Gold and better balance

by John Mulligan, Investment Marketing Manager, World Gold Council

As the financial markets hit unprecedented levels of turmoil, gold's value as an investment in times of duress is again in the media spotlight and attracting the attention of a growing number of investors. At the end of February 2009, the price again approached record highs, buoyed by unparalleled investment demand as investors sought out the safe haven qualities and security that gold offers.

Increased investor interest in gold over the course of 2008 occurred against a backdrop of the worst year on record for global stock markets and similarly wretched for many other asset classes. Dollar demand for the safe haven asset was pushed to $102 billion last year, a 29% increase on year earlier levels. According to the year-end edition of World Gold Council's (WGC) *Gold Demand Trends* report, shares on stock markets around the world lost an estimated $14 trillion in value, whereas identifiable investment demand for gold, which incorporates exchange traded funds (ETFs) and bars and coins, was 64% higher in 2008 than in 2007, equivalent to an additional inflow of $15 billion. The most striking trend across the year was the reawakening of investor interest in the holding of physical gold. Demand for bars and coins rose 87% over the year with shortages reported across many parts of the globe.

Gold has, of course, been valued as a precious commodity and as money for many centuries, but as an asset for consideration by the contemporary investor, it has really only featured on the radar of the financial community for less than a decade. It can be argued that during the 1980s and 1990s the pursuit for rapid and ample returns, and the exploding number of financial products driven by this pursuit, left gold languishing and neglected. But calamities in specific markets and more recent and extreme deteriorating economic conditions have caused many to reassess how they view the risk-return balance of their investments.

Volatility remains a pressing concern for fund managers and trustees, and there is considerable urgency behind the need to find ways to minimise it and mitigate risks within their portfolios. Many investment professionals are surprised to learn that, over the long term, gold is less volatile than most blue chip equity indexes, such as the S&P 500. Since 1984, the average monthly volatility of gold has been around 13.7%, compared to 15.3% for the S&P 500, one of the world's most liquid stock market indices. And looking at more recent movements, whilst the current market turmoil has raised the level of volatility across a range of asset classes, gold has maintained its relative stability, with far lower volatility than other commodities, and being generally less volatile than most stock markets.

Another key investment characteristic of gold is its lack of correlation with other mainstream assets, therefore rendering it an effective diversifier in a portfolio. For example, on average, the correlation between gold and equities tends to oscillate around zero. This is because the unique nature of gold market fundamentals mean the gold price is moved by a different set of drivers than most key assets, even most other commodities. Gold therefore reacts differently to events and conditions which are influential – and potentially damaging – to mainstream assets, such as stocks, thereby potentially offering protection from market falls. In other words, the diversification benefits of gold are maintained and may even increase in periods of severe market distress.

Gold's geographically and sectorally diverse demand base is a key factor in its independence from general market trends and the tendencies of other assets. Typically, around two thirds of global gold demand comes from the jewellery market and discretionary spending, unlike most other commodities which are reliant on industrial demand and heavily tied to economic cycles and consumption patterns in the developed world.

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On the supply side, mine production has remained relatively flat for several years. Mining is an extremely lengthy and complex process. Long lead times to production mean the supply-side cannot easily respond to exploit an ascendant gold price. Unlike

several other key commodities, such as oil, supply is also spread across the globe and can draw upon relatively accessible above-ground stocks to alleviate temporary shortages, reducing the immediate impact of supply shocks on the price.

An allocation to gold?

Good investment advisors recognise the importance of a diversified investment strategy, and the benefits of including allocations to instruments of varying risk/return characteristics to optimally balance a portfolio.

Whilst gold has traditionally been perceived as being at its strongest when other assets are declining sharply in value, a recent study by WGC, '*Gold as a Strategic Asset for UK Investors*', shows that a strategic allocation to gold can be optimal, irrespective of the stage in the economic cycle or market sentiment, and can enhance portfolio optimality across the risk spectrum.

The WGC study suggests that an optimal allocation to gold does not necessarily require a major shift in investment strategy or portfolio composition. The amount of gold required to achieve expected returns in an optimised portfolio varies depending on the level of risk tolerance. In fact, a small allocation to gold can improve stability of returns when combined with a portfolio of more conventional assets – as little as 4% in a low / medium risk portfolio through to 10% in a higher risk one.

Gold's properties as a hedge against inflation are well known and extend back for several centuries, whilst the use of gold as an effective hedge against movements in the US dollar is also widely acknowledged. These benefits have intuitive appeal for any investor with significant holdings of dollar assets. Two further risks that are in the forefront of many trustees' minds.

The flight to quality currently being witnessed is firmly rooted in how these qualities, underpinned by market fundamentals, combine to make gold an extremely potent tool that can be used by investors to manage and mitigate their exposure to risk.

In this context, gold also helps address the concerns of investors, heightened in the current market environment, regarding liquidity risk and counterparty risk. Gold is one of the most liquid assets, traded around the world, around the clock, and gold has no default risk; unlike many other liquid assets, gold's value is not dependent on the ability of a company or bank to service its debt and meet its obligations to stakeholders.

By understanding how gold can complement and balance more traditional investments, pension professionals can proactively address some of the more acute risk exposures their funds may face over the short, medium and long term.

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