Five reasons to hold gold at the core of your portfolio

Key Points:

- Gold has long been considered a safe-haven asset used by investors to hedge against event risk but is often not appreciated for the way in which it can aid portfolio returns in different market conditions.
- Over the long-term gold has close to zero correlation with share markets. This is good for investors. Uncorrelated assets provide diversification and help improve returns or reduce risk within a portfolio.
- ETFS Physical Gold (ASX: GOLD) is a simple and cost-effective and efficient way to access gold by providing a return equivalent to the movements in the gold spot price.

At ETF Securities, as manager of Australia's largest and the world's oldest exchange traded gold product (ASX: GOLD), we spend a lot of time looking at how gold can work for our clients to improve outcomes across their portfolios. Gold is well-known as a hedge against event risk and as a way of preserving capital against inflation, but people often don't appreciate how well a long-term holding can aid portfolio returns in different market conditions. When we talk about using gold in a portfolio, we tend to focus on its role as a core strategic holding, not an asset to trade in- and out- of on a regular basis. This article outlines five key reasons you should consider gold as a core holding.

1. Gold is an effective hedge against unpredictable events

Gold has been one of best performing assets globally over the past year and has attracted a lot of attention. In Australian dollar terms gold has never been more valuable, having risen 32% over the 12-month period to the end of September. Not only has gold performed very well, but it has done so against a backdrop of rising geopolitical risk, periodic bouts of equity market volatility, global growth concerns and an abrupt shift in monetary policy, both domestically and abroad.

The recent past is just one example in gold's long history of performing well when markets are in turmoil or when risks are heightened. Other prominent examples include[1];

- the 1987 stock market crash; gold rose 6% while the S&P 500 fell 33%
- the global financial crisis; gold rose 26% while the S&P 500 fell 56%
- the European sovereign debt crisis; gold rose 9% while the S&P 500 fell 19%

It is not surprising, therefore, that many people use gold as a safe-haven asset in much the same way they would use insurance to protect their physical assets. Of course, you don't just take out home insurance when you feel a flood or fire may be imminent, which is why we advocate holding gold long-term to protect against events that are inherently unpredictable.

2. The price of gold is driven by many factors and is difficult to predict

Gold does not conform to traditional financial asset principles and there is no widely accepted model to determine a fair price for gold. While many different models exist, it is fair to say that the price of gold is driven by a wide range of variables and is difficult to predict.

[1] Bloomberg data as at 30 November 2018

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Gold is both a consumption and an investment asset, which often makes it both pro- and counter-cyclical at the same time. Levels of economic growth are positively related to demand for gold for use in jewellery and technology products, while expectations of lower growth may drive investment or safe haven buying. Gold is used as a store of wealth and as protection against inflation, while it is also in demand when interest rates and inflation are low and economic prospect look poor. Further, central banks are key investors and have massive reserves and a wide range of different motivations for owning gold, which can heavily influence demand.

With such an array of competing factors for which to account, forecasting changes in the price of gold and the timing of changes is extremely difficult. We therefore rarely recommend gold as a trade-in/trade-out investment, where market timing is key. Instead we focus on how gold can be used as a core strategic holding. Depending on their circumstances, we often see investors using gold with a 2%, 5% or 10% allocation across their portfolios.

3. Gold's long-term returns are better than many other asset classes

Since gold became a freely traded commodity in 1971 its price has increased by an average of 11.7% per year in Australian dollar terms. Chart 1 shows how gold has performed relative to other major asset classes from the perspective of an Australian investor. While some investors worry that gold produces no regular income, its overall returns have out-stripped many more widely used investments. Gold has significantly outperformed both fixed income investments and diversified commodities. Its long-term returns are comparable with share market returns.

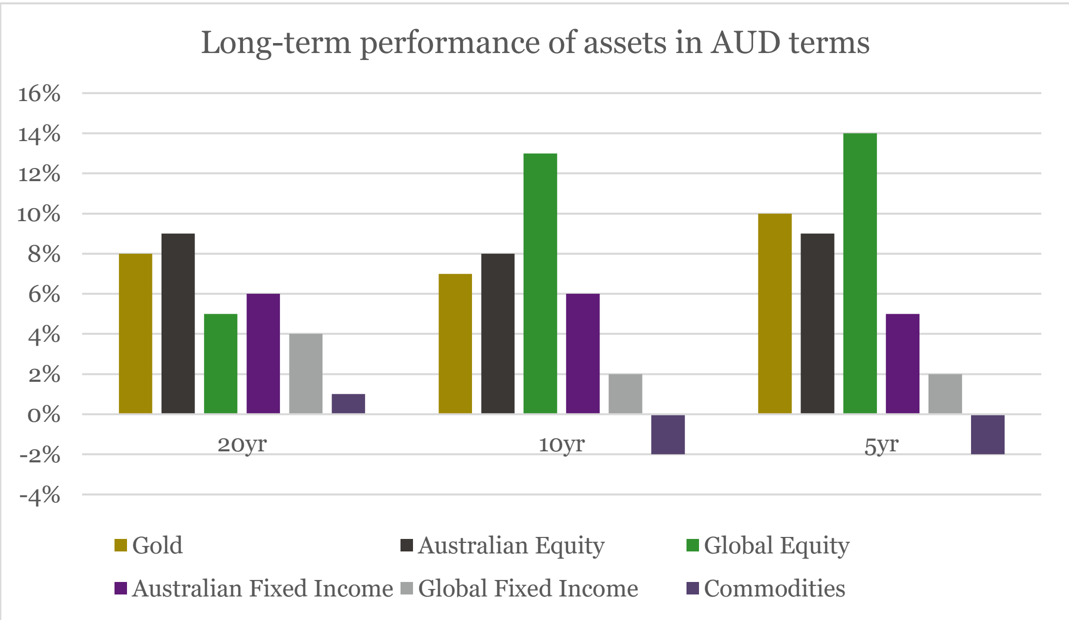


Chart 1. Source: Bloomberg data as at 30 September 2019. Returns shown are compounded annual growth rates. Australian Equity is represented by the S&P/ASX 200 Total Return Index. Global Equity is represented by the MSCI World Total Return Index. Australian Fixed Income is represented by the Bloomberg AusBond Composite 0+ Yr Index. Global Fixed Income is represented by the Bloomberg Barclays Global Aggregate Total Return Index. Commodities are represented by the Bloomberg Commodity Total Return Index.

4. Gold helps diversify your portfolio when you need it most

Over the long-term gold has close to zero correlation with share markets. This is good for investors. Uncorrelated assets provide diversification and help improve returns or reduce risk within a portfolio. Table 1 shows correlations between gold and other major asset classes over 20 years and you can see that gold generally has low correlations with other assets. It tends to be negatively correlated with equities, while being mildly positively correlated with bonds and commodities.

	Australian Equity	Global Equity	Australian Fixed Income	Global Fixed Income	Commodities
Correlation	-0.29	-0.12	0.37	0.06	0.31

Table 1. Source: Bloomberg data as at 30 September 2019. Correlations are calculated monthly over 20 years in Australian dollars. Australian Equity is represented by the S&P/ASX 200 Total Return Index. Global Equity is represented by the MSCI World Total Return Index. Australian Fixed Income is represented by the Bloomberg AusBond Composite 0+ Yr Index. Global Fixed Income is represented by the Bloomberg Barclays Global Aggregate Total Return Index. Commodities are represented by the Bloomberg Commodity Total Return Index.

Not only has gold's correlation with share markets been low, it has the nice property that it has tended to become more negative when stock markets are falling. Chart 2 shows the correlation between gold and global equities separately considering periods where the equity returns are positive, and then negative. This contrasts with other uncorrelated or "alternative" assets that became highly correlated with stock markets during the GFC. Not only does gold benefit from safe-haven buying during times of market stress, unlike most other financial assets, it has no element of credit risk, which immunises it from extreme market dislocations.

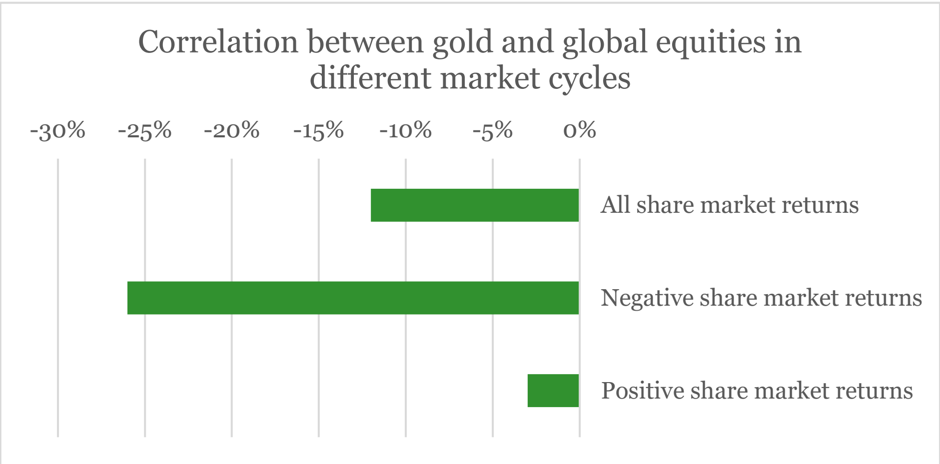
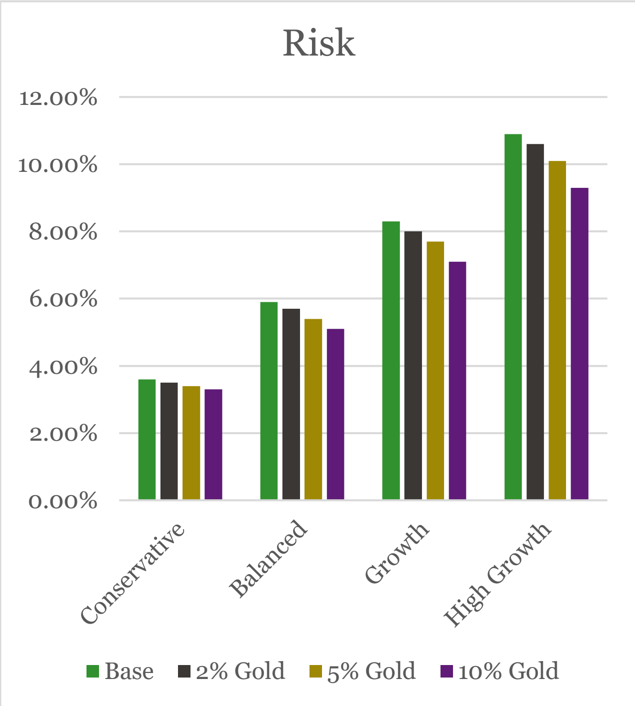


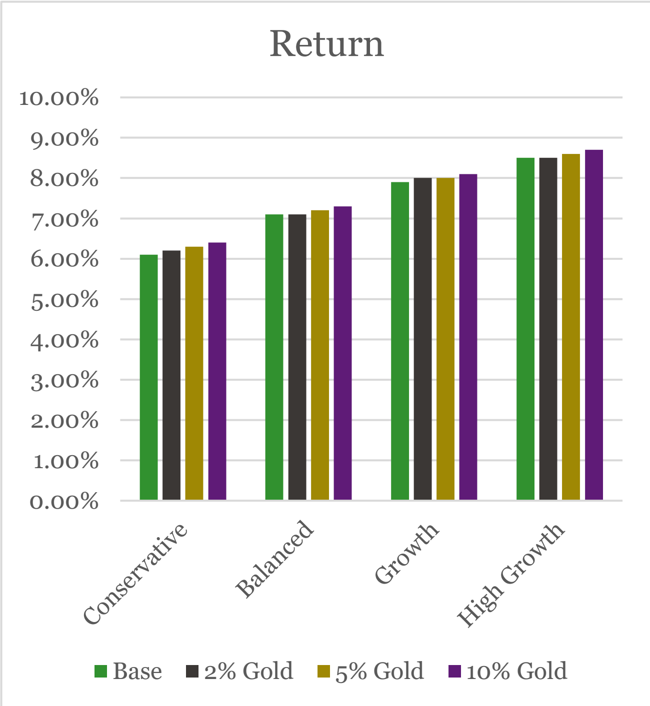
Chart 2. Source: Bloomberg data as at 30 September 2019.

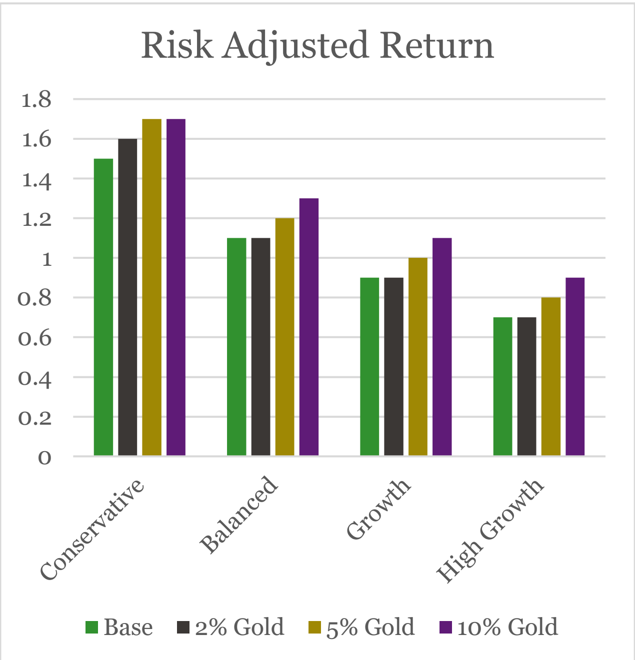
5. Gold can improve risk-adjusted returns over the long-term

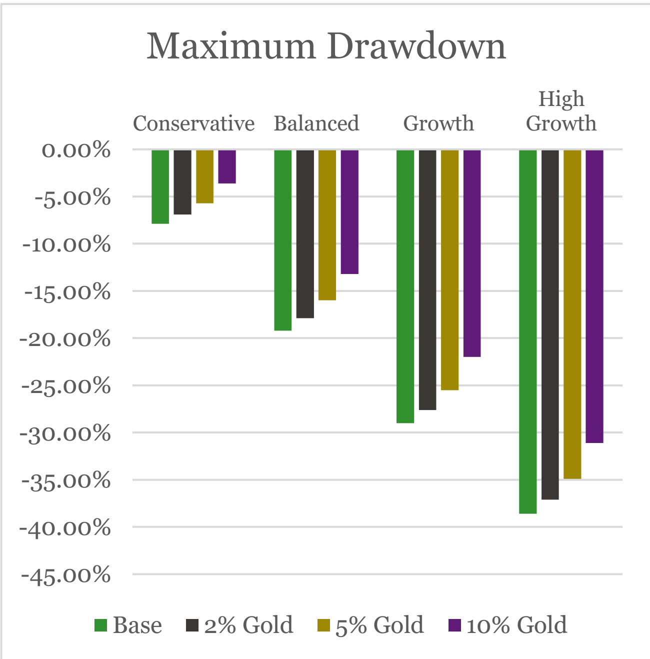
To demonstrate the impact that a core gold position can have in a portfolio, we have simulated adding a gold holding to a collection of typical asset allocation models that include Australian and international equity and fixed income assets with four different allocations representing Conservative, Balanced, Growth and High Growth profiles.

Charts 3 - 6 below show the outright return, volatility or risk (measured by standard deviation), maximum drawdown or biggest loss and the risk-adjusted return (measured by the Sharpe ratio) for each asset allocation portfolio and for each portfolio with the addition of 2%, 5% and 10% gold.









Source: Morningstar Direct data from 31 March 2003 to 30 September 2019. Conservative, Balanced, Growth and High Growth portfolios are represented by the Vanguard LifeStrategy funds, which have been live since February 2003 or longer. Gold is represented by ETFS Physical Gold (ASX: GOLD), which has been live since March 2003. Figures quoted are in Australian dollars and are net of fees.

What we observe is that the addition of gold to an otherwise diversified portfolio has aided performance in every case. Outright returns are higher and increase as the gold allocation is increased. From a risk perspective, however, the impact of gold is even more important. The addition of gold reduces risk through gold's ability to provide diversification. Risk-adjusted returns are higher and importantly drawdowns, or worst-case scenarios, are significantly improved.

Product in Focus: ETFS Physical Gold (ASX Code: GOLD)

Backed by physically allocated gold, GOLD is an Exchange Traded Commodity ("ETC") that can be created and redeemed on demand (by market makers). It trades on the ASX just like an equity, is settled and held in ordinary brokerage accounts, and its pricing and tracking operates similarly to an exchange traded fund.

Name	ETFS Physical Gold
ASX Code	GOLD
Management Fee	0.40% p.a.
Benchmark	LBMA Gold Price PM
Inception Date	28/03/2003

GOLD Factsheet
GOLD Product Page

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