Gold – a safe haven, or too hot to handle?

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Michael Kruger, CFA®
Investment Analyst
Morningstar Investment Management
South Africa

For Financial Advisors and their Clients

Financial market moves in 2020 can best be described with one word – unprecedented. Equity markets experienced one of the sharpest and speediest declines in the first quarter of 2020, only to recover most of these losses in the four months to the end of July. The market moves have been nothing short of breathtaking, with the swift action of governments and central banks to provide support in the form of fiscal stimulus and lower interest rates no doubt playing a role in the recovery. This, despite the economic ramifications of Covid-19 continuing to filter through to weak economic data and company earnings announcements.

One of the most significant winners year-to-date in 2020, has been gold. The price of the precious metal has risen 30% in US dollars since the beginning of the year (to the end of July), in the process becoming one of the most talked about trades of 2020. This has driven the performance of gold counters listed on the JSE – many of which are up over 100% since the beginning of the year – leading to them topping the list of best performers on the local exchange. Even long-term gold cynic, Warren Buffett, made news headlines recently when it was announced that his company, Berkshire Hathaway, added shares of Barrick Gold to its portfolio in the second quarter of the year.

So, what is behind the sudden interest in the yellow metal? In this article, we look at the history of gold as an investment and what may have been driving the rise in the price of gold in 2020.

A historic look at gold as an investment

Gold has a long history as a safe haven investment. This is largely since the price of gold is independent of other asset classes, which means that the metal has generally performed well during periods of market stress or volatility. Gold has also traditionally been a refuge against US dollar weakness, largely due to the inverse relationship between what is generally accepted as the world's reserve currency and commodity prices.

Investments in gold generally take place in one of two forms: namely buying the commodity itself (gold bullion) or buying shares of companies that mine and sell gold (gold equity). In the South African environment, investments in physical gold by investment managers usually take the form of investments in gold exchange traded funds or ETF's. Due to the impact of leverage (both financial and operating), investments in gold stocks tend to be more volatile than the direct investment in the physical commodity, which depends only on the price of the metal.

Investing in gold as protection against market declines

Historically, gold has excelled during periods of significant market declines and periods of unusually high market volatility. The metal has posted significantly better returns during market drawdowns and in some cases, has even notched positive total returns during periods of steep losses in equity markets.

The behaviour of gold during the Covid-19 sell-off provided an interesting case study, in that although gold fared better than stocks, it still posted a small loss. Market commentators have attributed this to many factors, including the fact that the sell-off was liquidity driven (and therefore all encompassing) and the feeling that interest rate cuts will support the US dollar (a negative for commodity prices). Lockdown measures introduced across the globe also caused mine closures and production shutdowns which affected gold producers negatively. Gold did, however, reverse course, moving significantly higher in the months following the market sell-off, reaching a peak of just over $2,000 an ounce.

Gold as an inflation hedge

Despite often being regarded as a hedge against inflation, it is interesting to note that gold's record of protection is rather mixed. The metal did provide significant protection during the high inflationary period of the 1970s, when higher oil prices and an expanding money supply pushed inflation to extreme levels in the United States. During more muted periods of inflation, including the early 1980s and between 1988 – 1991, gold delivered negative returns, lagging equity markets in the process.

Given the unprecedented levels of fiscal stimulus delivered by major central banks and governments in response to the pandemic, concerns have been raised that this may lead to a significant uptick in inflation. While this may be true, the evidence suggests that gold's role as an inflation hedge may be overdone and that there is no guarantee that the metal will provide protection if inflation becomes a problem.

Does the introduction of gold improve risk-adjusted returns?

Depending on the period in question, adding gold to a portfolio has shown evidence that it can improve risk-adjusted returns. In some cases, substituting equity allocations with an allocation to gold has shown to reduce volatility and improve risk-adjusted performance. What is important to highlight, however, is that the results are largely period dependent. In some cases, total returns, risk and/or risk-adjusted returns were improved, however, the results are not conclusive enough to indicate that adding gold allocations to a portfolio will always be beneficial.

So, what can we conclude about gold from the evidence?

The introduction of gold in a portfolio is not guaranteed to improve risk, returns or risk-adjusted returns for every period. Rather, the track record of the precious metal is mixed, and gold can go through long periods of underperformance. The strongest evidence for holding gold appears to be as a safe haven in periods of significant market volatility. In our view, it should be viewed as an insurance policy rather than a core holding. Investors should also be wary of the hype currently surrounding the price movements of gold – after all, as Warren Buffett once famously said: "what the wise man does in the beginning, the fool does in the end".

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+ t: (0)21 201 4645 + e: MIMSouthAfrica@morningstar.com + 5th Floor, 20 Vineyard Road, Claremont, 7708.