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Strategy

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Asset Management

The outlook is bright for gold and gold equities

Gold and gold equities have proven to be good long-term diversifiers of portfolios

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– Gold has long been considered an important part of a multi-asset investor's toolkit. Although interest in the asset class as a standalone investment has historically fluctuated, its reputation as a safe-haven, inflation-protecting diversifier has accounted for its consideration within a broader portfolio. Sentiment around interrelated factors such as the level of US real interest rates, US dollar weakness, central-bank policies and uncertainty/market volatility has contributed to ebbs and flows in investor demand for gold. Although at times gold has experienced a somewhat unpredictable price performance, ultimately investors have been rewarded through attractive returns over the long-term with significant portfolio diversification benefits.

– In 2020 we saw a perfect confluence of factors that pushed gold to record highs. Due in large part to the COVID-19 pandemic, rising economic uncertainty, inducing unprecedented levels of monetary easing and fiscal stimuli, combined with doubts about the defensiveness of government bonds to drive gold up through US$2000/oz. This backdrop, combined with an overall positive but volatile period for equity markets, also proved to be highly supportive for gold equities.

– In this paper, we outline the characteristics underpinning the asset class and identify the key drivers we believe are important for its performance. This is followed by a summary of the different ways that investors can access gold and a description of the benefits we see these different approaches having in a broader portfolio context.

The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Past performance is not a reliable indicator of future results. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Investment objectives and performance targets are subject to change and may not necessarily be achieved, losses may be made

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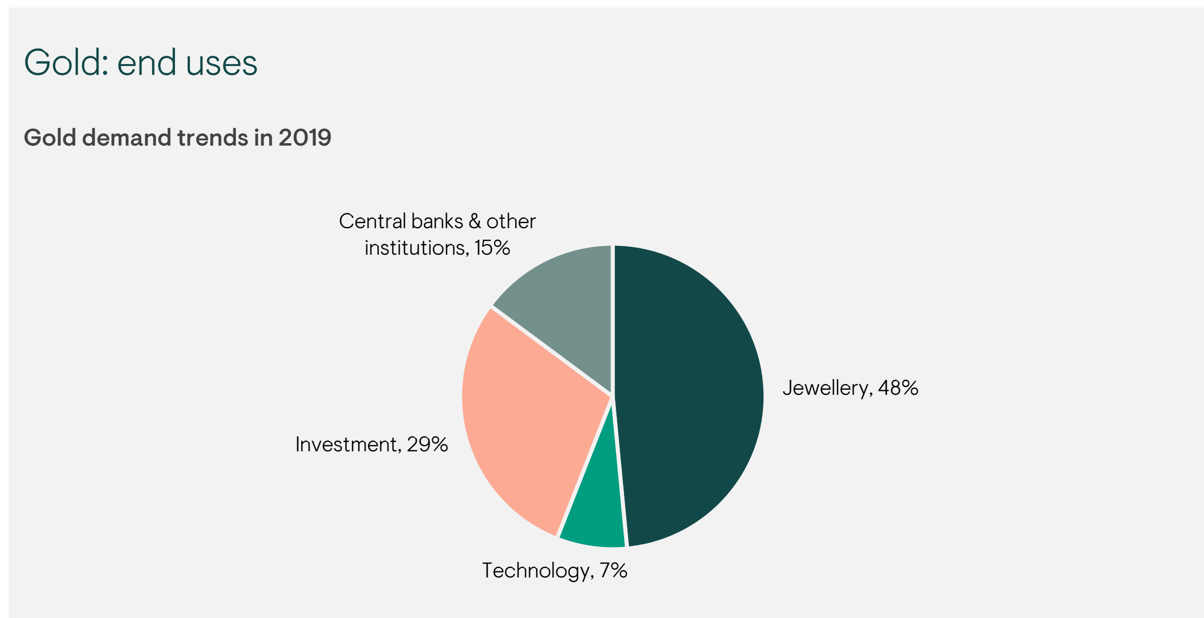
Characteristics and properties of gold:

Store of value

The association of gold with wealth has been in place for thousands of years with the metal's chemical stability, bright colour, density and relative rarity contributing to its attraction as a store of value. As the chart below illustrates, it is often manufactured into jewellery and decorative pieces but, even in these forms, it is still seen as a means of storing wealth.

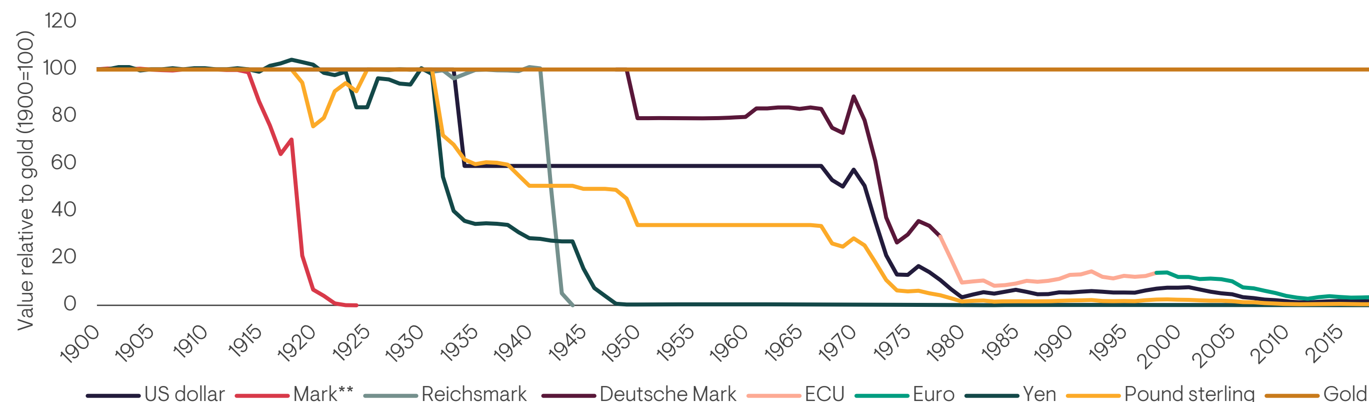


Source: World Gold Council, 2019. Numbers may not add up to 100% due to rounding.

In many countries, gold, either in the form of bars or jewellery, is a convenient and safe method of transferring wealth. China and India make up over half of the global market for gold jewellery as it is used as a method of transferring and preserving wealth, such as in the form of a wedding gift. This also explains why aspects like seasonal demand for gold (e.g. relating to the wedding season in India) have an impact on its price over the shorter-term.

The vast majority of the world's gold is held as a wealth store – either in bullion vaults or as jewellery. The stock of gold is not disappearing, with the World Gold Council estimating that there are 197,576 tonnes of gold above ground in existence at the end of 2019 or around US$12 trillion at US$1,900/oz. In addition, gold cannot be printed – neither physically nor in accounting terms – contrary to our money systems which are currently expanding significantly through quantitative easing measures. Gold mine production is just over 3,500t per year currently, meaning the stock of gold is growing by 1.75% p.a. or just over US$210 billion p.a. Its long-term store of value can be demonstrated in the following chart, which compares gold's value to different currencies since 1900.

Gold has been a store of value



Source: World Gold Council, March 2019. *The 'Mark' was the currency of the late German Empire. It was originally known as the Goldmark and backed by gold until 1914. It was known as the Papermark thereafter.

Gold

Gold also has limited industrial/technological uses – it is a very good conductor – but this makes up only around 8% of demand. Within investments, investors hold gold both for its ability to protect during turbulent markets, but also for the prospect of capital gains over the long-term. As we will explore later, it also has significant use by central banks around the world.

'Safe-haven' status

A safe-haven investment is one that retains or increases its value in times of economic and financial crises, political upheaval and other market environments which typically put downward pressure on asset prices.

Gold's store of value characteristic has contributed to it being considered a safe-haven asset, with demand for the asset class increasing in times of economic duress. This is demonstrated below, with gold having acted as a safe-haven consistently through periods of crisis seen in recent history.

Gold has performed positively in recent bear markets

Source: Bloomberg, gold spot price 30 September 2020. Shaded areas indicate risk-off environments for equities

The liquidity of the gold market enhances its safe-haven status, as investors can take comfort in the ease with which they can sell their gold in turbulent markets. The value of gold traded on a daily basis in 2019 was calculated by the World Gold Council to be around US$145 billion per day, close to the US$150 billion per day traded for the whole of the S&P500 or US 1-3 year treasuries. This, combined with the fact that there is no credit risk with gold as it is no one else's liability, also increases its attraction to many investors.

Inflation hedge

An inflation hedge is an asset that guards against the decreased purchasing power of money attributed to an overall increase in the price of goods and services. The price of gold has historically moved higher during inflationary periods, thereby proving useful as an inflation hedge. This is because when domestic inflation rises, the value of a nation's currency typically falls leading to increased interest in gold as a more reliable store of value.

	Average gold price return
US inflation >5% (high)	26.4%
US inflation 2% to 5% (moderate)	5.2%
US inflation <2% (low)	8.4%

Source: Ninety One. Average monthly inflation taken since 1970. Annual price return shown for gold spot price.

When looking back over the last two decades, inflation hedging is not something most developed economies have needed to be concerned about. However, as we describe later, should central banks leave interest rates too low for too long, or increase the money supply at a rate faster than the growth in real output, then a sharp uptick in the inflation rate could materialise as a real risk. In the event of a rising inflation rate, traditional inflation hedges such as gold are expected to outperform other asset classes.

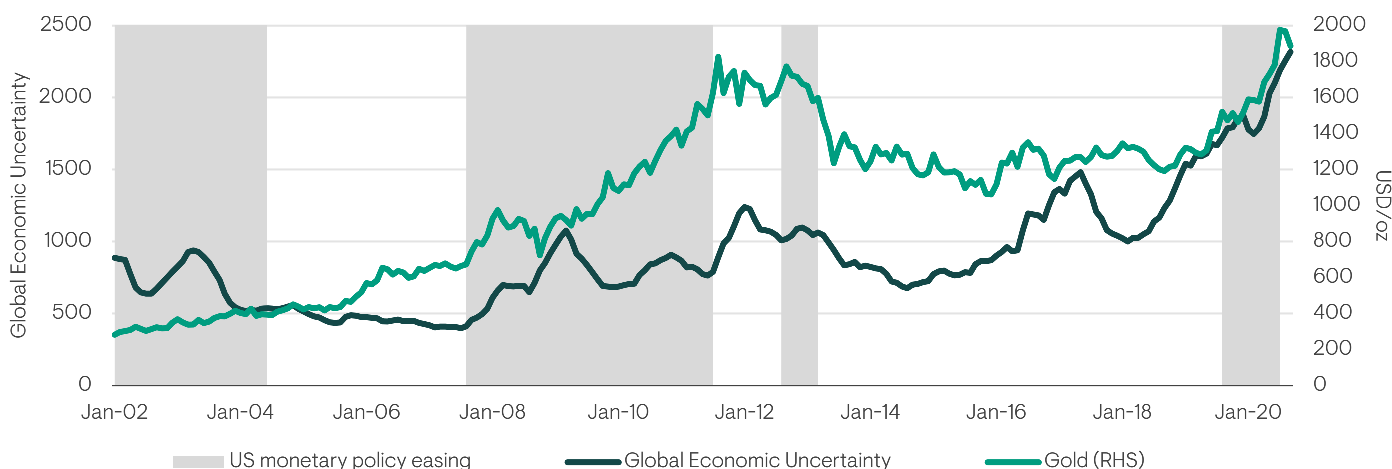
Factors influencing the gold price:

While gold has a reputation as an uncorrelated asset class with a somewhat unpredictable performance signature, our analysis suggests that there are a number of factors that can help to explain its performance. These factors are largely interrelated and include the level of economic uncertainty, economic growth, central bank liquidity and US dollar strength/weakness, while as we noted above, the relationship with inflation and therefore US real interest rates is commonly seen as another measure with which to assess likely performance patterns. Other factors that may influence the gold price include the possibility of changes in the international monetary and financial system – with China's involvement potentially directly impacting gold prices – as well as broader investor demand for alternative defensive assets in an environment where government bonds are less reliable for this purpose. We explore these various factors before showing how modelling a combination of them offers some insight into the valuation of gold.

Economic uncertainty encourages investors to buy gold as a safe-haven

Gold's reputation as a safe-haven asset means that as economic uncertainty increases (typically associated with falling equities), investors tend to allocate to gold. For example, at the beginning of 2020 as the COVID-19 pandemic began to engulf markets globally, we saw gold prices rise, with the settlement price for gold futures at one point surpassing US$2,000/oz. This relationship can be seen in the chart below, which shows how the gold price has varied against a global economic uncertainty measure.

Gold vs Economic Uncertainty and Monetary Policy



Source: Bloomberg, Baker, Bloom and Davis, 30 September 2020. Time period selected for contextual and illustrative reasons. Global economic uncertainty indices are calculated by Baker, Bloom and Davis based on news sources that contain terms related to uncertainty.

There is no sign of the prevailing economic uncertainty abating, with concerns over how the global economy will recover following a severe contraction triggered by the coronavirus pandemic and the rise in tensions between China and the US primary contributors of continued uncertainty. Markets will likely remain volatile until there is a clearer understanding of when and how the economy can get back to 'normal'.

Following the Global Financial Crisis in 2008, gold prices continued to rise for three years as concerns continued for the world economy and the measures that had been taken. Considering the measures taken this year have exceeded those of 2008 and the pandemic continues to spread globally, it does not seem unreasonable to believe the current uncertainty will continue for as long, if not longer, particularly if it threatens the international monetary and financial system, as discussed below.

The expansion of central banks' balance sheets should support gold prices

Monetary policy frameworks have evolved over the years. From the 1980s, central banks traditionally relied on cuts to short-term interest rates to stimulate economies as lower interest rates induced spending as opposed to saving. However, the constraint on this policy became clear during and after the Global Financial Crisis, as the US Federal Reserve (Fed) and other major central banks cut interest rates to, or close to, zero. With economies in freefall and traditional methods exhausted, central banks turned to new and unconventional policy tools, such as quantitative easing (QE; i.e., purchases of longer-term financial assets). At the time, this not only signalled policymakers' intention to keep short rates low for an extended period, but by reducing the net supply of longer-term assets, their prices increased which in turn stimulated spending through the wealth effect.

However, in 2020, the severe economic consequences of the response to the COVID-19 pandemic forced policymakers to consider other responses beyond interest rate cuts and quantitative easing. In most nations, we saw a coordinated monetary and fiscal policy leading to an unprecedented level of fiscal stimulus from governments combined with aggressive monetary policy decisions. The US gross national debt, for example, increased by US$4.2 trillion over the 12 months ending 30 September 2020 to US$27 trillion. This significant supply of debt is being acquired largely by central banks, which have effectively been printing money to fund huge fiscal deficits.

The result has been a significant expansion in the balance sheets of the major central banks. History has shown there is a reasonable relationship between global liquidity (as represented by the size of this balance sheet) and the price of gold, as can be seen in the chart below. With no sign of a reverse in balance-sheet expansion, given the commitment from these central banks to continue providing support in these uncertain times, it is likely that this glut of liquidity will continue to support the gold price.

G4 Balance Sheets % of GDP

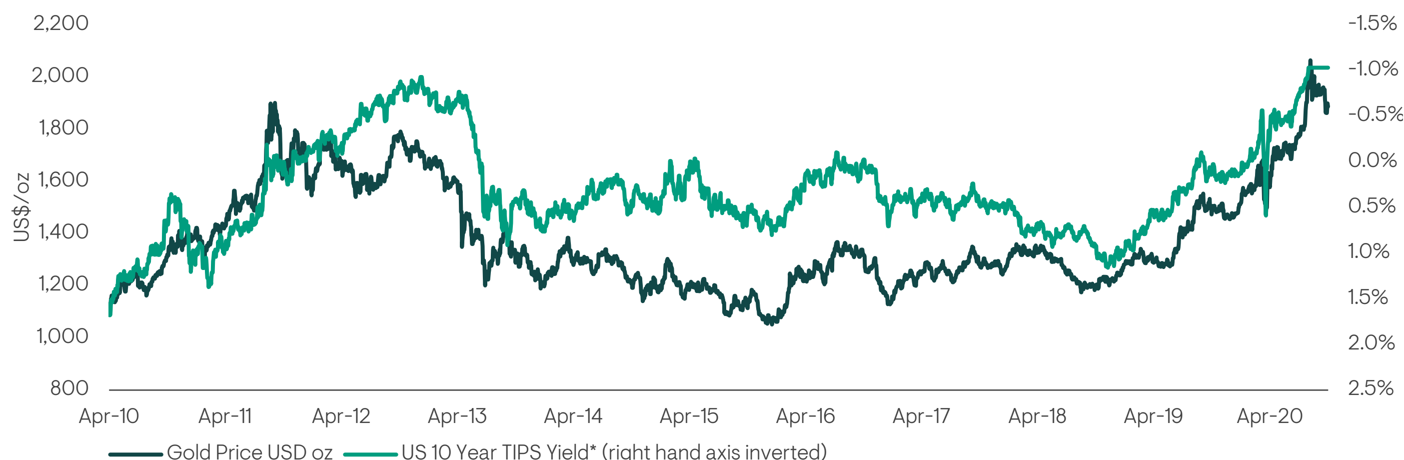
Source: Bloomberg, various central banks and Ninety One calculations. Gold spot price US$/oz 30 September 2020

Falling real rates support and even boost gold prices

The significant additional debt incurred by governments in response to the COVID-19 pandemic has been added to already high levels. This was the right way to respond to the crisis and governments had little choice. However, these eye-watering levels of debt must be repaid eventually and will burden generations to come unless something is done. Most solutions – such as taxes and growth – are unpopular or unrealistic. We believe 'financial repression' – the concept of government policies that prevent market participants from full investment freedom - is the most likely solution. The capping of bond yields via central bank yield curve control, regulations that require the financial sector to hold more government bonds, and keeping real yields negative – we believe these are the most likely tools that central banks will use.

The real yield of US 5-year bonds returned to negative territory at the start of 2020. If 'financial repression' materialises, real yields should fall further and, in that eventuality, we would argue that the most obvious shelter is gold. As we show below, falling real yields have coincided with a higher gold price.

High negative correlation to US real rates



Source: Bloomberg, 30 September 2020. Time period selected for contextual and illustrative reasons. * The yield on the US 10-year TIPS represents the real rate of return guaranteed by the US government, which is the interest rate that would be charged in a world where there is no inflation.

During the COVID-19 crisis, control of the supply of money has quietly passed from central banks to governments as governments spend printed money in the real economy with the hopes of reflation. We are seeing money handed out to the unemployed, to companies, and even to the hospitality sector through schemes such as 'Eat Out to Help Out' in the UK.

The recently announced policy shift to 'average inflation targeting' means that the central bank will be more inclined to allow inflation to run higher than the standard 2% target before hiking interest rates. A successful reflation in nominal terms could be beneficial for all assets generally. A risk is that we see stagflation – weak growth and high inflation; however, in this eventuality inflation-hedge assets such as gold typically outperform the likes of equities. Whether we see inflation or stagflation, combined with financial repression policies to keep the short-end pinned down through low interest rates and explicit forward guidance, we would expect to see real rates firmly entrenched in negative territory and possibly moving lower for the foreseeable future.

A weaker US dollar should lead to higher gold prices

Historically, gold has moved in the opposite direction to not only real interest rates, but also the US dollar. When the value of the dollar increases relative to other currencies around the world, the price of gold tends to fall in US-dollar terms. This is because gold becomes more expensive in other currencies. Conversely, as the value of the US dollar moves lower, gold tends to appreciate as it becomes cheaper in other currencies. Given the relationship between US growth and the US dollar, it follows that weakness in US growth leads to a weakening US dollar and therefore is a positive tailwind for gold.

Currently we believe the US dollar is torn between (a) an expensive valuation and a Fed that is attempting to engineer deeply negative interest rates and (b) a more dynamic structural economic backdrop than other major developed market currency blocs. Looking over the medium-term, if reflationary efforts in the US are successful, if Chinese supply-side reforms continue and if Europe takes further steps towards closer fiscal union among member states, the probability of a dollar down-cycle will increase. Whilst we need to see more evidence that the Euro is able to appreciate vs the US dollar, for other currencies (including gold) we have a strong negative US dollar view particularly given our high conviction on the Fed's policy being successful.

However, the US dollar weakness that is potentially unfolding could be structural in nature rather than purely a cyclical play. The 8-year US dollar bull market has been supported by a large interest rate differential and above-trend growth relative to the rest of the world. Since the pandemic-induced recession, we have seen the removal of the twin pillars that used to support the dollar – interest rate differentials and US growth exceptionalism. Even prior to the pandemic, we believe there were various structural factors at play that could accelerate 'de-dollarisation' moves and result in the end of US dollar hegemony, such as geopolitical shifts, changes in energy market dynamics, and structural shifts in China including an accelerated effort to reduce reliance on the US dollar and boost foreign investment. In a world that is no longer unipolar, gold makes sense, as it's no one's sovereign money. Therefore, a structural shift in the US dollar's dominance supports the case for making a long-term allocation to gold in portfolios given the diversification benefit gold offers in a global trend toward 'de-dollarisation'.

Reform of the IMFS could increase uncertainty and a weaker US dollar

The international monetary and financial system (IMFS) has been seen as the glue that binds national economies together, in that it should allow countries to achieve independent macroeconomic stabilisation, global financial stability and cross-border trade-enhancing capital mobility. However, the issue at the heart of the IMFS, as has been the case since the widespread adoption of the gold standard in 1870, is that achieving each of these three objectives at the same time is not possible. Since 1971 we have achieved capital mobility and independent monetary policy but seen increasing financial instability. The recent coronavirus pandemic and resulting 'dash for cash' brought the IMFS' fragility into question yet again, and monetary and fiscal authorities had little choice other than to attempt to keep economies on life support with massive stimulus. But as the virus passes and life begins a slow reversion to normal, the fault lines in the IMFS are still there. Reform is therefore desperately needed.

While we believe change is inevitable, a lesson from history is that the status quo can hold tight for longer than expected. In fact, the Global Financial Crisis was seen by many as a moment that meant reform was imminent, and yet 10 years later the IMFS remains largely as it was in 1979, except that financialisation, globalisation and debt imbalances have grown to extraordinary levels. A continuation of the status quo means widespread expansion of central bank balance sheets, lower for longer interest rates, and negative real rates. Against a backdrop of low or negative yielding rates, gold is an attractive asset as the opportunity cost disappears, and as a tangible asset with a finite supply the value of gold cannot be inflated away.

Another lesson learnt from history is that change can occur, and very quickly. In the aftermath of COVID-19, the pressure to change may manifest itself in several different ways.

1. Multipolar world

The rift between the US and China may widen further and the current US dollar-based system may splinter into a multipolar world that sees economies align to either a US dollar- or renminbi-based system. In this instance, it is not clear what this would mean for gold, but there is no reason to think it would be negative.

2. Central-bank digital currencies

A number of central banks are exploring the prospect of digital currencies, a new synthetic hegemonic currency (SHC) provided by the public sector. This technology could enable a government to give money directly to people via quantitative easing or implementing deeply negative interest rates. Under both options, gold is hugely attractive.

3. A united front?

An arranged breakup in the spirit of Bretton Woods could be revived, and much as the G20 implemented a coordinated policy response at the height of the Global Financial Crisis, the potential blow to the global economy from COVID-19 could see the major economies of the world come together to agree a path forward to a better designed IMFS and a plan to evolve the current non-system. But with substantial and growing disagreements between countries, this feels highly unlikely at the moment. Similar to the eventuality of a multipolar world, it is not clear what this would mean for gold but there is no reason to believe it would be negative.

4. Every country for itself

Finally, and as seen during the interwar period, it's 'every country for itself' as the economic cost and debt burden taken on during this crisis lead to radical policies intended to reflate economies. If economies turn to widespread monetary financing of debt and helicopter drops of money in order to give the illusion of prosperity, the pressure on those currencies unwilling to take such radical steps will become untenable and widespread capital controls will be imposed to stem the tide. In a messy breakup similar to that seen in the breakup of the gold standard, holding real assets such as gold would be preferable due to expected widespread currency turbulence and possible inflation.

While ultimately the future of the IMFS is a big unknown, the common denominator across all four scenarios is that we would expect the dominance of the US dollar to be reduced. As we mention elsewhere in this paper, historically gold has moved in the opposite direction to the US dollar and therefore this environment could act as a tailwind for gold.

A lack of return from bonds and the relative attractiveness of gold

For decades government bonds have provided attractive returns, with low volatility and often negative correlation to equities, making them effective portfolio diversifiers. However, the market crisis prompted by the coronavirus pandemic has accelerated previous trends and is challenging this basic tenet of investing. Low yields, poor future return expectations, higher volatility, as well as increasingly unstable correlations, are reducing the diversification benefit of bonds.

The aggressive rate-cutting action taken by central banks in March in response to the coronavirus pandemic, combined with the vast levels of quantitative easing undertaken year-to-date, means that countries that previously had room to ease monetary policy further, such as the US, have now converged with countries already on ultra-low rates. The current low level of yields means there are less

opportunities for yields to fall to boost returns, particularly given the reluctance of central banks to take interest rates materially below the zero lower bound.

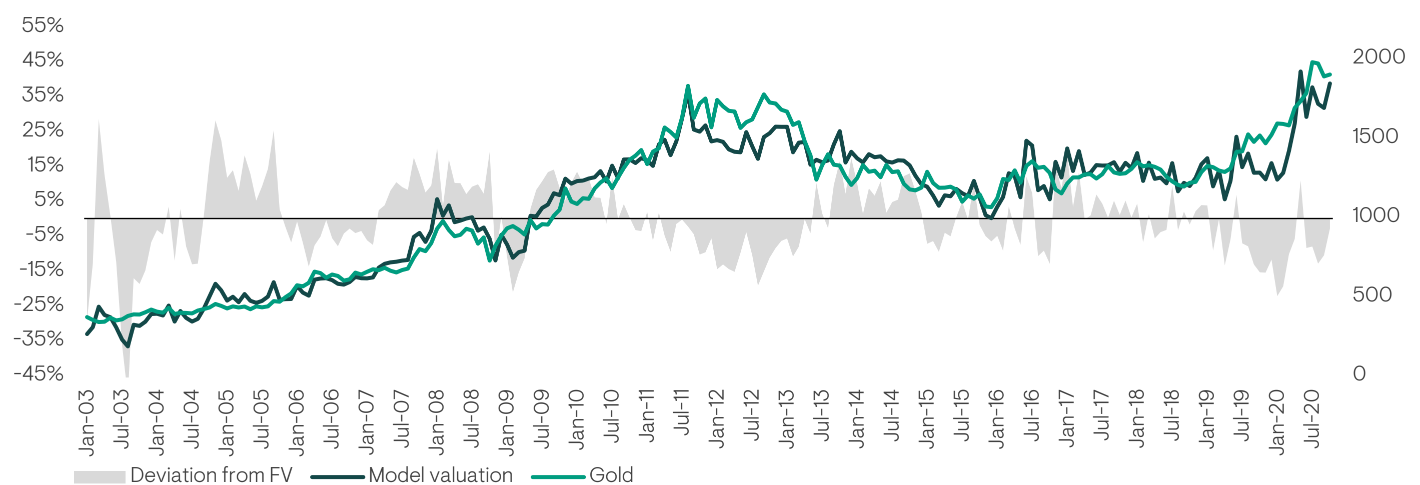
As the amount of low-yielding debt increases, gold becomes increasingly attractive. One of the key drivers of gold, especially in the short and medium term, is the opportunity cost of holding it. Unlike bonds, gold does not pay interest. This lack of yield has been a deterrent for some investors in the past. But in a world where US$15 trillion (July 2020) of developed market sovereign debt is trading with negative nominal rates and, an amount even greater once adjusted for inflation, the opportunity cost of gold goes away, even providing what can be seen as a positive cost-of-carry when compared to negative interest rates offered by some sovereign debt.

A lower rate environment, together with lacklustre future return expectations for bonds, may make gold more effective than bonds in mitigating equity risk, providing portfolio diversification and helping investors achieve their long-term investment objectives.

A gold price that reflects these influencing factors

As can be seen above, the drivers of gold prices are multiple but also interrelated. We have developed a valuation model that incorporates four of these inputs: uncertainty, the US dollar, central-bank balance sheets and equity skew (the degree to which investors are seeking protection through equity options). The model output shown below has historically demonstrated a strong relationship with the gold price, indicating that these factors should be considered when trying to determine the future direction of gold prices.

Gold Model



Source: Bloomberg, Ninety One calculations and gold spot price US$/oz 30 September 2020

Characteristics of gold equities:

Gold equities can build on physical gold investments

Gold equities offer many of the same investment characteristics as gold, including that they offer diversification away from other major asset classes. Gold equities also bring complementary qualities to a portfolio, summarised in the box and explored in more detail below.

Gold equities can offer leverage to the gold price

Gold equities can offer sustainable income

Gold equities offer growth optionality in an undersupplied market

Gold equities can offer attractive returns and free cashflow, with lower debt

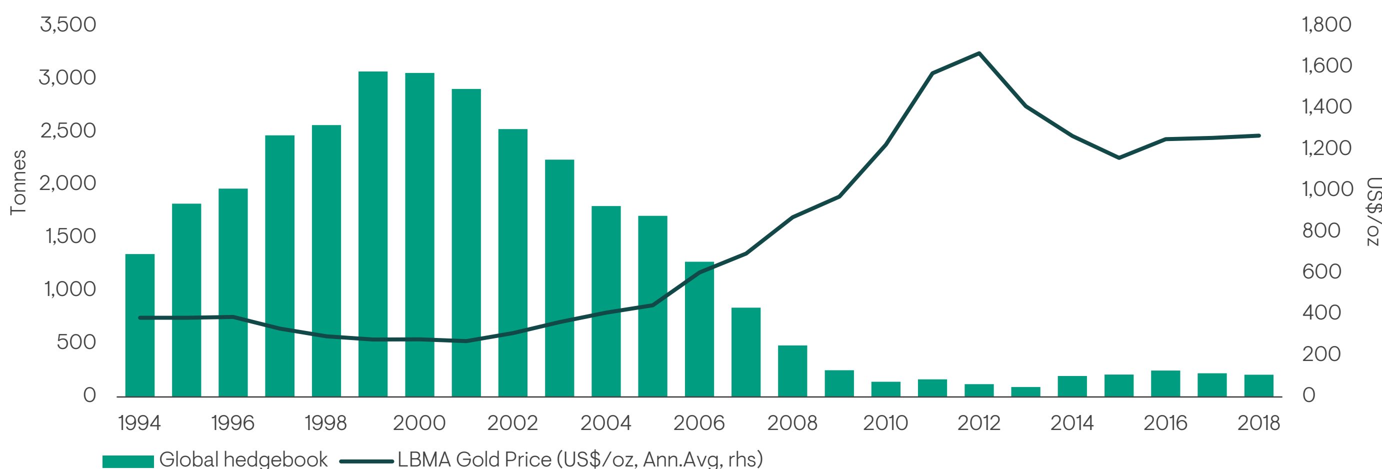
Opinions based on current market conditions; subject to change without notice and without any obligation to update.

Gold equities provide leverage to gold prices

The price performance of gold equities is more volatile than that of the commodity. For a given percentage change in the gold price, it is typical of gold miners to provide an amplified reaction in both directions. In other words, a relatively small increase in the price of gold can lead to a much larger gain in gold equities.

Although the level of sensitivity to the gold price is not a constant one and will change over time with factors such as gold miners' balance sheets and exploration plans, as well as the oil price (a key input cost), management quality and foreign currencies, historically the gold price has been the primary driver. This has increasingly been the case as hedging the gold price by selling future production at fixed prices fell out of favour in the gold mining industry as the gold price rallied, and several large gold miners such as Barrick Gold spent billions of dollars to unwind their hedges. There has not been a material return to the practice despite the falls in the gold price after 2011 and as such the correlation of gold miners' performance to the gold price should continue to increase.

Global Gold hedgebook volume



Source: Metals Focus; GFMS, Thomson Reuters; World Gold Council, November 2019. Time period selected for contextual and illustrative reasons.

Gold – the physical asset – does not offer growth potential over and above the changes in its value, since an ounce of gold will always just be an ounce of gold. A miner, however, is a business that can expand over time, and can produce more gold by investing in its mining operations. The most common measure of mining costs is called all-in sustaining costs (AISC), which includes the costs required to operate mines, maintain mines and equipment, and invest in mine development. When taking AISC into consideration, miners' exposure – and leverage – to the gold price is clear. This is best shown by an example.

Example 1:

A large cap company has AISC of US$900/oz. If the price of gold is US$1,500/oz, crudely speaking the company makes a profit of US$600/oz. Should the price of gold increase to US$2,000/oz, profit increases to US$1,100/oz. As such a 30% increase in the price of gold leads to an 80% increase in the company's profit/oz.

Example 2:

A smaller, more leveraged company has AISC of US$1,200/oz. Using the same 30% increase in the price of gold, profits go from US$300/oz to US$800/oz, showing a profit-margin increase of 170%.

So while larger companies benefit from economies of scale and lower costs, smaller companies with more leverage see their shares respond more dramatically to changes in the gold price.

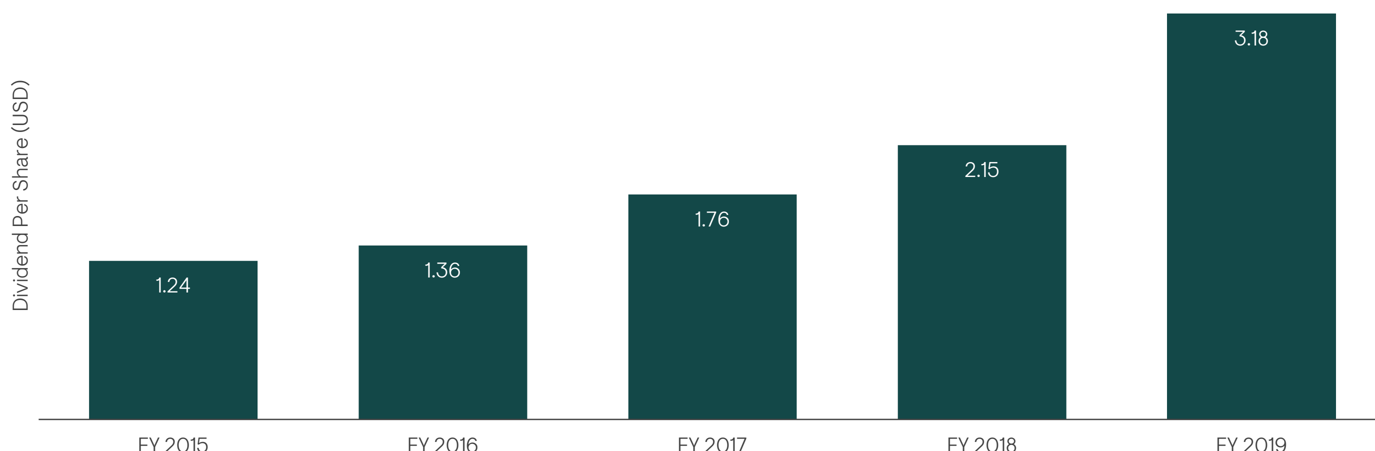
At today's price levels, gold companies are profitable. As balance sheets and sentiment towards the gold space have been repaired over recent years, if costs remain stable, gold equities are likely to display significant gains in response to upward moves in the gold price. It is important to remember, however, that a gold miner's leverage to the price of gold applies in both directions.

Gold equities can provide a yield unlike gold itself

While physical gold offers no income, gold equities increasingly do, in the form of dividends. Gold stocks generally rise and fall with the price of gold as detailed above; however the gold mining sector is continually reshaping itself to generate higher returns on capital even in a neutral gold price environment, meaning there are well-managed mining companies that are profitable even when the price of gold is considerably lower than it is today.

Gold miners are increasingly focused on producing value for shareholders rather than growth for the sake of growth. Dividends per share of the top five gold companies have doubled since 2015 and, at the time of writing, look set to increase again. The majors are leading the way with dividend raises, and smaller gold producers will likely follow. Against a backdrop of historically low interest rates, lacklustre returns from fixed income and enforced dividend cuts in other sectors such as banks, there is increase investor interest in gold mining companies.

Dividend per share for 5 largest gold companies



Forecasts are inherently limited and are not a reliable indicator of future results.

Source: Bloomberg, 30 June 2020. Time period selected for contextual and illustrative reasons. Five largest companies by market cap in the index, NYSE Arca Gold Miners Total Return Index.

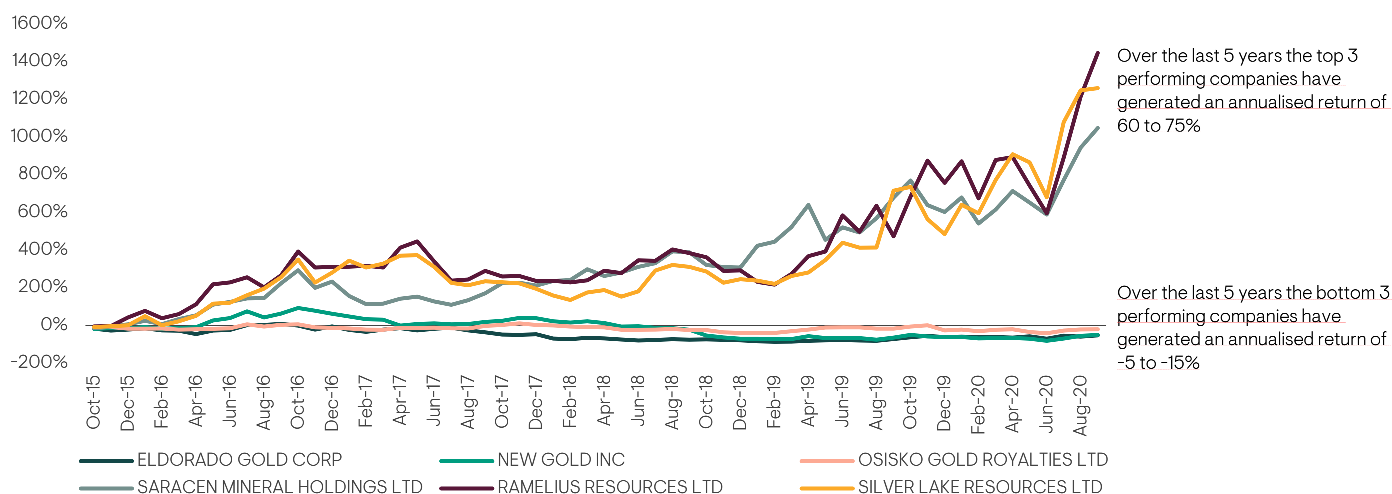
With a rising number of mining stocks now paying – and often raising – their dividends, adding gold equities to a broad portfolio can provide another useful income stream. Gold mining majors such as Newmont, Barrick Gold and Newcrest Mining, all currently pay a dividend yield above 1%; this is increasingly being reflected across the industry with many companies expected to maintain or increase shareholder returns. This is particularly valuable given the gold market is countercyclical; gold company dividends can improve the 'through-the-cycle' income sustainability of a diversified portfolio.

Active management within the gold equity sector can improve long-term returns

Market and industry dynamics make gold mining equities well suited to active management. There are several unique characteristics of the gold mining sector that active managers can seek to benefit from, including but not limited to: the operating dynamics of the sector, the volatility of the asset class, and fundamental research, including ESG factors.

The world's supply of unmined gold may be limited, but what there is will not be shared out evenly among gold producers. Overwhelmingly most of the profits from the gold sector come from a handful of quality mines. The best mines generate all the wealth and the best deposits generally reveal themselves over time. Gold companies have the potential to find new gold deposits or discover that existing ones are larger than expected. This can have a material effect on a company's share price. Obviously, the reverse is also true: overestimations of deposits, and underestimations of the costs of extracting ore, can have a materially negative impact on a gold stock. But for investors who lean towards active management and a selective approach, this 'growth optionality' characteristic of gold stocks can be appealing.

There is significant dispersion of returns between gold mining equities



Past performance is not a reliable indicator of future results, losses may be made.

Source: Ninety One, Bloomberg 30 September 2020. 5 year cumulative total return (in USD) of constituents of NYSE Arca Gold Miners Index. Top performers: Ramelius Resources Ltd, Saracen Mineral Holdings Ltd, Silver Lake Resources Ltd. Bottom performers: Eldorado Gold Corp, New Gold Inc, Osisko Gold Royalties Ltd.

The gold sector has seen an improvement in management teams and strategy

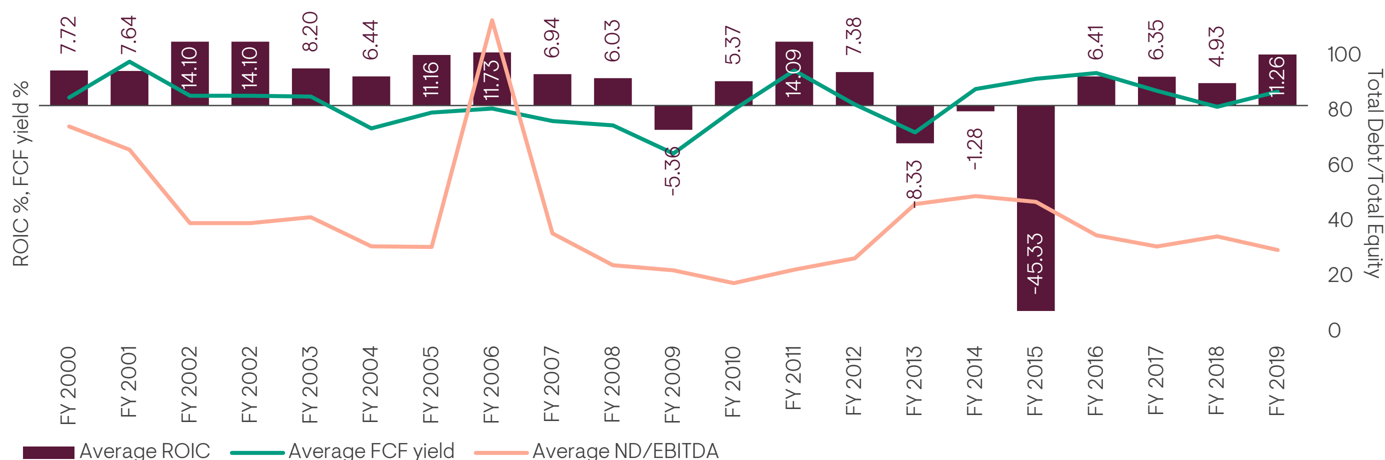
The downturn in gold stocks between 2011-2016 was exacerbated by over a decade of poor capital discipline, as most gold miners positioned themselves as leveraged options on the gold price rather than as businesses trying to generate a return. When an investor buys a gold mining equity, they are prioritising the margin over the life of the reserves in the ground. Gold shares underperformed gold (which fell from a high of US$1,906/oz in 2011 to US$1,056/oz by December 2015) as many companies, under pressure from highly indebted balance sheets, prioritised volumes to generate cash to repay debts. Many chased higher grades in the short term, which, in turn, put longer-term mine plans at risk.

With many companies burdened by high debts, bloated cost structures and large capital commitments, the industry was forced to restructure significantly. What followed from 2015 was an era of cost cutting and balance sheet deleveraging.

Companies significantly reduced capital expenditure and exploration budgets were dramatically cut as companies retrenched both headcount and exploration programmes. AngloGold reduced its AISC through operational improvements, including contract and labour management, while Newmont's AISC reduction was due to operational improvement and portfolio optimisation. These programmes were aided by lower oil prices and a strong US dollar.

The impact of these initiatives, coupled with higher gold prices, has restored the health of large gold companies, evidenced by stronger cashflows, leaner cost structures and deleveraged balance sheets (through divestments, asset impairments and closures), as well as improving profit margins. Companies are in a much stronger position today than they were five years ago; they have paid off debt, returned cash to shareholders and growth has reappeared on management agendas. A rising gold price therefore comes as a bonus on top of gold companies' efforts to improve efficiency.

The quality of gold companies continues to improve



Source: Bloomberg, Ninety One, 30 September 2020. *Simple average of Barrick, Newmont Goldcorp, Newcrest, Franco-Nevada, Buenaventura, Kirkland Lake Gold, Evolution Mining, Anglogold Ashanti, Wheaton Precious Metals

We believe gold equities not only have the potential to continue to provide positive leverage to the rising gold price, but also to protect value in a less favourable commodity price environment as, due to the improvement in the quality of management teams, gold miners are now leaner, fitter and able to survive in a lower gold price environment. Even if the metal price eases back, miners' profit margins remain attractive. The number of miners that have recently announced dividend increases reiterates that the capital discipline of many gold mining companies remains intact.

ESG considerations are highlighting the more sustainable companies

There has been a significant and structural shift in how investors approach assets, with environmental, social and governance (ESG) factors increasingly at the forefront of decision making for investors. Traditional investment principles have not been abandoned, but against a backdrop where change and uncertainty seem to be the only constants, it has become apparent that ESG criteria are vitally important when endeavouring to assess effectively a business's resilience, long-term sustainability and capacity for growth.

Gold mining has had a reputation of having negative social and environmental impacts; however, we think for some companies (although not all) this has now changed. As they have for investors, ESG factors have started to shape the evolution of gold mining companies, with key market participants developing a range of initiatives and standards in order to see that gold is produced sustainably and responsibly. For example, in 2019 the World Gold Council launched the Responsible Gold Mining Principles, a comprehensive framework that gold mining companies can use to give confidence that their gold has been produced responsibly. Strict and transparent ESG standards set by an external party reduce the risk of "greenwashing".

Climate-related risks are now a mainstream issue, core to business interests and increasingly at the heart of basic security valuation and selection processes. Given ESG factors are now seen as a source of value creation, shareholders and investors, such as Ninety One, are helping to drive mining companies to reshape their portfolios, review their supply chains and lower their carbon footprints.

In 2019, Ninety One wrote to 22 gold mining companies asking them to disclose emissions data across their supply chain, thus adding pressure on the sector to tackle climate change. We felt that the sector had been slow to publish data and there was a risk some companies wrongly believed Scope 3 emissions were not relevant to the gold mining sector, underestimating its importance because gold does not create use-of-sold-products emissions (one of the 15 scope 3 categories). Instead they focused predominantly on Scope 1 and 2 emissions, which are those generated by their own operations.

15 categories	Purchased goods and services	Capital goods	Fuel & energy related activities
Upstream transportation & distribution	Waste generated in operations	Business travel	Employee commuting
Upstream leased assets	Downstream transportation & distribution	Processing of sold products	Use of sold products
End-of-life treatment of sold products	Downstream leased assets	Franchises	Investments

There are 15 separate categories of scope 3 including:

- 8 relating to the supply chain
- 7 relating to the emissions of the products once they are sold/used

However, for us, it was important that the gold mining sector moved forward with other global sectors and improved disclosure of Scope 3, as not only does it allow for fair comparison of emissions data across sectors, but it also demonstrates the lower relative emissions gold producers have within their value chain when compared with other sectors. Understanding the full carbon footprint is highly complex, but we believe scrutinising emissions can be a broader way to improve governance, transparency and risk.

Ninety One considers what is material for gold miners in terms of sustainability. We believe externalities will increasingly be valued and potentially priced, starting with carbon emissions but rapidly evolving to other areas. Therefore, we must be able to judge which firms are minimising their negative externalities while maximising positive externalities where possible. By reviewing company sustainability reports and identifying sustainability themes, as well as by using external frameworks, we are able to define high standards/targets, red flags and aspirational targets within each of the four capitals: Natural, Human, Social and Financial. This framework enables us to effectively monitor to what extent the gold mining companies are becoming aware of their negative externalities, and how they are progressing towards contributing positively to each of the four capitals.

Effective application of our proprietary sustainability framework requires and benefits from continual engagement with company management. This is best shown by a case study.

Endeavour Mining was a stock which was poorly rated by third parties on ESG. Upon meeting with management to discuss the rating, the company demonstrated a strong and improving sustainability track record across environment, employment and health & safety; however, the strong ESG performance – which could add considerable value to the company – was not recognised by the market due to lack of disclosure. We subsequently engaged with management, proposing three clear goals, focused on performance and disclosure, that would help the company develop its sustainability report and thus address the material ESG issues for investors. Two goals have since been resolved, with the third in progress.

Gold mining companies not only have diversification and return benefits for investor portfolios but are also now in a strong position to demonstrate improving ESG standards.

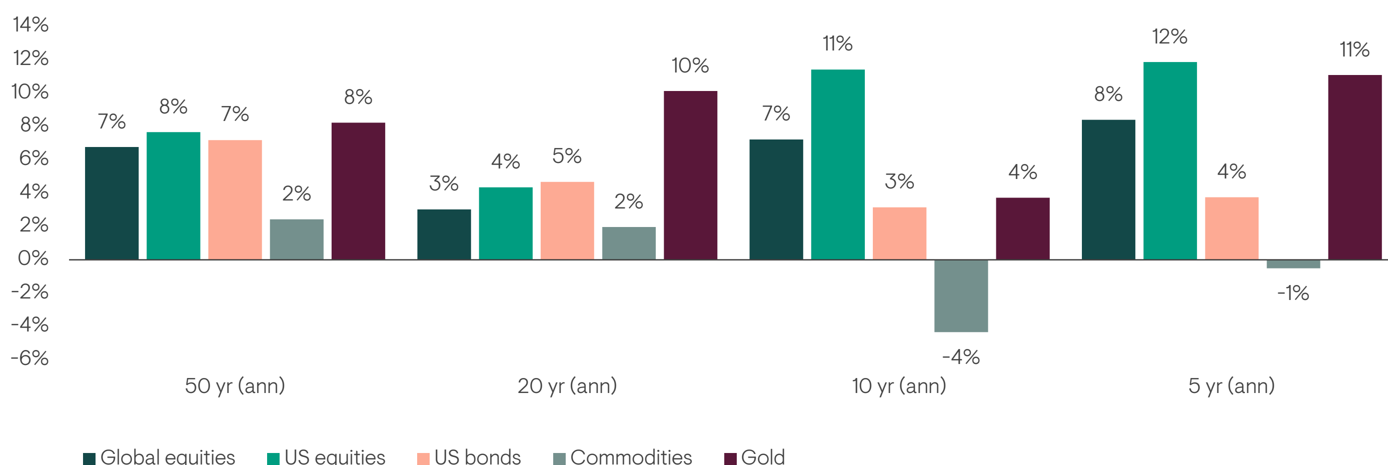
The role of gold and gold equities in a portfolio:

The decision on which route to choose is likely influenced by the funding source and the intended outcome. If wanting to fund from fixed income as a means to bring diversification then it is likely that physical gold is more appropriate. If from equities, it is likely that gold equities are more appropriate. Below we explore the return and diversification properties of gold and gold equities respectively. The Appendix explores the role gold and gold equities play in a diversified portfolio in more detail.

Gold has generated attractive long-term returns

As a store of wealth and a multifaceted hedge against instability and inflation, gold displays characteristics that make it a useful strategic component of portfolios. Gold has also generated attractive long-term returns.

Despite being known primarily as a safe-haven asset, it has provided robust performance in both rising and falling markets. Over the past half-century, it has delivered a return similar to that from developed market equities, and it has beaten practically all of the major asset classes shown over the past 5, 20 and 50 years.



Past performance is not a reliable indicator of future results, losses may be made.

Source: Ninety One, Bloomberg 30 September 2020. Global equities = MSCI World Index in USD. US equities = S&P 500 in USD. US bonds = US Treasury Total Return Unhedged Index in USD. Commodities = S&P Commodity Index in USD. Gold = Spot price.

Gold and gold equities provide good diversification for portfolios

One way to think of diversification is to have an array of assets that react differently to the same economic event. Any individual asset at any given moment could be susceptible to a significant decline in value or an increase in volatility. By holding a mixture of assets, an investor expects to, on average, yield higher risk-adjusted returns than any individual investment found within a portfolio. As such, diversification is the cornerstone of portfolio construction. However, finding an effective diversifier has proved to be more of a challenge for investors as many alternative assets have failed to provide supposed diversification benefits.

For example, the correlations between equities and two commonly used portfolio diversifiers, real estate and infrastructure, increased sharply in the 2008 Global Financial Crisis and have remained elevated ever since. Gold and gold equities, in contrast, have generally maintained their lower correlations to broad equity benchmarks and therefore stand out as a key component when identifying a long-term portfolio diversifier.

Performance of traditional and alternative assets during bear markets

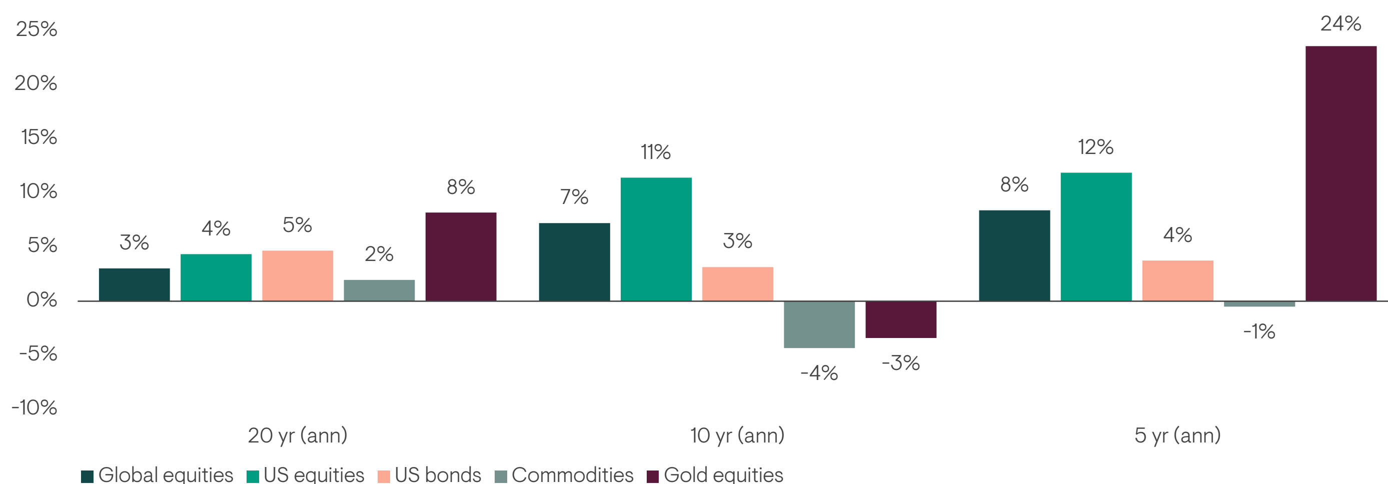
Cumulative Returns (%)	Equities	Bonds	Gold (physical)	Gold (equity)	Infrastructure	REITS	Hedge Funds	Commodities
Dot.com bubble[1]	-8%	56%	58%	187%	61%	82%	40%	27%
GFC[2]	-14%	24%	91%	39%	-27%	-33%	-8%	16%
Q4 2018[3]	-6%	3%	11%	23%	2%	3%	-4%	-16%
YTD 2020[4]	-9%	3%	14%	17%	-19%	-24%	-3%	-30%

Past performance is not a reliable indicator of future results, losses may be made.

Source: Ninety One, Bloomberg 30 September 2020. Equities = MSCI World Index in USD. Bonds = FTSE World Government Bond Index in USD. Gold (physical) = spot price. Gold equity = NYSE Arca Gold Miners Index USD. Infrastructure = S&P Global Infrastructure Index in USD. REITs = S&P Global REIT Index in USD. Hedge Funds = HFRX Global Hedge Fund Index in USD. Commodities = S&P GSCI Index in USD.

[1] = 1 September 2000 to 31 December 2004; [2] = 1 October 2007 to 31 December 2010; [3] = 1 October 2018 to 31 January 2019; [4] = 1 January 2020 to 31 May 2020

Gold equity return benefits



Past performance is not a reliable indicator of future results, losses may be made.
Source: Ninety One, Bloomberg 30 September 2020. Global equities = MSCI World Index in USD. US equities = S&P 500 in USD. US bonds = US Treasury Total Return Unhedged Index in USD. Commodities = S&P Commodity Index in USD. Gold equities = NYSE Arca Gold Miners Index in USD.

Gold equities have delivered compelling historic returns over most time horizons, although not all. Gold equities significantly underperformed between 2010-2015, attributed to poor capital discipline and exacerbated by a falling gold price, thus resulting in poor annualised returns over a 10-year period. However, this acted as a catalyst for many companies to restructure and ultimately drove a recovery in share prices.

Gold stocks appeal to both growth and income investors. With regard to the former, continued improvements in the gold price together with relatively flat costs suggest a positive outlook for earnings growth – at a time when earnings will be significantly down for most other sectors. In addition, the capital discipline of many gold mining companies has remained intact following an almost industrywide restructure in 2015, with a large number of miners recently having announced dividend increases.

Gold equities provide diversification as well as good returns over the long term

When thinking about the diversification benefits of gold equities, a related consideration is whether gold mining equities behave more like gold or more like general equities. If gold mining companies behave more like the latter, then they will add little diversification benefit for a traditional portfolio, particularly when compared to adding gold. If gold mining equities behave more like physical gold, displaying low correlations to traditional assets, then they provide similar attractive diversification benefits. Furthermore, if the returns on gold mining stocks exceed that of gold (but with similar correlation with stocks), then gold mining stocks would be preferred to gold.

The table below illustrates that, as with physical gold, gold equities also display low correlations with a broad range of assets, meaning an allocation to gold equities has the ability to enhance the risk-adjusted return of a traditional portfolio over the long-term.

20 year correlations

	Physical Gold	Gold equities	Global equities	Global listed infrastructure*	Global government bonds	Global corporate bonds	Emerging market debt (local)	US dollar (trade-weighted)
Physical Gold	1							
Gold equities	0.81	1						
Global equities	0.15	0.29	1					
Global listed infrastructure*	0.26	0.40	0.87	1				
Global government bonds	0.51	0.43	0.15	0.39	1			
Global corporate bonds	0.45	0.48	0.51	0.71	0.78	1		
Emerging market debt (local)	0.33	0.41	0.67	0.73	0.33	0.68	1	
US dollar (trade-weighted)	-0.48	-0.47	-0.53	-0.63	-0.73	-0.74	-0.55	1

Source: Bloomberg, Ninety One 30 September 2020. * Inception date December 2001. Gold = US$/oz, 91 , Gold equities = NYSE Arca Gold Miners, Global equities = MSCI ACWI, European equities = Eurostoxx 50 TR , Global listed infrastructure = S&P Global Listed Infrastructure, Global government bonds = FTSE World Government Bond, Global corporate bonds = ICE BofAML Global Corporate, EMD (local) = ICE BofAML Global EMD local.

Conclusion

Gold and gold equities are an important long-term component of a balanced portfolio

As the Ninety One Global Gold Strategy reaches its thirtieth year, the purpose of this paper is to bring together the various arguments that are commonly made to support investment in gold and gold equities. We also wanted to demonstrate that, while different arguments may vary in their conclusiveness over time, there is a compelling case for holding gold and gold equities over the long term. Often, this long-term robustness gets lost in the noise of the volatility of the markets and the more emotional points of view put forward by 'gold bugs' on their various blogs. The junior end of the sector with many exploration companies generates a lot of noise and many examples of bad practice and even fraud, which can divert investors' attention away from some of the larger and medium-sized companies that have built long-term sustainable businesses.

In this era of high economic uncertainty, driven by unprecedented experiments in financial policy, we continue to believe that gold and gold equities are an important part of a portfolio. In such a volatile sector, we think that it is important to hold companies that are producing attractive and sustainable free cashflows at the core, and around those look for companies with compelling growth stories or, at least, good optionality to deliver growth.

With real yields falling, and already negative in some cases, holding gold is attractive particularly relative to bonds where low yields mean they do not offer the same defensiveness that they have in the past. In this environment, the companies – which in many cases are operating at record margins – provide investors with a great opportunity to invest in assets that are increasing dividends and shareholder returns, and whose return profiles have low correlation to other equities.

After a challenging period for gold companies, with a decade of booming gold and general resources markets followed by a sudden fall in gold prices during 2011-2015, it is easy to believe the sector is plagued by mismanagement and poor returns. However, if one takes the whole 20-year cycle from 2000-2020, gold company returns have been in line with the general market. In what has been a very difficult environment for mining companies generally, as they were caught up in the commodity supercycle and subsequent vicious downturn, we must remind ourselves that over the long term gold mining is a business that can produce sustainable returns. Often these returns come when the rest of the market is struggling, and that diversification makes the case for long-term investing even more compelling.

As Ninety One's Global Gold Strategy approaches its thirtieth birthday, we are proud that as active managers we have produced robust returns over 30 years (over 5% p.a. net of fees), and consistently ahead of our benchmark (3.1% p.a. active return). This, in itself, should prove attractive to investors.

The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Past performance is not a reliable indicator of future results

Gold

Strategy returns over last five calendar years

	2019	2018	2017	2016	2015
Strategy	38.2%	-5.9%	11.5	48.0	-23.2
Index	40.5%	-10.0%	13.0%	57.1%	-20.9%

The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Past performance is not a reliable indicator of future results

Source: Morningstar, 5 years ending 31 December 2019. All performance, unless otherwise stated is net of fees (A Acc share class, NAV based, including ongoing charges, excluding initial charges), gross income reinvested, in USD. The Fund is actively managed. Any index is shown for illustrative purposes only.

Specific risks

Commodity-related investment: Commodity prices can be extremely volatile and significant losses may be made. Concentrated portfolio: The portfolio invests in a relatively small number of individual holdings. This may mean wider fluctuations in value than more broadly invested portfolios. Currency exchange: Changes in the relative values of different currencies may adversely affect the value of investments and any related income. Derivatives: The use of derivatives is not intended to increase the overall level of risk. However, the use of derivatives may still lead to large changes in value and includes the potential for large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. Emerging market: These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. Equity investment: The value of equities (e.g. shares) and equity-related investments may vary according to company profits and future prospects as well as more general market factors. In the event of a company default (e.g. insolvency), the owners of their equity rank last in terms of any financial payment from that company. Geographic / Sector: Investments may be primarily concentrated in specific countries, geographical regions and/or industry sectors. This may mean that the resulting value may decrease whilst portfolios more broadly invested might grow.

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Analysis of the role gold and gold equities play in a diversified portfolio:

As we stated at the beginning of this paper, gold has long been considered an important part of a multi-asset investor's toolkit. The decision on which route to choose is likely influenced by the funding source and the intended outcome. If wanting to fund from fixed income as a means to bring diversification then it is likely that physical gold is more appropriate. If from equities, it is likely that gold equities are more appropriate. Below we explore the role gold and gold equities play in a diversified portfolio in more detail.

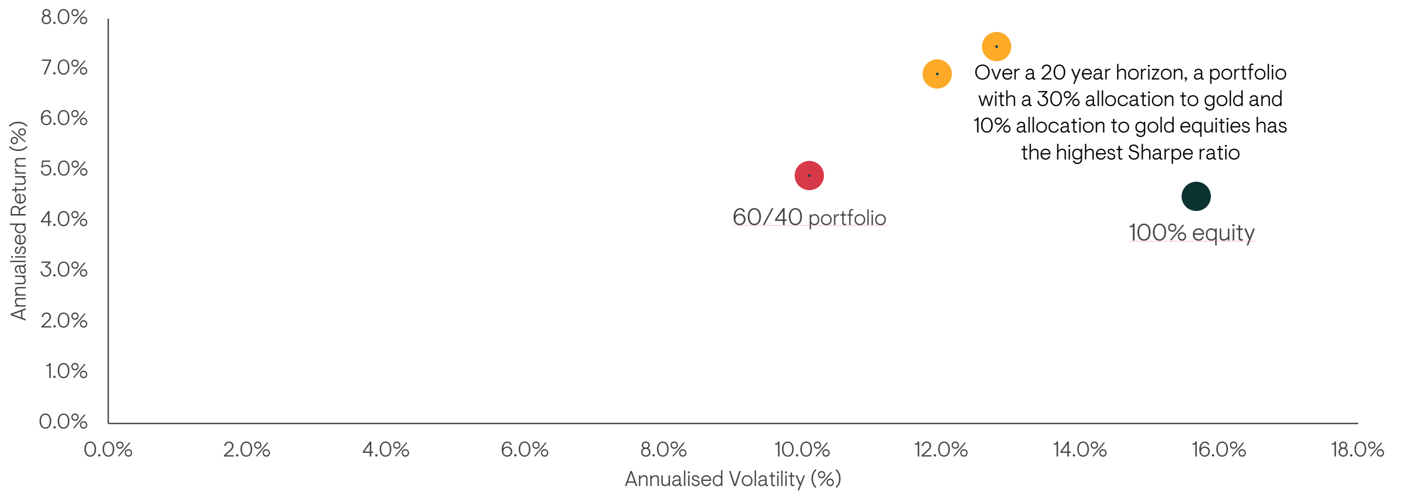
As high a standard as the 60/40 may have set, it materialises that returns – on a both absolute and risk-adjusted basis – could have been improved by adding physical gold and gold equities. We added gold and gold equities in graduated amounts to a 60/40 portfolio. The ability for gold to act as a diversifying asset was clear, as layering gold into a 60/40 portfolio over 5 and 20 years improved the portfolio risk/return characteristics in almost every amount. The exception is over 10 years, where the challenges in the sector during the years 2010-15 are clear as the 60/40 portfolio excluding gold generated a superior risk-adjusted return.

	Portfolio					Best risk adjusted returns		
	Equities	Bonds	Gold (funded by bonds)	Gold equities (funded by equities	Total gold allocation	20 year	10 year	5 year
100% equity	100%				0%			
60/40	60%	40%			0%			
Portfolio 1	55%	35%	5%	5%	10%			
Portfolio 2	53%	33%	8%	8%	15%			
Portfolio 3	50%	30%	10%	10%	20%			
Portfolio 4	48%	28%	13%	13%	25%			
Portfolio 5	45%	25%	15%	15%	30%			
Portfolio 6	40%	20%	20%	20%	40%			
Portfolio 7	50%	10%	30%	10%	40%			
Portfolio 8	50%	20%	20%	10%	30%			

Source: Bloomberg, Ninety One 30 September 2020. Equity = MSCI ACWI Index USD, bonds = FTSE World Government Bond Index (WGBI) USD. Gold = US$/oz. Gold equities = NYSE Arca Gold Miners Index USD. Traffic light colours illustrate best to worst risk-adjusted returns, with dark green representing the portfolio with the best risk-adjusted return, and dark red the worst.

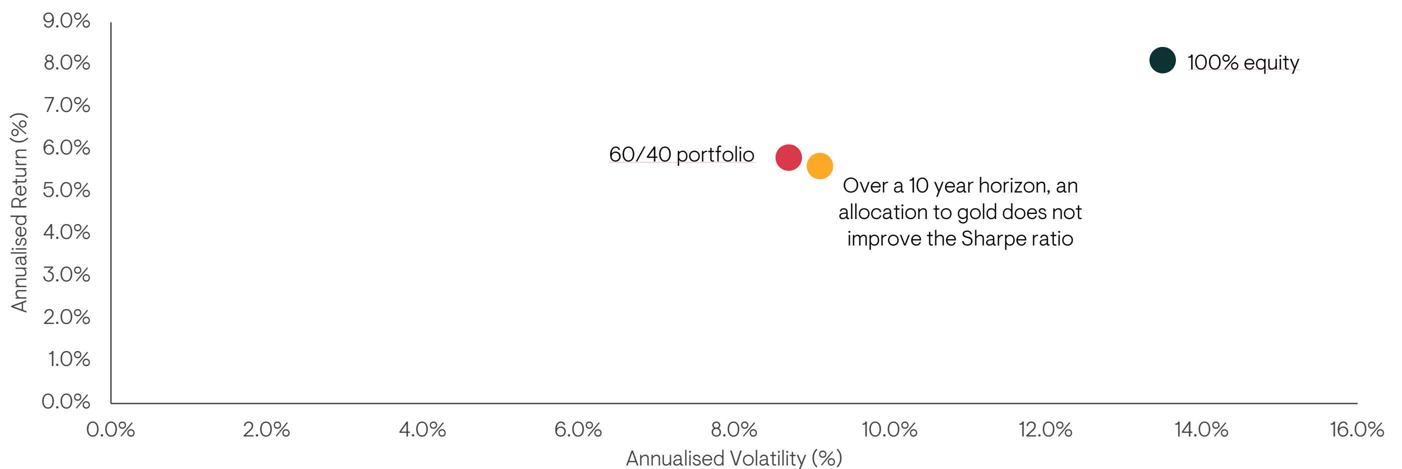
The below charts display the efficient frontier of adding gold (funded by fixed income) and gold equities (funded by equities) to a 60/40 portfolio over 5, 10 and 20 years, with consistent and continuous gains made from adding physical gold and gold equities, again, with the exception of over 10 years. The chart shows annualised returns on the vertical axis against the portfolio's volatility (standard deviation of returns) on the horizontal axis; consequently, points towards the upper left corner are the most attractive and towards the lower right the least. We have not shown all combinations on the chart.

20 Year Efficient Frontier: Adding Gold & Gold Equities to 60/40 Portfolio



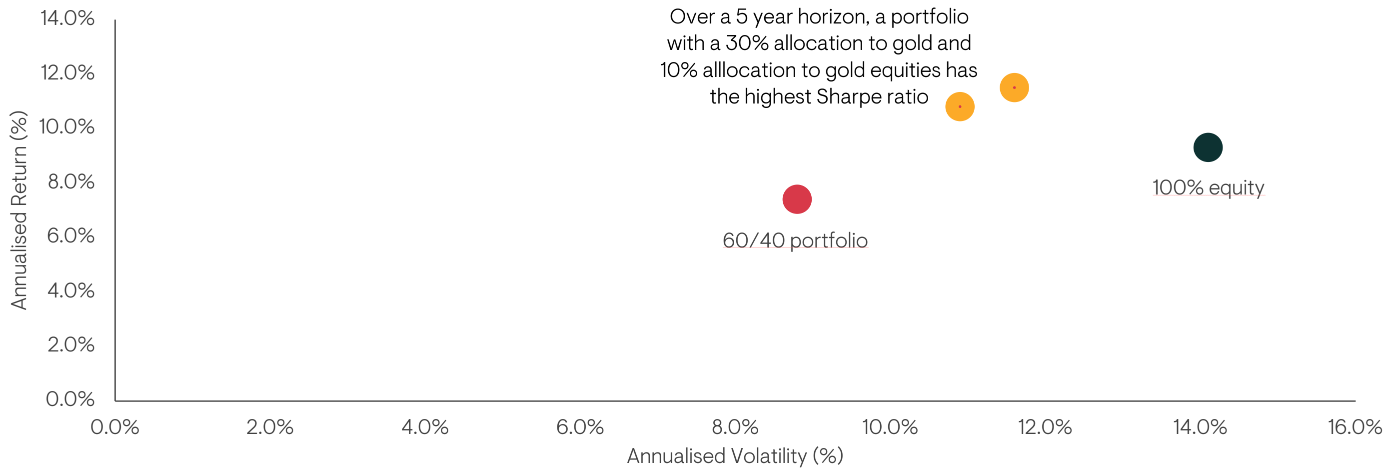
Source: Ninety One, 30 September 2020. Annualised volatility is calculated as standard deviation of returns. Red circle indicates 60/40 portfolio, green circle indicated 100% equity portfolio, and two yellow circles indicate gold portfolios with highest Sharpe over 20 years (portfolio 7 and 8).

10 Year Efficient Frontier: Adding Gold & Gold Equities to 60/40 Portfolio



Source: Ninety One, 30 September 2020. Annualised volatility is calculated as standard deviation of returns. Red circle indicates 60/40 portfolio, green circle indicated 100% equity portfolio, and two yellow circles indicates the gold portfolio with the highest Sharpe over 10 years (portfolio 1).

5 Year Efficient Frontier: Adding Gold & Gold Equities 60/40 Portfolio



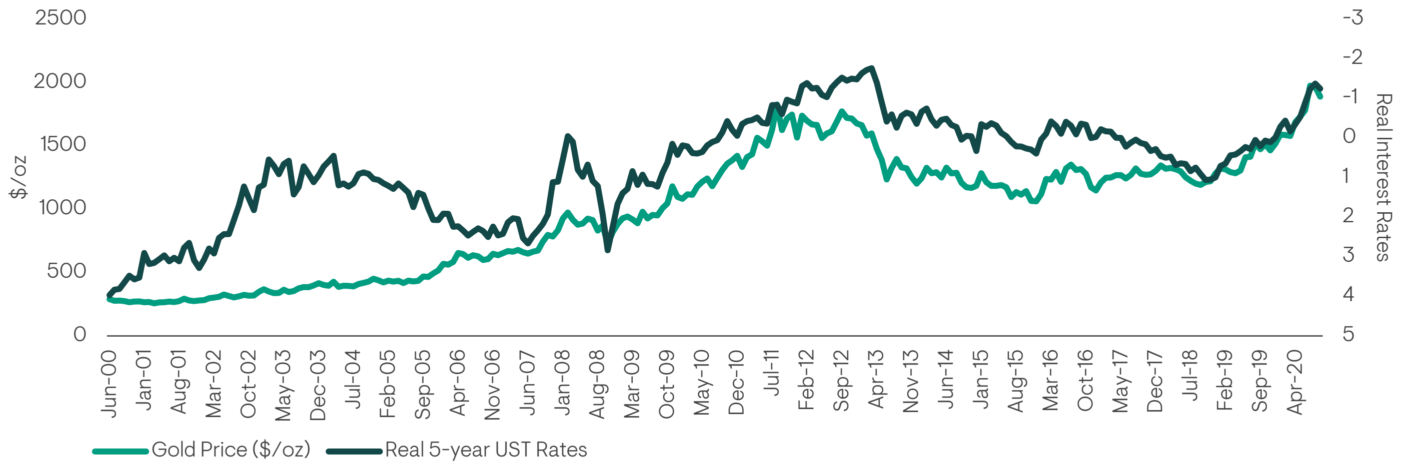
Source: Ninety One, 30 September 2020. Annualised volatility is calculated as standard deviation of returns. Red circle indicates 60/40 portfolio, green circle indicated 100% equity portfolio, and two yellow circles indicate gold portfolios with highest Sharpe over 5 years (portfolio 7 and 8).

From a quantitative perspective, including physical gold and gold equities has provided superior returns – both absolute and risk-adjusted – when compared to a 60/40 portfolio and also a straight equity portfolio. This analysis demonstrates that gold does not have to be confined to a small or short-term holding in the portfolio, but in fact carries the potential for powerful results at substantially larger allocations over different time horizons.

Analysis of gold in different rate regimes:

As we have discussed, the gold price is tied to low or negative real interest rates, which are essentially the by-product of inflation. When real bond yields are falling, the price of gold rises; on the flip side, when real rates are rising, gold can fall very quickly. As demonstrated below, historically there has been a strong inverse relationship between real interest rates and gold; while there has been some major gold volatility, the relationship is reasonably tight through time with correlation of -86%. In fact, when real yields are falling and are negative, gold outperforms Treasury Inflation-Protected Securities (TIPS).

Gold and Real 5-year UST Rates



Source: Bloomberg, 30 September 2020. Time period selected for contextual and illustrative reasons. * The yield on the US 5-year TIPS represents the real rate of return guaranteed by the US government, which is the interest rate that would be charged in a world where there is no inflation. (right hand axis inverted)

Important information

Index descriptions

Index	Description
S&P 500	The S&P 500 is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. Captures approximately 80% coverage of available market capitalization.
BCOM Industrial Commodities	The Bloomberg Commodity Industrial Metal Index is a financial benchmark designed to provide liquid and diversified exposure to physical commodities via futures contracts. This rolling index track exchange-traded futures on physical commodities and is weighted to account for economic significance and market liquidity. It represents the Industrial Metals components of the Bloomberg Commodity Index (BCOM)
DXY Dollar Index	The US Dollar Index (DXY or USDX) is an index of the value of the United States dollar relative to a basket of foreign currencies. It is a weighted measure using the dollar's movements relative to other select currencies in an attempt to represent our major trading partners.
Euromoney Global Gold Index	The Euromoney Global Mining Indices measure the returns of companies in the metal and mineral extraction
Euromoney Global Gold Mines	The Euromoney Global Mining Index is an equity index consisting go companies engaged in mining production. The Mining Index and sub-indices are free float market capitalisation weighted indices, covering global markets where liquid shares are available to foreign investors.
FTSE Gold Mines	The FTSE Gold Mines Index is designed to reflect the performance of the worldwide market in the shares of companies whose principal activity is the mining of gold. The index series encompasses all gold mining companies that have a sustainable and attributable gold production of at least 300,000 ounces a year, and that derive 51% or more of their revenue from mined gold.
MSCI AC World	The MSCI All Country World Index is a market capitalisation weighted index designed to provide a broad measure of equity-market performance throughout the world. Comprised of stocks from developed and emerging markets. Maintained by Morgan Stanley Capital International.
MSCI ACWI Metals and Mining	The MSCI All Country World Index Metals and Mining Index is composed of large and mid cap stocks across 23 Developed Markets (DM) countries and 23 Emerging Markets (EM) countries. All securities in the index are classified in the Metals & Mining industry (within the Materials sector) according to the Global Industry Classification Standard (GICS®).
MSCI ACWI Select Gold Miners	The MSCI ACWI Select Gold Miners Investable Market Index (IMI) aims to focus on companies in the gold mining industry that are highly sensitive to underlying prices of gold. The index includes companies primarily engaged in gold mining or that derive a majority of their revenues from gold mining as classified by the Global Industry Classification Standard (GICS®) and additionally that do not hedge their exposure to underlying gold prices.
MSCI China	The MSCI China Index captures large and mid cap representation across China H shares, B shares, Red chips and P chips. The index covers about 85% of this China equity universe.
MSCI Emerging Markets	The MSCI Emerging Markets Index is a free float-adjusted market capitalisation index that is designed to measure equity market performance of emerging markets. Maintained by Morgan Stanley Capital International.
MSCI World	The MSCI World Index is a market capitalisation weighted index which captures large and mid-cap representation across a number of developed markets. Maintained by Morgan Stanley Capital International.
NYSE Arca Exchange Gold BUGS	The NYSE Arca Gold BUGS Index (HUI) is a modified equal dollar weighted index of companies involved in gold mining. The HUI Index was designed to provide significant exposure to near term movements in gold prices by including companies that do not hedge their gold production beyond 1.5 years.
NYSE Arca Exchange Gold Miners	The NYSE Arca Gold Miners Index (GDM) is a modified market capitalization weighted index comprised of publicly traded companies primarily involved in the mining of gold and silver in locations around the world.
Philadelphia Gold and Silver	The Philadelphia Gold and Silver Index (XAU) is a capitalization-weighted index composed of companies involved in the gold or silver mining industry that is traded on the Philadelphia Stock Exchange.
S&P/TSX Global Gold	The S&P/TSX Global Gold Index is designed to provide an investable index of global gold securities. Eligible Securities includes producers of gold and related products, including companies that mine or process gold and the South African finance houses which primarily invest in, but do not operate, gold mines.

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Additional information on our investment strategies can be provided on request.

Investment Team

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Performance Target

The target is based on Manager's good faith estimate of the likelihood of the performance of the asset class under current market conditions. There can be no assurances that any Strategy or Fund will generate such returns, that any client or investor will achieve comparable results or that the manager will be able to implement its investment strategy. Actual performance of Fund investments and the Fund overall may be adversely affected by a variety of factors, beyond the manager's control, such as, political and socio-economic events, adverse changes in the interest rate environment, changes to investment expenses, and a lack of suitable investment opportunities. Accordingly, target returns may be expected to change over time and may differ from previous reports.

Specific Portfolio Names

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