Are Gold Mining Stocks Set to Take Off?

So far this year, mining stocks have lagged behind the soaring price of gold

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Fear has crept back into the markets, and the most obvious beneficiary of renewed concerns of a global recession is gold. The metal, which now trades near $2,000 an ounce, is up more than 30 percent this year. Historically, when investors get nervous, they buy gold to protect against further declines in the market, boosting the metal's price. But this time, a strange thing has happened: The stocks of the companies that pull gold out of the ground haven't yet taken off.

"Traditionally, gold mining companies actually give you leverage to gold prices, so when gold prices go up by, say, a percent, typically, share prices of gold mining companies should go up by 2 or 3 percent," says Joung Park, an equity analyst at Morningstar in Chicago. In this case, there are a number of reasons why gold mining stocks haven't moved up alongside the price of the precious metal.

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For starters, when the stock market experiences a major sell-off as it has recently, investors tend to sell indiscriminately. "Gold stocks are ultimately just stocks, and they've sold off with the rest of the market," says Thomas Winmill, manager of the Midas Fund (symbol MIDSX).

Gold miners have also been hit hard by rising costs of commodities like the price of oil, which has cut into their profit margins. But now that oil has dropped to around $80 barrel, experts are bullish on the prospects for gold mining stocks. "Going forward, the underperformance of miners compared to bullion will likely shrink or even reverse, because you've seen oil prices go down substantially from their highs," Park says. "If gold prices continue to remain elevated, then [gold] prices are up, costs either stabilize or go down if the economy weakens further, and that could be a recipe for fat profit margins [for gold mining stocks]."

[See In Pictures: 5 Ways to Measure Investment Risk.]

Winmill offers a rule-of-thumb for evaluating the attractiveness of mining stocks. He compares the price of the BUGS Index (HUI), which stands for "basket of unhedged gold stocks," to the price of gold. To do this, divide the price of the HUI Index by the price of gold to get a ratio. When that ratio is between 0.35 and 0.4, it's in what Winmill calls a "neutral range." If it rises above 0.4, he says investors should sell gold mining stocks and buy gold. But when it's below 0.35, investors should think about buying gold mining stocks. "We've been in that zone now for the last three months," he says. Within the Midas Fund, Winmill owns big names like Goldcorp and Newmont Mining, both of which are Canadian companies, as well as smaller growth stocks like UK-based Avocet Mining.

Frank Holmes, CEO and chief investment officer for U.S. Global Investors, a San Antonio-based investment adviser, says he's bullish on gold mining stocks because they're paying big dividends to attract investors in what is otherwise a low-yield environment. "They have to compete with the bullion [exchange-traded fund]," Holmes says, referring to SPDR Gold Shares (GLD), which gives investors easy access to the price of gold through a physically-backed ETF. Since launching in 2004, GLD has quickly grown to be one of the largest ETFs available because of the popularity of the yellow metal.

Some companies have even promised to link their dividend policy to the price of gold. Earlier this year, Newmont said it would raise its dividend by a five cents a share for each $100-per-ounce rise in the previous quarter's price of gold bullion. At the end of the third quarter, Newmont pledged to raise its dividend 50 percent from the second quarter, to 30 cents a share. (It currently yields 2 percent.) By investing in these types of stocks, Holmes says, "You can get dividends, plus you have a scenario that supports rising gold prices."

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For yield-hungry investors, Park says there are seven gold miners with market caps of $5 billion or more that offer dividends of greater than 1 percent. The list includes Barrick, Newmont, Gold Fields, Agnico-Eagle, Buenaventura Mining, Harmony Gold, and Yamana Gold.

[See What the Latest Fed Policy Means for Your Money.]

If you're looking for broad exposure to all gold mining stocks, Park suggests two ETFs: Market Vectors Gold Miners (GDX) and Market Vectors Junior Gold Miners (GDXJ). The former provides exposure to the largest mining stocks, and the latter offers exposure to "junior" miners—those that are considered small and midsize stocks.

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