

Why diamonds may be an investing gem

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Can you name a precious commodity that hit record prices this summer? That has long been considered highly valuable for its remarkable beauty alone? In which demand is surging at the same time as mineable supplies are shrinking?

Yes, yes, there's gold. We know all about that one – it's been in all the papers. But there's a hidden gem that gets much less attention than gold, yet has put in a similarly spectacular performance over the past several months – and may well outperform gold in the next few years.

Diamonds.

Despite a modest pullback last month, prices for both rough and polished diamonds are still up more than 30 per cent in the past year, as new supplies were unable to keep up with surprisingly strong demand. Price for top-quality polished stones reached an unprecedented \$150,000 a carat this summer.

Diamond demand is largely driven by the jewellery business, but experts report that an increasing number of investors have been looking to diamonds as an alternative to gold as another safe shelter for their money, amid financial uncertainty and economic and currency instability.

But while the high-profile excitement over gold has propelled interest in gold-producer stocks (the S&P/TSX global gold index is up 25 per cent since mid-June), diamond producers haven't matched their frenetic pace.

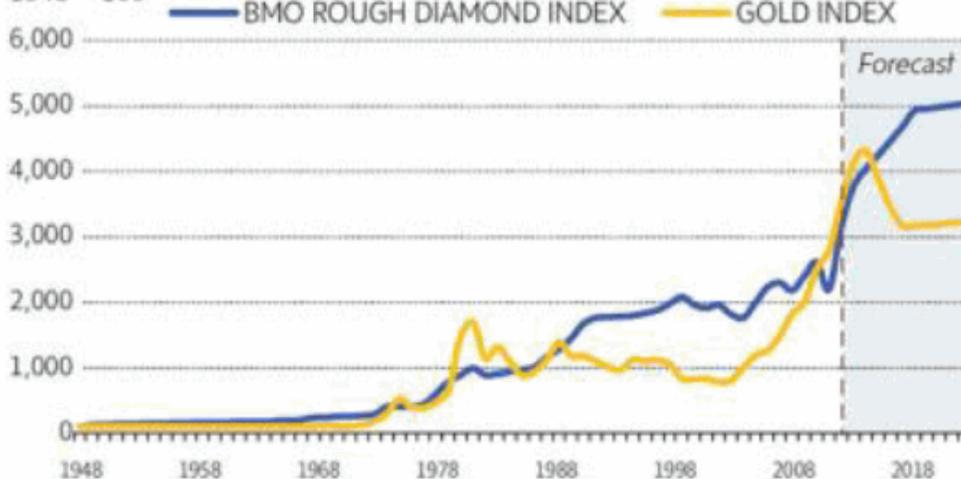
"Diamond companies look underpriced versus gold, [platinum group metals] and silver stocks on a [price-to-net-present-value] basis," wrote Edward Sterck, diamond-producer equity analyst for BMO Nesbitt Burns in London, in a recent research report.

Gold and diamond prices have historically moved in the same direction, with diamonds generally trading at a modest premium to gold. But gold prices have got ahead of diamonds since the 2008 market crisis, as a recession-driven drop-off in jewellery sales initially weighed on the diamond market. Diamond prices have been playing catch-up this year – and Mr. Sterck predicted they will outperform gold and return to a premium position by 2013, as investors' gold rush moderates while continued demand growth and supply constraints drive diamonds higher.

"Whether diamonds represent a store of value or not, is arguable," Mr. Sterck wrote. "However, as a mid- to late-cycle commodity, it could be theorized that the valuation disconnect between diamonds and precious metals should close."

GOOD AS GOLD

1948 = 100



THE GLOBE AND MAIL ■ SOURCE: BMO CAPITAL MARKETS

Regardless of the investment thesis on diamonds as a gold alternative, analysts said, the outlook for the gems looks strong on a good old-fashioned supply-and-demand basis.

“The prospect of a shortage of gem-quality rough diamonds has been the driving investment thesis in the diamond space for some years,” said Des Kilalea, diamond analyst at RBC Dominion Securities in London, in a recent report.

In response to the weaker diamond market in the 2008-09 recession, many major diamond producers mothballed mines, and production has been slow to come back. Many major producers have responded to the strong market by dipping into their inventories – which has not only depleted diamond stockpiles, but signals that producers are having trouble meeting demand through their mining operations. Existing diamond mines are becoming depleted, little new production has come on stream in the past decade, and the prospects for major new discoveries are considered slim.

“Rough diamond production peaked in 2006,” Mr. Sterck said. “Despite some returning production and a handful of new mines forecast to enter production ... rough diamond supply is highly unlikely to ever return to its 2006 high water mark.”

Meanwhile, the rapid expansion of major emerging economies such as China and especially India – a country where jewellery has long been popular as an investment and currency alternative – is driving a surge of demand, as a massive base of new middle-class buyers can finally afford diamonds for the first time. Last year, diamond demand jumped 31 per cent in India and 25 per cent in China.

And despite a continued sluggish U.S. consumer economy, demand in the U.S. market jumped a surprising 7 per cent in 2010 – evidence of the growing popularity of diamonds as an investment.

“Longer term, the outlook is extremely positive,” Mr. Sterck said via e-mail. “The supply picture is extremely constrained, whilst demand is expected to grow strongly.”

Canadian investors will get a close-up look at the state of the diamond business Wednesday, when Toronto-based diamond miner and retailer Harry Winston Diamond Corp. reports its second-quarter financial results. While analysts are expecting a solid quarter (consensus estimates are for a profit of 13 cents (U.S.) a share), there will be plenty of investor focus on the outlook for the rest of the year – amid signs that the lofty prices may be temporarily discouraging demand.

Mr. Kilalea said the high prices have put a strain on major diamond buyers’ working capital. He added that the current global economic uncertainty “is likely to have been a catalyst” for a slowdown in the market for diamonds.

“We believe the next three to six months will see consolidation in rough prices, and perhaps even some weakness,” he said. “This could weigh on share prices of producers in the short term, but once global economic conditions are on an even keel, we would expect valuations to recover.”