Insights on recent market events

September, 2020

Market Update: "On the Money" A Conversation with Vice President & Portfolio Manager Robert Cohen. Leveraging his extensive global experience as a mining engineer and 22 years in investment management, Robert provides his opinion on the performance of gold prices in the light of the COVID-19 related stimulus measures and shares the investment philosophy behind his investment approach. He further explains the risks and rewards associated with investing in gold bullion and gold equities and breaks down the concept of gold as a safe haven and why investors may choose to hold it in their portfolios.

Let's go over the concept of gold as an asset class, which is often referred to as a safe haven and a hedge against inflation. Could you start us off by going over the thesis for holding gold in a portfolio?

I think gold is the quintessential monetary asset in the world. It is the only metal that is used by central banks around the world to back their foreign exchange reserves. It's been revered as a monetary asset for thousands of years. It is most importantly used as a way to protect the purchasing power of a dollar.

A lot of people are always measuring everything in terms of what something costs, whether it be in dollars or euros or what have you. They get very fixated on those prices except the problem with measuring things with paper money is that the purchasing power of paper money deteriorates over time. When people see the gold price rising, it is probably better to think about it as the value of the dollar falling. We often quote the gold price mostly in US dollars.

We're trading just under $2,000 US an ounce right now. The proper way to think about it is how many ounces of gold do I get per dollar? As the value of a dollar deteriorates, that number goes down. One way to protect your purchasing power is to own gold.

If we look at the economy in 2020, how does the outlook for the COVID recovery and the related measures being taken in the form of fiscal and monetary stimulus make the case for having a position in gold within a portfolio?

What you are seeing going on around the world is the government's response to the COVID crisis - very loose monetary policy, quantitative easing - but this was happening even pre-COVID. In the US, you see the massive expansion of the M2 money supply (M2 is a broad measure of money supply that is watched closely as a gauge for potential inflation).

All those factors combined with a negative real rate environment (which means, if you take the 10-year bond and you subtract the inflation rate, you actually come out with a negative number) have been propelling the gold price higher. Certainly, in terms of what's going on with the COVID pandemic, this is expected to continue for the foreseeable future.

Going back to the measurement of gold in currencies, how is gold performing in Canadian dollar terms as well as the US dollar, or the Euro, the Japanese Yen? Is there a correlation between gold's performance and the changes in interest rates and money supply implemented by governments around the world?

I can simply answer that question with the broad stroke that gold has gone up in almost any currency that we measure. Whether it be US Dollars, Canadian Dollars, Euros, Yen, Rubles, you name the currency, it has gone up in that currency. That is a reflection of the amount of monetary policy and quantitative easing around the world that is occurring.

If you look at G7 countries, the amount of debt out there is reaching all-time highs. If you take government debt plus personal debt and corporate debt, in most developed countries you are getting the numbers of 250% of GDP. That's very significant. When governments have that amount of debt, the only politically acceptable way to deal with it is to inflate their way out of it.

While gold has performed very well, gold equities have also done very well over the past year. Could you go over the relationship and difference between investing in the two, and what investors need to consider when choosing to invest in bullion versus equities?

Effectively, let's start with owning gold. If you own gold, whether it’s bullion or gold certificates, what you own at the end of the day is one ounce of gold if you buy an ounce of gold. If the gold price goes up 1%, you've increased your wealth by 1%. It's a pretty simple relationship. When you own gold equities, you are buying shares in a public company that represent the gold miners.

This is a different concept. You are actually buying the profitability of a gold miner. For example, if a gold miner, at the current gold price, is making a 50% margin, and let's assume the gold price goes up 1% without other costs creep and other things, just all else being equal and the stock market acting efficiently, then you're dealing with a 50% margin mathematically, you've increased your margin by 2%. You have additional leverage to the gold price.

With that said, it doesn't come without its risks. In finance you have risk-reward. If you own a gold miner, the reward is having higher leverage to the gold price. You also have the leverage to, for example, things like exploration success. If you own an ounce a physical gold, it's not going to replicate itself; you're always stuck with one ounce of gold. If you own a gold miner and they find a bunch more gold, you're effectively getting that gold for very, very low costs. That's one source of leverage.

On the other hand with mining operations, you could have something, for example, that goes wrong, whether it be a political situation in a country or a technical problem with the mine where the mine production does not meet its projected guidance. It is all about risk-reward.

What are some of the main differentiators within your precious metals portfolio here at Dynamic compared to the TSX global gold index and how much overlap would you have? How does the breakdown compare in terms of producers versus exploration, market cap, geography, et cetera?

Essentially, at Dynamic Funds, we don't want to give investors something they can easily do on their own. Investors can go buy, for example, an exchange-traded fund that represents the underlying index at a fairly low fee. We want to do something a lot more sophisticated and different than just merely buying the gold index .

At Dynamic we have a lot of information flow. We are very much plugged into the industry globally. So when we're looking at the type of stocks we own, half of the stocks are generally listed on the Toronto Stock Exchange, probably the largest stock exchange of gold miners globally. The second largest is the Australian Stock Exchange, so we are very active there as well. That sets us apart from our competitors, even here in Canada, because about 45% of the portfolio is invested in Australian listed companies which is an area many of our competitors don’t venture in to.

We also have a little bit more gearing toward development companies. While about half of the fund is invested in the companies that are actually producing gold, the rest of the fund is invested in the companies that are advanced development stage level or at different levels of exploration, where you are ready or almost ready to go into a pre-feasibility level or full feasibility study. These types of companies typically get acquired by the more senior companies, because when senior companies need to grow or maintain their production levels, they often have to do so by acquiring other companies.

The industry just works more efficiently that way. You let the junior companies do the exploring, and then you go and cherry-pick the best opportunities globally. With that said, we also own what we regard as the best miners. We're very particular about that.

In terms of comparing what we own in the Fund to the underlying index, it is quite different. As a matter of fact, out of say 35-40 companies that we may own in the Fund at any one time, we have only about four or five companies that actually overlap with the companies that are a part of the index.

With the recent fluctuations that we've seen in the gold price, especially on an upward trend some investors feel like they've missed a move once an asset has hit an all-time high. How do you view the upside and downside risks at this point for someone who is considering adding gold to their portfolio, or is fundamentally asking the question, "Did I miss it"?

I've been dealing with that type of investor psychology for over 20 years, since I've joined Dynamic. We've seen, in US dollar terms, gold prices move from $250 an ounce up to $2,000 an ounce over the last 20 years. You are always getting investors every time it moves up a little bit, a $100 or $200, "Oh, that's it? I think it has to top out." I think the way to look at it is that timing any market is almost a fluke.

The idea is to diversify your portfolio, you want to have a little of a few different things that are uncorrelated with each other. If you look at any journal or finance paper, or anything of that level, you will find that the conclusion is that the gold sector is the most uncorrelated asset class with all other asset classes. Uncorrelated doesn't mean a negative correlation, that does not mean that if one asset class is going up, the other one is going down, it just means that at certain periods of time, you can have both moving in tandem and other periods of time you can have them moving away from each other.

That's the concept of portfolio construction and the tenant why you want to own an asset class such as gold. I've already talked about purchasing power of paper money, and I think this is the ideal hard asset, that’s divisible and liquid. It's more akin to owning, for example, real estate. Real estate is another example of a hard asset that maintains the purchasing power of your investment over time, except, for example, if you own a house and you need to have some liquidity, you can't just sell one room in the house, you have to sell the whole house.

There are a lot of friction costs in owning real estate, for example. Gold is a nice clean alternative hard asset class. It should be a part of all investors' portfolios. One should always consult with their financial advisor to determine the appropriate weighting, but I think it is a mistake to have it at zero.

In recently written commentaries, you mentioned gold as a safe haven and what's potentially coming down the pipe for the world with the upcoming elections in the United States, looming civil unrest around the globe, and the state of denial about the virus, which has allowed for the continued spread. Do you continue to see gold as that safe haven until we're out the other side of this pandemic?

As a betting person, I would agree with all the comments you've recapped there. I just wouldn't bet against any of those things right now. The S&P, the stock market has had many years of a solid run. We just don't know what will happen with the upcoming US election. If the Democrats get in, you can count on higher taxes and the higher taxes could cause the stock market to change its direction and reverse.

On the other hand, if the Republicans win, we could see an even more amplified civil unrest. The question is where are we going? We don't know, but as some form of protection, I believe it’s appropriate to have some gold regardless. I think this is an interesting time that we live in right now. As I said in my last comment, I probably would not be naked on the gold position in one's portfolio.

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