Looking to gold

Pension funds increasingly recognise gold's diversification potential

Global levels of risk and uncertainty have burgeoned in the last couple of years under the shadow of a global pandemic, surging inflation and, more recently, events in Ukraine. Together with a prolonged period of ultra-low interest rates and multi-decade high levels of inflation – to say nothing of dizzyingly high equity valuations – this has created a challenging environment for asset allocation.

Understandably in this changed environment, investors, including pensions funds, face a pressing need to diversify risk and build resilient portfolios which can weather market turmoil.

Bonds no longer the diversifier they once were

Investors have traditionally used government bonds as the primary vehicle to mitigate risk – a strategy that has been broadly successful for the past couple of decades, thanks to generous legacy coupons and the strong bull market during that time. But that has changed with the ultra-low yield/high inflation environment in which we now find ourselves.

Crucially, it is important that investors don't rely on data and assumptions that shaped the past two decades. Financial markets are in a different place today. Our analysis suggests that the negative bond/equity correlation – a relationship that is key for bonds to play their role as a portfolio diversifier – breaks down at inflation rates above 2 per cent.[1] Given the elevated global inflation outlook, it seems increasingly likely that the long-relied-upon correlations of the past 20 years could break down if this environment persists. And as central banks turn decidedly hawkish in response to soaring prices, bonds are likely to be increasingly susceptible to downside risk.

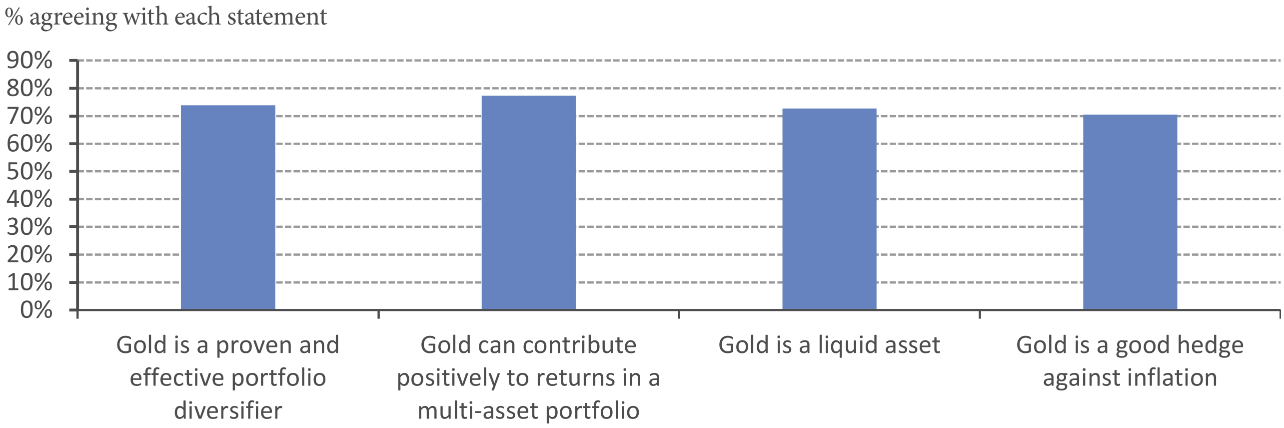
So, if bonds are less likely to be effective diversifiers going forward, what other assets could pension funds consider in their asset mix? We believe that gold is uniquely placed to play an important diversification role in pension fund portfolios, not just in the current environment but over the long term too. And the results of our third annual survey – conducted jointly with *Pensions Age* – suggests that UK pension funds increasingly agree.

Strategic gold allocations amongst UK pension funds have increased

The findings of our latest survey show that nearly 40 per cent of respondents hold an allocation to gold. This is up from 31 per cent of survey participants in 2021. Although these allocations are currently relatively modest (29 of the 34 respondents holding gold have an allocation of 2 per cent or less), it is nonetheless encouraging that they are more commonplace among the UK pension fund audience.

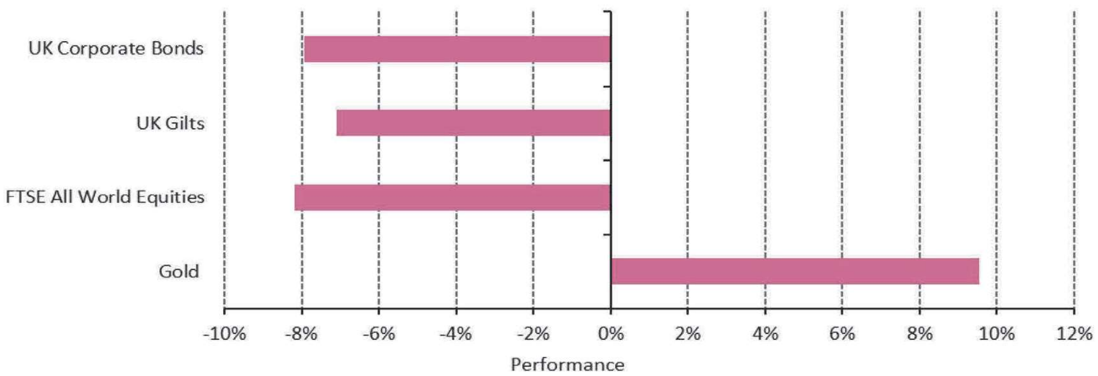
And the results suggest this is not a temporary phenomenon. The gold allocations were primarily described as strategic rather than tactical. And when asked how their allocation to gold may shift over the next 12 months, 39 per cent of respondents said that it would likely increase. That compares with less than one third expecting their bond allocation to increase. Is gold, therefore, becoming increasingly relevant as a portfolio diversifier in the current environment?

Chart 1: UK pension fund survey respondents view gold as an effective and liquid diversifier and inflation hedge



Base: 88 respondents

Chart 2: Year-to-date returns for gold versus UK bonds and global equities*



Source: Bloomberg
* As of 15 March 2022

Inflation a key risk for pension funds
Our survey responses indicate that may be the case. As inflation races to multi-decade highs, our survey showed widespread recognition to gold's diversification and inflation-hedging potential: around three quarters of the respondents agreed that gold has a proven track record as an effective portfolio diversifier and hedge against inflation.

The evidence suggests they are justified in this view. Our analysis has shown that gold's average annual return since the turn of the century, measured in pound sterling, is 11 per cent, far outpacing average annual UK CPI (2 per cent) over the same period.[2] And gold can also protect investors against higher inflation levels. In years when inflation was above 2 per cent, gold's price increased on average by 12 per cent.[3] Over the long term, therefore, gold has not only preserved capital but helped it grow.

Respondents also recognised gold's ability to generate long-term returns, with 80 per cent agreeing that it can positively contribute to returns within a multi-asset portfolio. Historically, gold has contributed positive performance during both good economic times and bad. Looking back over the half century since the end of the gold standard in 1971, the price of gold in pound sterling has increased by an average of nearly 12 per cent per year – a performance comparable to equities and higher than bonds.[4]

Gold provides downside protection
Many assets often become increasingly correlated as market uncertainty rises and volatility becomes more pronounced, driven in part by risk-on/risk-off investment decisions. As a result, many so-called diversifiers fail to protect portfolios when investors need them most.

Gold is different; its asymmetric correlation with other asset classes helps to make it a particularly effective portfolio diversifier. During periods of market stress, its negative correlation to equities and other risk assets actually increases as these assets sell off. We have seen this recently: While equities and bonds have tumbled in value since the start of the year (see chart 2), gold has rallied, increasing by 9.5 per cent in pound sterling.[5]

Conclusion
Pension funds looking to protect their portfolios should carefully consider whether the diversifiers they choose will be effective in protecting portfolio performance when they need it the most. Bonds, the traditional asset of choice for defined contribution funds, may no longer offer the diversification benefits they once did.

Our work has found that gold's unique characteristics make it stand apart from other mainstream assets. The prolonged environment of ultra-low interest rates, together with potentially persistent high inflation and greater uncertainty, seems to be boosting interest in gold as a diversifier, particularly given its historical track record of strong performance during periods of high inflation. And recent geopolitical events represent a clear example of why gold is such an effective and well-established hedge against both expected and unexpected market risks.

The World Gold Council/Pensions Age survey was conducted in February 2022 and participants were from 88 UK master trusts, DC and DB schemes. Questions related to the article or gold can be directed to claire.lincoln@gold.org

In association with WORLD GOLD COUNCIL

[1] Stocks go down, bonds go... down? | Post by World Gold Council | Gold Focus blog | World Gold Council
[2] As of 31 Dec 2021. Source: 'The Relevance of Gold as a Strategic Asset 2022', World Gold Council
[3] Source: Bloomberg; ICE Benchmark Administration
[4] Ibid.
[5] As of 15 March 2022