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Gold: Defensive or growth asset?

Jordan Elisio

This paper comprises an excerpt from The Perth Mint's *The case for gold* report of May 2021.

The difficulty in working out a fair value given the absence of a cash flow is only one of the challenges that can make it difficult for institutional investors to allocate to gold.

A second challenge is the categorisation of gold as a growth or a defensive asset. This too is understandably difficult for many investors, given the precious metal does not fit neatly into either of these categories.

Some view the metal as part of the broader commodity complex and, therefore, see it predominantly as a growth asset. Others, including the majority of the world's central banks, tend to see gold as a currency, or a form of money.

Viewed through this lens, gold is typically seen as a defensive asset.

Growth asset characteristics

Supporting the argument that gold is a growth asset is the fact that the total return on gold is driven exclusively by capital gains or losses, with returns solely driven by changes in the gold price.

The facts that gold generates no income for most investors (noting there is a robust market for gold leasing among central banks and other financial institutions) and exhibits price volatility similar to equity markets, also support the notion that gold is a growth asset.

Those who believe gold is a growth asset could also point to the fact that gold held in jewellery form accounts for almost half of all the gold that has ever been mined, which is highlighted in Table 1.

Table 1. Gold ownership by sector as at end 2020

Sector	Holdings (tonnes)	Percentage share of total holdings
Jewellery	93,253.1	46%
Official holdings	34,210.6	17%
Private investment	44,384.4	22%
Bars and coins	40,620.5	20%
Gold ETFs	3,763.8	2%
Fabrication and other	29,448.0	15%
Total	21,296.1	100%

Source: World Gold Council. Private investment is made up or bars + coins and gold ETFs

The majority of this jewellery demand takes place in Asia (especially India and the Middle East) where gold demand is highly correlated to rising incomes and economic growth.

Defensive asset characteristics

Gold remains widely recognised as a safe-haven asset that investors typically turn to when their desire to protect wealth increases. It also has a long history as a monetary asset, and to this day is treated as such by central banks which hold more than 34,000 tonnes of the precious metal as part of their monetary reserves.

Factors like this suggest gold is a defensive asset.

This view is reinforced by the data contained in this paper, which demonstrates gold's ability to reduce drawdowns suffered by diversified strategies during periods when those strategies decline in value.

Gold's strong historical outperformance in periods of heightened equity market stress between 1971 and 2020 also attests to its defensive qualities.

Further, the fact that gold behaves in a unique way from a market return perspective in risk-off environments relative to the broader commodity complex furthers the argument that the precious metal is more a defensive asset from a portfolio management perspective.

This divergent performance in periods of heightened market stress can be seen in Table 2, which comes from a 2019 World Gold Council (WGC) report titled *Gold: the most effective commodity investment*. Table 2 highlights the returns of the S&P 500, gold and the Bloomberg Commodity Index across a number of high-profile risk-off periods that have afflicted markets in the past 30 plus years.

Table 3 reinforces this point, looking at the correlation of both gold and commodities to the S&P 500 during periods when equity market performance falls within two standard deviations of the mean, as well as when the market rises or falls by more than two standard deviations.

Gold's unique ability to protect a portfolio from downside risk in equity markets, both in absolute terms and relative to other commodities is evident in Tables 2 and 3.

Historically, gold in Australian dollars has performed even better in extreme risk-off environments, owing to the fact risk-off periods typically coincide with weakness in the Australian dollar. In February 2021, the WGC issued a report, *The relevance of gold as a strategic asset*, which found that gold unhedged in Australian dollars delivered average returns of more than 16% in risk-off events since the Long-Term Capital Management crisis of 1998, outperforming commodities and bonds, with the latter only rising 6.9% in such periods.

The historical interplay between gold prices, commodity prices and inflation is another factor suggesting gold is a defensive asset. While both commodities and gold have historically risen in periods of high inflation (with gold the higher performer of the two), only gold has delivered positive returns in periods of low inflation.

This can be seen in Table 4, which looks at the performance of gold and commodities during years where inflation in the US was 3% or higher, and in years when inflation there was less than 3%.

While Table 4 is based on US dollar price data from 1971 to 2018, the performance of gold in the past two years (rising by 18% in 2019 and 25% in 2020 despite CPI increases of less than 3% in both years, versus a broadly flat Bloomberg Commodities Index over the same time-

The quote

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Table 2. S&P 500, gold and commodity returns (%) during periods of heightened market risk

Crisis event	Dates	S&P 500	USD gold	Commodities
Black Monday	Sept to Nov 1987	–31.6	9.1	0.0
Long-Term Capital Management crisis	Aug 1998	–18.0	2.8	–2.8
Dot-com bubble	Mar 2000 to Mar 2001	–23.1	–6.7	15.1
September 11 terrorist attacks	Sept 2001	–8.0	5.2	1.8
2002 recession	Mar 2002 to July 2002	–31.7	7.8	1.7
Global financial crisis	Oct 2007 to Feb 2009	–47.8	47.5	–36.1
Sovereign debt crisis v1	Jan 2010 to June 2010	–11.1	6.4	–10.4
Sovereign debt crisis v2	Feb 2011 to Oct 2011	–9.0	30.2	–2.1
2018 pullback	Oct 2018 to Dec 2018	–19.6	6.6	–10.1
COVID market crash	Q1 2020	–20.0	6.2	–23.5
Average return		–22.0	11.5	–6.6

Source: Perth Mint, World Gold Council

Table 3. S&P 500, gold and commodity correlations during differing periods for equities

Equity market environment	Correlation: Gold to S&P 500	Correlation: Commodities to S&P 500
S&P 500 between 2 SD	–0.01	+0.09
S&P 500 up by more than 2 SD	+0.21	+0.04
S&P 500 down by more than 2 SD	–0.20	+0.32

Source: World Gold Council, data based on weekly returns from 1971 to end 2019

Table 4. Average annual return (%) for gold and commodities in high- and low-inflation environments

Inflation environment	Gold	Commodities
High inflation (>3% CPI increase)	+15.1%	+12.9%
Low inflation (<3% increase)	+5.1%	-2.6%

Source: World Gold Council

frame) reinforces the point that relative to a basket of commodities, the precious metal has a unique ability to perform in both high- and low-inflation environments.

WGC analysis based on the return of gold and commodities priced in Australian dollars highlights similar results to those seen in Table 4, with gold returning 20.3% in high-inflation environments and 3.7% in low-inflation environments. By contrast, commodities returned 12.98% in high-inflation environments but fell 0.82% when inflation was low.

Furthering the argument that gold is a defensive asset is the fact that the precious metal tends to trade like a bond and has many bond-like attributes. It is highly liquid, has no maturity date (like a perpetual bond), a credit risk of zero (like a sovereign bond) and offers no income stream (like a zero-coupon bond).

Given these attributes, it is not surprising that historical analysis demonstrates investors' willingness to pay more for such an asset in environments where the real yield available on zero credit risk (but not zero inflation risk) bonds is declining.

This is demonstrated in Figure 1, which plots the correlation between the US dollar gold price and the real yield (which is inverted on the chart) on US 10-year Treasury bonds from January 2003 to December 2020.

Gold's high liquidity and absence of credit risk also support the notion that gold is a defensive asset.

While these attributes do not show up directly in ex-post analysis, a good argument can be made that the desire by investors to hold an asset with these characteristics is a key driver of the outperformance that gold has historically delivered in periods of heightened economic instability and/or equity market stress.

Hybrid asset with a distinct portfolio role

A rational argument can be made that gold is a growth asset and a defensive asset.

Rather than needing to categorise it exclusively in one camp or the other, Australian institutional portfolio managers may be better served seeing it as a hybrid of the two.

Treating gold in such a manner would align it with the way many superannuation funds now look at other assets they already include in their portfolios, including unlisted infrastructure and unlisted property.

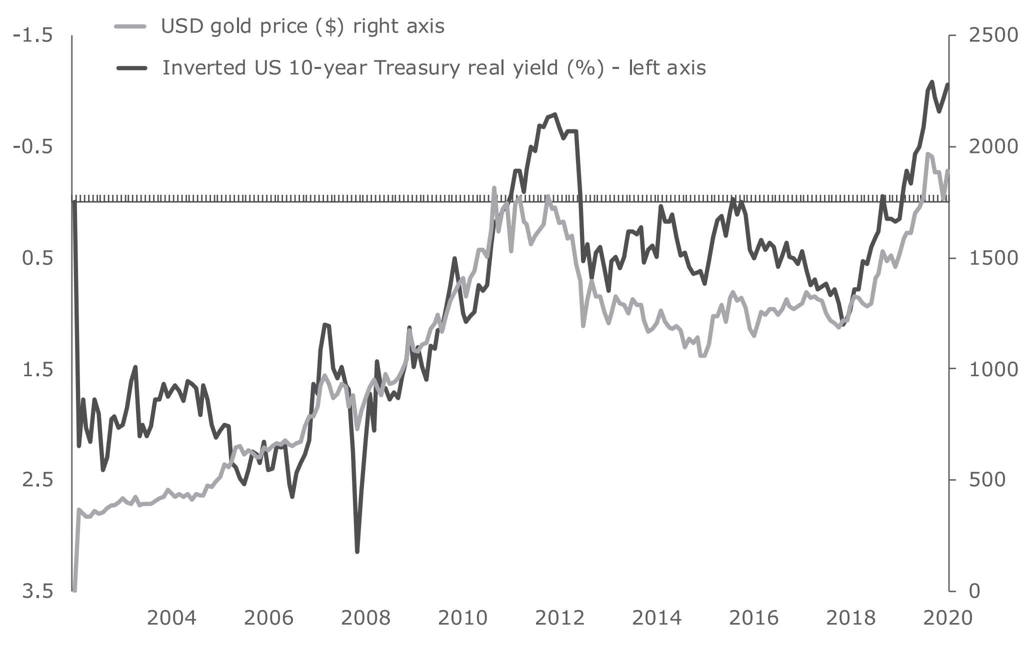
Many sophisticated investors who own gold have at the very least made the distinction between the precious metal and the broader commodity complex.

Examples include Shayne McGuire, an Emerging Markets & Gold Fund portfolio manager at the Teachers Retirement System of Texas, the eighth largest pension fund in the US. In the June 2016 WGC edition of *Gold Investor*, he was interviewed about why the fund invests in gold.

The following quote is an edited extract from that interview, with McGuire noting (bolded emphasis The Perth Mint):

… there is the issue of where gold should reside in asset allocation. The precious metal is listed on the FX page on the Bloomberg financial system, but also on its Commodities page. It is an inflation hedge (it rose 2,300% during the inflationary 1970s), and yet a deflation hedge in times of deep economic stress (such as the early 1930s and 2008)—it tends to rise as investors begin to anticipate the need for dramatic inflationary monetary intervention. ***Ultimately, our decision to invest in gold as an asset separate from commodities was based on the diversification benefits to the overall portfolio.***

Figure 1. US dollar price of gold and real yield on 10-year US Treasury—2003 to 2020



Source: The Perth Mint, Reuters, US Treasury, St. Louis Federal Reserve

In Australia, Davin Hood, founder and manager of The Cor Capital Fund, which maintains a strategic gold allocation, offered the following insights to the Perth Mint as to why Cor Capital holds gold:

"… the portfolio managers at Cor Capital view gold bullion as a unique form of insurance. Historically, it has delivered positive returns when risk assets are rising, but also pays off in a range of less positive environments; from deflationary shocks to rising inflation, carry crash / liquidity squeeze, financial system instability etc. This asymmetry makes gold a valuable tool in any diversified portfolio, while the opportunity it provides for volatility capture when held in larger weightings is particularly attractive for absolute return strategies like ours."

The logic of treating gold as a hybrid asset is arguably enhanced by the fact it has shown it can add value in environments where traditional defensive assets flourish and, inversely, in environments where traditinal growth assets flourish. Crucially, it can also add value in environments where no traditional asset classes flourish.

This can be seen in Table 5, which comes from a Bridgewater paper, 'Some perspective on gold in the new paradigm', published in 2020. The table highlights the average annualised real returns on gold, stocks, bonds and cash in environments of deflation, reflation and stagflation. The results are based on returns in the US, UK and Japan across relevant cycles from 1929 onward.

Table 5. Average annualised real returns (%) for multiple asset classes in various environments

Market environment	Cash	Bonds	Equities	Gold
Deflationary	3.7	7.2	–8.6	2.7
Reflationary	–1.4	2.3	11.9	6.5
Stagflationary	–1.7	–2.1	–1.6	21.7

Source: Bridgewater, 'Some perspective on gold in the new paradigm', September 2020

No traditional defensive or growth asset offered the kind of return profile that gold did in these periods, with the precious metal the only asset class that generated positive real returns in all environments.

Moving forward, an asset class with these return attributes could be particularly valuable, given the highly uncertain economic environment, current valuations in equity markets, real yields on fixed income assets, and the monetary environment institutional investors must navigate on behalf of their clients. **FS**

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