Where are the fortunes to be made from gold?

Investing: Sage of Omaha questions precious metal's allure

BY BARRY O'NEILL

Gold hit a new record price of nearly $1,900 an ounce last year.

It has fallen back since then and is now just above the $1,700 mark.

There has been speculation the price could climb to new record highs, however, words of investment wisdom from the "Sage of Omaha", Warren Buffett, are usually ignored at one's peril.

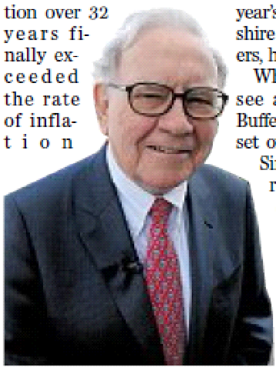
For more than 30 years the subject of that most loved commodity – gold – was notably absent from Mr Buffett's pronouncements.

You had to look back to the 1980 annual letter to Berkshire Hathaway shareholders, in which Mr Buffet seemed dismayed that the increase in the firm's book value over the previous 15 years had been matched by a shiny metal with no business acumen at all.

Some believe gold is an excellent hedge against inflation, but gold prices were 25% lower 15 years after Mr Buffett's last comments.

ALTERNATIVE INVESTMENT: Some believe gold is an excellent hedge against inflation

Even 31 years later, at the end of 2010, gold had failed to keep pace with rising consumer prices. A year later and gold's appreciation over 32 years finally exceeded the rate of inflation (205% versus 195%) but still trailed well behind the total return on one-month Treasury bills (398%).



Warren Buffett: long-run potential

Gold did merit some warning comments in last year's annual letter to Berkshire Hathaway shareholders, however.

Where gold advocates see a safe harbour, Mr Buffett sees just a different set of rocks to crash into.

Since gold generates no return, the only source of appreciation for today's anxious purchaser is the buyer of tomorrow who is even more anxious.

Mr Buffett compares the long-run potential of two portfolios of similar value.

The first holds all the gold in the world, about 170,000 metric tons which if melded together would form a cube roughly 68ft per side and be worth about $9.6trillion, but will produce absolutely nothing over the next century.

The second owns all the cropland in America (400million acres with output of about $200billion annually), plus the equivalent of 16 ExxonMobils (the world's most profitable company, earning more than $40billion annually), and still have $1trillion spare to spot further investment opportunities, or "walking around money" as Mr Buffett puts it and will generate a river of corn, cotton, and petroleum products.

Can you imagine any serious long-term investor with $9.6trillion selecting the first option?

When Mr Buffett assumed control of Berkshire Hathaway in 1965, the book value was $19 a share, or roughly half an ounce of gold. Using the cash flow from existing businesses and re-investing in new ones, Berkshire has grown into a substantial enterprise with a book value at year-end 2011 of $99,860 per share. The half ounce of gold is still a half ounce and has never generated a penny that could have been invested in more gold. At today's prices, assuming it is 24 carat, it would be worth about $900.

Few can hope to emulate Mr Buffett's record, but the underlying principles of re-investment and compound interest require no special knowledge. Most of us could point to individuals who have accumulated substantial real wealth from investment in businesses, farms, or property.

Where are the fortunes created from gold?

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