

A new gold rush?

Prospecting for 2010

Cormac Naughten discusses the current attraction of gold and the different ways in which investors can utilise its value

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Gold has been much in the headlines lately with the gold price reaching consecutive all-time highs to the point where it now stands at almost \$1,200 an ounce – an increase of over 60% in the last year alone. A month ago Britain's most prestigious department store – Harrods – even announced that it would be selling gold in the form of bars and coins to shoppers. It noted that the current financial environment has kindled a new demand for physical gold amongst private investors in Britain but that for many of them this is a new and unfamiliar asset class.

Whilst this holds true as many investors have never actually invested in gold themselves, we are all familiar with the metal itself and the connotations attached to it. Over the centuries it has been used as a universal currency and at points a medium for international trade and exchange.

A boost to confidence

Historically, investors have been attracted to gold whenever they lose confidence in paper currencies, because of its durability and scarcity. The Gold Council states that the best estimates are that the total volume of gold ever mined up to the end of 2006 was 158,000 tonnes. It is seen as a safe haven during times of economic volatility and a source of wealth preservation in the event of debasement of paper currencies, unexpected inflation or the failure of the monetary system. Some people observe that gold goes up when the dollar falls, and use gold ownership as either a hedge against the dollar or a means of expressing investment views on the dollar. Others simply use it as a means of portfolio diversification away from equities and bonds.

Right now, all these reasons to buy gold seem relevant. Indeed, a further one can be added: it is

an 'anti-currency'. If Mars had a currency, it would probably be a good idea to buy some, because however hard you look, it is pretty difficult to find a currency on earth which is really attractive. Absent Mars money, gold will have to do.

There has always been a problem with the notion of paper money, which 'promises to pay the bearer' a sum of money. After all, if it is backed by nothing more than confidence in the central bank, is it really a store of value? That question becomes even more relevant when the central bank engages in 'quantitative easing', effectively creating more money to buy up government debt, as the Bank of England and the US Federal Reserve have done this year. Arbitrarily increasing the amount of money in the economy scares people and the fall of the pound and the dollar that followed the announcement is understandable.

Economists can drone on about the falling velocity of money to explain that this is not inflationary, but most people are highly sceptical of the idea you can simply print more money without decreasing its underlying value. Hence, the desire to sell the pound and the dollar, initially relative to any other currency where the central bank was not engaged in printing more of it and ultimately against a currency whose supply cannot be increased. The limited supply of gold and its long history as a store of value make it a more practical alternative. And unlike,

say, the Australian dollar or the Brazilian real, there is not a central bank which will intervene to stop the price of gold rising, cut interest rates or increase supply. Valuations matter in currencies.

Fear of central bank dilution of the money is a powerful psychological force pushing people towards gold. So too is the general loss of confidence in the financial system. But for a more concrete argument, have a look at the chart below. It shows the price of gold, in US dollars, and the level of yields on 10-year TIPS, US inflation indexed securities, which is on an inverted scale. This shows the 'real' yield on a 10-year instrument. The higher 'real' interest rates are, the less demand for gold there is. Why does this help the price of gold? Gold doesn't pay interest but it does protect underlying value because the supply of it is constrained. So, the lower real interest rates, the higher the price of gold.

A bright future

On that basis, the positive outlook for gold isn't set to change soon. Low real interest rates are a cornerstone of current policies to return to economic growth. Central banks are keeping rates low in order to encourage spending and prevent a dramatic rise in the savings rate. They are not concerned about inflation, and they welcome the recovery in asset prices. And they are struggling to revive bank lending. It all argues in favour of keeping interest rate low



until economic recovery is well entrenched, the banking sector is in better health and inflation is a real rather than an imaginary fear.

For those looking to invest in gold, the next issue is the best means of doing so. Broadly there are two main methods of investment. Either investors can physically purchase gold (whether it is in the form of bars, coins or jewellery) or they can invest in securities or derivatives which reflect the gold price to varying degrees.

Bullion coins and bars allow investors to own investment grade gold, the value of which is determined by the actual gold price. Larger purchases will require storage with a secure third party in the likely event that the owner decides not to take delivery. For smaller amounts, secure transport and insurance all need to be examined if the owner wishes to take possession – all of which adds to the costs involved. Allocated accounts with gold held in a vault on the owner's behalf offer the same correlation to the gold price with the owner holding title over specific bars or coins. This should provide good levels of security of storage and insurance although it will come at a cost. A lower cost alternative is the unallocated account where a set quantity of gold in the custodian vault is owned by the investor rather than specific bars/coins. This presents counterparty risk in the event of the custodian going bust, as the investor would most likely

become just another unsecured creditor of the failed firm. Regardless of the type of account chosen, investors or their advisors should carefully conduct due diligence on the gold account provider/custodian and their history, security and credit rating.

The appeal of ETFs

Gold exchange traded funds (ETFs) are securities that can be purchased via stockbrokers which reflect the gold price. They have become increasingly popular with holdings in gold ETFs, reaching an all time high of 1,761.3 tonnes in mid-October according to the Financial Times. Unlike physical gold purchases, there are no storage or insurance costs although there are annual administration fees of anything from 0.3% to 0.5% and a spread between the bid and offer prices.

Exposure can also be gained via shares in gold mining companies or through funds which invest in a range of such firms. However gold shares are not physical gold and as such it is not just the case that the share or fund's price will go up if the gold price goes up. As with any equities a variety of other factors such as the performance of the company management will influence the stock price. Funds will also involve management fees and potential initial charges.

For those looking purely to speculate on the gold price then futures, options and

spreadbetting offer derivatives based solutions. They all offer leverage but as a result are viewed as high risk investments and tend to be seen as ways of expressing shorter term views. As such they will not be suitable for all investors. Spread-betting offers returns that are free of capital gains tax but like futures, investors run the risk of losing more than their initial investment.

The current attraction for many investors to gold is the sharp appreciation in the value of gold over the last year and the possibility of further price increases with some commentators pointing to \$2,000 an ounce and even \$6,000.

There are many ways to get involved but the chosen methodology should reflect the investor's underlying motivation and ultimate aims. The investor and their advisors need to be clear whether they are price motivated short term speculators or if they are investing for the medium or long term. They also need to establish whether they are looking for portfolio diversification, "insurance" against financial risk or long term wealth preservation. The costs, risks and security implications will also need to be weighed up and crucially they will also need to consider how closely their chosen investment's performance will reflect the actual price of gold. ■

