The Frontier Line

Thought leadership and insights from Frontier

Issue 179 | **July 2021**

A golden conundrum

Why investors are weighing up the most prized element

frontieradvisors.com.au

frontier

About us

Frontier has been at the forefront of institutional investment advice in Australia for over twenty five years and provides advice over more than $470 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Nicholas Thomas

Senior Consultant

Nicholas Thomas is a Senior Consultant and member of the Capital Markets and Asset Allocation team, having joined the firm in 2019. Nicholas has over 15 years investment experience across Lonsec, Russell Investments, and MLC. His most recent role was as a Senior Consultant at Lonsec where his responsibilities included leading the review of capital market assumptions and strategic asset allocation, making dynamic asset allocation recommendations, and constructing multi-asset and sector portfolios. Nicholas holds a Bachelor of Economics from Monash University, a Bachelor of Music from the University of Melbourne, a Masters of Applied Finance from Macquarie University, and is a CFA Charterholder.

Chris Trevillyan

Director of Investment Strategy

Chris Trevillyan is the Director of Investment Strategy at Frontier having joined the firm in 2004. His responsibilities at Frontier include leadership of the Capital Markets and Asset Allocation Research Team, providing consulting support to Frontier's clients, and involvement with investment and manager research. Chris is the Chair of Frontier's Investment Committee and oversees the firm's investment strategy research program. He has previously filled the leadership roles of Frontier's infrastructure specialisation team and Quantitative Solutions Group. Prior to Frontier Chris was employed by Primary Superannuation Services as a Finance and Business Associate working with industry superannuation funds, and spent time working in London with Close Brothers and Granville Baird private equity firms. Chris holds a Bachelor of Commerce from the University of Melbourne, is a qualified CPA and has completed a Master of Applied Finance at the University of Melbourne.

frontier

Introduction

Gold is a unique investment asset.

It generates no cashflow yet has delivered a real return over very long timeframes. It is recognised as a safe haven but can also experience significant falls in value. It can help offset rising inflation over the long-term, yet its short-term relationship with inflation is mixed.

There is a long history and fascination with gold that remains intact. Investors are increasingly thinking about gold's merits in an environment of ultra-low returns, potentially rising inflation, and economic uncertainty.

Investing in gold is purchasing an asset not based on a fundamental value. Gold's future expected return relies on investors' continued perception of gold as a precious metal and store of value. This belief could change at any time, however, it has persisted for thousands of years.

This report considers the history of gold, what drives the price of gold and how it has performed in different market environments.

frontier

Why invest in gold?

Unlike most other commodities, gold has limited industrial uses: most of the world's stockpile is held by central banks and private investors.

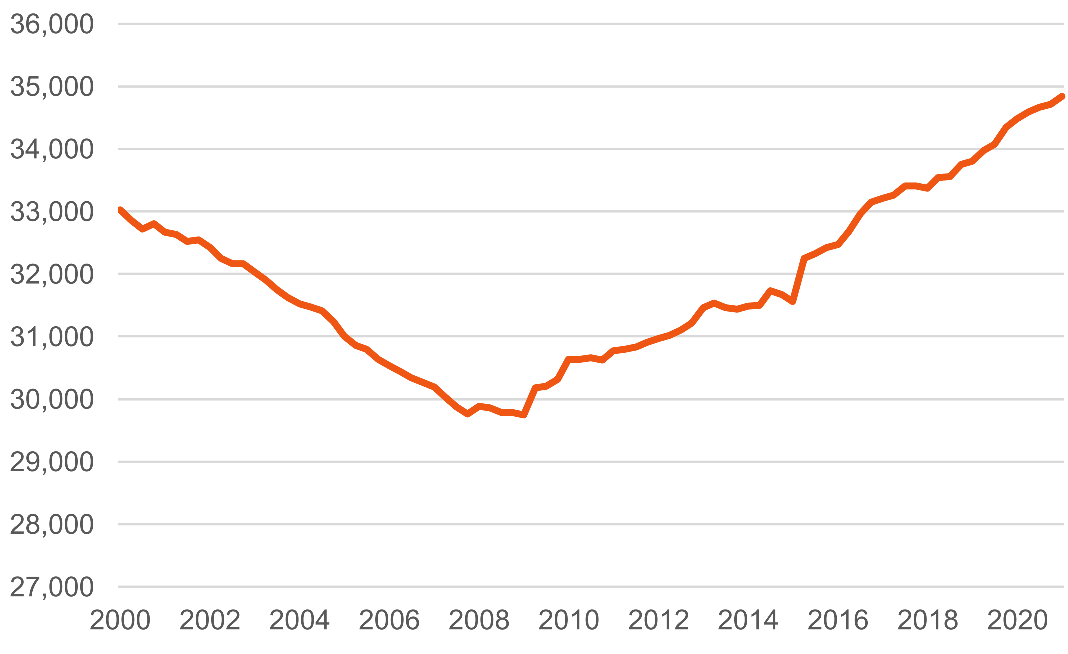
Retail investors are increasingly investing in gold via exchange-traded funds, with the first mainstream gold ETFs launched around 2003. Some of this demand has been driven by speculators, but also deep-seated beliefs that gold has an intrinsic value and can act as a safe haven in troubled times.

However, gold price volatility is high, similar to equities, and heightened during periods of rapidly rising inflation, such as the early and late 1970s, or changing inflation expectations, such as the mid-1980s.

Gold's performance has been largely uncorrelated with major asset classes. It has historically often provided some downside protection during equity market drawdowns.

Central banks have, in aggregate, been net buyers of gold since the global financial crisis in 2008, reversing a trend of selling down their gold reserves through the 1980s and 90s. One reason has been the diversification it offers. Geopolitical interests also play a role with some central banks, such as those in China and Russia, buying gold to lower their reliance on the US dollar within foreign reserves.

Chart 1: Aggregate central bank gold holdings (tonnes)



Source: World Gold Council

Institutional investors have generally had little investment in gold because it provides no yield, unlike equities or bonds, and is therefore difficult to value. However, prospective returns from traditional asset classes are low and rising inflation expectations mean more investors are considering if an allocation to gold should be considered.

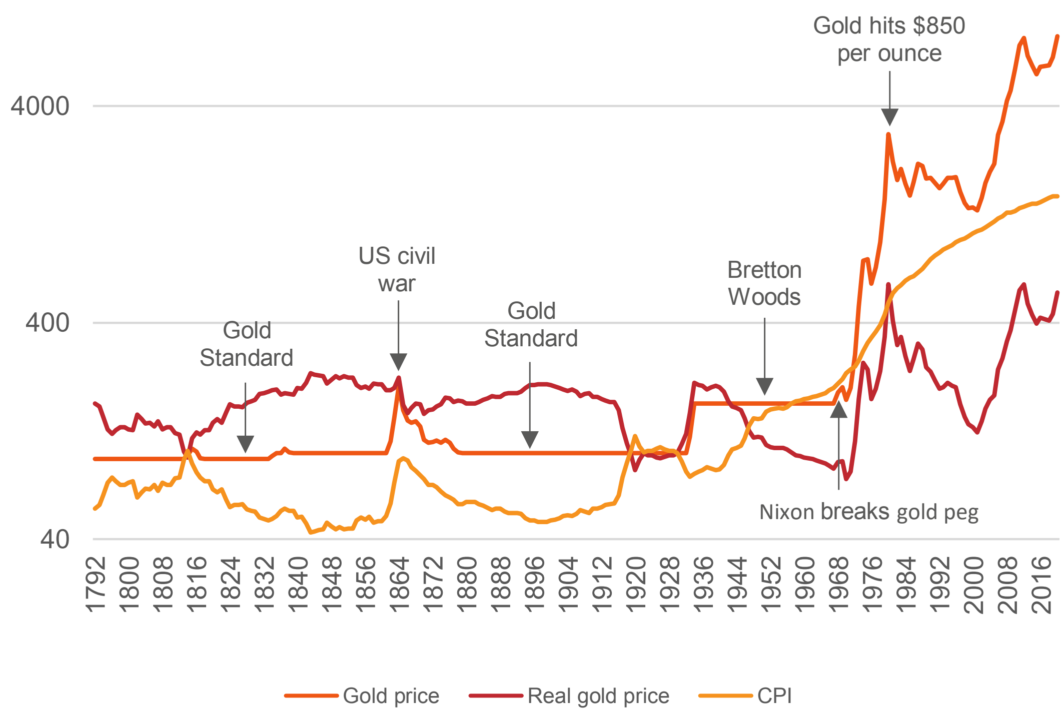
Deep-seated beliefs about the investment characteristics of gold suggest it could play a role in a portfolio. Can it act as a safe haven during market turmoil, an inflation hedge, and portfolio diversifier?

A short history of gold

Gold has served as a store of wealth and a medium of exchange for thousands of years. This was explicitly the case when the asset was used to back the value of currencies. A gold standard existed throughout most of the 19th century, and the Bretton Woods system from 1944 to 1973.

During periods in which the gold price was fixed, purchasing power was preserved because over long periods prices would move away then revert back to the prevailing gold price.

Chart 2: Index of USA nominal gold price, real gold price, and CPI, 1792 - 2020



Sources: Lawrence H. Officer and Samuel H. Williamson, 'The Price of Gold, 1257-2014,' MeasuringWorth, Eikon Refinitiv, Frontier

The fixed relationship between currencies and gold initially formed the foundation of the international currency system and the US dollar's status as a reserve currency. The Bretton Woods system created the status of the US dollar as a reserve currency. It meant that currencies were pegged to the US dollar since it was convertible to gold (at a rate of US$35 per troy ounce).

Inflationary pressures and economic instability eventually caused the US to 'de-peg' the dollar. Two years later, the Bretton Woods system was dead, currency was no longer backed by gold, and countries began floating their currencies.

Since then, the gold price has fluctuated dramatically, driven by several competing factors. But its power as an attractive precious metal and its bespoke ability to remain a store of value make it still an important asset today.

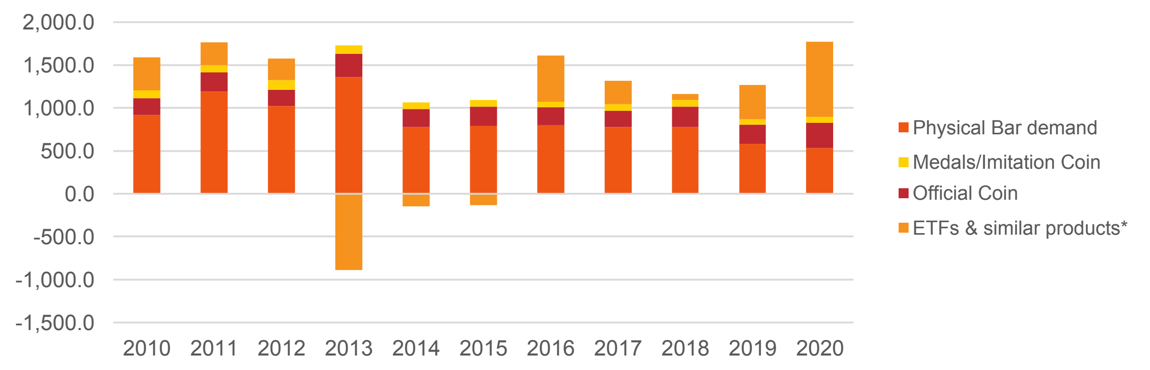
Unique characteristics drive the price of gold

Gold displays both currency and commodity characteristics and cannot be valued using common methods (such as discounted cashflows) because it generates no cashflows. It is similar to a commodity because it is a raw material of value that can be bought and sold, but it has limited industrial purposes and acts more as a store of wealth.

But unlike currencies, it is not issued by a central bank, has no counterparty exposure, and cannot be debased through increasing supply. It can, in this sense, be considered a global currency. The supply of gold is generally stable, meaning its price is ultimately driven by demand. The above-ground stocks of gold have tended to consistently increase by just 1.5% to 2% each year.

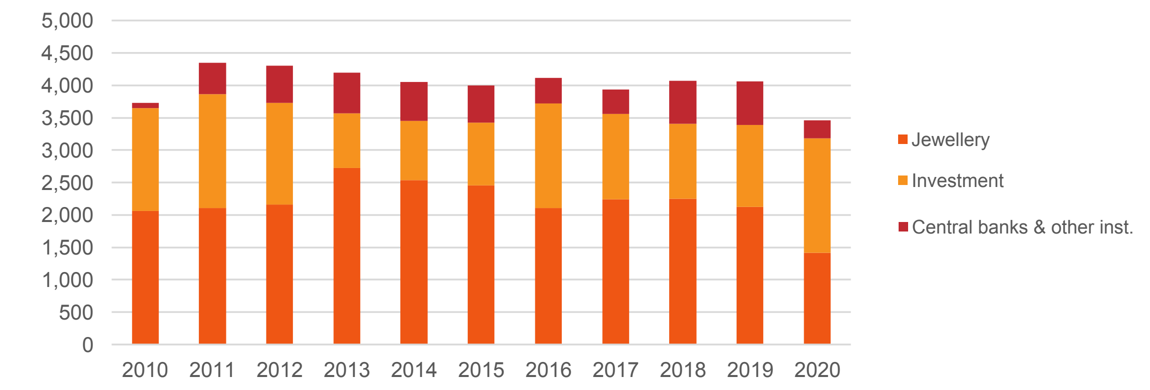
This demand for gold is based on the belief it is intrinsically valuable – it has little industrial use beyond decorative jewellery. While jewellery accounts for around half of global gold demand, investors generally drive the price volatility.

Chart 3: : Investment demand by sub-type



Source: World Gold Council

Chart 4: Gold demand composition



Source: World Gold Council

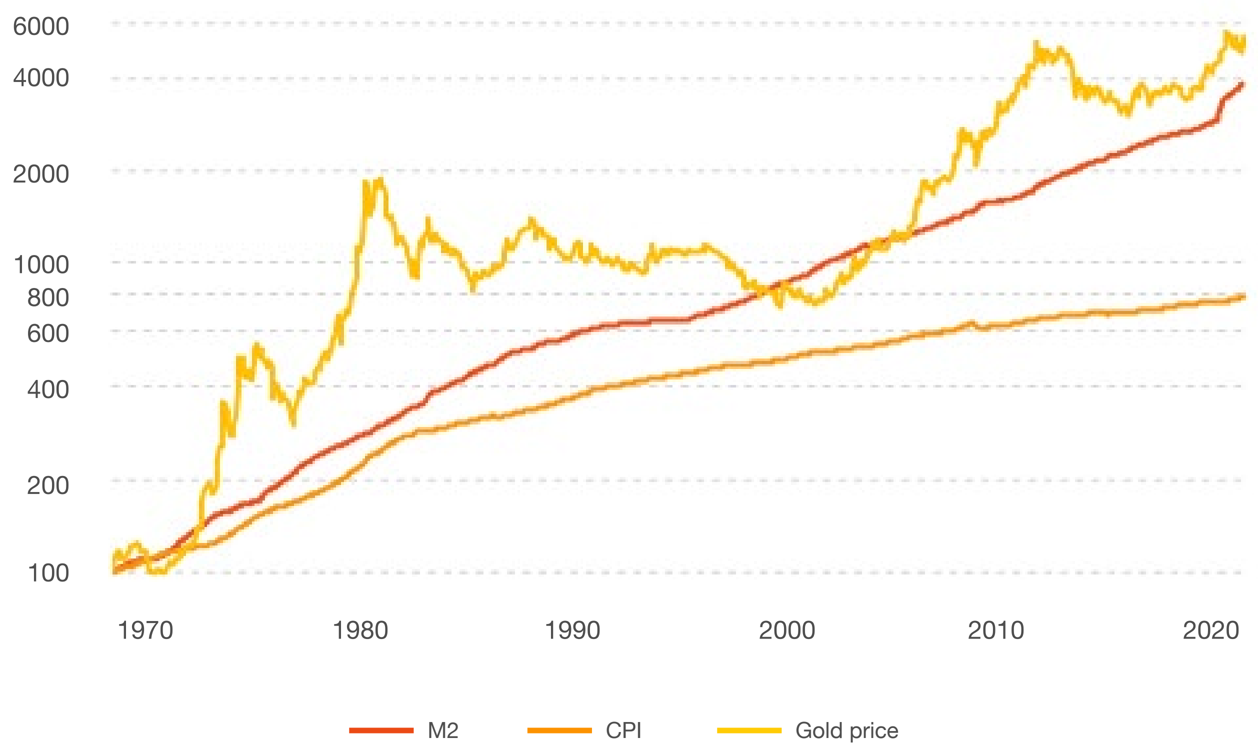
The characteristics of gold make it difficult to value and predict price movements, but links emerge over the long term across:

- money supply growth
- moves in the US dollar and real bond yields
- real and expected inflation.

Money supply growth

There appears to be some link between changes in the money supply and the price of gold over the long-term. Rapid money supply growth in the 1970s was associated with an increase in inflation and the price of gold. The stabilisation of money supply through the 1980s and early 1990s coincided with a decline in the gold price which lasted until around 2000. More recently, government response to COVID-19 has resulted in a level of money supply growth not seen since the 1970s. This could potentially be supportive for gold prices in the medium term.

Chart 5: Change in US money supply, inflation and gold price, 1970-2021 (indexed to 100)



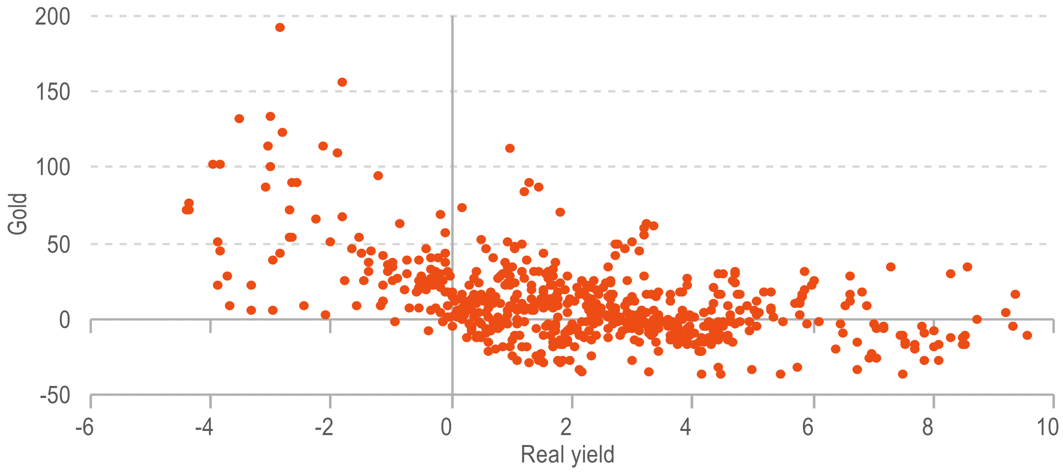
Sources: Refinitiv Datastream

The US dollar and real bond yields

There has been a fairly reliable relationship between the price of gold, the value of the US dollar, and real yields.

Since 1970 periods of negative real yields have generally been associated with increases in the gold price.

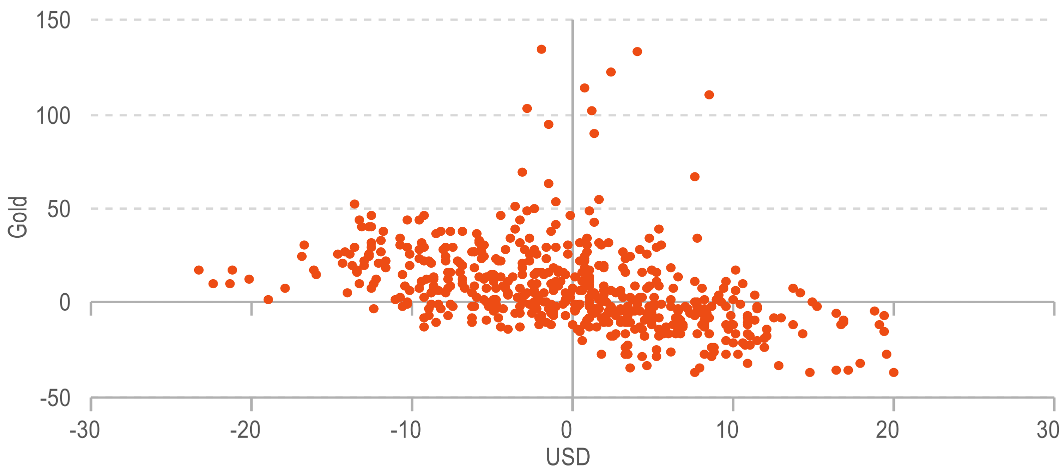
Chart 6: Real 10-year bond yield versus annual gold return 1970-2020 (%)



Sources: Refinitiv Datastream

Conversely, periods of US dollar strength have tended to be associated with lower gold prices.

Chart 7: USD v gold price 1970-2020 (annual change, %)



Sources: Refinitiv Datastream

A mixed record against inflation

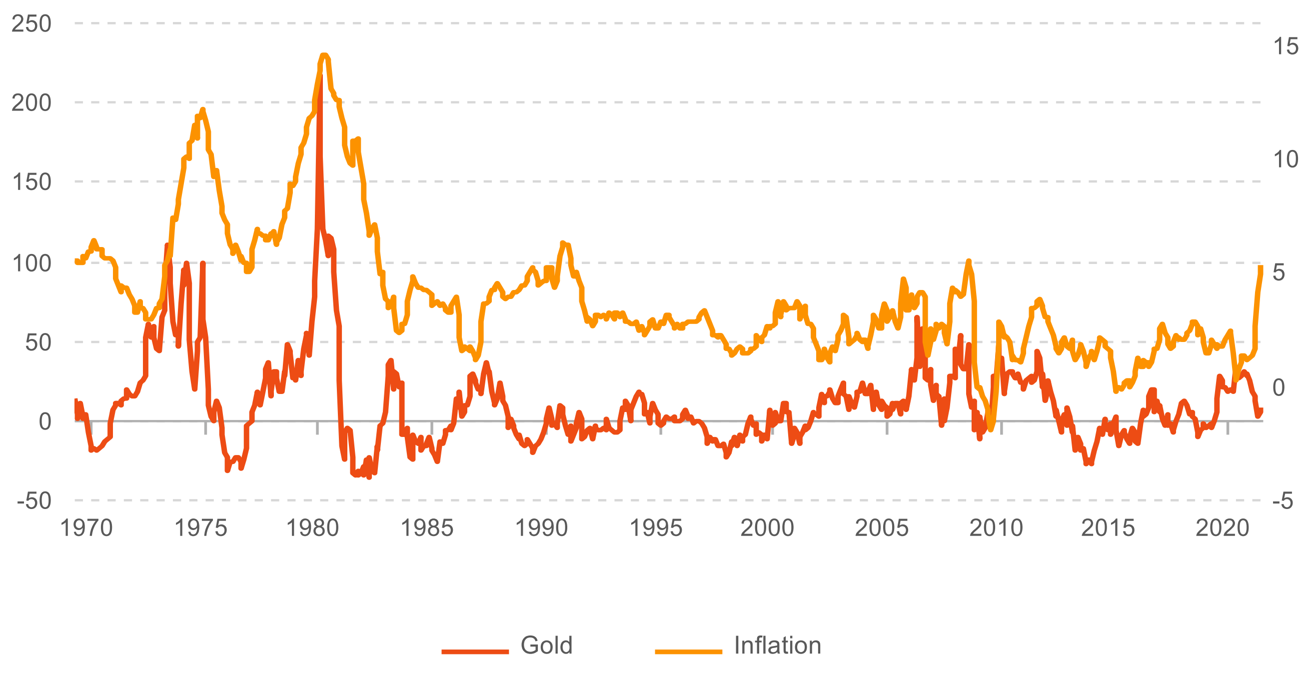
Gold has long held a reputation as an inflation hedge. Unlike fiat money issued by governments, the ability to increase the supply of gold is constrained. Historically the supply of gold has been inelastic to the prevailing price, meaning supply increases tend not to change even during periods of high gold prices. This is one of its appeals as a store of wealth.

Gold's short-term relationship with inflation is mixed, given inflation expectations can change quickly and are often built into the gold price ahead of actual inflation movements.

Overall gold did steeply increase in value when inflation climbed in the 1970s, however this was not consistent, and it went through periods of sharp declines well ahead of actual declines in inflation.

There has not been a sustained period of deflation since gold was defixed in 1970, however, it performed poorly from the late 1980s around the end of the tech bubble, when inflation was positive but consistently declining.

Chart 8: Gold price v US inflation (rolling 12-month change %)



Sources: Refinitiv Datastream

Can gold offer protection during a crisis?

Gold's liquidity, acceptability across nations and its portability are each qualities that are perceived to make gold an effective hedge against crises such as foreign occupation or threatened economic collapse.

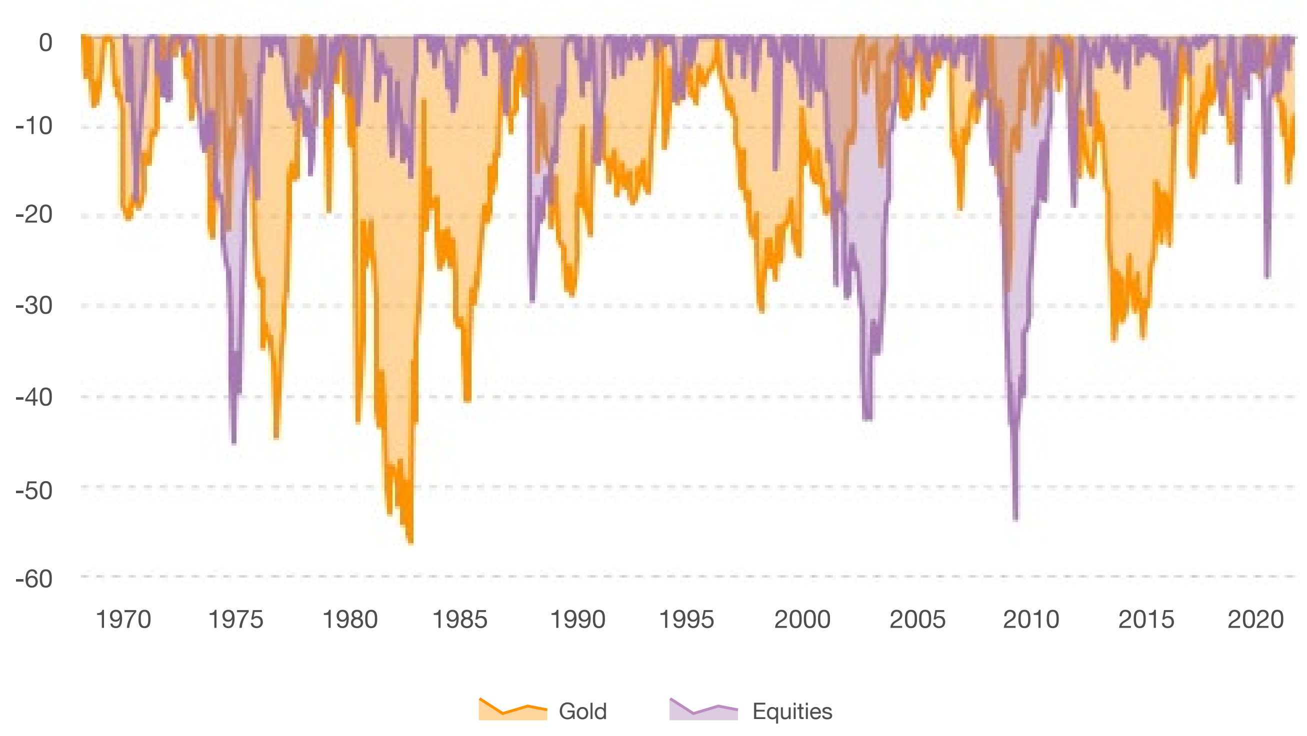
Yet gold's capital preservation record during significant equity market drawdowns is somewhat mixed.

Gold prices may not necessarily hold up well during all crises. For example, gold did not perform well during the GFC as investors sold off quality assets to cover losses on 'junk' positions. Government bonds performed better as a crisis hedge.

Gold is likely to provide better portfolio protection if confidence in fiat money (such as the US dollar or the Euro) declines or during periods of heightened sensitivity to sovereign risk.

This is where gold's inability to generate cashflows is a benefit: it has no counterparty that could default.

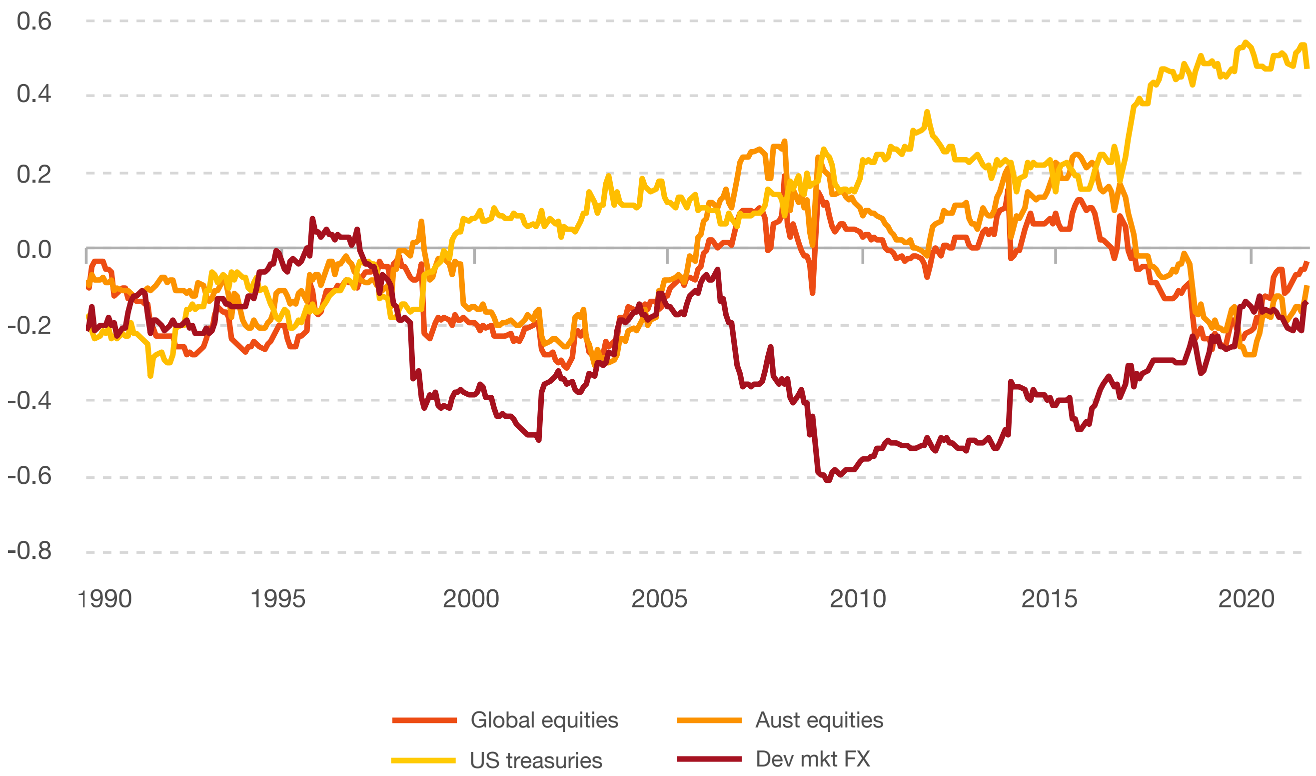
Chart 9: US equities versus gold drawdowns (%)



Sources: Refinitiv Datastream

Despite its limitations, gold offers the potential for diversification benefits. Its performance is lowly correlated with most major asset classes such as Australian, global, and emerging market equities, as well as sovereign bonds and global currencies.

Chart 10: Gold correlation with other asset classes (5-year rolling)



Sources: Refinitiv Datastream

Return expectations for gold

Gold's unique characteristics make it challenging to forecast an expected return profile. Its worth is intrinsic given it generates no cashflows – if investors decided gold was 'worth' half its current level, it would be.

However, gold has historically held its purchasing power and delivered a positive real return over the very long-term. Investing in gold relies on gold, having held its store of value for thousands of years, continuing that in the future.

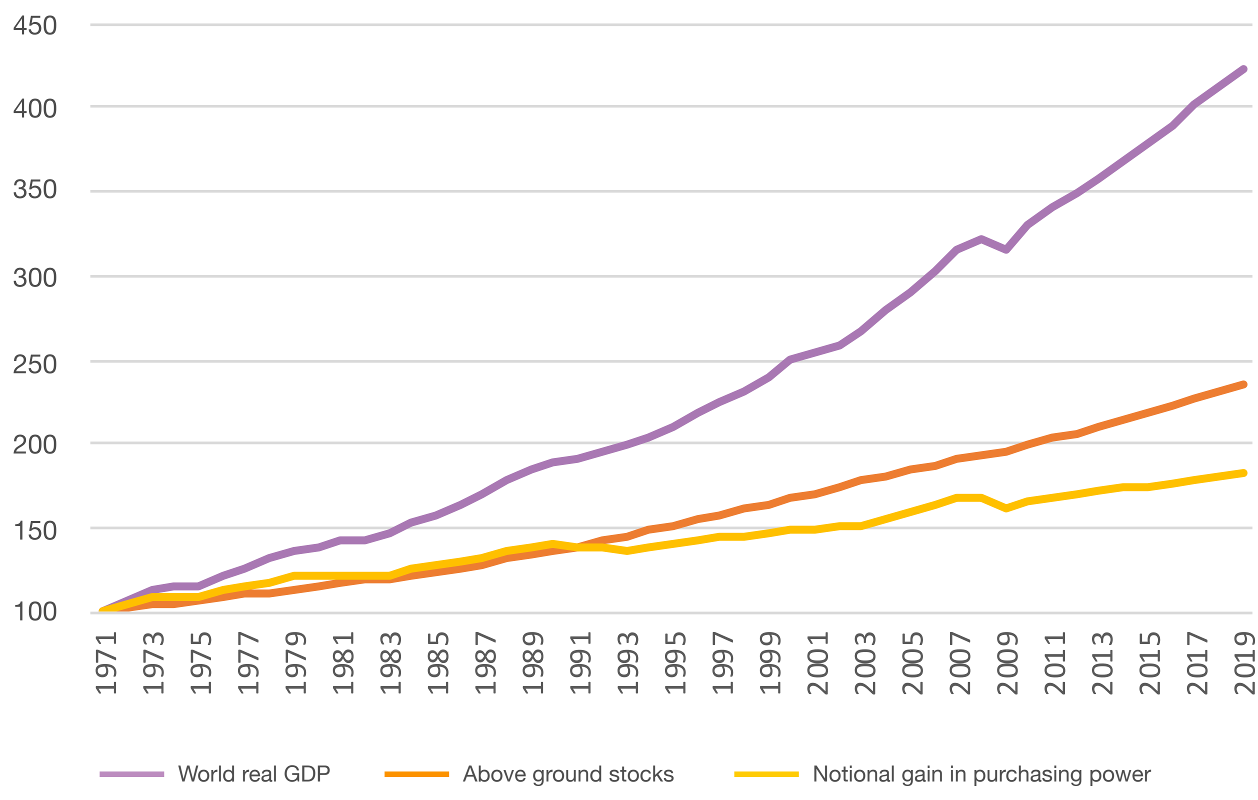
If we express gold in terms of its global purchasing power, its value is driven by two main factors:

- the above ground stock of gold (supply)
- world real GDP (what can be purchased with the supply).

If gold's purchasing power remains constant over the long term, it should generate a real return to the extent that global real GDP grows faster than above ground stocks. That is, that global real GDP grows faster than the 1.5% to 2% that above ground stocks of gold have tended to increase annually.

We expect gold to outperform CPI by a small margin over the very long term (our long-term assumption is 1% per annum). This is less than our assumption that cash will deliver CPI plus 2% over the very long-term. However, in the near-term our expectation is cash will not deliver that excess return to CPI, in fact we assume cash will deliver a negative real return over the next ten years. This potentially makes gold a more interesting investment prospect.

Chart 11: Growth in world GPD and above ground gold stocks (indexed to 100)



Source: GoldMoney Foundation (above ground gold stocks), Eikon Refinitiv, Frontier

The final word

Gold has fascinated, and been highly valued by, civilisations for thousands of years. It still holds a deep-seated attraction for investors today although its investment characteristics are unlike other assets.

Its worth is intrinsic, it is not reliant on a counterparty that can default in times of crisis. But this also means it generates no cashflows.

While many people say gold is a relic and should not be considered in modern investment portfolios, it has held a position as a store of wealth for several thousand years.

While it has delivered a positive real return over long time frames, its price is highly volatile, and it will not always act as an inflation or crisis hedge, despite its reputation.

Over the very long-term, Frontier expects gold to retain its purchasing power and outperform the rate of inflation (CPI) by a small margin. But the lack of an underlying fundamental value for gold makes it difficult to recommend investment in the asset. The real price of gold is currently near historic highs, suggesting caution investing today. But, given the expensiveness of traditional asset classes and the expectation of negative real yields from cash, the potential diversification benefits of gold are attractive.

The allure of gold remains.

Want to learn more?

We hope this paper has generated lots of ideas for your own portfolios. If this is the case, please reach out to Frontier to discuss how we can work with you to use in this space.

frontier

Frontier

Level 17, 130 Lonsdale Street, Melbourne, Victoria 3000

Tel +61 3 8648 4300

Frontier is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266