GOLD AND TAILS OF THE UNEXPECTED

In terms of investment seasons, 2011 saw more than you would expect over several years.

The year began with hope. After initially strong market performance early in the year, partly based on the expectation of a return to a more stable growth path for the US economy and resynchronised global economic growth, a number of events led to heightened levels of market volatility which have eroded both wealth and confidence.

Firstly, the Arab Spring intensified significantly in Egypt, Libya, Bahrain and Syria causing concerns over the prospect of continued destabilisation across the Middle East and North Africa. Then, in March the earthquake, tsunami and subsequent nuclear crisis in Japan wiped 6% off the Japanese economy and affected growth more widely. Add to this a summer of ongoing spasms in the Eurozone crisis, the possibility of sovereign debt defaults, a US debt downgrade to AA+ and one can see why investors had little to calm their nerves.

These waves of disruption have had the effect of destabilising financial markets and increasing asset volatility; further testing investor resolve.

For most, 2011 served as a sharp reminder that while systemic risk (so-called 'tail risk' events) is not necessarily expected or likely, the unexpected which impacts financial markets can seriously erode capital. Tail risk is the higher-than-expected risk of an investment moving more than three standard deviations away from the mean, but it really refers to events that are of very low probability but can have substantial, negative impact on an investors' capital.

In his 2007 bestselling book, The Black Swan, Nassim Nicholas Taleb refers to the disproportionate effect of rare and unpredictable events, such as Black Monday in 1987, and asserts that rather than try to predict the unpredictable, it's possible to protect against negative events that occur and potentially exploit positive ones.

The positive outcome of recent conditions is just that. Investors have refocused their attention on assets that offer downside protection and will preserve wealth, whatever the prevailing economic climate. They are thinking ahead to the unthinkable. In periods of economic expansion, especially prior to 2007, many investors concentrated on return seeking strategies at the expense of incurring higher risk. While these kinds of strategies may prove effective in some periods, recent events continue to put these actions in perspective and highlight the need for assets that can offer downside protection and help investors hedge against 'tail risk', without dampening returns in sunnier climes.

One such asset is gold, which in contrast to many assets and the purchasing power of many currencies, typically remains remarkably stable during periods of uncertainty. The combined effect of investors seeking out gold's wealth preservation qualities and resurgent demand for jewellery in gold's cultural heartland of China and India has enabled gold to prove its mettle once again and continue on its long-term trajectory.

So, the lessons learned during tough times, particularly in the aftermath of the financial crisis, have stoked investor demand for downside protection. The market has responded with a spate of tail risk strategies since 2008, particularly from the hedge fund community looking to cash in on unprecedented events which can hurt investor portfolios.

There are different ways to hedge tail risk, but a popular one among alternative asset managers is to create a basket of derivatives, which is designed to perform poorly in normal markets but soar when markets suffer any shocks.

These tail-risk products are often likened to insurance, where investors pay a premium each year in essence to avoid financial catastrophe later. This means that investors are in effect paying away performance every month, while they wait for an extreme event to occur. These strategies can also require a significant allocation (some suggest as high as 20%) in order to have the optimum impact on the overall risk/return profile of a portfolio.

Gold, on the other hand, can offer the same benefits as more exotic tail risk strategies, for a smaller allocation and without impacting overall portfolio performance in less volatile markets. Recent research from the World Gold Council; *Gold as a Tail Risk Hedge* shows that portfolios which include a modest, consistent gold holding have an improved risk/return profile while benefiting from downside protection during times of crisis for investors.

In the analysis the World Gold Council shows that during the period between October 2007 and March 2009—the height of the global financial meltdown—an investor with a portfolio of US$10 million experienced an additional US$500,000 financial loss simply by not maintaining a position in gold. The study used a composition similar to a benchmark portfolio[1] which included an 8.5% allocation to gold, to show that total losses incurred during the period reduced by 5% relative to an equivalent portfolio without gold. In 18 of the 24 tail risk scenarios[2] analysed by the World Gold Council, portfolios which included gold outperformed those which did not.

This behaviour is a direct consequence of the dynamics of the gold market: a market where the sources of demand and supply are diverse and complementary; where a ready, deep and liquid global market exists; and where gold is often viewed as an alternative monetary asset with no default risk. Indeed, gold's physical attributes and functional characteristics set it apart from the rest of the commodity complex. For example, the technology and industrial sectors account for a much larger portion of demand for most other metals, including silver. Therefore, gold is less exposed to swings in business cycles, typically exhibits lower volatility and tends to be significantly more robust at times of financial duress. In turn, this causes gold's correlation to other commodities and other asset classes to be low.

Commodity allocations have become more common among investors as another way in which diversification can be enhanced and portfolios can be made more robust, as well as providing a hedge against inflation or currency depreciation. While gold is often considered by investors as part of a larger set of commodities, its weighting in most commodity indices is small. Within

[1] A benchmark portfolio is considered to be one with a 50%-60% position in equities, 30%-40% in fixed income and 5-10% in alternative investments.
[2] In particular, the study concentrates on events that fall more than two standard deviations away from the mean

indices such as the S&P Goldman Sachs Commodity Index or the Dow Jones-UBS Commodity Index, for example, gold's weighting typically ranges between just 3% and 7%.

World Gold Council research also shows that if part of a commodity allocation is directly assigned to gold, portfolio performance is improved, while the potential for loss is reduced[3]. In 2008, an investor with an asset allocation similar to a simple benchmark portfolio (50% equities, 40% fixed income, 10% commodities) would have reduced portfolio losses by between US$200,000 and US$400,000 on a US$10mn investment by allocating 5% to 10% of the overall portfolio directly to gold and proportionally reducing the exposure to other commodities. These findings suggest that portfolio managers and investors who already have exposure to commodities in their portfolio stand to benefit by including gold as a separate strategic asset class, without compromising long-term returns.

Gold's ability to move independently of most assets usually held by institutions and individuals, and to hedge against inflation and currency fluctuations, means that it is highly effective as a preserver of long term wealth and should form a foundation of any long term investment portfolio. Gold's positive effects are not replicable by a commodity index and its ability to stablise wealth through in the darkest of days is compelling.

Put simply, it offers investors the confidence to invest in other risk assets to generate desired returns, especially in periods of economic uncertainty. With investment now the fastest growing category of gold demand investors are voting for these benefits with their feet.

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[3] Gold: A commodity like no other – WGC April 2011