Recovering stability and confidence in an uncertain and risky world

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The UK pensions industry appears to be at a crossroads, both in terms of policy and funding. Notwithstanding the lack of consensus regarding the eventual impact or efficacy of Lord Hutton's recent recommendations for the transformation of public sector pensions provision, there are also growing concerns as to how UK pension scheme investment strategies can successfully participate in the nascent market recovery, while ensuring far greater stability and more robust protection of their capital than they have exhibited in recent years.

While the receding winter gloom may have brought with it a renewed sense of optimism, the broader economic environment during the first quarter of 2011 has been anything but bright and breezy. The financial markets have been distinctly twitchy of late, with issues such as the prospect of a further European sovereign debt default, continuing civil unrest in parts of the Middle East and North Africa, the devastating catastrophe in Japan (the full consequences of which are still unknown) and the uncertainty of the long term price of oil all sources of anxiety.

Only a few of months ago, most analysts and market commentators were expressing confidence in the economic recovery and the climate for corporate earnings; the IMF predicted a global annual growth rate of 4.2% in 2011 and pension fund investors predicted European blue chip stocks to record annual earnings growth in double figures[1]. While market sentiment for the prospect of longer-term growth remains positive in many quarters, a substantial number in the investment community are now, understandably, proceeding with greater caution than might have been the case prior to 2008 and more recent shocks.

Fortunately, there are signs that pension professionals and asset managers are becoming more alert to this dynamic. The need to actively assess and manage the downside risk of investment strategies frequently tops current lists of investor concerns and priorities. Investors have been forced to acknowledge that unexpected and statistically abnormal risks are now a permanent threat. For example, Reuters recently reported that at the AXA Investment Managers' annual economics symposium on 'Post-crisis Globalisation' (March 2011), a number of asset managers identified the prospect of increasing 'tail risk' or 'black swan' events as inevitable and simply something they would have to learn 'to live with'[2].

This awareness is also reflected in a number of new initiatives, which aim to better protect portfolios against unexpected events which may place extreme pressure on specific asset classes or wider global markets. For example, Oxford University's Saïd Business School[3] recently announced they had constructed a statistical investor sentiment model to predict extreme market events. In addition, researchers from JP Morgan Asset Management announced last year that they had developed a system aimed at more accurately analysing Value at Risk (VaR) through non-normal return distributions, so as to produce a modified risk framework and improve portfolio efficiency and resilience[4]. Interestingly, this latter model confirmed that a broader allocation to alternatives can reduce overall VaR – and thereby reduce severe losses in portfolios – with only a minor reduction in returns.

Regardless of the specifics of the models and methods used in these new initiatives, these conclusions do not surprise us at the World Gold Council. Our perspective, backed by a considerable body of research, is that greater portfolio diversification into alternative asset classes is a positive and, indeed, necessary move. We believe many of the post-crisis views regarding diversification – suggestions that it is of more theoretical than practical value – are perhaps based on a slightly superficial approach to the subject and, in particular, inadequate examination of the drivers underpinning the diversification benefits of specific assets.

This is often clearly evident in institutional investors' attitudes to gold. We believe that many pension funds have a somewhat one-dimensional view of gold as an asset, considering it primarily as a relatively 'peripheral' alternative instrument, most typically as part of the wider commodities complex, and very often purely on the basis of its shorter-term, tactical characteristics. In our view, while this perception may implicitly acknowledge gold's strengths as a diversifier in some regards, it also neglects its benefits in others. The failure to examine gold's unique range of attributes as an asset that elevates it well above most commodities can result in the persistent undervaluation of gold's worth as a strategic buffer against market risk.

For example, gold is more insulated from western market cycles than most other commodities as demand is geographically diverse, less dependent on industrial consumption and often strongest in more dynamic 'growth' economies[5], such as China, India and Turkey, which have proved remarkably resilient to the recent financial downturn. This trend helps buffer gold from the impact of recession and also reduces its volatility.

Gold has, traditionally, been an asset class perhaps best known for its attributes as an inflation hedge and its capacity to act as a store of value, but its virtues as an asset are far broader and deeper than this. Our research suggest that gold, as a distinct asset class (that is, beyond its inclusion in commodity baskets), has been empirically proven as a highly effective and consistent portfolio diversifier, not only helping increase expected risk-adjusted returns, but also considerably mitigating the potential for capital to be eroded by extreme events.

In a recent report entitled "Gold: Hedging against tail risk", we examined the impact that an allocation to gold would have on a portfolio in the event of a tail risk. Analysing different portfolio compositions and variations of a benchmark portfolio, the report assessed the performance of these combined assets during previous periods of extreme market stress, both when gold was included and when it was absent. The research found that for three quarters (18 out of 24) of the tail risk scenarios analysed (from a period between December 1987 and July 2010), portfolios which included gold consistently outperformed those which did not. Thus, small allocations to gold (ranging from 2.5% to 9.0%, for example) can increase risk-adjusted returns and help reduce the weekly 1% and 2.5% VaR of a portfolio by up to 18.5%.

In summary, we found that a modest holding of gold consistently reduces the probability of significant portfolio losses during extreme market events and, moreover, the downside protection on offer does not hinder potential upside. This research supports other World Gold Council analyses of optimal portfolio composition that have repeatedly shown that in multiple market conditions an allocation to gold can reduce the volatility of a diversified investment portfolio without sacrificing expected returns.

Much has been written on gold in recent years and some commentators have questioned the durability of its buoyant performance. Many of these arguments are based on a significant over-estimation of the level of institutional investment in gold, suggesting a crowded market, which is far from the case. However, to place the discussion on a more empirical basis, recent analysis[6] of the longer term performance of gold shows that the current level is very much sustainable, well within statistically 'normal' growth trends and driven by strong market fundamentals, with considerable scope for additional development in key geographical and sectoral markets.

In short, we suggest that there is a strong and rational case for gold to have an enduring place in institutional investment portfolios, particularly in such an unstable world. While investors understandably wish to exploit the opportunities presented by the economic recovery and resurgent markets, they also need some firm foundations on which to base their confidence to invest in riskier assets in a riskier world.

1 *Pension Funds Asset Allocation Survey*, bfinance, January 2011

2 *Analysis – Living with "fat tails" and coping with risk*, Reuters, 23 March 2011

3 *Mitigating equity market risk with investor sentiment*, K.Tan, A. Karpov and H. Shimada (in collaboration with Thurleigh Investment Managers), December 2010

4 *Non-Normality of Market Returns: A Framework for Asset Allocation Decision Making*, A. Sheikh and H. Qiao, The Journal of Alternative Investments, Winter 2010

5 *O'Neill: after BRICs try 'growth markets'*, blogs.ft.com/beyondbrics, 16 January 2011

6 *The ten year gold bull market in perspective*, World Gold Council, September 2010