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About the World Gold Council

The World Gold Council is the market development organisation for the gold industry. Working within the investment, jewellery and technology sectors, as well as engaging with governments and central banks, our purpose is to provide industry leadership, whilst stimulating and sustaining demand for gold.

We develop gold-backed solutions, services and markets based on true market insight. As a result we create structural shifts in demand for gold across key market sectors.

We provide insights into international gold markets, helping people to better understand the wealth preservation qualities of gold and its role in meeting the social and environmental needs of society.

Based in the UK, with operations in India, the Far East, Europe and the US, the World Gold Council is an association whose members comprise the world s leading gold mining companies.

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Foreword

Welcome to the sixth edition of Gold Investor. This issue contains three thought-provoking articles, and a common thread runs through them all: the balance between diversification and performance.

This is a highly relevant theme for two reasons. Firstly, our focus is on the value that gold can deliver to investors: gold has a well-recognised role in portfolio performance.[1] Secondly, we live in the shadow of the 2008-2009 financial crisis, with its harsh lessons on risk and how to use portfolio diversification to manage it.

In each article our analysts take a close look at a different asset class, examine its context and characteristics, and analyse how it compares to and interacts with gold.

Alternative assets can deliver outperformance but fare less well as diversifiers

First, in *How gold improves alternative-asset performance*, we scrutinised alternative assets private equity, hedge funds, real estate, and commodities to see if they deliver performance and diversification. We found good news, room for improvement and a few surprises.

The good news is that alternatives can deliver outperformance. Some investors may be surprised to find that gold returns outperformed some alternative assets and an important diversification-and-performance point has a correlation to equities that is lower than any alternative asset.

Gold is often labelled a commodity but it behaves more like a currency

In *Gold: metal by design, currency by nature* we make the case for gold as a distinct asset class rather than a commodity.

Marcus Grubb

Managing Director,

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Juan Carlos Artigas

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Many people find it odd that peas and courgettes (or zucchini in the US) are classified as fruits. Botany says that because they have seeds they must be fruits, but chefs use them as they would other vegetables. Our analysis shows that gold suffers from a similar kind of category confusion. It features in commodity indexes, but it responds to different economic factors (particularly those that drive currencies), is less volatile, and has a far lower correlation to the business cycle.

Gold can deliver on liquid alts promise of liquidity, returns and diversification

Finally, we look at liquid alternatives (or liquid alts) in *The most liquid of all liquid alts* . Liquid alts offer investors a more liquid investment in alternative assets. They have grown dramatically since 2008 and are expected to keep rising: a Citigroup reports predicts that liquid-alt assets could reach US$1.3 trillion by 2017.

However, when we compared liquid alts to gold we found two interesting results. Gold meets the key criteria of liquid alts as it is a non-traditional asset or strategy, is more liquid than alternative assets, and is a transparent investment. In addition, gold does not have the drawbacks including limited liquidity and relatively high costs that may put some investors off liquid alts.

We hope you find this edition of *Gold Investor* informative and stimulating. If you have comments or questions on any of the articles please get in touch at **investmentresearch@gold.org**.

1 New Frontier Advisors and World Gold Council, *Gold as a strategic asset*, September 2006; New Frontier Advisors, *Gold as a strategic asset for European investors*, December 2011; Oxford Economics, *The impact of inflation and deflation in the case for gold*, July 2011; J.P. Morgan, *Gold in asset allocation*, July 2012; Mercer, *Gold as an asset class for institutional investors*, February 2011; Matos, P. and R. Evans, *Gold as a portfolio diversifier: the World Gold Council and investing in gold*, Darden Business Publishing, University of Virginia, September 2012.

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I: How gold improves alternative asset performance

Investors look to alternative assets private equity, hedge funds, real estate, and commodities for returns and diversification. We ran the numbers and found good news, room for improvement, and a few surprises.

The good news is that alternatives can deliver outperformance. What may surprise some investors is that gold performs well often better than alternatives. It delivers respectable risk-adjusted returns and has a lower correlation to equities than any other alternative.

We also found that even a modest gold holding helps reduce risk without sacrificing returns for portfolios that include alternatives.

Searching for return from uncorrelated sources: how demand for alternatives flourished

Demand for alternatives has grown substantially over the past decade

Interest in alternative assets anything other than a stock, bond, or money-market instrument has significantly grown over the past decade. Investors have put money to work in private equity, hedge funds, real estate, and commodities for two main reasons. Firstly, they want positive risk-adjusted returns that beat stocks (using industry jargon, to find alpha). Secondly, they want these assets to better diversify portfolios and help mitigate risk (reduce their beta).

and accelerated after the financial crisis.

The fallout from the 2008-2009 crisis has further fuelled the growth of alternatives. The aggressive monetary policies implemented by central banks to reactivate economic growth have pushed down interest rates to historically low levels. This has prompted investors to look for additional sources of return. At the same time, the financial crisis also created greater awareness of risk and highlighted the importance of appropriate diversification.

In addition, some alternative strategies have become available to a larger set of investors. Hedge funds are now able to advertise publically as a result of the implementation of the 2012 Jumpstart Our Business Startups Act (aimed to spur capital-raising and job growth).[1] Investment firms have also developed liquid alts alternative assets typically offered via a mutual fund or exchange-traded fund. Liquid alts give investors a way to overcome alternates low liquidity and poor transparency (see *The most liquid of all liquid alts* for more detail on how gold fits into the liquid-alt story).

1 Securities and Exchange Commission: http://www.sec.gov/spotlight/jobs-act.shtml.

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In response, assets under management (AUM) of global private equity funds have grown from less than US$400 billion in 2001 to more than US$3.5 trillion by 2013.[2] The notional outstanding in commodity futures, forwards and swaps has grown from US$260 billion to US$1.5 trillion over the same period.[3] Similarly, the largest hedge funds (and funds of funds) collectively hold US$2.9 trillion in AUM, having more than quadrupled in size since 2000.[4] Lastly, liquid alts have tripled since 2009, and a Citigroup survey suggests they will reach US$1.3 trillion by 2017.[5]

We explore both the benefits that alternative assets can bring and the ways that investors can use gold to improve their alternative-asset strategies.

Alternatives are grouped into a single family but offer different benefits

Alternatives encompass many assets, and all aim to improve risk-adjusted returns

A key principle of modern asset allocation is that, over time, a well-balanced portfolio increases risk-adjusted returns. In the past, investors relied on a combination of traditional assets (typically stocks, bonds and cash) to diversify their portfolios. However, these basic allocation strategies did not always lead to the most effective mix of assets.

Today, alternative assets provide investors with a wider set of options. While it is easy to call something an alternative, the category is very broad. It includes multiple asset sub-types and investment strategies that often have little in common from hedge funds and private equity to real estate and commodities (including all their related variants).

This range of assets and strategies gives investors several potential ways to diversify their portfolios and mitigate risk. For example:

- Hedge funds give investors access to sophisticated expertise along with a wide range of assets and investment tactics. They can allow asset managers to outperform a given benchmark without increasing risk.[6]
- Private equity can help an investor diversify a portfolio and get access to the profits of business deals and long-term development projects that are not available through public markets.[7]
- Commodities, gold and real estate investments can give investors exposure to underlying economic growth and demand for scarce assets.

2 Prequin, *The 2014 Prequin global private equity report*.
3 Bank for International Settlements and World Federation of Exchanges.
4 Evestment, *Global hedge fund asset flows report*, April 2014.
5 Barron s, *Goldman on liquid alts: like the go-go days of ETFs*, December 2013: http://blogs.barrons.com/focusonfunds/2013/12/06/goldman-on-liquid-alts-like-the-go-go-days-of-etfs/; and Citigroup and Citi Prime Finance, *The rise of liquid alternatives and the changing dynamics of alternative product manufacturing and distribution*, May 2013.
6 Hedge funds are private investment partnerships that are open to a limited number of qualified or accredited investors (as defined by a country s financial regulatory body) who can meet investment minimums. Many investors associate hedge funds with sophisticated and complex strategies because they employ leverage, take

short and long positions and use derivatives in order to precisely express their markets views. They offer investors the potential for absolute returns with the expectation that their strategies are superior to long-only holdings of traditional assets in a portfolio. There are many types of hedge funds, but they generally fall into four main categories: equity funds, event-driven funds, macro funds and relative-value funds. In addition, a fund of hedge funds (FoHF) is an alternative way to access hedge funds. A FoHF is an investment vehicle whose portfolio consists of holdings in a number of different hedge funds.

7 Private equity is a broad term that describes capital invested in private companies that are not listed on public exchanges. Private equity funds are vehicles that allow investors to participate in the growth of non exchange-traded companies. There are many sub-strategies within private equity space, but some of the most popular ones include venture capital (VC) and leveraged buyouts (LBOs). Investors access private equity through a similar legal structure as hedge funds, whereby limited partners combine funds while general partners deploy the pool of capital. However, investors seeking to gain the benefits of high and uncorrelated returns with private equity investments have to sacrifice transparency and be willing to hold illiquid securities in potentially highly leveraged vehicles. For example, many private equity funds (as well as hedge funds) have lock-up periods of anywhere between one to seven years, forcing investors to sell their limited partnership interests into an illiquid market if there s an urgent need for cash.

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but investors have only started to fully embrace them.

Not all investors have been able to take advantage of alternatives. Retail investors had no access to alternates before liquid alts or the recent relaxation of hedge fund advertisement rules and some of these assets do not cover the full active-management smorgasbord of alternative strategies. In addition, some institutional mandates, particularly those of some pension funds, allow investments only in traditional assets. The result is that only an estimated 5% of financial assets are in alternative investments, with less than 1% in gold (**Chart 1**).

Chart 1: Only 5% of US$153 trillion financial assets are currently in alternatives

Percentages do not add to 100% due to rounding. Additional reference notes are listed at the end of this article.

Source: Bank for International Settlements, Hedge Fund Research, Cambridge Associates, GFMS, Thomson Reuters, World Federation of Exchanges, World Gold Council

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The pros and cons of alternatives; returns and diversification

Investors who commit funds to alternatives look for two things: additional returns, and diversification. When we analyse how alternative assets deliver against these criteria, we find mixed results.

Relative returns: alternatives offer good value for the money

Alternatives have generally outperformed stocks on a risk-adjusted basis

We find that alternatives have generally given investors better bang for the buck relative to stocks (**Chart 2**). While much of the available data (typically indices that act as proxies for private-equity and hedge funds) tends to overestimate returns,[8] respected academic researchers have found evidence of outperformance. For example, Harrison, Jenkins and Kaplan show that buyout funds have produced an excess annual return of 3% against the S&P 500 since 1990, while venture capital funds outperformed during the 1990s but have underperformed since 2000.[9]

Before we move on to our analysis of alternatives as a diversification tool, it is worth noting a relevant fact about gold: it has not only outperformed stocks, but also REITs and commodities on average since 1990   and even more so since 2000.

Chart 2: Alternatives have generally provided better risk-adjusted returns than US stocks

Information ratio defined as the annualised return in excess of the MSCI US total return index divided by the corresponding volatility

Reference notes are listed at the end of this article.

Source: Bloomberg, Cambridge Associates, Dow Jones, HFR, The London Gold Market Fixing Ltd, World Gold Council

8 Some of the most commonly used benchmarks either do not give a full representation of the data or suffer from self-reporting and survival bias. For example, The Hedge Fund Research Fund-Weighted Composite Index (HFRI) is a commonly used global, equal-weighted index of over 2,000 single-manager funds that report to Hedge Fund Research database. Constituent funds report monthly net of all fees performance in US dollars and have a minimum of US$50 million under management or a 12 month track record of active performance. Total AUM of HFRI constituents represents about a third of the estimated total size of the hedge fund universe. Similarly, the Cambridge Associates Private Equity Index is an end-to-end calculation based on data compiled from 1,125 U.S. private equity funds (buyout, growth equity, private equity energy and mezzanine funds), including fully liquidated partnerships, formed between 1986 and 2013. It is based on financial statements and narratives as the primary source of information concerning cash flows and ending residual/net asset values

(NAV) for both partnerships and portfolio company investments. Kaplan and Schoar (*Private equity performance: returns, persistence and capital flows*, The Journal of Finance, Vol. LX, No. 4, August 2005) suggest that private equity performance data has been found to suffer from a survival bias in which reporting is voluntary, leading to exaggerated returns that are not representative of industry averages. Additionally, successful funds tend to continue outperforming while under-performers continue to lag.

9 Harris, Jenkins and Kaplan, *Private equity performance: what do we know?,* July 2013. To appear in The Journal of Finance.

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Diversification: most alternatives significantly correlate to stocks

but not all offer the diversification that investors seek. This is where gold really stands out.

When it comes to diversification and risk reduction, the picture is not as positive for many alternatives. Hedge funds, private equity funds and real estate can be highly correlated to stocks (**Chart 3**). Even commodities, with lower average correlations than the others, are still influenced by the economic cycle (see *Gold: metal by design, currency by nature*).

Gold stands out for its low correlations both to US and international stocks.

Chart 3: Hedge funds, private equity funds and REITs have high correlations to stocks

Correlations based on monthly returns (quarterly for private equity due to data availability) between January 1990 and March 2014

Reference notes are listed at the end of this article.

Source: Bloomberg, World Gold Council

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Gold s role in alternative-investment strategies

We have carried out extensive original research that shows that gold is a valuable part of an alternative-asset portfolio strategy (see our 40-page report *Gold: alternative investment, foundation asset*).[10]

This section sets out relevant highlights from that research:

How gold can overcome specific alternative-investment portfolio issues (gold adds liquidity and reduces credit and counter-party risks)

Optimal gold holdings for portfolios that include alternative assets

Please note that the next section, *A recap of gold s portfolio attributes,* describes the factors that make gold a valuable part of any portfolio. We emphasise that the ideas we draw on in this article are not ours alone. Well-respected organisations that have arrived at the same conclusion include New Frontier Advisors, Oxford Economics, J.P. Morgan, Mercer, and The University of Virginia Darden School of Business, among others.[11]

Gold adds liquidity to an alternative-asset strategy

Gold can provide liquidity when other markets dry up

Alternative investments higher returns come with liquidity constraints that can restrict investors access to funds during times of crisis or when other attractive opportunities present themselves.[12] If gold is part of an investor s alternate-asset strategy it can help fund liabilities during periods of systemic risk. We discuss this subject at length in *The most liquid of all liquid alts* .

Gold is remarkably liquid. Investors can access it through exchange-traded funds (ETFs), exchange-traded derivative contracts and over-the-counter vehicles. Gold-backed ETFs collectively trade US$1 billion a day, rivalling single stocks and many equity-linked ETFs. Futures in COMEX alone trade a daily average of US$18 billion.[13] What really stands out, though, is the over-the-counter (OTC) market. We estimate that, during 2013, gold contracts traded between US$60 billion and US$160 billion a day most of them in the form of spot contracts. Further, during 2011 when liquidity was particularly high, daily volumes surpassed US$240bn, according to the London Bullion Market Association.[14] In other words, gold s liquidity in the OTC market rivals major currency pairs and surpasses all US stocks combined.

Gold helps reduce credit and counterparty risks

and it doesn t carry credit risk and often carries no

Hedge funds and private-equity funds use a range of credit and debt instruments and carry consequent credit risk (the risk that a borrower will default on a debt).

counterparty risk.

Commodities and real-estate investments tend not to be subject to credit risk in the same way but may still be subject to counterparty risk (the risk that a party in a transaction fails to meet the terms of the financial contract).

Given that gold is easily accessible in physically-backed securities and contracts, investors not only remove credit risk but can also minimise counterparty risk. For example, investors can take delivery of gold, keep it in allocated accounts, or hold ETFs that are backed by physical gold.

10 World Gold Council, *Gold: alternative investment, foundation asset*, October 2011.

11 New Frontier Advisors and World Gold Council, *Gold as a strategic asset*, September 2006; New Frontier Advisors, *Gold as a strategic asset for European investors*, December 2011; Oxford Economics, *The impact of inflation and deflation in the case for gold*, July 2011; J.P. Morgan, *Gold in asset allocation*, July 2012; Mercer, *Gold as an asset class for institutional investors*, February 2011; Matos, P. and R. Evans, *Gold as a portfolio diversifier: the World Gold Council and investing in gold*, Darden Business Publishing, University of Virginia, September 2012.

12 For example, private equity, hedge funds and other private investment vehicles are subject to lock-up periods, redemption notices and gating clauses. Lock- up periods refer to the initial period in which investors are not allowed to withdraw funds and can range from three months to three years. Redemption notices stipulate that investors need to let managers know they are planning to redeem funds in advance (typically three months). Finally, gating clauses give managers discretion to restrict withdrawals on otherwise permissible periods.

13 Volumes for ETFs, stocks and futures contracts based on 1-year averages ending March 2013.

14 London Bullion Market Association, *LBMA gold turnover survey for Q1 2011*, The Alchemist, August 2011.

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Optimal gold holdings for portfolios that include alternative assets

As we have shown in previous research studies, whether investors are based in the US, the UK, continental Europe or Japan, adding 2%-10% in gold provides benefits that may not be easily replicated by a combination of traditional assets and commodities.[15]

Having as little as 4% in gold in a well-balanced portfolio, alongside other alternatives, can effectively reduce risk without erodingreturns.

In particular, our research shows that a 5%-6% allocation to gold is optimal for investors with a well-balanced medium-risk portfolio (a 60/40 portfolio in equities, cash and bonds).[16] When a portfolio also includes real estate, private equity and hedge funds, the optimal allocation for gold is closer to 4% in a medium risk portfolio (**Chart 4**).

Chart 4: An allocation of 4% to gold for diversified portfolios that include alternatives can improve risk-adjusted returns and reduce losses during periods of systemic risk

Reference notes are listed at the end of this article.

Source: World Gold Council

15 World Gold Council, *Why invest in gold?* Gold Investor, Volume 4, October 2013. Gold s appeal is not restricted to US dollar-based investors. Research shows that euro, yen and pound sterling investors have historically obtained similar results. See New Frontier Advisors, *Gold as a strategic asset for European investors*, December 2011; World Gold Council; *Gold as a strategic asset for UK investors*, July 2012; World Gold Council, *The role of gold in portfolio risk management for Japanese investors*, November 2013.

16 To find the mix that delivers the best possible returns for a given level of risk (in this case, measured by volatility), we use the Resampled Efficiency (RE) optimisation developed by Richard Michaud and Robert Michaud and described in *Efficiency Asset Management: a practical guide to stock and portfolio optimisation and asset allocation*, 2008, 2nd edition, Oxford Press, New York.

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A recap on gold s portfolio attributes

In the previous section we highlighted the attributes of gold that are particularly relevant to alternative-asset strategies: exceptional liquidity along with lower credit and counter-party risk.

We believe these particular benefits to holding gold apply to all portfolio types, and this section is a broader recap of gold s portfolio benefits (see *Why invest in gold?* for more detail).[17]

Gold s benefits are not solely driven by its price

Gold s price appreciation is the cherry on top. Its key role is in diversifying a portfolio and reducing risk.

Even under the assumption that gold s annual return in nominal terms is a modest 2%-4% over the long run lower than its historical return and akin to the global rate of inflation (**Table 1**) gold s benefits mean that including gold can improve overall portfolio performance. The key lies in gold s ability to:

- Diversify a portfolio and consequently lower portfolio volatility
- Reduce losses in periods of financial turmoil
- Preserve purchasing power through its ready liquidity.

Table 1: Gold has outpaced inflation in the US and abroad, as well as short-term rates

Annualised average monthly returns

	Nominal gold return	Real gold return using US inflation	Real gold return using global inflation	Gold return in excess of: US cash	Gold return in excess of: global cash
Average since 1971	10.37%	4.19%	5.96%	5.13%	na
25-year average	5.24%	2.56%	1.58%	0.99%	0.09%
10-year average	14.43%	11.94%	12.10%	12.06%	11.04%

Reference notes are listed at the end of this article.

Source: Bureau of Labor Statistics, The London Gold Market Fixing Limited, World Gold Council

A flexible way to manage portfolio risk

Gold is uncorrelated and protects capital during a crisis.

Gold can help investors manage portfolio risk. The key is the way that gold interacts with other assets. Two factors are particularly important:

***Low correlation with equities*. Chart 3** (found in subsection *Diversification: most alternatives significantly correlate to stocks*) shows that gold has low correlations lower than that of assets that are often seen as diversifiers to stocks over long periods of time.

***Outperformance during crises*.** Gold tends to outperform other assets in periods of economic and financial turmoil (**Chart 5**). This gives investors a way to reduce risk when it is most needed.[18]

17 World Gold Council, *Why invest in gold?* Gold Investor, Volume 4, October 2013.

18 See World Gold Council, *Tail-risk hedging: an international perspective*, Gold Investor, Volume 1, January 2013; and World Gold Council, *Gold: alternative investment, foundation asset*, October 2011.

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Chart 5: Gold has consistently outperformed stocks as well as other alternatives during tail-risk events

Returns during periods of systemic risk

Reference notes are listed at the end of this article.

Source: Bloomberg, World Gold Council

Gold s unique supply-and-demand factors lower volatility and deliver returns

Gold is driven by a diverse set of uses, users and producers around the world.

The drivers of demand for gold work at all stages of the business cycle. Gold s unique demand and supply dynamics ensure its role as a true diversifier for investors. Gold demand is distributed between jewellery (49%), investment (34%), technology (10%) and central banks (8%).[19] Broadly speaking, economic growth spurs demand for gold in the form of jewellery and technology, but in recessions investors tend to buy gold as a store of value. This creates the balanced demand that accounts for gold s lack of correlation to other assets.

Gold demand is widely distributed. Demand from Asia (57%) and the Middle East (10%) reduces the usual commodity demand dominated by developed countries and influenced by their business cycles.[20] A balance between East and West allows different sectors of gold demand to flourish when conditions are unfavourable in other sectors or regions.

Gold supply is widely distributed. On the supply side, mine production accounts for approximately 65%, leaving another 35% to recycling. Given that gold mine production is spread around the globe, gold s price performance tends to be less subject to geopolitical and other idiosyncratic risks (see *Gold: metal by design, currency by nature*). Further, recycled gold constantly re-enters the market, providing a balancing factor that can further absorb shocks to the supply chain.

19 Five-year average demand ending in 2013 based on estimates by GFMS, Thompson Reuters. Investment includes bars, coins as well as exchange-traded and similar products.

20 Five-year average demand ending in 2013 based on estimates by GFMS, Thompson Reuters. It includes jewellery, technology, bars, coins, and ETF demand. It excludes over-the-counter transactions and central bank purchases.

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Chart 1: Only 5% of US$153 trillion financial assets are currently in alternatives

The chart values are as of December 2013. Estimates include the global market capitalisation of all publicly traded stocks and REITs, the total value of outstanding bonds and money market instruments, total open interest on major commodity futures plus above ground stocks of precious metals, the assets under management of private equity and hedge funds and private holdings of gold bullion. Central bank holdings of gold and bonds were excluded.

Chart 2: Alternatives have generally provided better risk-adjusted returns than US stocks

Information ratio defined as the annualised return in excess of the MSCI US total return index divided by the corresponding volatility. HFRI used as a proxy for hedge funds. Cambridge Associate index represents private equity. US REITs stand for real estate, S&P Goldman Sachs Commodity Index for commodities and London PM fix for gold. All returns based in US dollars.

Chart 3: Hedge funds, private equity funds and REITs have high correlations to stocks

Correlations based on monthly returns (quarterly for private equity due to data availability) between January 1990 and March 2014. US equity indices include MSCI US, Russell small cap, Russell mid cap, MSCI EAFE and MSCI emerging markets. HFRI used as a proxy for hedge funds. Cambridge Associate index represents private equity. US REITs stand for real estate, S&P Goldman Sachs Commodity Index for commodities and London PM fix for gold. All returns based in US dollars.

Chart 4: An allocation of 4% to gold for diversified portfolios that include alternatives can improve risk-adjusted returns and reduce losses during

periods of systemic risk

These results display the optimal portfolios that were found for the *Gold: alternative investment, foundation asset* report published by the World Gold Council in October 2011.

Table 1: Gold has outpaced inflation in the US and abroad, as well as short-term rates

Shows the annualised average monthly returns for gold between 1972 and 2013 adjusted by: 1) US CPI; 2) OECD global inflation; 3) 3-month T-bill; 4) 3-month global cash index.

Chart 5: Gold has consistently outperformed stocks as well as other alternatives during tail-risk events

Returns during periods of systemic risk. For equities: MSCI US. HFRI used as a proxy for hedge funds. Cambridge Associates index represents private equity. US REITs stand for real estate, S&P Goldman Sachs Commodity Index for commodities and London PM fix for gold. All returns based in US dollars. Persian Gulf War I: Q3 1990, LTCM: Q3 1998, Dot-com meltdown: Q1 2001, 9/11: Q3 2001, 2002 recession: Q2/Q3 2002, US Credit Crisis: Q4 2008/Q1 2009, European sovereign debt crisis: Q2 2010.

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II: Gold: metal by design, currency by nature

We have taken a close look at commodities, including their rather bleak recent past, and have arrived at two key thoughts. Firstly, we believe that commodities are a valuable portfolio-performance tool. Secondly, we have found good reasons why investors should treat gold as an asset class of its own.

Our analysis shows that gold does not fit neatly into the commodities category. It responds to several factors that drive currencies, and it has a much lower correlation to the business cycle than the rest of the commodities complex.

This is good news for investors looking for optimal portfolio performance.

Poor performance may not spell the end of commodities

Commodities have suffered over the recent past and are out of favour with many investors

Commodities have taken a beating over the past 18 months, but the rout has lasted longer than that: commodities have underperformed equities and bonds since 2009. In 2013, investors withdrew US$50bn from passive commodity-index funds,[1] the end result of poor performance, a slowdown in China, and tighter regulation of commodities trading. A recent survey by Barclays put commodities in general and base metals in particular at the bottom of the pile of near-term performance prospects.[2]

Commodities are also volatile. So far this year a number of events have highlighted the uncertain nature of investing in commodities. In January, Indonesia s ban on nickel-ore exports triggered a 50% rise in price to May. In the first quarter of 2014, approximately 40% of global platinum production came under threat by striking miners in South Africa.[3] Elsewhere, cocoa has been affected by political events in the Ivory Coast, the largest producer, and severe droughts in Brazil have had a material impact on coffee prices. Volatility is a boon for speculators but presents a real problem for firms involved in the physical supply or consumption of the resource.

but there are signs that the rout may be drawing to a close.

But not all commentators are despondent. Among the optimists, investment bank Goldman Sachs argues that commodity performance has played to expectations given the stage of the business cycle and that the commodity complex is now poised to benefit from a global economic recovery. And some fund managers who are concerned about the outlook for equities (a view we detailed in *Can gold replace bonds in balancing equity risk?*[4]) are actively considering redeploying commodities as a portfolio diversifier.

To us, the commodity story serves as context. It is useful to understand the commodity complex because there are some similarities between its constituents and gold. It is also useful to understand the portfolio benefits of commodities and their impact on inflation. However, what we highlight in this paper is how distinct gold is from the group, why this is the case, and what the implications are for investors.

1 FT.com, *Investors starting to look at commodities again*, 14 April 2014.
2 Barclays, *Global Macro Survey*, 18 March 2014.
3 Reuters, *Platinum firm Lonmin says bleeding from South Africa strike*, 19 May 2014.
4 World Gold Council, *Can gold replace bonds in balancing equity risk?,* Gold Investor, Volume 5, March 2014.

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Gold is a distinct asset class

Why gold is often defined as a commodity

We believe in the strategic case for commodities but urge investors to view gold as a distinct asset.

Gold is often lumped together with the commodity complex by investors and investment practitioners alike. Whether as a component in a commodity index (S&P Goldman Sachs Commodity Index, Dow Jones UBS Commodity Index), one of the securities in an ETF, or as a future trading on a commodity exchange, gold is viewed as a part of this complex. Before setting out to show how different gold is from its nearest commodity cousins and by extension the rest of the complex, we detail the similarities.

Zooming in to the tradable commodities we are familiar with, gold shares characteristics with other commodities in that it:

Gold shares some similarities with members of the commodity complex; it is a metal, after all

Is extracted, and shares other commonalities with commodities including scarcity, consumption and fungibility.

Forms part of commodity structured products. Gold is a component of many well known indices, and this inclusion will invariably align some of the price movements of the constituent commodities. These influences include both end-of-year rebalancing where futures are bought/sold to realign commodity weightings in these indices, and the effect of exchange-traded products that track such indices.

Gold undoubtedly shares some similarities with other commodities. But a detailed look at the make-up of supply and demand highlights that the differences outnumber the similarities.

The supply of gold is balanced, deep and broad, helping to quell uncertainty and volatility

but the differences outweigh the similarities.

A good deal of what makes gold behave differently from other metals and commodities lies in the structure of its supply and demand. These differences all add up to create a fundamental framework that is evidently unique compared to the members of the commodity complex. **Table 1** details the geographic spread of primary production according to where it is mined, rather than refined.[5]

Table 1: Gold production is geographically widely distributed

Geographical distribution of primary supply (mining) of various commodities

Europe	Eurasia	Africa

	North America	**Central and South America**			**Middle East**		**Asia and Oceania**
Aluminium	9.7%	3.8%	8.6%	7.9%	0.0%	3.6%	66.5%
Lead	13.6%	26.5%	15.2%	0.0%	0.0%	3.9%	40.8%
Zinc							