Winning gold: Bullion as a portfolio diversifier

Percival Stanion explains why gold represents a valuable hedge and portfolio diversifier

Gold holds an important position in investment portfolios these days as a diversifying and hedging asset. But this hasn't always been the case for what John Maynard Keynes called a "barbarous relic".

One of the seismic side effects of the global financial crisis was to resurrect an investment case for gold, an asset long derided by mainstream asset managers.

Before the crisis, gold was indeed a poor investment. Warren Buffett once pointed out that it is dug up in Africa, shipped half way across the world only to be sunk back into the ground in a heavily fortified bank vault. Gold doesn't generate an income, is too unwieldy to be used as money and incurs storage and insurance costs.

But since then, repeated bouts of severe market turmoil, concerns about systemic financial crises and rising political risk have all helped to make a case for owning gold, not least thanks to its shock absorbing properties. As Dirk Baur and Brian Lucey at Dublin City University and Trinity College Dublin respectively have argued that gold is a moderate hedge against equities and bonds during normal market conditions, becoming a very good hedge in times of crisis, albeit for short periods.

This is an attribute investors should prize right now. In a world of unorthodox central bank policies, where a third of developed economy government debt posts a negative yield, where income generated by bonds is in many cases so paltry that investors peg all their hopes on capital appreciation, where financial and political crises follow each other like buses, gold's defensive qualities come into their own.

Gold's ability to mitigate the impact of market upheavals owes much to its distinctive correlation with other asset classes. Most of the time, the precious metal is marginally more correlated with bonds than equities but not particularly correlated with either. But in times of market stress, it becomes more negatively correlated with equities, giving investors useful protection against bouts of risk aversion. Over the past five years, gold, among other major asset classes, has had one of the lowest correlations with global equities according to our propriety risk indicator.

Adding gold to a typical investment portfolio with an initial 60 per cent allocation to equities and 40 per cent to bonds would over the past decade have reduced volatility – thus improving the portfolio's Sharpe ratio – and would have lessened peak to trough falls and lowered worst losses in slumping markets. Its persistently low correlation with equities would have provided diversification benefits. Indeed, a 10 per cent holding in gold (and proportional reduction of equities and bonds) since the start of 2007 would have improved a portfolio's annual returns and lowered its volatility by half a percentage point, according to our analysis.

Gold also acts as insurance against potentially damaging effects of policy errors. Ultimately, ever more extreme monetary measures will trigger inflation. And when inflation finally arrives, there's a substantial risk that central banks will be reluctant to step on the brakes for fear of causing another severe recession. Although gold's performance as an inflation hedge has been mixed over some periods, it has been a useful store of value during periods of very high inflation such as during the 1970s. Which is why it tends to be seen as a barometer of expectations about future price pressures. As Alan Greenspan argued when he was chairman of the Federal Reserve, "the price of gold… can be broadly reflective of inflation expectations".[1]

Currently we have over 6 per cent of our fund in bullion and nearly 2 per cent in gold mining stocks.[2] We have built up a position in the miners because they'd become very cheap after suffering a multi-year bear market.

Of course, there are potential risks to holding gold. In extreme circumstances, authorities may try to restrict its use. There is a precedent. In 1933, US President Franklin Roosevelt issued an executive order forbidding "the hoarding of gold coins, gold bullion and gold certificates", and furthermore that almost all gold was to be sold to the Federal Reserve.[3] But for the ordinary spectrum of bad economic outcomes – high and rising rates of inflation that central banks find themselves unable to control, market meltdowns and financial crisis of the type we've experienced over the past few decades – gold represents a valuable hedge and portfolio diversifier.

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[1]"The Fed Aims for Price Stability," Challenge, vol 36, no 5 (September/October 1993), p. 5.
[2]Holdings in the Pictet Sicav II – Dynamic Asset Allocation Fund as at 09.09.2016.
[3]https://fraser.stlouisfed.org/docs/meltzer/bogsub040233.pdf