BETWEEN THE GOLD BUGS AND GOLD BEARS

The case for gold as a financial asset divides investors and commentators like few other subjects. In one camp you have those who see gold as the only unprintable currency and therefore an essential hedge against the debasement of fiat currencies.[1] At other end of the spectrum are those who view gold as just another volatile commodity offering no yield and being reliant on the "greater fool" theory[2] for price appreciation. In this article we attempt to sketch out a moderate position in the sparsely populated middle ground between the gold bugs and gold bears.

A UNIQUE SAFE HAVEN?

Gold has played a formal and an informal role in financial systems for millennia, with the first known coins containing gold having been struck in Lydia, Asia Minor, around 600 BC. Gold's attractions as a currency include its durability, limited industrial use and relative stability of supply (in contrast to other precious metals). The most recent period in which gold had a widespread formal role in currency arrangements was in the post-war period, from 1944 to 1971, under the Bretton Woods system, in which the world's major currencies were pegged to the US dollar — which itself was convertible to gold at a fixed exchange rate. Although it no longer has a formal role in currency arrangements, many central banks retain large gold holdings (the US being the most significant holder with c.8,000 tonnes).

A number of factors arguably make the case for gold more interesting at the current time. Highly indebted governments (particularly in the developed world), the rise of populism and signs of increasing social conflict all point to an environment of heightened political uncertainty and risk. At the same time, financial assets have been inflated by almost a decade of ultra-stimulative monetary policy, leaving investors with very few safe havens that are not exposed to the risk of a faster-than-expected unwind of monetary support.

As a financial asset, gold has exhibited attractive diversifying characteristics to both equities and bonds, especially in periods of rising inflation. In particular, in the stagflationary 1970s, gold provided strongly positive real returns, whereas equities and government bonds exhibited negative real returns. In addition, gold has tended to exhibit a negative correlation with equities during market crises — for example, during the financial crisis the gold price rose by 28%, whereas over the same period, developed equity markets fell by more than 50% from peak to trough.[3] Furthermore, the correlation between gold and equities tends to move further into negative territory, the more extreme the downward move in equities. Gold is therefore considered by some to be a valuable hedge against tail events and "risk off" periods in general.

---

[1] Fiat money (in contrast to commodity money) is a currency without intrinsic value established as money by government regulation or law. Source: Wikipedia.

[2] The greater fool theory states that the price of an object is determined not by its intrinsic value but rather by the irrational beliefs and expectations of market participants. A price can be justified by a rational buyer under the belief that another party (the greater fool) is willing to pay an even higher price. Source: Wikipedia.

[3] Price index returns based on the period November 2007 to February 2009. Source: Thomson Reuters Datastream.

OR JUST A VOLATILE COMMODITY?

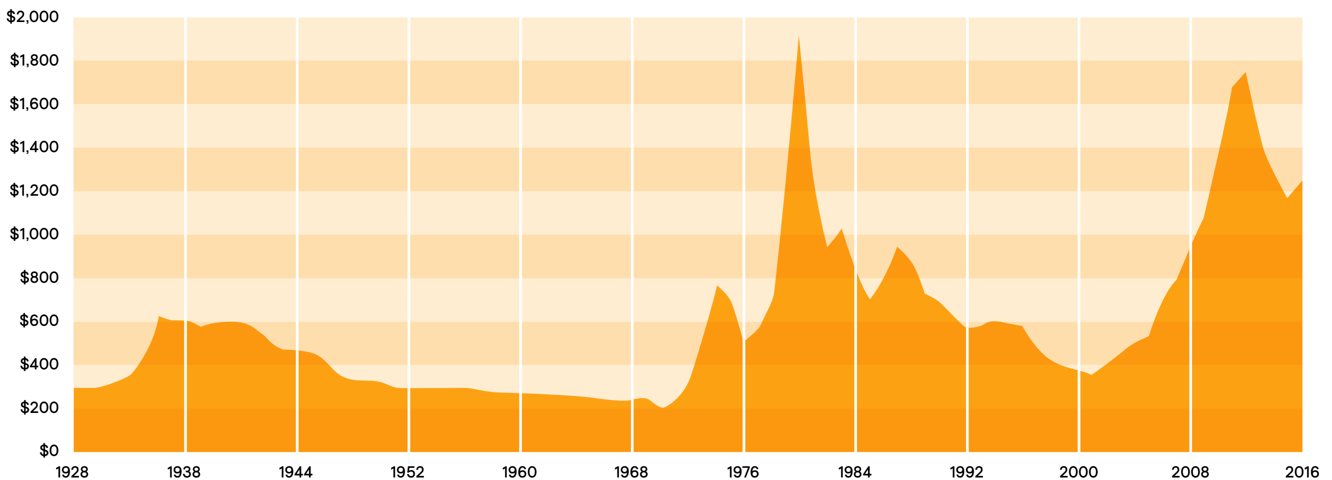
The primary challenge to gold as a financial asset comes from the absence of any yield or risk premium, making it difficult for many institutional investors to justify a long-term strategic holding. As noted in the 2012 Credit Suisse Global Investment Returns Yearbook, gold has produced low real returns over the very long term (c.1% p.a. in sterling terms from 1900 to 2011).

The gold price is also highly volatile, tending to exhibit greater price volatility than developed market equities. Further, during periods of low or falling inflation, with decent levels of economic growth, gold has tended to struggle. For example, during the Great Moderation, in which business cycle volatility and inflation both reduced, the gold price fell by over 80% in real US dollar terms.[4]

These characteristics — a highly uncertain future return and high volatility — make sizing any allocation to gold challenging. If the allocation is too small, it will have a limited impact on overall risk return characteristics; if the allocation is too large, it may act as a painful drag on returns in periods when the gold price falls. This perhaps argues for a tactical approach to gold. However, timing gold poses at least as many challenges as timing other market exposures — and perhaps more given the lack of any fundamental basis for making an assessment of fair value. Few institutional investors are set up to make tactical asset allocation decisions, and we therefore believe that such activity is best left to macro and trend-following hedge funds.

Finally, there can be no guarantee that gold will exhibit the same risk/return characteristics as it has in the past. This essentially relies on a belief that gold will continue to be perceived by a sufficient number of investors as an alternative currency of sorts. A few thousand years of being treated as such clearly provides some comfort, but at a time when digital cryptocurrencies are gaining attention, there can be no certainty that investors will always treat gold as the only unprintable currency.

VALUE OF GOLD, 1928-2016



Sources: Officer LH, Williamson SH. The Price of Gold, 1257-2016; *and MeasuringWorth.*
The Annual Consumer Price Index for the United States, 1774-2016.
Notes: End of year values adjusted for inflation, representing price per ounce in 2016 dollars
New York market price (US $ [1928–1949] per fine ounce)
London market price (US $ [1950–2016] per fine ounce)

[4] From 1980 peak to 2001 low. Source: Credit Suisse Global Investment Returns Yearbook 2012.

FINDING A ROLE FOR GOLD

The investment case for gold will continue to polarize, and it is difficult to make sweeping generalizations about the types of investors for whom a strategic allocation might make sense. However, it is possible to suggest some of the characteristics of investors who are more likely to be open to the merits of gold. These include:

- Investors who are highly sensitive to inflationary scenarios, while not being able to access other forms of inflation hedge (such as inflation swaps)
- Investors with a willingness to accept a potentially significant drag on returns in normal scenarios in order to access some protection against extreme scenarios (for example, one in which investors lose faith in the fiat money system)
- Investors with a willingness to view gold as a risk management tool in a portfolio context, as opposed to an isolated exposure that is expected to deliver a consistent contribution to the total return

Investors for whom an allocation to gold is less likely to be suitable include:

- Investors with nominal liabilities or an alternative approach to hedging inflation risk
- Investors with an alternative way of plugging any gap that arises from disappointing real returns (for example, a strong sponsor covenant for a pension scheme or other sources of income/ support for an individual)
- Investors able to adopt a multi-decade time horizon with flexibility in their long-term liabilities, such that experiencing a decade of disappointing real returns from equities is not catastrophic (for example, a young defined contribution investor)

Ultimately, consideration of gold will necessarily be an investor-specific decision. However, we believe that some investors will find the diversifying characteristics of gold attractive in mitigating the impact of certain extreme scenarios. The views of gold bugs and gold bears will remain entrenched, but investors should aspire to achieve a rational and well-reasoned view on the merits and challenges of gold, in the context of their own circumstances.

For more information, please visit our website

IMPORTANT NOTICES

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

© 2018 Mercer LLC. All rights reserved.

Information contained herein has been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

No investment decision should be made based on this information without first obtaining appropriate professional legal, tax and accounting advice and considering your circumstances.

Investing involves risk. The value of your investment will fluctuate over time and you may gain or lose money.

MMC Securities LLC is a registered broker dealer and an SEC registered investment adviser. Securities offered through MMC Securities; member FINRA/SIPC, main office: 1166 Avenue of the Americas, New York, New York 10036.

Variable insurance products distributed through Marsh Insurance & Investments LLC; and Marsh Insurance Agency & Investments in New York.

Mercer, Mercer Investment Consulting LLC, Mercer Investment Management, Inc., Guy Carpenter, Oliver Wyman, Marsh and Marsh & McLennan Companies are affiliates of MMC Securities.