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Can gold miners offer a safe haven?

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SAN FRANCISCO (MarketWatch) — There's no doubt that gold is perceived as a safe haven, but opportunity in gold-mining shares is screaming for attention — and the sector may be transforming into one of the best means of escape from the economic and financial chaos investors find themselves in today.

Considering the frequent bloodbaths in global stock markets, gold-mining stocks have held up well, generally trading higher for the month to date, with mostly double-digit percentage gains for the quarter so far.

"Gold mining stocks can be a safe haven in the current trading climate," said Sean Brodrick, a natural-resource analyst for Uncommon Wisdom Daily. "While a market sell-off affects almost all stocks, miners — especially big miners — can go down less and rebound quickly."

Shares of Newmont Mining Corp. and Barrick Gold Corp. are up over 9% quarter to date, while the NYSE Arca Gold Bugs Index and the PHLX Gold & Silver index are each up 11% for the quarter to date.

Those gains outpace the rise in gold prices , which have climbed 8% since the end of last quarter.

Newmont, in particular, has seen its shares strengthen this year, up 12% so far after announcing a move in April to link its dividend to the average realized gold prices.

"Gold miners have historically paid little, if any, dividends — so the fact that this sector is returning cash to shareholders is a game changer," said Paul Simon, chief investment officer of Tactical Allocation Group in Birmingham, Mich.

That could be good news for gold mining equities, which this year have been underperforming gold prices. The XAU is trading down 9.3% year-to-date, compared with gold futures' 24% rise to $1,760 an ounce. Read about opportunity in gold and silver shares.

"Investors in gold miners still have to account for business risk and global uncertainty," said Simon. "Part of the problem miners face is they're located in countries with governments in bad fiscal positions or uncertain political climates."

At the same time, the sector has suffered from rising production costs.

Companies building mines have had to raise "substantially higher of capital than they originally anticipated in their feasibility studies," said Nolan Watson, president and chief executive officer for Sandstorm Gold Ltd. and Sandstorm Metals & Energy Ltd. , which provide financing to mining and energy companies.

Sometimes the increase is as much as 30%-60%, as costs of building and operating mines during the commissioning process have increased "dramatically" in the past 18 months.

Bear in mind as well that shareholders of precious-metal mining shares are concentrated by far in the developed world, not emerging markets, according to a recent report from GoldForecaster.com. "They are, therefore, susceptible to all the developed world financial woes."

Brighter prospects?

But the picture for gold miners appears to be improving. The Market Vectors Gold Miners ETF , for example, trades just 2.1% lower year-to-date, up 9% quarter-to-date. A month ago, it was losing 8% year-to-date.

"The gold mining industry is one of the few sectors where you can actually say that companies are significantly better off than they were at the beginning of the year," said Stephen Land, portfolio manager of the Franklin Gold and Precious Metals Fund . "This has been highlighted by third-quarter results, where many gold companies delivered record earnings and cash flow."

The broader market can't boast anything quite as impressive, though it has managed to drag gold-related stocks down with it.

Still, so far this month, gold miners are off to a "rip-roaring start," said Brodrick — and they have a lot going for them.

Gold and the stocks associated with it "always do well this time of year," and central banks, including those in Thailand, Turkey, Bolivia and Kazakhstan have been buying gold, he said.

Europe continues to crumble, Chinese buying is "going through the roof," and gold miners are "cheap," said Brodrick. Chinese gold imports from Hong Kong reportedly reached a record 56.9 metric tons in September.

“Gold miners have great potential because they have been unfavorably punished with other equities despite rising profitability and high levels of cash flow,” said Frank Holmes, chief executive officer of U.S. Global Investors. “Gold miners will eventually rise to levels equitable with today’s gold price.”

Even so, there are some analysts who don’t see gold miners as full-fledged safe havens, given the short-term risks in gold prices.

“The kindling under recent gold prices is euro currency uncertainty, but kindling will not start a fire if the wood is damp,” said Seth Rabinowitz, who covers gold and other commodities as a partner at Silicon Associates. “As credit tightens in non-U.S. markets due to European chaos, it will put downward pressure on gold — traders will want to offset their losses with gains from getting into gold early, and to do that, they’ll have to sell their gold holdings.”

So “gold is an excellent long-run safe haven, but it’s not a worthy insulator from short-run fluctuations,” he said.

And as for gold miners, Holmes Osborne, a private money manager and principal of Osborne Global Investors, doesn’t actually view them as safe havens. “They are volatile stocks and rise and fall with the price of gold.”

Attracting investors

Gold miners have been taking note of the rising gold prices, however, and some have made moves to link their dividends to the price of the metal, making miners more attractive to investors.

Newmont’s annual payout increases at a rate of 20 cents per share for each $100-per-ounce rise in the average realized gold price.

“Many producers are now offering added income, with dividend policies leveraged to higher gold prices,” said U.S. Global Investors’ Holmes, who’s also co-manager of the Gold & Precious Metals Fund and World Precious Minerals Fund .

He pointed out that Barrick and Newmont announced dividend increases in late October for the fourth quarter, as the price of gold increased cash levels.

Eldorado Gold Corp. also links its semi-annual dividend to gold prices and the number of ounces sold.

“It makes sense to ensure dividends are tied to free cash flow as the price of gold fluctuates,” said Sandstorm’s Watson.

For Newmont, the move allows it to “have its dividend match its cash flow without having to change its dividend policy,” he said, adding that it’s a “smart idea.”

Newmont’s move has also provided a means to attract investors, particularly those who need income and inflation hedge, to its stock, said John O’Donnell, chief knowledge officer for Online Trading Academy.

“The miners are growing earnings per share, and many will become major growing dividend payers for investors,” he said. “The miners are great leverage plays for gold prices moving higher in times of uncertainty, as they have [million of ounces] in the ground as proven reserves.” See Weekend Investor report on gold bugs.

What to look for

So what’s the best approach to take when considering gold miners?

“From a bottom-up perspective, we look for miners that have growing cash flow, rising production and growth in reserves on a per share basis,” said Holmes. “Cash flow is important for funding growth through capital expenditure and also playing dividends. We ask the question: ‘How fast can they turn their gold into dollars?’”

Randgold Resources Ltd. is one of his funds’ largest holdings. It’s a company with a history of good management and has been growing its production on a per-share basis, he said. The funds also own shares in Newmont, Eldorado and Barrick.

But the prospects don’t rest exclusively on the big gold miners. Investing in junior exploration companies has advantages too, especially if investors are betting on higher prices for gold.

“Investors are attracted to junior mining companies because they present the possibility to go to the moon overnight and reap astronomical multiples,” said Lori McClenahan, president and chief executive officer at junior exploration company St. Elias Mines Ltd.

“Investing in a big mining company is less risky, but you can’t get the same return on your investment,” she said. By investing in a junior mining “investors give up the safety for the possibility of higher returns.”