The case for gold in an investment portfolio

AAAU White Paper 2020
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Introduction

For millennia gold has been sought after for both its beauty and its monetary worth. To this day investors ranging from individuals to institutional portfolio managers, sovereign wealth funds and central banks hold the metal as a trusted store of value.

This white paper looks at the case for gold in a modern investment portfolio as we enter a new decade. We begin with a review of the key market drivers that contributed to the gold price rise across the past year which saw it reach more than USD 1,500 per troy ounce in 2019.

The second section looks at the role gold can play in a modern investment portfolio and discusses five key reasons many astute investors allocate 5-10% of a diversified portfolio to gold.

The final section covers why investors want to purchase gold and the reasons to consider The Perth Mint Physical Gold ETF (AAAU), outlining the unique features of this product that make it a convenient, cost-effective and secure way to add the precious metal to a portfolio.
Gold in 2019: Back on the investment radar

Gold re-established its strong credentials on the investment radar in 2019, rising by almost 20% across the course of the year.

The rally in the gold price saw the yellow metal climb back above USD 1,500 per troy ounce. This was driven by multiple factors including:

- A return to monetary easing by the United States (US) Federal Reserve, with three interest rate cuts in the second half of the year, as well as intervention in money markets which saw the Federal Reserve’s balance sheet expand back above USD 4.1 trillion by the end of last year.
- The significant decline in bond yields globally, with US 10-year government bond yields dropping 29% for the year, to end 2019 at just 1.91%.
- The increase in the value of negative yielding debt, which at one point topped USD 17 trillion, with more than a quarter of developed market sovereign debt trading with a negative yield.
- Growing recession fears leading to the US yield curve inverting in 2019 as ongoing Brexit discussions and the turbulent US-China trade deal fuelled uncertainty.
- Rising geopolitical unrest, which has carried over into early 2020 as tensions between Iran and the US escalate.

Given this momentum, it is little surprise that gold performed as well as it did in 2019. Last year’s increase represented the strongest annual rise in the gold price since 2010, as indicated in the chart below.

GOLD PRICE RETURNS (%) BY CALENDAR YEAR – 2000 TO 2019

The increase in gold price was even more impressive over the 15 months to end 2019, a time period that includes the sharp correction in equity markets in late 2018 which first helped reignite safe haven demand for the precious metal.

From the beginning of Q4 2018 to the end of 2019 the gold price in USD rose by 27.30%, strongly outperforming the S&P 500 which increased by just 10.87% across the same time period.

The case for gold was further boosted in 2019 by high profile investors speaking favourably about the yellow metal and the role it may play in a portfolio. This includes Bridgewater Associates Founder, Co-Chairman and Co-Chief Investment Officer Ray Dalio, who in July 2019 released a widely read report titled Paradigm Shifts, which warned that investors may continue to face low to negative returns in traditional safe haven assets like bonds and cash for years to come.

Should this occur, Dalio believes it will “lead investors to increasingly prefer alternative forms of money (eg. gold).” He considers, “It would be both risk-reducing and return enhancing to consider adding gold to one’s portfolio” stating that gold is an “effective portfolio diversifier.”

Blackrock also published a research piece titled The Monetary Policy Endgame, which looked at the potential investment implications of the economic environment investors face today and the challenge it poses to investors. The research warned there is a risk that the worst assets to hold could be sovereign bonds with negative yields, closely followed by paper money at zero yield, in part because both have “a theoretically infinite supply.”

The solution to this challenge, according to Blackrock, would be to “hold an asset that maintains its real value – an asset that cannot be printed.” Gold is mentioned as one of the assets that meets this criteria.
The factors that drove the rally in the gold price throughout 2019 also contributed to a notable uptick in investment demand, seen globally across:

- Global gold exchange traded product (ETP) holdings rose by approximately 400 tonnes for the year, with total holdings sitting near their all-time highs. More than 2,700 tonnes of gold were held across all gold ETPs at the end of 2019, according to the Refinitiv GFMS Gold Survey 2019 H2 Update and Outlook.

- A surge in gold demand by high net worth investors. A late 2019 report by Goldman Sachs stated that volumes of gold custodied in countries like Switzerland and the UK had grown by more than 1,200 tonnes across the past three years.

- Unprecedented levels of central bank gold buying, with estimates from the Refinitiv GFMS Gold Survey 2019 H2 Update and Outlook suggesting total central bank purchases equalled 623 tonnes for the year. According to this report, demand from central banks was the highest in any calendar year since 1964.

The Perth Mint has seen firsthand this increase in gold demand from investors using our exchange traded products, including Perth Mint Physical Gold ETF (AAAU) and other depository services with the total value of precious metals custodied for Perth Mint clients now exceeding USD 3 billion.

In 2020, we expect demand for gold to be sustained, as low real interest rates and negative yielding debt, combined with expensive equity market valuations and ongoing geopolitical tension, all reinforce safe haven demand for the yellow metal.

Further support for gold can be expected if the USD were to weaken, or if inflationary concerns continue to build, with monetary policy likely to remain accommodative in the US and in developed markets more broadly for the foreseeable future.
Why investors should consider gold

The principal reasons investors choose to allocate a portion of their portfolio to gold relates to the precious metal’s traditional attributes including:

- Attractive long-term returns
- Strong performance when real rates are low
- Ability to effectively hedge against equity market falls
- Strong performance when the US dollar weakens
- Simplicity and transparency
1. Gold has delivered attractive long-term returns

The price of gold has risen from below USD 40 per troy ounce at the beginning of the 1970s to just over USD 1,500 per ounce by the end of 2019.

Gold has also performed well relative to other asset classes, as illustrated in the following graph. It shows the return of gold, as well as the capital return on equities, and the total returns on cash and US treasuries across multiple time periods between the end of 1971 and the end of 2019.

ASSET CLASS RETURNS (%) – MULTIPLE TIME PERIODS TO END 2019

With share markets recovering from significant declines witnessed during the global financial crisis, it is not surprising they have outperformed gold over the past five to 10 years. However, this has not stopped the yellow metal from being the highest performing asset class over the past 20 years, with the return on gold more than doubling the capital return delivered by equities since the end of the nineties.

Since the end of 1971, gold has risen by more than 7.5% per annum, outperforming cash and US treasuries over this time period.
2. Gold has been a strong performer when real rates are low

Given gold has been seen as a monetary commodity, and indeed is still owned by central banks as part of their monetary reserves, it can also play a role within a portfolio as a ‘cash alternative’. This feature of gold can be seen especially during low interest rate environments, such as the one the US has been experiencing since the onset of the global financial crisis more than a decade ago.

Analysis of the gold price and short-term debt (three-month US treasury bills) returns, as well as inflation data, shows that gold has historically performed well in climates where real cash rates are low.

Real interest rates factor in inflation as well as the nominal cash rate. As an example, if the interest paid on cash in a given year was 8%, then that would be the nominal return on cash. However, if inflation for that same year was 5%, the real return on cash would be just 3%.

Of the 47 years between 1972 and 2019, there have been 33 years when real interest rates in the US were 2% or lower. In those 33 years the price of gold rose on average by more than 16% in nominal terms and 12% in real terms.

It should be no surprise that gold would perform so well during periods when real rates have been low for two key reasons:

1. Low or even negative real rates are typically implemented only as a form of monetary stimulus when the economy is weak or softening. In such environments it’s natural that investors adopt a more defensive approach by seeking out safe haven assets such as gold.

2. If the real interest rates paid from cash or short-term bonds are low, or even negative, then the opportunity cost of investing in gold, which doesn’t produce income, may be significantly reduced.

Gold’s performance in low real interest rate environments is particularly relevant for American investors today considering the multiple interest rate cuts delivered by the Federal Reserve last year, which brought the target federal funds rate range down to 1.50-1.75%. Inflation data suggested US consumer prices rose by 2.30% in the year to December 2019.

Real interest rates are negative in the US, with current long-term bond yields of 1.82% (US 10-year treasuries) to 2.27% (US 30-year treasuries) as at 14 January 2020 suggesting they may remain this way for years to come.
3. Gold has been an effective hedge against equity market falls

Apart from the strong long-term returns gold has generated, another reason many investors include a permanent allocation to gold in their portfolio is its historical ability to balance out overall portfolio returns.

Gold has helped provide balance because its returns have been typically uncorrelated to those generated by financial assets in general. Correlation is a measure of how asset prices move relative to one another. The lower the correlation, the less these assets move in the same direction at one time. Most importantly for gold, it has been negatively correlated to equities when equity markets have fallen, providing diversification when it has been needed most.

Evidence of gold’s ability to hedge against equity market drawdowns can be seen in the chart above, which shows the performance of gold and the S&P 500 during the five worst calendar years for equities from the early 1970s through to the end of 2019.

In the five calendar years highlighted in the chart, the average decline in the equity market was almost 25%. By contrast, gold rose in each of these years, with an average gain of almost 34%. The data therefore highlights how gold could have helped mitigate losses at the portfolio level and why it has such valuable diversification qualities. This is one of the main reasons gold has become known as a safe haven asset and why it continues to be held by many investors within a diversified portfolio.

Gold’s defensive qualities are particularly relevant given the investment environment American investors find themselves in today, with many equity markets trading at or near all-time highs.
4. Gold has performed well when the US dollar weakens

A fourth factor supporting the role of gold in a portfolio is its traditional ability to deliver above average returns in environments where the USD weakens.

This can perhaps be best visualized through the long-term chart below which plots the USD spot price of gold and the US Dollar Index from the end of 1969 to the end of 2019.

**GOLD PRICE PER OUNCE AND US DOLLAR INDEX – 1969 TO 2019**

As you can see, there have been several periods of notable USD weakness, in particular throughout the early 1970s and again in the first decade of the new millennium, when the gold price rose significantly.

The correction in the USD gold price between 2011 and 2015 can in part be attributed to the strong rally in the USD seen over that time period. However, gold, which ended 2019 trading above USD 1,500 per ounce, is up by more than 42% since that corrective phase came to an end approximately four years ago.

To further illustrate the historical strength of gold in environments of USD weakness, consider that there have been 23 calendar years between 1970 and 2019 when the USD has fallen. Gold has risen in 20 of those, with an average gain of 25% across every year the USD fell.
5. Gold is a simple and transparent investment

Another driver of investment demand for gold is its simplicity as an investment. Gold in particular is:

- Easy to invest in
- Accessible to a broad range of investors
- Subject to minimal execution risk

Each of these features, and why they are a virtue from an investment perspective, are explored in more detail below.

a) Easy to invest in

Gold is incredibly easy to purchase.

One of the most popular and accessible ways to invest in gold today is via ETFs, including The Perth Mint Physical Gold ETF (NYSE: AAAU). The first ETF with sovereign-backed gold, AAAU is designed to track the international price of gold in USD and is available through a standard share trading account.

See more about AAAU’s unique set of features including:

b) Accessible to all investors

Given there are no minimum investments for ETFs, other than those set by a broker/dealer, ETFs such as AAAU are typically accessible to a broad range of investors. These include young savers looking to start building wealth through to institutional asset managers with pension and hedge funds, as well as sovereign wealth funds and central banks.

c) Subject to minimal execution risk

The Perth Mint defines execution risk as the risk that the performance an investor generates from their investment within an asset class is different to the performance of that asset class as a whole, over a given time period.

For example, whilst the S&P 500 delivered capital growth of 4.02% per annum in the 20 years to end 2019, not every investor in US stocks will have earned that return, with the performance they generated dependent on the shares, ETFs or mutual funds they owned.

As gold is a homogenous asset class, every investor who owns gold over a given time period will generate the same return. This makes gold a simple asset class to invest in, with less moving parts for an investor to worry about when it comes to allocating a portion of their portfolio to gold.
How to invest in gold

The Perth Mint Physical Gold ETF (AAAU)

AAAU offers investors an accessible and potentially attractive vehicle to gain exposure to gold in their portfolios with the understanding that the shares are backed by physical gold.

AAAU’s distinct features include:

• A competitive management fee of 0.18% per annum.
• Shares backed by allocated gold secured in The Perth Mint’s network of central bank grade vaults in Perth, Australia. The largest such network in the southern hemisphere, it offers an alternative to vaulting in London and New York within one of the world’s most geopolitically safe regions.
• All gold underlying the fund is guaranteed by the Government of Western Australia, a highly rated sovereign entity.
• The option to exchange shares for a range of physical gold bullion products which are manufactured by The Perth Mint.

More about The Perth Mint

One of the world’s leading precious metals enterprises, The Perth Mint:

• Processes more than 10% of annual global gold production and over 90% of gold mined in Australia, with Australia being the world’s second largest producer of newly mined gold after China.
• Operates one of the largest and most efficient precious metals refineries in the world, with gold and silver refining capacities in excess of 800 tonnes and 900 tonnes per annum respectively.
• Safeguards wealth worth over USD 3 billion for clients ranging from central banks and sovereign wealth funds to individuals within its state-of-the-art vaults.
• Distributes a wide range of precious metal products worth approximately USD 14 billion to more than 130 countries annually including the US, where The Perth Mint’s coins are one of the most popular and trusted brands.

Learn more about the unique characteristics of AAAU and latest news about the fund at https://www.aaauetf.com/
Disclosures

This material must be preceded or accompanied by a prospectus, a copy of which may be obtained by clicking here. Before investing, you should carefully consider the trust’s investment objectives, risks, charges and expenses. Please read the prospectus carefully before you invest.

All obligations of the trust custodian, The Perth Mint, including the gold held on behalf of investors in AAAU, are guaranteed by the government of Western Australia.

The government guarantee is subject to the claims-paying ability of the Government of Western Australia. If the custodian becomes insolvent, its assets, and the assets of the Government of Western Australia under the government guarantee, may not be adequate to satisfy a claim by the trust or any authorized participant. The referenced guarantee does not apply to fluctuations in the value of shares based on the price of gold which could create potential losses. Gold owned by the trust may be subject to loss, damage, theft or restriction on access.

The trust is not a mutual fund or any other type of investment company within the meaning of the Investment Company Act of 1940, as amended, and is not subject to regulation thereunder. The value of your shares fluctuates based upon the price of the gold held by the trust. Fluctuations in the price of gold could materially adversely affect your investment in the shares. Investors should be advised that there is no assurance that gold will maintain its long-term value in terms of U.S. dollar value in the future. The lack of an active trading market for the shares may result in losses on your investment at the time of disposition of your shares. Because the trust invests only in gold, an investment in the Trust may be more volatile than an investment in a more broadly diversified portfolio. Substantial sales of gold by central banks, governmental agencies and multi-lateral institutions could adversely affect an investment in the shares.

The request for the exchange of shares for gold is subject to a number of risks including but not limited to the potential for the price of gold to decline during the time between the submission of the request and delivery. Delivery may take a considerable amount of time depending on your location. The trust may suspend redemptions of baskets by authorized participants and Gold Corporation may suspend or reject the exchange of shares for physical gold, which could affect the market price of the shares. The withdrawal of an authorized participant and substantial redemptions by authorized participants may affect the liquidity of the shares. Market Price: The current price at which shares are bought and sold. Market returns are based upon the last trade price.

NAV: The dollar value of a single share, based on the value of the underlying assets of the fund minus its liabilities, divided by the number of shares outstanding. Calculated at the end of each business day at 4:00PM.

Marketing Agent: Foreside Fund Services, LLC