RISK MANAGEMENT

The ultimate portfolio insurance

Studies show that portfolios that include gold or gold shares provide strong protection against the volatility that affects stocks and bonds.

By David Derwin

MANY TECHNIQUES HAVE BEEN USED to develop a solid program to hedge portfolio risk. But instead of just looking at sophisticated computer models and financial derivatives, perhaps we should simply turn to one of oldest monetary assets known to man: gold.

Many extensive studies have found that holding gold assets (i.e. gold bullion or gold shares) as part of an investment portfolio may help to improve long-term returns while reducing risk versus holding just stocks and bonds.

Gold is one of the oldest monetary standards in the world. It is recognized by every country in the world, and many countries have actually used it as their currency at one time or another. Gold is liquid, it is portable, and its value is accepted everywhere.

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Gold draws its strength as a preserver of wealth from its relatively consistent price parity with other commodities throughout history. Two studies have documented this historical stability. The first, *The Golden Constant*, by Roy W. Jastram, published in 1977, analyzes gold prices in comparison to other commodities, represented by the wholesale price index, in Britain and the United States. The second, *Gold as a Store of Value, a Research Study for the World Gold Council* by Stephen Harmston, extends this study to France, Japan and Germany.

The studies demonstrate that in these five industrialized nations, gold has historically maintained a stable purchasing-power parity, with the United States and Britain recording the most stable trends. (The purchasing-power parity of gold is calculated by dividing the gold index by the wholesale price index.) This relative stability can be seen in Figure 1, which compares the fluctuations in the gold index with the wholesale price index in the United States.

The trends in purchasing-power parity are comparable in each of these five countries. It is this historical consistency that makes gold an effective wealth preserver during economically unstable times. Consider the following quotes:

- "Over time, gold has proved to be an effective preserver of wealth. In periods of economic and social instability, when the value of other assets has been all but

Figure 1: U.S. gold price, wholesale prices and gold's purchasing power 1796 – 1997

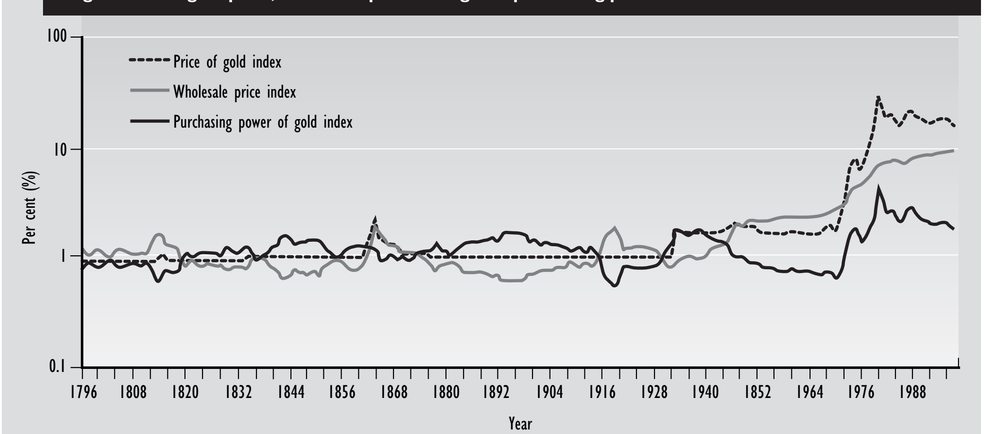
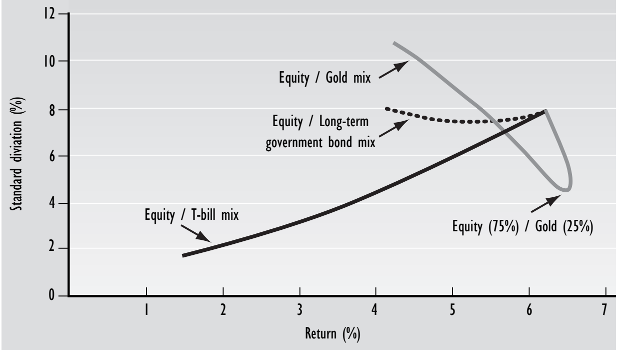


Figure 2: Trade off between risk (Standard deviation) and real return for different portfolio mixes in the US, 1968 – 1996



1910	$1,820	$1,820	0%
1920	$1,540	$1,520	-1.3%
1930	$5,130	$4,730	-7.8%
1931	$2,830	$3,350	+18.4%
1940	$2,780	$4,640	+66.9%
1950	$5,020	$7,460	+48.61%
1960	$13,150	$18,110	+37.7%
1970	$17,680	$24,440	+38.2%
1980	$20,590	$39,140	+90.1%
1990	$56,210	$87,770	+56.2%
1998	$195,160	$245,300	+25.7%

wiped out, gold has been a safe haven." (Stephen Harmston, *Gold as a store of value.*)

- "Gold provides a stabilizing effect in a world of entirely flexible currencies." (Economist Robert Mundell, 1999.)

Gold bears point to gold's characteristic stability when they argue against investing in it. They state that returns on gold tend to underperform returns from stocks and bonds. However, when gold is introduced into a diversified portfolio, the portfolios diversified with gold outperform portfolios without gold.

Two separate studies, one performed by the World Gold Council and one conducted independently, determined that investment portfolios that include a 15%-25% weighting of gold or gold shares tended to outperform no-gold portfolios.

These two reports attribute this trend to the fact that returns from gold are non-correlated with returns generated from stocks and bonds. Gold's non-correlation allows it to be used as a hedge against the risk of fluctuations in the stock and bond portions of a portfolio. Gold helps provide more consistent returns to portfolios consisting solely of stocks and bonds. This may be especially true during periods when interest rates and stock markets are experiencing downward pressure.

One study, the source of Figure 2, determined that, when gold was introduced into a portfolio consisting solely of equity, returns tended to increase while risk (standard deviation) decreased.

This was found to be the case for portfolios with up to a 75%-equity/25%-gold ratio. For the Equity/T-bill portfolios, the study found that, as the portion of T-bills in the portfolio was increased, risk declined, but so did the portfolio's rates of return. As for the Equity/Long-term government bond portfolio, increasing the level of bonds in the portfolio reduced the level of risk, with ratios of up to approximately 55%-equity/45%-bonds. However, the reduction in risk from introducing bonds into the investment portfolio was marginal. This study was conducted using physical gold.

The next study, conducted in 1999 by Taylor Hard Money Advisors, Inc., called *Preserving Wealth with Gold Shares*, analyzed the benefits of gold in an investment portfolio using gold stocks. This method for investing in gold may have advantages over using physical gold.

The study utilized information from one of the longest-running mines in the United States, Homestake Mining. The study analyzed the returns on the portfolios from 1903 to 1998 and found that a portfolio containing 15% gold shares (the optimal portfolio) outperformed the returns on a portfolio comprised solely of the Dow Jones Industrial Average over the long-term.

These studies indicate that gold or gold shares, when used effectively within a diversified portfolio, can insulate a portfolio from fluctuations in the economy. This ability to preserve value and stabilize earnings can be attributed to gold's non-correlation with stocks and bonds and to its inherent ability to maintain its value in relation to other products in times of economic instability.

Gold and gold shares prices are historically cheap. Given gold's long-term stability, diversification characteristics and return benefits, gold assets are a necessary component in an investment portfolio. Gold is well suited for long-term funds such as pensions, retirement funds, life insurance and endowment funds, especially in these times of overvalued equity markets, low interest rates and global economic uncertainty. There has never been a better time to buy portfolio insurance. With the leverage of gold shares at about 2.5 to 1 versus the price of physical gold, we suggest including a diversified holding of gold shares in all portfolios.

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