

Schroders TalkingPoint



Why 'gold plus' is the way to play the gold rush

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Why the gold bull market should continue

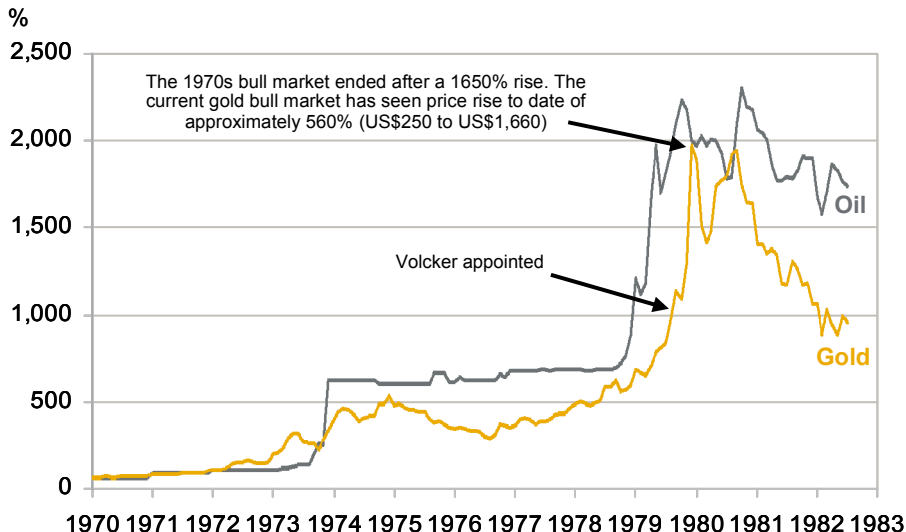
Gold has been in a bull market for ten years and we are often asked if this is a bubble. But in fact the rise in gold has been very civilised and it's still cheap compared to its historic inflation-adjusted high.

The chart below shows that in the 1970s gold prices rose a huge amount – by 1,650%. And gold gave its best performance in the latter stages of the bull market. By comparison in the current bull market the price has risen by 652% (\$250 to \$1,880) so far, and in our view there is further to go.



Incorporating other precious metals into the mix can also offer excellent diversification opportunities but the timing has to be right in order to maximise the benefits.”

1970s bull market



Source: Thomson Datastream

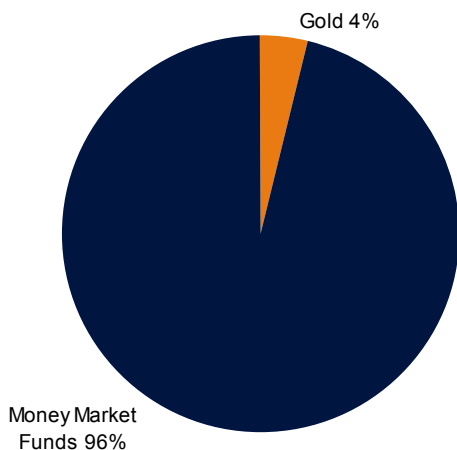
There are quite a few driving factors in place behind the continued rise in gold. First of all, it has a 'safe haven' status which is really coming into play amid the uncertainty surrounding the US deficit and US dollar, problems in the eurozone and geopolitical problems in the Middle East and North Africa. Gold is increasingly becoming seen as an alternative currency, as the euro and sterling come under pressure as well.



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Gold also performs well as a hedge against inflation, and when real interest rates are negative. Like many other investors, we believe we are now entering an inflationary era. Investors are already finding it more difficult to find assets which offer any positive real return with low risk – with returns from money markets typically being negative in inflation-adjusted terms. Consequently, private investors have started to turn to gold instead, and since gold ownership is still only tiny relative to the proportion of money market fund ownership (see the chart below), there is plenty of scope for this trend to continue.

Total global holdings in gold ETFs vs. US money market funds



Sources: UBS, ICI; WGC; ETFs; ZKB; Schroders – 31 March 2011

Indeed, the rise in private ownership of gold is increasing quickly as exchange traded funds (ETFs) have democratised the asset class, providing easy access – and recently central banks like Mexico, Russia and China, as well as sovereign wealth funds, have been buying gold for their reserves.

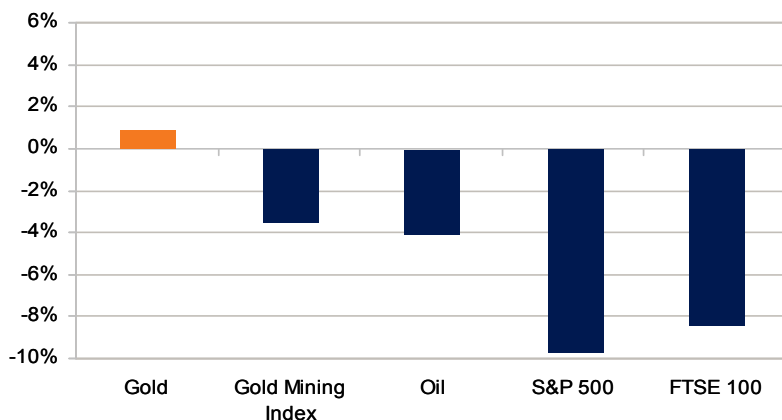
This is a change in trend from the last 20 years (when net official transactions were negative), and we believe it will continue as emerging markets have a long way to go before their gold reserves are comparable to those in developed markets.

Pension fund ownership of gold is also still at low levels, despite the fact that US pension funds have recently been allocating more to gold as a hedge against inflation.

The longer-term case

We think all investors should consider gold as a long-term strategic asset in their portfolios, because it performs well as a diversifier and can provide a form of portfolio insurance. In addition, gold has the lowest rate of annual volatility out of all the commodities. It also performs well relative to other asset classes when there are geopolitical shocks. The chart below shows the performance of gold when equities have suffered sharp falls.

Average monthly return during the ten worst falls in the S&P December 1998 to March 2011



Source: Bloomberg – 31 March 2011

Importantly, there is an imbalance between constricted supply and rising demand. The traditional producers (the US, South Africa, Canada and Australia) have seen declining production for years, as new discoveries diminish. South Africa for example is at its lowest rate of supply since 1932.

Challenges to the gold lining – what happens when interest rates rise?

Central banks are a long way behind the curve right now. But even if you think that they will start to raise rates more aggressively, there's still room for gold to go a lot further.

In the chart showing the 1970s bull market on the first page, you can see that even when Volcker was appointed to bring inflation under control in the US in the 1970s, and interest rates started to rise, gold continued to perform well. It took some time before the opportunity cost of owning gold (in other words, the rates of return on other assets) became too high.

Why a gold 'plus' strategy?

Precious metals continue to offer excellent diversification opportunities, the potential for strong returns, a low correlation to other assets, protection against rising inflation, as well as a natural hedge against geopolitical events. Schroders' Commodities team feels that we remain in a bull market for gold, and that one of the biggest opportunities lies in the ability to manage actively exposure between gold (ETFs and futures), gold related equities, other precious metals and cash.

A diversified approach

The historical divergence in performance of ETFs and equities shows there is an opportunity to tactically allocate between the two. Unlike pure gold equity funds, removing market beta when equities are volatile is much easier when the two approaches are combined.

Investing in other precious metals is a much more diversified approach than simply going out and buying an ETF or a basket of volatile mining companies – and we believe that it is possible to outperform the gold price in the long run by taking this approach.

Other precious metals

Incorporating other precious metals into the mix can also offer excellent diversification opportunities but the timing has to be right in order to maximise the benefits.

Because silver is more cyclical than gold, with more than 50% of demand being for industrial use, the price tends to be more volatile. However, it is starting to be supported by recovering industrial demand (particularly for solar panels). It also shares some of gold's defensive characteristics and is seen as protection against uncertainty, inflation and currency devaluations.

Palladium and platinum have a higher percentage of industrial usage, and we're cautious for now. In the medium term, palladium, which is heavily used in the auto industry, will benefit from rising demand from China and other emerging markets. Platinum will benefit from stricter emission control regulations and supply constraints in South Africa, where 90% of the metal is produced. We would typically hold more of these assets at a time when risk assets are doing well.

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