Gold's Role as a Portfolio Diversifier

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The term Liability Driven Investment (LDI) has become somewhat of an industry buzzword over the last few years, although some commentators have suggested it is simply a refinement of current best practice. However, regardless of whether LDI represents a genuinely new approach or merely a retooling of an older one, even the most conservative of advisors recognise the value of assembling a portfolio of assets, using instruments with varying risk/return characteristics, with the aim of more closely replicating the liability and payment profile of a pension scheme.

The means by which LDI is to be achieved still remains an issue of debate, while the composition of the vast majority of pension funds remains restricted to a few asset classes, with most schemes focusing primarily on bonds and equities. It can be argued that this narrow focus is flawed in that it fails to consider assets that may bring greater diversity and therefore greater flexibility and balance to a portfolio.

That said, an increasing number of long-term investors now recognize the value of diversification and are actively seeking to make an allocation to alternative assets, such as commodities and property. And shining bright among these alternatives is gold.

Whilst gold's value as an investment in times of duress is widely recognised, its usefulness is not limited to times of crisis. There is a growing recognition, backed by solid research, of the strategic value gold can add to a portfolio.

A key investment characteristic of gold is its lack of correlation with other assets. This means that it offers reliable diversification of risk. On average, the correlation between gold and equities tends to hover around zero, meaning its price is generally unaffected by the events and conditions which drive the value of other assets, thereby offering protection from equity market falls. Furthermore, analysis suggests that under times of duress this relationship may become an inverse one, with gold moving in the opposite direction of other failing markets. In other words, the diversification benefits of gold are maintained and may even increase in periods of severe equity market distress.

The risk of rising inflation can be one of the largest exposures pension schemes face. Recent independent research has substantiated gold's importance as a long-term hedge against inflation. Whilst gold's value may deviate in the short term, its purchasing power will hold over the long run.

Another vitally important issue for fund managers and trustees is the need to minimise unwanted risk and manage market volatility. Some are surprised to learn that, over the long-term, gold is 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. It is also worth mentioning that periods of high gold volatility are generally linked to price increases, whereas equity volatility generally indicates a fall.

Gold's lack of correlation to other key assets and its relatively low volatility lie in the structure of the underlying market. Similarly, gold's sustained price rally, leading to recent record highs, whilst driven by safe haven buying and concerns regarding the US economy and inflationary pressures, is also underpinned by positive market fundamentals.

The sectoral and geographical diversity of gold supply and demand are key to its special investment characteristics and relative independence from the factors that drive other markets.

Supply has remained relatively flat for several years. Mining is an extremely lengthy process, with long lead times meaning production cannot easily respond to exploit the ascendant gold price. Central bank sales are also now fairly stable, since gold agreements were implemented to moderate the levels of gold entering the market from the official sector.

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On the other hand, global demand for gold has risen steadily over recent years. Consumer demand for gold jewellery has shown sustained growth, particularly in the world's buoyant developing economies. Industrial demand also looks consistently optimistic, with new applications for gold in emerging technologies. Investor interest in gold has grown remarkably since the price started to rally in 2001, with an increase in demand of over 450% in value terms. More recently, there have been net inflows to gold investment of nearly US$15 billion over the 12 months ending 30th September 2007.

New ways of investing in gold have also stimulated demand. The introduction of gold Exchange Traded Funds (ETFs), listed on stock exchanges around the world, mean it has become as easy to invest in gold as it is to invest in shares. This form of gold investment has proved extremely popular, representing holdings of nearly 870 tonnes, valued at over US$23 billion at the end of 2007.

However, while investment demand has been growing rapidly, allocations to gold and other commodities remain 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 professionals can proactively address some of the more acute risk exposures their funds may face.

For more information and details of the research mentioned above go to www.pensions.gold.org