

Every five or ten years a new investment class emerges and we pinch ourselves for not having invested earlier. Everyone sees the risks of the new and popular investment as being relatively low compared to the upside. Or so they think.

Take today's most sought after investment, gold. Gold is permanent and indestructible. There is also the reassuring thought that it has been a currency and store of wealth for centuries. Its total above ground supply is a mere 150,000 metric tons. Every year the gold that is mined only increases the total amount of gold in the world by 1.5%, making supply essentially fixed.

Perhaps then the question we should be asking is why not have everything in gold? To answer this question it is essential to gain an appreciation for what happened to gold investors the last time it was in vogue.

Prior to 1971, most currencies were either freely convertible into gold or United States dollars (which in turn were convertible into gold). Central bankers had to theoretically purchase additional gold each time a bank note was printed. Unsurprisingly, the supply of United States dollars in circulation remained relatively constant, as did the price of gold. However, in the mid 1960s the United States became embroiled in a costly and prolonged war – not on terror, but communism. By the early 1970s, America's borrowing had ballooned. To repay its debts, President Nixon decided to print additional dollars. In order to do this he needed to revoke the right to convert United States dollars into gold. It takes billions of years to make an ounce of gold or a barrel of oil, but now there was nothing stopping the United States government printing a billion dollars overnight. The result was a highly inflationary environment in which gold soared from US\$35 to US\$850 an ounce. Meanwhile, the return from alternative investments such as shares and bonds collapsed as companies struggled with the ever-increasing cost of goods and labour. But the reverse was also to hold true.

PRICE OF GOLD (US\$)



Source: Bloomberg.

In the years following the Fed's decision to control inflation, under Chairman Volker, real investments with earnings, innovators, tenants, plant equipment and dividends rose sharply in value while gold plummeted. In the twenty years following 1980, \$100 invested in gold was only worth \$32, whereas \$100 invested in global shares had grown to \$1,350.

And therein lies the problem with gold. Other than for its intrinsic beauty, gold is a good investment when the printing presses are whirring or during rare moments of investor panic, which are fleeting. As gold does not earn or yield anything, over the long term it does nothing more than preserve investors' capital against inflation. Furthermore, its lack of earnings or yield makes it notoriously difficult to value. Nowhere on an ingot does it promise that the price will not fall below US\$1,000 an ounce again. Neither is it a haven of stability. Since 1971, the price of gold has been more volatile than the share market. Lastly, there is the additional complication of gold being valued in United States dollars. For New Zealand investors, much of gold's strong returns in 2008 actually came from the New Zealand dollar dropping in value against the United States dollar. Since 2009, our currency has risen sharply against the greenback, significantly diminishing investors' returns.

The market for gold in the short run is a voting machine requiring money, not intelligence. There is a risk that this short-term voting machine has got ahead of itself, making gold a 'crowded trade'. But in the long run all markets are weighing machines. The more money printed to restart the

global economy or repay excessive government borrowing, the higher gold will levitate.

The coming decade may see an unprecedented rise in inflationary pressures from which gold stands to benefit. What we are seeing in gold's price today is the increasing tension between the rapidly depreciating value of paper money and term deposits, and the scarcity of physical assets, be they listed property, monopolistic utility companies or ounces of gold. There is also the wild card that central banks in emerging markets such as China, Korea and Brazil, which hold less than 2% of their foreign exchange reserves in gold compared to developed nations' 70%, decide to increase their ownership.

Today's investors are stuck between bullion and a hard place. Physical assets such as mortgaged property, shares and commodities are likely to be more volatile than what most New Zealanders in their retirement would feel comfortable with. On the other hand, inflation is an imminent threat to investors who hold their lifetime savings in cash. Gold alone, alluring as it seems, is not the solution. Investors should instead use it as one component of their retirement strategy, limiting the size of the investment so as not to become a panic-stricken seller in the event of a pullback in gold's recent run-up in price. More sophisticated investors may want to wait for just such a price correction to buy gold or invest in listed, blue-chip mining companies (which incidentally are a way of enjoying both a dividend yield and the rising price of gold).

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