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(General article)

Emergence of Gold as an Attractive Investment Opportunity and as a Hedge Tool in Investment Portfolio

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Abstract

Gold, the most famous of all precious metals, is widely sought after throughout the world for both its investment qualities and industrial properties. Indeed, gold traditionally has served three functions: as a monetary instrument, as a financial asset, and as a raw material primarily used in jewelry and decorative objects. As an investment, gold typically is viewed as a financial asset that will maintain its value during times of political, social, or economic distress. As such, gold can provide individual and institutional investors alike with a portfolio safety net against sharp downward spikes in complementary assets such as stocks and bonds. While investment demand is important, the largest use for gold is in jewelry.

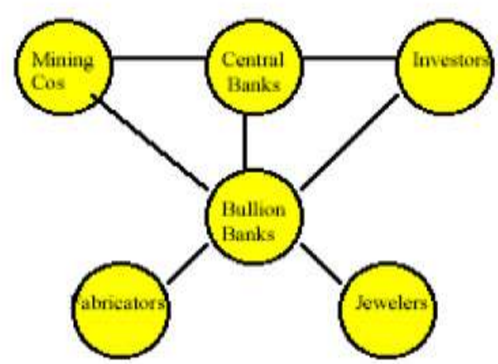
***Keywords**: Gold, Investment*

1. Introduction

Gold has been known and highly valued since prehistoric times. It may have been the first metal used by humans and was valued for ornamentation and rituals, majority of use occurring in the United States, Japan, Italy, India, China, and Thailand. Jewelry production has been growing at a robust pace in the developing countries of Southeast Asia and the Middle East since 1988. Gold also is used in electronic connectors and dental alloys. Gold is mined in more than 76 countries around the world, with the large number of development projects in these countries expected to keep production growing well into the next century. Currently, China is the largest gold producing country, followed by the Australia,

Basic structure of the gold market

It consists of central banks, bullion banks (international banks with specialist skill in bullion trading such as J P Morgan, Goldman Sachs, Deutsche Bank, Chase Manhattan, Citigroup), mining companies and investors.
The central banks lend gold to bullion banks at an interest rate known as the lease rate. Bullion banks, the financial intermediary, in turn sell the gold in the spot market to different segments of the market, such as jewelers and fabricators, and the resultant cash proceeds are used for investment. At the same time, bullion banks or their customers run a price risk, as there is an obligation to return the physical gold back to the central banks after the lease period. For this, they go long in the gold forward market.



The counter-party in this deal is generally a gold-mining company, investor or speculator (hedge fund, for instance), which want to gain from contango. In fact, the gold forward premium has a close link with the gold lease and the money market rates. The gold forward rate is almost same as the difference between the dollar rate (Libor) and the gold lease rate. And as long the difference between the two is positive, there is a spread or contango; if the difference is negative, there is backwardation, and that is, spot gold is in demand. Gold being the second largest component of central bank reserves, having an intrinsic value link to the dollar and is often kept in a safe band by well-orchestrated efforts of central banks.

Gold markets: Today, gold trades in many markets around the world. At any time of the day or night a current market price is being established somewhere. Two of the most important world markets, however, are in London and New York. The London market is one of the oldest in the world and is the largest market for physical gold. Since September 12, 1919 the price of gold has been set at "the London gold fix" and this price is used in contract arrangements around the world. Today, the gold fixings take place at 10:30am and 3pm and provide published prices which are used as official pricing medium by producers, consumers and central banks. The New York market opens as the second London fix takes place and gold then trades throughout the day. The New York market is particularly noted for the volume of "paper gold transactions" such as futures contracts that are traded on the exchange. The Comex division of the New York Mercantile Exchange is the center of these activities. There are other important gold markets in Zurich, Tokyo, Sydney, Hong Kong and elsewhere - so gold is being traded somewhere 24 hours a day.

Factor affecting gold market

Gold Demand Obviously the higher the demand for Gold, the higher its price. Certain nations hold the metal in high regard and often use it for major purchases or investments (by purchasing jewelry etc). China and India are very important consumers where there seems to be a emerging business population looking to invest in some physical cash assets. Gold, Platinum and Diamonds are also heavily used in industry. Dollar Price Gold is typically quoted in Dollars, and if the dollar begins to sink then the value of Gold tends to increase and vice-versa. Market Fear Whenever the stock markets or political situations look bad then people tend to fly towards Gold. Stock market crashes, terrorist attacks, or wars will all tend to push the value of Gold up. Market Greed As with all investments their performance can be self perpetuating, i.e. they start doing well and so more people get interested, the Gold funds start appear on the front page of the Money section in the telegraph, and the general public are advised to buy, buy, buy. This obviously has the effect of pushing gold prices, and gold mine share prices up, as everyone wants to get in on the act. Followings are the factors affecting the gold market.

Sentiment: It used to be said that *"Gold is the world's frightened bunny"*. Whenever crisis threatened, the demand for physical gold increased.

Bank failures: When dollars were fully convertible into gold, both were regarded as money. However, most people preferred to carry around paper banknotes rather than the somewhat heavier and less divisible gold coins. If people feared their bank would fail, a bank run might have been the result. This is what happened in the USA during the Great Depression of the 1930s, leading President Roosevelt to impose a national emergency and to outlaw the holding of gold by US citizens.

Inflation: Paper currencies pose a risk of being inflated, possibly to the point of hyperinflation. Historically, currencies have lost their value in this way over time. In times of inflation, people seek to protect their savings by purchasing liquid, tangible assets that are valued for some other purpose. Gold is in this respect a good candidate, since producing more is far more difficult than issuing new fiat currency and its value does not rely on any particular government's health.

Low or negative real interest rates: Gold has a long history of being an inflation proof investment. During times of low or negative real interest rates when significant inflation is present and interest rates are relatively low investors seek the safe haven of gold to protect their capital. A prime example of this is the period of Stagflation that occurred during the 1970s and which led to an economic bubble forming in precious metals.

War, invasion, looting, and crisis: In times of national crisis, people fear that their assets may be seized, and the currency may become worthless. They see gold as a solid asset which will always buy food or transportation. Thus in times of great uncertainty, particularly when war is feared, the demand for gold rises.

Demand and Supply Scenario: Gold demand in 2010 reached a 10-year high of 3,812.2 tonnes, worth US$150billon, China was the world's largest gold producer with 340.88 tonnes in 2010, followed by the United States and South Africa.In 2010, India was the world's largest gold consumer with an annual demand of 963 tonnes.The total supply of gold coming onto the market in 2010 reached 4,108 tonnes, a rise of 2% from 2009 levels.

Gold as an investment avenue

Gold is the oldest precious metal known to man. Therefore, it is a timely subject for several reasons. It is the opinion of the more objective market experts that the traditional investment vehicles of stocks and bonds are in the areas of their all-time highs and may be due for a severe correction. To fully appreciate why 8,000 years of experience say "gold is forever", why gold is "good as gold" is an intriguing question.

- Gold is primarily a monetary asset and partly a commodity.
- More than two thirds of gold's total accumulated holdings account as 'value for investment' with

central bank reserves, private players and high-carat Jewelry.

- Less than one third of gold's total accumulated holdings are as a 'commodity' for Jewelry in Western markets and usage in industry.
- The Gold market is highly liquid and gold held by central banks, other major institutions and retail Jewelry keep coming back to the market.
- It is argued that the core driver of the real price of gold is stock equilibrium rather than flow equilibrium.
- Economic forces that determine the price of gold are different from, and in many cases opposed to the forces that influence most financial assets.
- India is the world's largest gold consumer with an annual demand of 963 tons.

Why invest in gold?

Portfolio diversification: To minimize the investment risk one has to diversify his investments into different asset class. Adding gold to a portfolio introduces an entirely different asset class- a tangible & real asset which increases the portfolio's degree of diversification.
Effective portfolio diversifier

Source: Rediff Business

As depicted above, while the overall return of a portfolio without gold is 14% that of a portfolio with gold is over 16%. Hence an allocation of physical gold in a financial portfolio not just helps reduce the impact of the volatility created by the other asset classes like equity, bonds etc., but also increases the average return over a period of time.

- A financial portfolio containing gold is generally more robust because it improves the stability and predictability of better average returns.
- By extension, this provides gold an inverse correlation with other asset classes especially with equities. Thus, even in a potentially recessionary business environment, gold tends to provide an upswing to the portfolio and provides stability in a volatile market.

Portfolios that contain gold are generally more robust and better able to cope with market uncertainties than those that don't. Adding gold to a portfolio introduces an entirely different class of asset. Gold is unusual because it is both a commodity and a monetary asset. It is an 'effective diversifier' because its performance tends to move independently of other investments and key economic indicators. Recent independent studies have shown that traditional diversifiers (such as bonds and alternative assets) often fail during times of market stress or instability. Even a small allocation of gold has been proven to significantly improve the consistency of portfolio performance during both stable and unstable financial periods.

Gold as an alternative investment: In the search for effective diversification against a background of increasing convergence among mainstream asset classes, investors are considering a variety of non-traditional alternative investment vehicles. Prominent among these are hedge and private equity funds, although gold, commodities, timber and forestry, fine art and collectibles may also come under review.

Investors should give careful consideration to each of these alternatives in the light of their particular requirements and may choose to invest in several of them.

- Gold is the most liquid asset class due to its universal acceptance as an alternative to currency, and also because globally, the gold market is functional 24x7.
- Same cannot be said about any other asset class as they take much longer time to liquidate (from 1 day to up to 3-4 months).

Preservation of wealth, maintaining long term value: Market cycles come and go, but gold has maintained its long term value. Previous studies demonstrated that in inflationary and deflationary times, in the very long term, gold kept its purchasing power. The value of gold, in terms of real goods and services that it can buy, has remained remarkably stable. In contrast, the purchasing power of many currencies has generally declined. This is why gold is often bought: to counter the effects of inflation and currency fluctuations. It is bring into being that over the long term, in spite of price fluctuations:

- Gold has consistently reverted to its historic purchasing power parity
- Gold has proved to an effective preserver of wealth
- During periods of financial, economic and social turmoil, gold has been a safe refuge when the value of other assets was all but destroyed.

One reason we much prefer gold to all other commodities in the current environment is that gold tends to perform relatively well when real economic growth is slow, and slow, or no, real growth is a likely outcome as far as the coming year is concerned.

Why central banks hold gold

Economic Security: Gold is a unique asset in that it is no one else's liability. Its status cannot therefore be undermined by inflation in a reserve currency country. Nor is there any risk of the liability being repudiated. Gold has maintained its value in terms of real purchasing power in the long run and is thus particularly suited to form part of central banks' reserves. In contrast, paper currencies always lose value in the long run and often in the short term as well.

Physical Security: Countries have in the past imposed exchange controls or, at the worst, total asset freezes. Reserves held in the form of foreign securities are vulnerable to such measures. Where appropriately located, gold is much less vulnerable. Reserves are for using when you need to. Total and incontrovertible liquidity is therefore essential. Gold provides this.

Unexpected needs: If there is one thing of which we can be certain, it is that today's status quo will not last forever. Economic developments both at home and in the rest of the world can upset countries' plans, while global shocks can affect the whole international monetary system.Owning gold is thus an option against an unknown future. It provides a form of insurance against some improbable but, if it occurs, highly damaging event. Such events might include war, unexpected surge ion inflation, a generalized crisis leading to repudiation of foreign debts by major sovereign borrowers, a regression to a world of currency or trading blocs or the international isolation of a country. In emergencies countries may need liquid resources. Gold is liquid and is universally acceptable as a means of payment. It can also serve as collateral for borrowing.

Confidence: The public takes confidence from knowing that its Government holds gold - an indestructible asset and one not prone to the inflationary worries overhanging paper money. Some countries give explicit recognition to its support for the domestic currency. And rating agencies will take comfort from the presence of gold in a country's reserves.The IMF's Executive Board, representing the world's governments, has recognized that the Fund's own holdings of gold give a "fundamental strength" to its balance sheet. The same applies to gold held on the balance sheet of a central bank.

Income*:* Gold is sometimes described as a non income-earning asset. This is untrue. There is a gold lending market and gold can also be traded to generate profits. There may be an "opportunity cost" of holding gold but, in a world of low interest rates, this is less than is often thought. The other advantages of gold may well offset any such costs.

Insurance: The opportunity cost of holding gold may be viewed as comparable to an insurance premium. It is the price deliberately paid to provide protection against a highly improbable but highly damaging event. Such an event might be war, an unexpected surge of inflation, a generalized debt crisis involving the repudiation of foreign debts by major sovereign borrowers, a regression to a world of currency and trading blocs, or the international isolation of a country.

Liquidity: The gold market is a deep and liquid one in which trades can be executed 24 hours a day with the capacity to trade single transactions well in excess of $25M at a time, under normal market conditions.

Ease of trading: Traditionally, access to the gold market has been through:

- Investment in physical gold, usually as gold coins or small bars, or, for larger quantities, by way of the over the counter market
- Gold futures and options
- Gold mining equities, often packaged in gold-oriented mutual funds
- Exchange-Traded Funds (ETFs) and similar products, offering potential investors cost-efficient, easy access to gold through stock exchanges

But more recently, new ways to invest in gold have come on stream for potential investors, providing cost-efficient, easy access through stock exchanges.

Hedge against us dollar: US$ gold price and the Dollar Index generally trend in opposite directions; or, to put it another way, that the US$ gold price and the Swiss Franc generally trend in the same direction. This reciprocal relationship between gold and the dollar is often not evident on a daily or weekly basis, but is almost always evident during periods of 12 months or longer. The reason that gold and the dollar generally trend in opposite directions is that in one respect gold is just another currency. It is no longer money in the true meaning of the word, but it tends to trade as if it were. As a result, when the dollar weakens on the foreign exchange market over an extended period then the US$ gold price will generally rise during the same period; and when the dollar strengthens over many months the US$ gold price will usually fall. There are, of course, leads and lags and there's no reason to expect that percentage changes in one will be accompanied by equal-and-opposite percentage changes in the other, but when charts of the dollar and gold are compared it quickly becomes apparent that the two have been inversely correlated since the floating -- some would say sinking -- currency system came into being in the early 1970s.

Other Reasons: Performance of gold not linked to performance of any company, industry or government. Gold is an asset, which is not simultaneously a liability, unlike stocks. It doesn't require political & social stability to survive; in fact it thrives under worst societal conditions. Gold doesn't ever lose its intrinsic value.

Conclusion

An investor has numerous investment options to choose from, Gold is a budding option of the various investment alternatives available to the investor. The low volatility of gold prices as compared to equity market, weakening of Indian Rupee against US Dollar and growing uncertainty about global economy resulted in the emergence of Gold as a strong asset class. Allocation of a small portion of investment in Gold diversifies the portfolio risk. During the days of economic meltdown and volatile movements on stocks and commodities markets, Gold is an investment boulevard that can provide 'insurance' against intense movements of economic and social turmoil. End result of study reveals that diversifying, hedging and safe haven properties of gold are the reasons behind the emergence of gold as a hedging and investment opportunity.

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