Going for gold as a diversifier in DC portfolios

Faced with higher inflation, hawkish central banks and record-low bond yields, DC investors face a dilemma when selecting effective diversifiers that reduce portfolio volatility and enhance risk adjusted returns of members. But a new white paper suggests how an allocation to gold could play a supportive role in DC asset allocation

The uncorrelated returns generated by equities and bonds have been a feature of markets for the past 15 years, as central banks maintained ultra-low interest rates and quantitative easing continued unabated.

This has meant, historically, that government bonds have been used by defined contribution (DC) investors as a diversifier alongside an allocation to riskier assets, such as equities. However, a new white paper published by the World Gold Council argues that, given a combination of macroeconomic factors, investors should rethink this traditional diversification mix and consider including an allocation to gold in DC portfolios.

The threat posed by inflation

For context, high-quality government bonds – such as UK gilts – earned their place in retirement portfolios as a defensive asset that compensated investors generously, given the bull market in sovereign bonds.

But the macroeconomic backdrop against which DC portfolios are invested today is in stark contrast, the World Gold Council warns. Persistent inflation and growing geopolitical threats have prompted central banks, including the US Federal Reserve and Bank of England, to adopt a more hawkish stance and both have plotted several interest rate rises for this year. Yet, bond yields remain low in real terms compared to historical levels.

Perhaps the key finding for DC investors in the white paper is that when inflation is below 2%, global equities and global treasuries are negatively correlated, providing that much-needed diversification mix in portfolios. However, at inflation levels above 2%, this relationship "starts to break down".

In other words, government bonds are no longer the so-called 'safe-haven' asset they once were.

Gold – onto a winner?

Yet, DC investors still need to achieve the right mix of asset classes to create a well-balanced portfolio that will see their scheme members through accumulation, up to retirement, and beyond.

This, the World Gold Council explains, is where gold comes in, given that it acts as both an effective diversifier and a hedge against inflation, currency depreciation and systemic risk.

Among the precious metal's other key features is its ability to act as a store of wealth, deliver positive returns and provide liquidity during periods of market stress. A key point made in the white paper's analysis highlights that, as the sell-off in equities and other risk assets increases with market uncertainty, gold's negative correlation to those assets increases concurrently.

So far, so good – gold seems to have all the characteristics that investors require from a diversifier and at a time when these are "sometimes hard to find". But the inflationary environment is creating a more acute issue for those DC members in the decumulation phase of their journey. Inflation left unchecked will quickly erode the real value of members' savings and may affect their investment goals and retirement plans.

Here, too, gold can play a role, as the data shows that the precious metal delivered an annualised nominal return of 9.1% in sterling terms over the past 50 years, outpacing both the UK and world consumer price indices, which measure the prices of goods and services.

In a case study, the World Gold Council sets out at what part of the DC investing journey an allocation to gold can be most beneficial – typically, at the 'consolidation' and 'retirement' phases, when members are more risk averse.

Their case study analysis used long-term asset class forecasts and assumptions around starting salary, salary increases and contributions to project a range of potential pension outcomes for a glidepath with and without gold. These forward-looking projections provided the following key insight: a 5% allocation throughout retirement could provide a more secure income in retirement as a portfolio following a glidepath with gold will exhaust its assets after a portfolio without gold. Ultimately, the white paper concludes that adding gold to traditional portfolios comprising allocations to equities and bonds is likely to appeal to DC investors. As they and their members brace for further risks on the horizon, gold alongside other effective diversifiers could help provide resilience to portfolios by providing diversification that works, protection against high and extreme inflation and enhancing risk-adjusted returns.

To view the paper, please visit www.gold.org/goldhub/research/market-update/case-gold-dc-asset-allocations

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