Seeking refuge in gold

With major currencies continuing to erode in value, and supply of gold struggling to meet demand, gold and gold-denominated products are likely to remain in focus

FROM THE DESK OF

Christian Baha
Owner and founder
Superfund group of companies

THE recent conversations I have been having with investors have evolved from optimism to uncertainty in a span of the past year. Although the global equity markets look stabilised, through coordinated fiscal stimulus package and better than expected earnings and economic data, the weak private sector and soft consumer spending in the US, and with stocks no longer cheap, investors are moving towards skepticism of the fast recovery, towards safer haven like gold. Gold and gold-denominated products are likely to remain focal points for both traders and investors until uncertainties and underlying problems are resolved.

Gold has surpassed the psychological US$1,000 an ounce. In Asia, investing in physical gold is a long tradition instilled even today, but in other parts of the world, when I advised investors to invest in gold since 2003, many were skeptical. It is likely that demand for physical gold and hedging will continue as long as the US dollar continues to decline.

Taking a step back to look at the big picture, although the stimulus package made headlines at US$2 trillion, it's been widely reported total US debt including social security, government pensions and Medicare in the first quarter of 2009 was US$51 trillion and by May, *USA Today* reported it grew to US$63 trillion. Whichever figure it is, it is clear the US is overleveraged and in commercial terms "insolvent", and this figure will continue to grow unless some active measures are taken.

To gain some perspective in such a ballooning credit environment, we refer to the old measuring system of currency that was valid for over 3,000 years – gold. The total value of gold that has ever been mined globally is valued at about US$5 trillion, although the US holds the biggest reserves with 28 per cent share, around 8,100 tonnes, they have been able to issue debt at 10 times what they are worth. Since President Nixon abandoned the gold standard in 1971, money has been printing through the issuance of bonds. Therefore, this credit expansion will somehow have to correct itself before we can move forward. Currently, worldwide assets including bonds, stocks and derivatives are valued at around US$500 trillion, approximately 100 times value of gold. This means, in the worst case scenario, we will have 100:1 correction of today's paper asset classes, turning into hyperinflation.

Given the situation, it is impossible not to think the value of currencies will continue to erode. In some countries like Singapore, this explains the strong demand in asset based investments like gold and property. For those who are looking to diversify amongst currencies, commodity based currencies like the Brazilian real, Australian dollars, and Canadian dollars are worth considering over the main currencies.

> Other than the emotional comfort of having physical gold, the real case for investing in gold and gold-denominated products is the low correlation it has compared to other asset classes and the diversification of risk it provides from a portfolio context. Even amongst the commodity sector, gold has held up while other commodities have not.

From a fundamental supply and demand perspective, buyers from China and India will take advantage of any price dips. The World Gold Council reports gold demand from China was up 76 per cent since 2003 as they look to diversify their US dollar exposure. The Chinese government is publicly encouraging citizens to buy into gold and silver, to meet the growing demand for gold, China has increased its gold mining activity by 70 per cent. In India, although some buying appetite has abated on higher prices, the purchase of gold during festivities and as gifts is very much in the culture which will act as support for gold price.

On the supply side, data shows it is struggling to keep up with demand and global gold mining production, declining steadily since 2000 despite rising gold prices with supply contracting 3 per cent in 2008. Some of the issues that deter gold mining include high costs of production, difficulty in mining gold as it relies on open-pit mines which require moving mountains of earth, and environmental issues for communities near mines.

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It is clear investing in physical gold preserves wealth but it does not pay interest. So what are the other ways investors can get exposure to gold?

Gold ETF

An inexpensive and relatively convenient alternative to owning physical gold or buying gold futures. However, investors need to be aware of the market and counterparty risks associated with Gold ETFs and the fees you have to pay which causes discrepancies in the actual value of the spot gold price and ETF value.

Gold stocks

A popular option for those who already own equities. The key distinction however is you own the shares of the companies but not the metal itself so you will be exposed to operational and corporate risks but the potential capital and dividend rewards can seem attractive.

Gold-denominated funds

In my opinion, this provides the highest probability in wealth creation other than wealth protection in holding physical gold or gold certificates. It is a relatively new idea to link the price of your investments in a fund with the benefit of rising gold prices, thereby allowing investors exposure to gold and a separate asset class in the one investment. Superfund first started offering our managed futures strategies priced in gold in 2005 and due to these unique features has become a preferred investment class for both our existing and new investors.

Although other precious metals like silver, platinum and palladium have outperformed gold this year, investors still continue to seek refuge in gold as uncertainty looms.