Gold's relevance to UK pension funds

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Few advisors would suggest that investing only in bond-like assets is an optimal strategy for matching liabilities. This is despite the fact that pension fund liabilities are bond-like in nature. Although the wisdom of diversification is widely acclaimed, most funds continue to invest in a relatively restricted range of asset classes. Here we explore what pension funds stand to gain by using gold as part of a diversified liability-driven investment (LDI) strategy.

Long recognised as a safe haven investment, gold's usefulness as an investment is not limited to times of crisis. The precious metal has shown strong returns over recent years, but its most valuable contribution to a portfolio remains the fact that it is not correlated with most other assets. This property stems from the factors that determine gold supply and demand, which are, on the whole, quite different from those that move bond and equity markets.

Seemingly in sharper focus today, given the asset/liability shortfalls many schemes face, market volatility is an issue with which trustees continue to struggle. Some are surprised to learn that gold is generally slightly less volatile than the S&P 500. For example, since 1984, the average monthly volatility of gold has been around 12.5%, compared to 14.7% for the S&P 500, one of the world's most liquid stock market indices. This feature is particularly striking when one considers that a blue chip stock market index is, as a whole, generally less volatile than each of its components. The low volatility of gold lies in the structure of the underlying market. It is worth mentioning that gold's volatility is generally linked to price rallies, whereas equity volatility generally indicates a fall.

Given the legacy focus on bond investments, the risk of rising inflation can be one of the largest exposures pension schemes face. Gold's importance as a long-term hedge against inflation is supported by a range of independent research.

In the short run, though, the gold can deviate from its long-run inflation-hedge price for years at a time, the most recent trend providing a good example of this, with gold having shown double-digit returns on average for more than five years. The bull market that investors in gold have enjoyed since early 2002 has been supported by simple economics. Supply has simply not managed to keep pace with continuing strength in demand for gold, a situation that looks set to persist. For example, investor interest in gold, which saw net inflows of nearly US$11billion over the 12 months ending on September 30th 2006, has grown by 250% since 2001.

A diverse set of reasons lie behind this trend. Geopolitical tension, particularly in the Middle East, has been a supportive factor for investors seeking the assurance of a safe haven asset.

But the search for assets with uncorrelated returns has also attracted newcomers. Growing concern over the US economy and the related implications for the Dollar have motivated some investors to make an allocation, on the basis that gold is a more effective hedge against Dollar depreciation than other commodities. Inflationary expectations or nominal interest rate movements have been the tipping point for others.

> *“New ways of investing in gold have also stimulated demand”*

New ways of investing in gold have also stimulated demand because it has become as easy to trade gold as it is to trade any stock or share, now that it is listed on at least 10 stock exchanges around the world (Australian Stock Exchange, Mexican Bourse, Euronext Paris, Singapore, Swiss Exchange, Istanbul Stock Exchange, American Stock Exchange, New York Stock Exchange, London Stock Exchange, Johannesburg Securities Exchange).

The information presented here is all rooted in historical data. What matters to most of us is confidence in what lies ahead, so it is important to understand that the lack of correlation between risk and return on gold and that of other assets has its roots in the gold market's fundamentals. The supply of gold is relatively constrained. This is partly due to long lead times associated with mining – up to 10 years, but also because of political constraints introduced through agreements that govern, or regulate, the stream of gold that comes on to the market each year.

While investment demand has been growing rapidly, allocation to gold, and other commodities, remains relatively minor when calculated as a percentage of overall assets. Evidence shows that an optimal allocation to gold does not require a major shift. A small allocation to gold can improve the stability of an investment in more conventional assets. Quite simply, by understanding how alternative assets can complement more traditional investments, pension funds can proactively address some of the more acute risk exposures many funds face.

For more information go to: www.pensions.gold.org