SE Portfolio

HD **Why you should consider gold**

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Gold shares little in common with most popular investments: it performs no useful function, nor does it generate future earnings or produce a yield. And yet the precious metal holds a special place in the psyche of investors, even as much of its lustre has worn off in the past two years.

"Sentiment is bad – it's a tough place and very hard to get people interested," says Baker Steel Capital Managers managing director David Baker, who manages a gold fund. "But this is where you make the money – by buying now and putting it in the bottom drawer . . . I think if you've made some money elsewhere in the market, now is a good time to diversify."

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The price of gold peaked at almost $US1900 an ounce in 2011 but has since fallen to around $US1200 to $US1300 as the global economy and the performance of sharemarkets has returned, luring investors back to more growth-oriented areas of the market.

It was a sharply different case during much of the previous decade. The US dollar price of gold surged by an annualised 15.4 per cent a year between December 1999 and March 2012, outpacing the US consumer price index (up 2.5 per cent a year), US stocks (1.5 per cent) and bonds (6.4 per cent).

The bubble burst later that year but investors remain attracted to the asset for its ability to act as an inflation hedge, a currency hedge, and as a safe haven in times of economic stress. Another investment rationale suggests that gold remains under-owned by institutional investors and central banks in emerging markets.

However this remarkable range of distinctive properties attributed to gold are as difficult to prove as they are controversial.Protection in tough times?

As the US economy continues to recover and lead the way out of the global financial crisis, gold has lost much of its appeal. However, the recovery remains tenuous and a number of investors continue to turn to gold for protection.

Frontier Investment Consulting consultant Justine O'Connell says a number of its super fund clients raised the prospect of investing in gold just after the GFC. However, its research found that the performance of gold was highly market-specific.

For example, during a low-growth, high-inflation period in the 1970s, gold acted as an effective inflation hedge. "But then you get really long periods where that relationship just falls away and actually becomes negatively correlated," O'Connell says, noting that super funds prefer to use assets such as infrastructure and direct property, which tend to work in a broader range of inflationary environments.

Similarly, it found gold, which has no counterpart risk when held in its physical form, could act as a crisis hedge, but only in certain environments and, even then, during the tumultuous period from 2008-10, government bonds performed better.

"It can have a place, but we think there are other ways [to hedge] which are more reliable with other asset classes," O'Connell says, noting that the asset consultant has not changed its view on **gold** in the current market conditions.

Globally, institutional investors are mostly underweight **gold**, the market of which is just a fraction of the size of more established asset markets.

A research paper published by the Financial Analysts Journal in 2013, The Golden Dilemma, found the total value of investable **gold** to be less than 2 per cent of the combined capitalisation of world stock and bond markets.

"A widespread move to increase **gold** in diversified portfolios would **lead** to upward pressure on the real and nominal prices of **gold**," the report said.

However, their research suggests little reason for institutional investors to support **gold** in the near term after analysing the asset's long-term performance – the evidence left the authors largely sceptical about **gold**'s ability to act as a safe haven, as a currency hedge or as an inflation hedge.

"**Gold** may very well be a long-run inflation hedge," the paper said. "The long run, however, may be longer than an investor's investment time horizon or lifespan."**Gold**-plated emerging markets

It may be obvious to suggest that a rise in demand for **gold** will spur an increase in its price, but it remains a key driver for a precious metal whose primary use is ornamental. Enter emerging markets.

Since 2000, **China**, Russia, and Saudi Arabia have been enthusiastic purchasers of **gold**, while the Netherlands, France and Switzerland reduced their holdings of **gold**, according to the World **Gold** Council.

Gold reserves provide an important backdrop of confidence in emerging markets, which continue to liberalise their financial controls and capital accounts.

Strong demand from **China** last year helped prop up the faltering **gold** price as exchange traded funds (ETFs) were forced to divest about one-third of their total holdings when investors lost interest in the asset.

Meanwhile, India – the world's second-biggest consumer of **gold** after **China** – has suggested it will ease recent restrictions on importing **gold** under the country's new government led by Narendra Modi.

India placed tight curbs on bullion imports last year, including placing a 10 per cent duty on overseas purchases and introducing an 80-20 rule that required one-fifth of all imports to be exported – moves that were aimed at reining in the country's current account deficit.

Baker says it looks as if India will relax its import regulations, which would provide a surge in demand. "That is something I would be watching in the near term," he says.

Emerging markets still hold substantially less **gold** than the US and other developed markets on several relative measures.

The central banks of the BRIC nations (Brazil, Russia, India and **China**) hold substantially less **gold** than the US, which holds the world's largest **gold** reserve.

If those emerging economies pegged their **gold** reserves at the same ratio as the US does relative to GDP, it would prompt a more than 2½ times lift in their **gold** reserves to 6233 metric tons, according to the Financial Analysts Journal.

"If a country pursues a 'keeping up with the Joneses' approach to owning **gold**, targeted holdings based on the size of population or GDP [gross domestic product] will not be affected by changes in the price of **gold**," the paper said.

Nonetheless, the price of **gold** remains under pressure, with ANZ commodity analyst Victor Thianpiriya suggesting that it is set to head further south after **China** almost doubled its usual annual inventory last year.

"A lot of demand has been brought forward and prices continue to slide further down – it's having a negative impact on sentiment and people are now a little bit more gun-shy of buying **gold** on every single dip.

"That is why we haven't seen the **Chinese** demand respond as strongly this year even though prices [are down]."

Central banks around the world hold almost 20 per cent of the estimated above-ground gold stock, although a number of western countries spent years reducing their stocks (subject to central bank gold agreements aimed at dampening liquidity issues). Thianpiriya says the GFC changed that.

"That is a shift that I don't think will reverse," he says. "Central banks globally still view gold as a key part of their reserves, so we're not likely to see the same sort of liquidation of gold from that sector as we did for a good part of the past 25 years."Access without the intermediaries

There are several more efficient ways to add gold to your portfolio than hiding bars under the mattress, despite it being the method preferred by those keen to reduce the role of intermediaries.

The simplest exposure path is via ETFs, which are backed by physical gold bullion.

The ETF Securities Physical Gold established by Australian ETF pioneer and BRW Rich Lister Graham Tuckwell that trades under the ASX code, GOLD, is a popular example and charges just 0.4 per cent a year in fees.

Investors concerned about the impact of currency fluctuations and want a purely directional exposure may want to investigate the BetaShares Gold Bullion ETF Currency Hedged product, which charges a management fee of 0.49 per cent and trades under the code, QUA.

The Perth Mint offers something slightly different: a listed call option on the ASX which entitles investors to physically acquire gold (one hundredth of a troy ounce of fine gold per option). The management fee is just 0.15 per cent and this may prove to be a suitable exposure for someone looking for a portfolio insurance policy.

A number of managed funds also include gold in the mix, although its place is largely relegated to commodity-focused or alternative asset portfolios.

Van Eyk Research chief executive Mark Thomas says the $200 million Blueprint Diversified Alternatives Fund has about 15 per cent of its portfolio allocated to gold in fully hedged $US bullion and BetaShares ETFs.

The fund charged total fees of 1.94 per cent last financial year and also trades on the ASX.

"It's at the riskier end," Thomas said. "It needs to be part of a diversified strategy."

He recommends investors opt for a fully hedged US dollar-denominated exposure because the price of gold is linked to the trade-weighted US dollar: when the US dollar rises the Australian dollar falls and so offsets any impact the investment may have.

The Baker Steel Gold Fund takes a different approach and instead invests in listed small to mid-cap gold and precious metal companies around the world. It is sold through Select Asset Management and charges total fees of 1.82 per cent (not inclusive of a 10.25 per cent performance fee that kicks in for returns above the FTSEGold Mines Index return).

Managing director David Baker says gold companies have been excessively sold off by the market and a rise in the price of gold would produce a significant and immediate earnings uplift.

"I think there's a huge amount of value in the market from some of the larger companies, but you've got to be really careful playing some of the junior companies," he says.

"So I can see how I can quickly make 10 times my money on some of these assets even if we have a small, 20 to 30 per cent uplift in the gold price, which isn't unrealistic."Producers over explorers

He nominates a number of gold producers (rather than gold explorers) such as South Africa's Gold Fields, Hong Kong's G-Resources, and ASX-listed AngloGold Ashanti and Endeavour Mining Corporation as representing significant value.

At last month's Global Metals and Mining conference in Miami, major gold producer Newmont Mining said it is managing its business for a gold price of $US1200 but noted that every $US100 rise will generate a cumulative $1 billion in free cash flow over next three years.

Nonetheless, most gold companies at the conference were focused on getting to a position of positive cash flow at the lowest possible gold price rather than focusing on increases in the price of gold, according to Bank of America Merrill Lynch analysts.

Baker is also supportive of recent moves by some gold companies to improve shareholder returns by linking their dividend payments to the price of gold.

Last year, Australian gold producer Evolution Mining pledged to pay 2 per cent of its gold production in dividends – a move which should go some way towards curbing the recent underperformance of gold companies relative to the price of gold.

"We like that business model because then we've got a direct link between what's in the ground and what we're getting back as shareholders," Baker says.

"It's like a contract between shareholders and management and we know that if the gold price goes up they're not going to clip our dividend – I've got a linkage into the higher gold price."

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