Aon's Investment Research and Insights

Gold – A defensive asset in portfolios

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Empower Results®

Contents

About Aon's Investment Research and Insights

Aon's robust portfolio of ideas, tools and researched solutions supports trustees and sponsors to anticipate their future investment requirements.

By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

To learn more and to access other research and insights from Aon's investment experts, visit **aon.com/investmentuk**

Background

Gold has historically only been used sparingly in institutional portfolios, however recent events have led many to reconsider this. We believe gold can be a useful addition to client portfolios and indeed where we have discretion we currently invest in gold on behalf of these clients. This note outlines the case for gold.

Gold – why now?

Following the outbreak of COVID-19 policy makers have stepped in with unprecedented stimulus programs vowing to "do whatever it takes" to support economies. Central banks have unleashed huge asset purchase programs, expanding their balance sheet, creating currency and buying bonds at a scale unseen before. This action has driven government bonds yields to record lows and even negative in some cases.

In this environment we see gold as becoming relatively more attractive for 3 main reasons:

1 Interest rate collapse

Gold becomes relatively more attractive as interest rates have collapsed following COVID.

Historically gold has been less attractive as it pays no yield. But now the yield from bonds have collapsed, reducing the opportunity cost of holding gold.

Gold has performed well historically even without a yield, returning 7.5% p.a. since 1972*. So, the lack of a yield can be compensated for by capital appreciation.

2 Safe haven asset

Gold has valuable safe haven and diversification properties.

Markets have recovered incredibly following the initial COVID outbreak, but another market drawdown is possible.

Including some defensive assets in portfolio construction has always made sense for diversification, but especially now.

Gold is a defensive asset as it tends to hold value well in market downturns. It is also a very diversifying asset, with a low beta to equities.

3 Currency debasement

Gold hedges against central banks debasing their currencies (resulting from Q.E).

Central banks are creating vast quantities of additional currency. Against that background one would expect all major currencies to lose purchasing power thereby putting upward pressure on inflation.

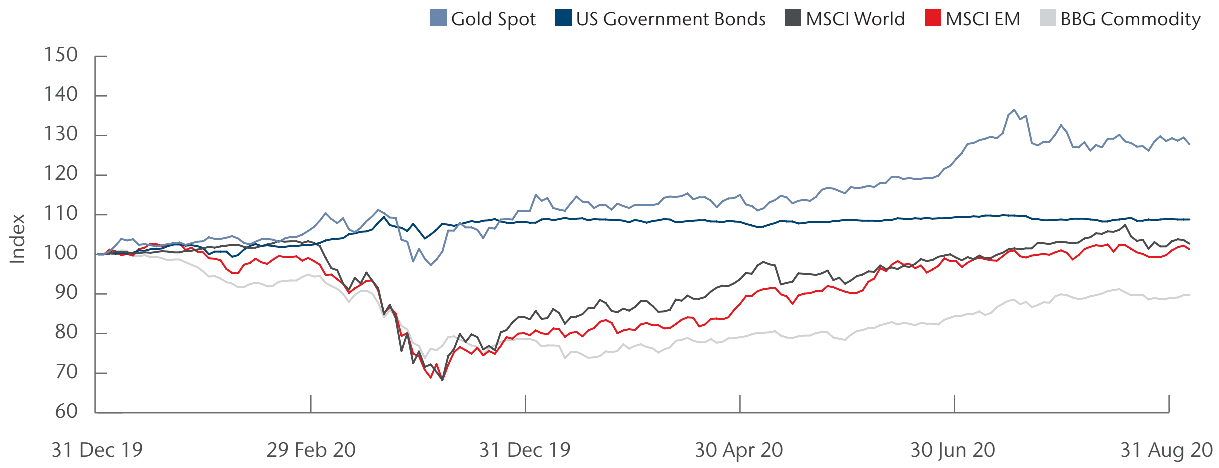
Gold may provide some protection if high inflation results from this extensive stimulus. However, gold will not track any formal inflation measure with any degree of accuracy and would exhibit significant volatility around this.

*From Jan 1972 to Sept 2020 Gold (priced in USD) returned 7.5% p.a. rising from $58/oz to $1942/oz.

How has gold performed recently?

Gold has performed very well in 2020, holding up during the sell-off in March and performing strongly since then as global economic uncertainty remains elevated. Gold made the headlines in August as it breached the $2000/oz mark for the first time as investors sought a safe haven amid the uncertainty. Gold is currently up around 30% year to date[1] and is one of the best performing asset classes this year.

Gold leads the way in 2020



Source: London Bullion Market Association, MSCI, Bloomberg . All shown in USD. Performance shown up to 17/09/2020. Past performance is not a guide to the future.

Although one might argue that this recent strength weakens the case for gold going forwards, it is worth remembering the role of gold in the portfolio as a defensive diversifying asset, meaning even at higher entry points it should have value in the overall portfolio context. In addition, instead of thinking of gold as being at or near all-time highs, one might view other currencies as being at or approaching all-time lows (in terms of purchasing power) versus gold (due to currency creation), and while central bank balance sheets continue to expand, it is hard to see this trend reversing. This trend puts upward pressure on the gold price as the purchasing power of these currencies falls relative to gold. Finally, it is also worth remembering that gold is currently[2] only 3% higher than its 2011 peak level of $1886/oz.

Drivers of the Gold Price

Gold is expected to be in demand, and appreciate when:

1. Yields on substitute assets (i.e. government bonds) fall lower.
2. Fear of recession causes investors to seek safe haven assets.
3. Currencies fall in value.

The gold price can also be impacted by consumer demand for items such as jewellery.

It may also be reasonable to expect gold to rise very broadly in line with inflation over the very long term, due to its stable purchasing power over very long time periods, resulting from its finite supply (unlike other currencies with expanding supplies).

Risks

As with any asset class there are some risks related to an investment in gold, such as:

- Gold may not provide protection during an equity crash.
- Gold may not increase in line with inflation.
- In a bull market gold is likely to underperform equities.
- Other basic risks related to implementation such as liquidity risk, manager risk etc.

[1]Gold is up 30% in GBP terms and up 28% in USD terms in 2020 up to 17 September.

[2]As at 17 September 2020 at $1942/oz.

How to invest?

Investing a portfolio allocation into gold is possible with various managers having suitable implementation options. Relatively small allocations to gold around the 5% mark are likely to be suitable for most clients, given the defensive but volatile nature of gold.

An exchange-traded product backed by physical gold such as an ETF (Exchange Traded Fund) or ETC (Exchange Traded Certificate) is a popular choice. An ETC is a certificate that can be bought and sold on an exchange, where the issuer agrees to pay the holder a specified return (the gold return in this case.) Fees for investing via an ETC can be as low as 15bps, and they also provide close tracking of the gold spot price in a very liquid manner with low trading fees (spreads of around 2-3bps). Historically pension funds without a custodian may have struggled to invest in a ETC, however managers have now setup solutions which easily overcome this (for example by wrapping the ETC into a life fund, whereby the life fund invests 100% in the Gold ETC).

Other implementation methods are possible, and suitability will depend on client preference. Currency hedging is also a factor to consider. Investing in gold responsibly is also possible by using ETCs that only hold gold bars that were mined adhering to the London Bullion Market Association (LBMA)'s 2012 responsible gold mining guidance.

We note that clients may have some small indirect exposure to gold already, as many multi asset managers have used gold in their portfolios for some time as a defensive diversifier. However, we believe a distinct separate allocation to gold is worth considering, particularly as it provides simple and low-cost access to one of the most diversifying assets used by multi asset managers.

Please speak to your consultant if interested.

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