THE ERA OF GOLD

By: Gary Dugan
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- Gold is a strategic asset for most investors' portfolios
- Lack of a ‘safe’ currency supports the case for gold
- Gold provides a diversification benefit to most portfolios
- Gold maintains its long term value

Gold needs to be taken seriously. We believe it is too simplistic to ask whether the Gold price can repeat the feat of rising 150% over the last five years (Chart 1). Gold has not just a tactical role to play in the average investor’s portfolio, but more a strategic position to protect wealth. Gold is your friend through periods of stress. We believe that the global imbalances will continue to generate financial stress in the global economy for some years to come hence Gold will remain very much in investor’s minds.

Chart 1: Gold Price (US$/oz)

Source: Bloomberg

We believe that Gold will have a central role in the global economy whilst the world works out its imbalances that have been building for some time. The inevitable ageing of the developed world is coming at a time when western economies have never been so indebted. Global leadership is switching from the old democratic countries of the west to the new economies of the East with all of the potential risks of economies going through enormous social change. Whilst the emerging countries generate plentiful cash and see upgrades to their credit ratings the old world faces the need to work off debt or risk a credit downgrade. Global certainty and low volatility has been replaced with financial stress and high volatility. Whilst the inevitable domination of the eastern economies is a widely held view, no one is too sure how the baton of global leadership can seamlessly shift from West to East.

The world is searching for a new monetary regime to try and substitute the economic havoc that is still threatening the global economy. But is Gold the answer? Commentators talk equally about inflation and deflation. Gold is some protection from inflation and would we be a store of value during the economic crisis that could lead to global deflation. Sales of gold by major western central banks have all but dried up as the new central banks of the East have sought to secure more of their reserves in gold rather than monetary currencies.
Why is Gold an Asset Class Worthy of Any Portfolio?

A secure store of value
Put simply when all else is going wrong in the world, Gold would be one of very few asset classes that would remain a secure store of value. In a 'normal' world, Gold is joined by US Treasuries as a defensive asset. However, as we have seen in recent years, the lustre of developed market bonds has fallen. With the old world of the United States and the Eurozone weighed down by substantial amounts of debt, the security of investing in their bond markets has fallen. It is an open question whether even US government bonds can hold their AAA rating over the long term. The UK's rating is already under review by a number of the rating agencies. In the Eurozone the bond markets are challenged by the problems in the periphery countries. Ireland, Greece, Portugal and Spain if they remain inside the Eurozone will remain a distraction to investors and undermine confidence in the bond markets of the financially stronger France and Germany.

The more extreme view of the security of gold is that it is a portable store of wealth at times of war. Whilst the topic of war is a topic that most of us would prefer to avoid it is worth bearing in mind that it is estimated that in all the history of humanity, less than eight percent of recorded history can be described as times of peace. Historians estimate that in the last 32 centuries there have been fewer than 300 years of peace.

Diversifier of risk
From a portfolio perspective Gold as an asset class has a well established reputation for being a diversifier of risk. A number of studies have shown that gold has a negative correlation with other assets. Chart 4 below shows the correlation between gold and a number of assets during 1990's. Correlation data can only give a snapshot of the characteristics of assets. Correlations are also dynamic and can move up and down. However what is clear is that the degree of negative correlation between gold and other asset classes tends to get stronger at times of stress. This is in contrast to the rather transitory diversification benefits of other asset classes where they tend to become more positively correlated as stress in the financial system increases.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Correlation with Gold price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade weighted dollar</td>
<td>-0.45</td>
</tr>
<tr>
<td>Brent crude oil</td>
<td>0.35</td>
</tr>
<tr>
<td>S&amp;P GS Commodity Index</td>
<td>0.35</td>
</tr>
<tr>
<td>US T-Bills</td>
<td>0.06</td>
</tr>
<tr>
<td>S&amp;P 500 equity index</td>
<td>-0.05</td>
</tr>
<tr>
<td>MSCI World ex US Equity Index</td>
<td>0.11</td>
</tr>
</tbody>
</table>

Source: HIS Global Insight, WGC
Note: based on correlations of total returns

Colin Lawrence conducted a research testing the argument that Gold was not correlated to economic activity (report published March 2003). The lack of correlation between returns on gold and those on financial assets such as equities has become widely established. The research tested the argument that the fundamental reason for this lack of correlation is that returns on gold are not correlated to economic activity whereas returns on mainstream financial assets are. Other commodities, which are generally thought to be correlated with economic activity, were also tested. A number of different relationships were examined to show that returns on gold are independent of the business cycle. Using both static and dynamic analysis this study examined to what extent there is a relationship between economic variables and (i) financial indices (ii) commodities and (iii) gold.

Using the gold price and US macroeconomic and financial market quarterly data from January 1975 to December 2001, the following conclusions were reached:

• There is no statistically significant correlation between returns on gold and changes in macroeconomic variables such as GDP, inflation and interest rates

• Returns on financial assets such as the Dow Jones Industrial Average Index, Standard & Poor's 500 index and 10-year US government bonds are correlated with changes in macroeconomic variables

• Changes in macroeconomic variables have a much stronger impact on other commodities (such as aluminium, oil and zinc) than they do on gold. In recent times the volatility of gold has been below that of
many other commodities (Chart 2) and gold has had less of a link than broad commodity indices with equity market performance (Chart 3).

- Returns on gold are less correlated with returns on equity and bond indices than are returns on other commodities.

These results support the notion that gold may be an effective portfolio diversifier.

We believe that commodities in general are a good source of diversification and enhanced returns in a portfolio. However gold is a commodity apart.

**Chart 2: Annualised commodities volatility during Q1 2011 for selected commodities**

![Chart 2: Annualised commodities volatility during Q1 2011 for selected commodities](source)

There are three crucial attributes of gold:

1. It is fungible
2. Indestructible
3. The inventory of above-ground stocks of gold is enormous relative to the supply flow.

The last attribute means that a sudden surge in gold demand can be quickly and easily met through sales of existing holdings of gold jewellery or other products (either to fund new purchases or for cash), in this way increasing the amount of gold recovered from scrap. It may also be met through the mechanism of the gold leasing market allied to the trading of gold bullion Over-the-Counter. The potential for gold to be highly liquid and responsive to price changes is seen as its critical difference from other commodities. Although returns on gold may be correlated with those on other commodities, it is thought that the strength of this relationship depends on the extent to which each commodity shares the crucial attributes of gold, particularly that of high liquidity.
Just how much Gold in a portfolio?
Given the many characteristics of gold the question is then just how much should a portfolio hold. An interesting study conducted by Alphen Asset Management in South Africa found that in study optimal portfolio weightings of SA cash, SA bonds, SA equities and gold that across of spectrum of targeted risk profiles gold had a high weighting in optimised portfolios. For moderate risk portfolios gold took a weighting of around 20%. The study was conducted on data from 1968 through to 2008. Our own portfolio optimisation work suggests that gold should be around 2-5% of a portfolio dependent on the level of risk that an investor wishes to bear. However another way of looking at gold is to consider it purely as a store of value. In India, gold is viewed as a secure, liquid investment, a capital and value preserver and second preferred investment after bank deposits. Saving rates at around 30% of which 10% is gold.

Gold as a currency
Gold is a currency- just look the weightings of assets in central bank reserves, gold is a substantial percentage of assets (Table 3). Gold has good diversification properties in a currency portfolio. These come from the fact that its value is determined by supply and demand in the world gold markets, whereas currencies and government securities depend on government promises and the variations in central banks’ monetary policies. The price of gold therefore behaves in a completely different way from the prices of currencies or the exchange rates between currencies and as we have seen from other asset classes.

Table 2: Weighting of Gold in Reserves of Largest Holders of Gold

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Gold Holdings</th>
<th>% of Reserves</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>US</td>
<td>8,133</td>
<td>74.8</td>
</tr>
<tr>
<td>2</td>
<td>Germany</td>
<td>3,401</td>
<td>70.8</td>
</tr>
<tr>
<td>3</td>
<td>IMF</td>
<td>2,814</td>
<td>1)</td>
</tr>
<tr>
<td>4</td>
<td>Italy</td>
<td>2,452</td>
<td>69.0</td>
</tr>
<tr>
<td>5</td>
<td>France</td>
<td>2,435</td>
<td>65.9</td>
</tr>
<tr>
<td>6</td>
<td>China</td>
<td>1,054</td>
<td>1.6</td>
</tr>
<tr>
<td>7</td>
<td>Switzerland</td>
<td>1,040</td>
<td>16.3</td>
</tr>
<tr>
<td>8</td>
<td>Russia</td>
<td>792</td>
<td>7.3</td>
</tr>
<tr>
<td>9</td>
<td>Japan</td>
<td>765</td>
<td>3.1</td>
</tr>
<tr>
<td>10</td>
<td>Netherlands</td>
<td>613</td>
<td>58.5</td>
</tr>
</tbody>
</table>

Sources:

Why is Gold different from other asset classes – An Empirical investigation by Colin Lawrence March 2003
Gold Investment Digest – World Gold Council – April 2011
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