

## PANNING FOR GOLD

Whenever the markets turn south, interest in gold increases—so here are some tips to keep in mind

**W**henver we are faced with volatile swings in commodities or global currencies, or when extreme pessimism overtakes the capital markets, interest in gold as an alternative or safe haven invariably spikes.

While investor opinions vary strongly on the value of gold as a hedge or a core portfolio holding, many can agree that gold offers some benefits. For example, gold has a low or negative correlation to other asset classes and to gross domestic product or GDP. Gold has shown recent volatility, but this has been tame compared to the spike in the early 1980s that was associated with severe economic upheaval. That was a period marked by extraordinarily high interest rates and unemployment that led to an inevitable economic slowdown and deflationary pressures.

Given its importance during down markets, let's review gold across three themes of investor interest:

**Gold as a commodity:** Perhaps surprisingly, gold plays a minor role in commodity index investing, with a component weight of 2% to 10% across most common futures-based retail products. It has also been one of the less volatile index components, as cyclical demand has had a greater impact on industrial metals and energy.

If history continues to be a reliable guide, gold pricing will continue to be driven primarily by jewelry demand—particularly in China and India—and incremental purchases by investors seeking a haven from inflation and currency devaluations.

**Gold as a currency hedge:** While the U.S. government has the world's largest cache of gold (almost 9,000 tons according to the International Monetary Fund) the dollar has not been convertible into gold since 1973 and its value depends upon confidence in government policies

and currency management.

As global money supply has long been driven by monetary policy rather than gold reserves, many have sought out gold as a hedge against too-liberal paper money creation.

The nominal price of gold recently reached the \$850 peak attained in January 1980, yet it is still well below historical highs on an inflation-adjusted basis. But it has recovered much ground since 2001, and relative-value measures (such as the barrels of oil that can be bought per ounce of gold) appear reasonable.

**Gold as an investment choice:** Derivatives, linked bonds and coins represent some of the more exotic gold vehicles available. Simple gold bullion exchange-traded funds warehouse physical gold and, absent expenses, closely track the current price of gold on a daily basis. These ETFs should provide the diversification and return potential of gold in a conveniently traded form.

Another approach is through equity ETFs or individual gold mining stocks. The historical correlation between mining stocks and the broad equity market is low, but returns will vary depending upon company-specific factors, including management ability, capital structure and operating costs. The multi-year run-up in industrial metals has helped subsidize the gold production costs of companies whose ore deposits contain by-products such as copper and zinc. But many operations have seen no such relief, and higher fuel and machinery costs have cut into margins.

Foreign currency exposure is also a consideration for stocks of companies based in nations such as Australia and South Africa, where many mines can be found. Attractive opportunities may be present, but not without stock-specific risk and some equity beta. ■



*\* Jewelry demand, particularly in China and India, will continue to be a primary driver of gold pricing.*

*\* Equity ETFs or individual gold mining stocks are one approach.*

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