With gold trading at around the Rs 15,600-15,700 per 10 gram level last week, investors were discussing gold in the breathlessly excited tones that they normally reserve for raging equity markets. Get cautious

GOLD

IS THIS THE TIME TO BUY OR TO SELL GOLD?

SANJAY KR SINGH

IT'S THE classic error in investment: investors get attracted to an asset class after it has turned red hot and its prices are at or near their long-term peak. With gold trading at around Rs 15,600-15,700 per 10 grams last week, the buzz around the yellow metal reached fever pitch. For conservative, long-term investors, this might precisely be the time to turn cautious.

Constrained supply

The supply of gold comes either from what gets mined each year or from the sale of existing above-the-ground stocks.

As for mining supply, no major mine has been discovered in the last several years. Supplies from existing mines have been stagnant and are likely to diminish in future. In South Africa, the world's major producer, the depth of the pit from where gold is extracted is now five kilometres, which pushes up cost and makes the enterprise economically unviable.

Supply also comes from privately-held stocks belonging either to central banks or to individuals. Central banks have been holding on to their gold reserves because of the uncertainty surrounding the value of the dollar and the Euro. China, in fact, has been augmenting its reserves: it has purchased around 600 tonnes over the last six-seven years.

Supplies from individuals, called recycled gold or scrap gold, tend to come into the market whenever gold prices rein high, as is the case now. However, as Ajay Mitra, managing director, World Gold Council, India subcontinent, informs: "Over the last 10-15 days scrap has not been coming into the market either because individuals have already sold what they owned or because they are holding it back in anticipation of higher prices in future."

Thus there are fundamental constraints on supply.

tinuously moved up. That was because the rupee was depreciating against the dollar." The bottomline: when the the rupee depreciates against the dollar (it has slid from around Rs 40 one-and-a-half years ago to around Rs 50 now), gold becomes more expensive in India.

Rise further or correct?

For the one-year period ended September 18, 2009, gold ETFs are up 20.3 per cent. Gold ETFs ended last week at Rs 1,568 per unit (one unit is equivalent to 1 gram of physical gold). Has gold peaked and is it likely to see a correction, or will it soar further?

According to Dhawan, "Because of inflationary concerns gold is likely to appreciate over the next two years, albeit with corrections along the way." He has recommended to his clients that they augment their allocation to gold from 10 to 15 per cent.

Manglik is convinced that gold looks set to touch Rs 18,000 per ten grams within this financial year. His reasons: one, the expected rise in the price of gold internationally due to weakening of the dollar; and two, a lack of credible alternatives that will drive the investment demand for gold. The coming festival season could lead to further strengthening of gold in the fourth quarter of the calendar year.

Limit the allocation to gold in your portfolio to 8-10 per cent. Buy now only if you have not reached that level in your portfolio. If your gold allocation exceeds that level, sell and rebalance

What should you do?

While gold may rise further, this is by no means certain. A wide range of factors constraints on supply.

Strong demand

The demand for gold emanates from two sources: jewellery demand and investment demand. A very high percentage of jewellery demand emanates from India. Over the last three-four years, jewellery demand has slackened because of gold's high price. But this slack has been compensated for by high investment demand. Let us turn now to the key drivers of investment demand.

Weakening dollar. Due to the high level of US debt, there is widespread expectation that the US dollar will decline vis-à-vis other major currencies over the long term. Until now the US dollar has served as the world's reserve currency. Nations like China, which hold large dollar reserves, risk suffering a loss due to the dollar's decline in value. Tthey are diversifying their holdings away from the dollar and into gold.

Inflationary concerns. The loose monetary policy being pursued by central banks of all major economies to stave off recession has let loose an avalanche of liquidity. Unless mopped up in good time, this will stoke inflation. "So far, however, only the Indian central bank has voiced concerns about inflation. Central banks in the West have indicated that they will continue with their accommodative monetary stance until they are sure that growth is underway," says Vishal Dhawan, a Mumbai-based financial planner. Given these well-founded concerns about inflation, investors are increasing their allocation to gold — the classic hedge against inflation.

Illustration: ANIRBAN BORA

Low US interest rates. Investors, retail and institutional, also invest in US treasury bonds, known to be the safest of investments. But when interest rates in the US dip, as is the case now, the returns from these securities become unremunerative. Investors then shun treasuries and seek refuge in gold.

Geopolitical and economic uncertainty. As an investment gold does well when a war breaks out or economic calamity strikes (as in 2008). This explains why till recently (before the rally in equities gathered steam) gold exchange traded funds (ETFs) were the best-performing class of mutual funds in India.

Lack of investment alternatives. Many investors have only recently (in 2008) burnt their fingers in equities and real estate. With bonds there is the fear that their values will nosedive once the Reserve Bank starts monetary tightening. The returns from bank deposits are low. Says Jayant Manglik, president, Religare Commodities: "Due to the lack of alternatives, even retail money is going into gold via gold ETFs. It is mainly financial investment that is driving gold prices up."

Where is the rupee headed?

The price of gold in India is directly linked to global prices. It is only marginally higher on account of transportation expenses and taxes.

However, an additional factor affects the price of gold in India: how the rupee moves vis-à-vis the dollar. Says Dhawan: "Till a month ago, the price of gold internationally had been fairly flat for the prior 12-month period, ranging between $750-900 per ounce. But if you looked at data in the Indian market gold con-

means certain. A wide range of factors affect its price. A lay investor can by no means track them all and assess their impact. What is also obvious is that having yielded a strong performance over the last one-and-a-half years, gold is no longer undervalued. Conservative investors must avoid the urge to speculate in this asset over the short term. Warns Maglik: "Over the medium term, as countries come out of the tough economic conditions they are facing now, other assets will strengthen and gold prices will fall. Just as Rs 18,000 per 10 grams seems achievable now, if global economic conditions improve then 18 months down the line gold could tumble to Rs 8,000 per 10 grams."

Remember also that over the long term gold is not all that great an investment: it gives returns that barely exceed the long-term average inflation rate by a couple of percentage points (which means less than double-digit returns). For building wealth over the long term a diversified basket of equities, held either through an index fund or ETF or a few high-quality actively managed funds, is a better option. Limit the allocation to gold in your portfolio to 8-10 per cent. Buy now only if you have not reached that asset allocation level and hold for the long term (more than 10 years). If you had bought at lower levels and your gold allocation exceeds the stipulated level due to the recent price run up, book profits and rebalance your portfolio. ◆

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"Over the last three-four years, jewellery demand, a high percentage of which comes from India, has diminished. But gold continues to rise because investment demand has increased"

AJAY MITRA, World Gold Council, India subcontinent

"Gold looks set to touch Rs 18,000 per ten grams within this financial year for two reasons: weakening of the dollar against major currencies and a lack of credible investment alternatives"

JAYANT MANGLIK, Religare Commodities