative to ETFs such as the SPDR Gold Trust, the ETFs are a much more direct play on gold prices than the miners' stocks.

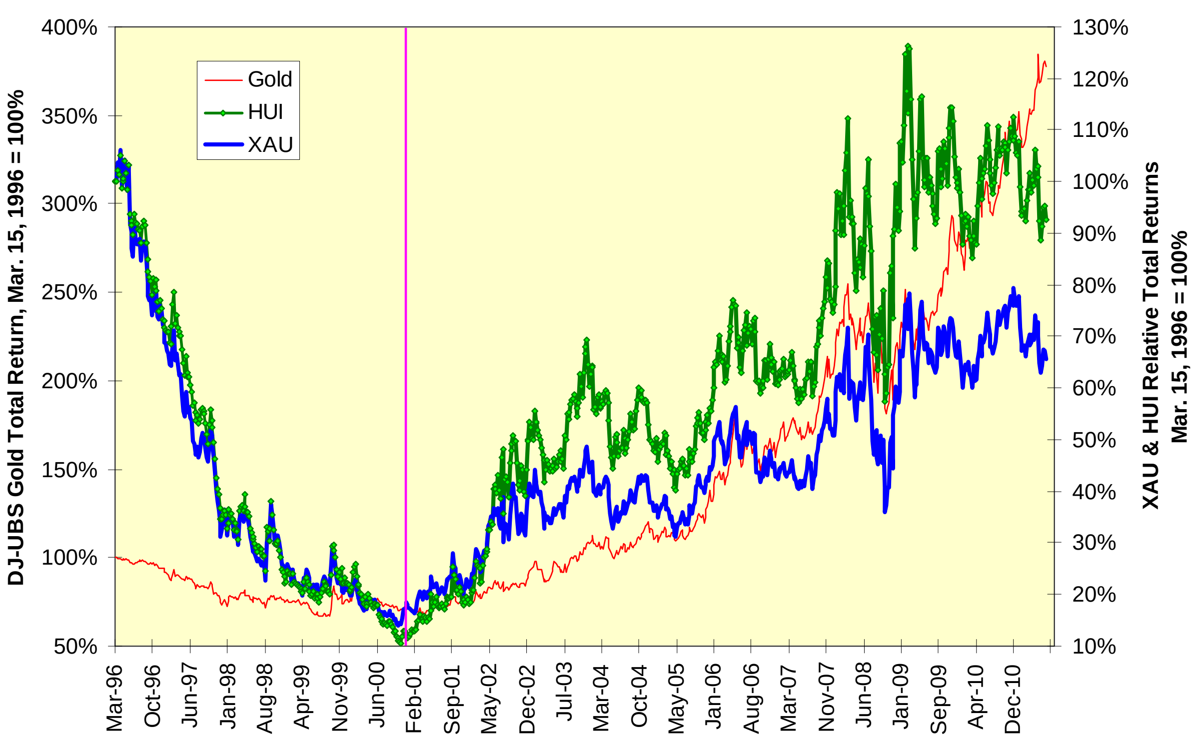
As far as raising the dividend, these firms' managements clearly did not get the memo about the Modigliani-Miller theorem stating the value of a firm is independent of its payout ratio. After all, the money paid out to shareholders who then must pay the appropriate taxes thereon is money not retained by the firm for purposes better or worse, generally worse. I discussed this in February.

Miners Are Underperforming

Let's update an analysis from December 2010 on the relative performance of two gold mining stock indices, the capitalization-weighted Philadelphia Gold & Silver index (XAU) and the equal-weighted NYSE Arca Gold BUGS index (HUI). Firms in the HUI do not hedge their production forward past 18 months. I noted at the time investors were starting to penalize the firms that did not hedge. This was a sign they were worried gold prices had increased too quickly.

They were wrong then and still are today. The total return paths for the HUI and XAU have disconnected to the downside from the total return path of the Dow Jones-UBS gold sub-index, a good approximation of the true costs and returns for holding gold. The January 2001 date of the first Federal Reserve "surprise" rate cut – I am waiting for their first "surprise" rate hike – is marked with a magenta vertical line.

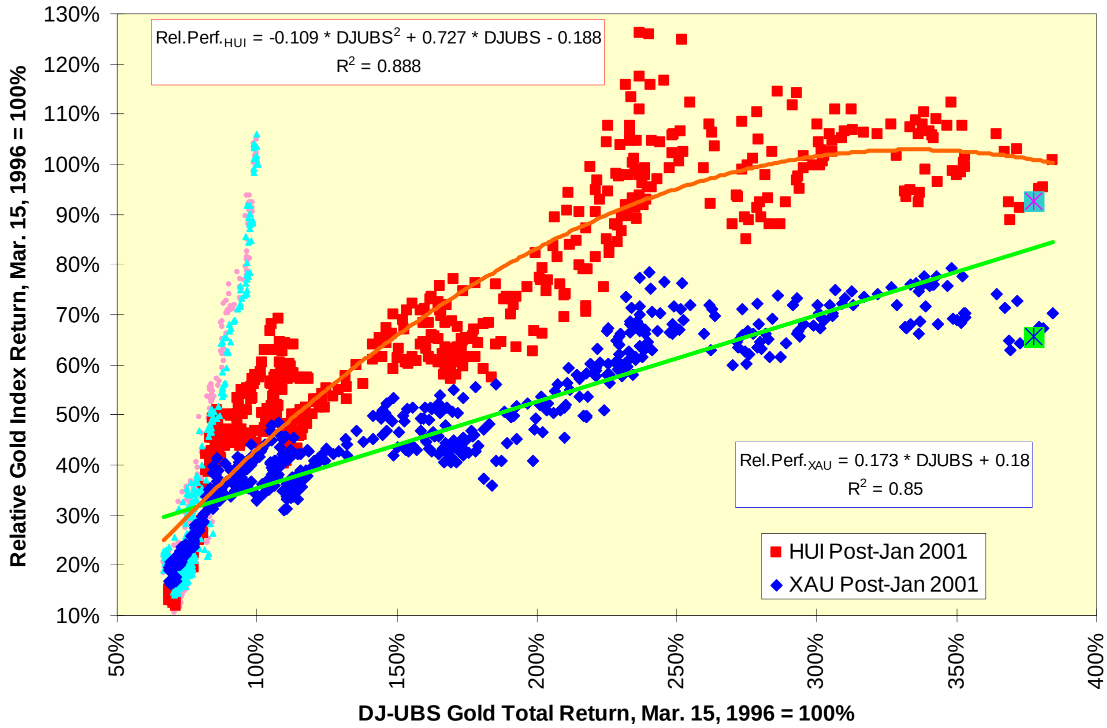
Gold Stock Indices Not Leading Gold Futures



If we rearrange the data above to display the stock indices' returns as a function of the DJ-UBS index' returns, we see two things. First, both indices are trading well below their trend values, as indicated by the highlighted markers.

Second, the penalty being unhedged, applicable only to the HUI, has not become appreciably worse. Some can interpret this bullishly; others can take a contrarian route and argue it is evidence of too much complacency. While they are beating each other over the head with their unsubstantiated assertions, I will wander over to the buffet table and Hoover down the good stuff.

Gold Stock Indices Trading Below Trend



The overall conclusion remains the same: If you want to buy gold, buy gold. Stop buying gold miners who face rising operating costs.