WORLD GOLD COUNCIL

Investment Update
Using gold to hedge emerging market risk

May 2018 www.gold.org

Over the long run, economic growth is a key driver of gold demand, especially in emerging market (EM) countries where there is a high affinity for gold as jewellery and investment. At the same time, gold tends to perform well in periods of crisis. Having a strategic position in gold helps improve EM portfolio performance as it can be used to:

- capture EM upside through gold's link to rising incomes
- protect against systemic risks, which reduce portfolio volatility and losses – producing gains in some systemic sell-offs
- hedge foreign-exchange risk at a lower cost than traditional currency hedges.

Gold pairs well with EM

Dual nature of holding gold
Gold has performed well over time with returns on par with stocks over multiple time periods (**Chart 1**). It is not simply a hedge that eats into returns, but it also provides diversification during bull and bear market environments.

Emerging markets growth and potential
EM investments have a tremendous amount of potential for growth supported by economic and demographic trends. EM continues to play an ever-important role in asset allocation as a source of return, but it usually carries higher volatility. Gold benefits from growth in EM as 70% of annual demand is linked to EM countries, especially Asia, but does not suffer from the same risks (**Figure 1**, **page 3**).

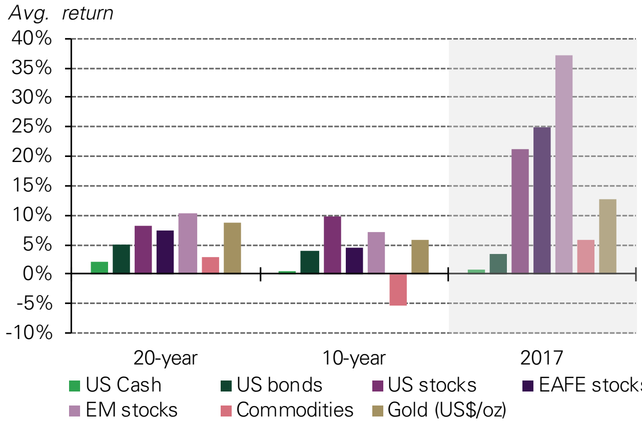
Lofty valuations, market downturns and correlation
Lofty valuations in developed markets as well as low bond yields across most developed economies have led to a greater proportion of investment growth in new markets like emerging ones. Cheaper funding in the US has allowed better access to EM. However, expectations of rising interest rates in the US could cause uncertainty and hurt the attractiveness of EM exposure.

There is a higher beta of 1.26 in emerging markets versus the MSCI World Index.[1] Systemic risks that impact global economies have an even larger effect on emerging markets. As gold often acts as a safe haven and hedge against systemic risks, it can provide an appropriate hedge to EM exposure.

And while EM stock performance is often linked and correlated to commodity performance, this does not hold true with gold, especially in market downturns (**Chart 2a**). Gold has negative correlation with risky assets during extreme market sell-offs yet provides returns during market strength. EM jewellery demand typically falls during market downturns, but this is typically offset by the increase in investment demand worldwide.

Gold is a proven safe-haven investment. Its preservation qualities are highlighted during extreme systemic events. Its price has historically increased during financial crises including some linked to EM (**Chart 2b**).

Chart 1: Gold's long-term performance compared to other financial assets*



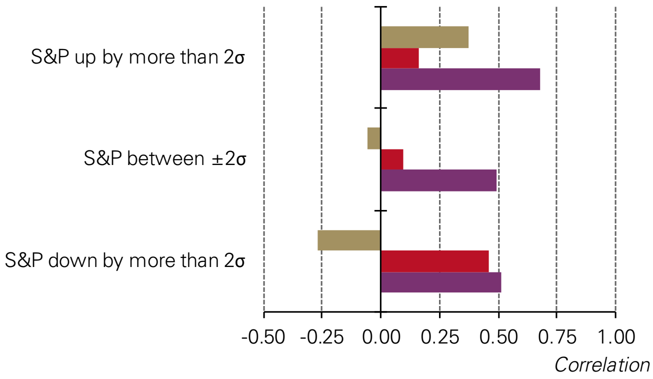
*Based on total returns indices including MSCI US, MSCI EAFE, MSCI EM, JP Morgan 3-month US cash, Bloomberg Barclays US Bond Aggregate, Bloomberg Commodity. Gold performance based on the LBMA Gold Price. Data between January 1971 and December 2017.

Source: Bloomberg, ICE Benchmark Administration, World Gold Council

1 Beta of the MSCI Emerging Markets Index versus the MSCI World Index, computed using monthly returns from January 1991 to December 2017.

Chart 2: Gold has historically performed well when stock indices fall sharply

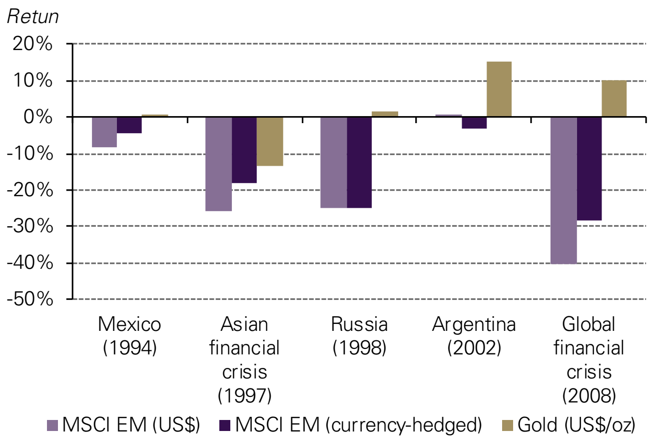
(a) Correlation between gold, commodities & EM compared to S&P 500 moves of different magnitude*



*Based on weekly returns between March 1987 and March 2018.

Source: Bloomberg, World Gold Council

(b) Gold acted as a diversifier during major EM crises*



*Mexico: Nov–Dec 1994; SE Asia: June–Dec 1997; Russia: July–Sep 1998; Argentina: Dec 2001–June 2002; global financial crisis: Aug 2008–Mar 2009.

Source: Bloomberg, World Gold Council

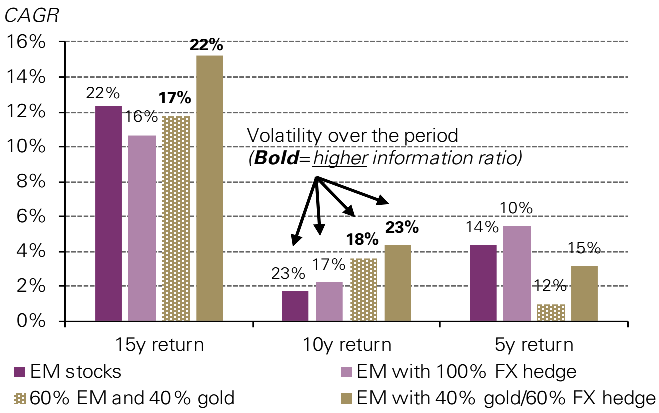
Currency volatility and hedging costs

Currency exposure is a principal component of risk and performance for a US investor holding EM securities. While some investors are comfortable holding the foreign-currency risk, as EM currency appreciation may deliver additional return, foreign-currency exposure leaves a portfolio vulnerable to high volatility and strong pullbacks.

Local currency exposure affects real returns for US dollar-based investors. Along with high correlation risk to domestic markets, inflation influences their own currency and subsequent real local returns. Adding gold to an EM portfolio lowers portfolio drawdown risk.

Having a gold allocation to a portfolio with EM currency exposure can also potentially enhance returns.

Chart 3: Hypothetical performance of various selected strategies for EM stocks*



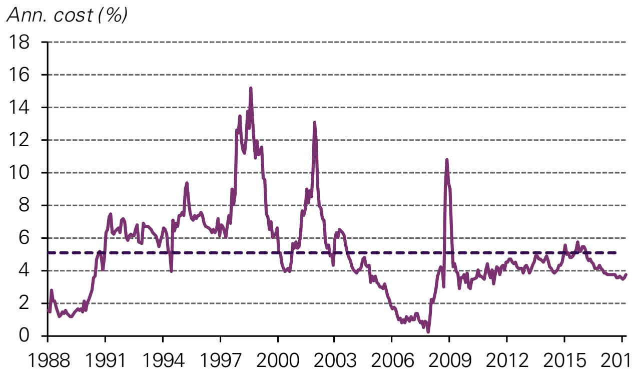
*Data ending December 2017. MSCI Emerging Markets Net Total Return Index (unhedged). Numbers above bars represent volatility over the given period. Bolded numbers represent holdings that had the highest information ratios.

Source: Bloomberg, World Gold Council

Our analysis, summarized in **Chart 3** and **Table 1**, shows that, over one-, ten-, and fifteen-year time horizons, unhedged EM portfolios including an allocation to gold as well as EM portfolios with an FX hedge (or overlay) including gold generally outperformed and had higher information ratios than portfolios without gold.

Gold's advantage as an FX hedge is in part due to the high cost of hedging EM currency via traditional currency swaps, forwards, and futures, especially in periods when interest rate differentials between developed and emerging economies increase. For example, between 2002 and 2017, the average implied cost to hedge an EM portfolio was 4.1% (**Chart 4**), whereas the average annual performance of gold over that period was 11.2%. And while interest rate differentials have compressed, gold overlays remain highly cost effective.

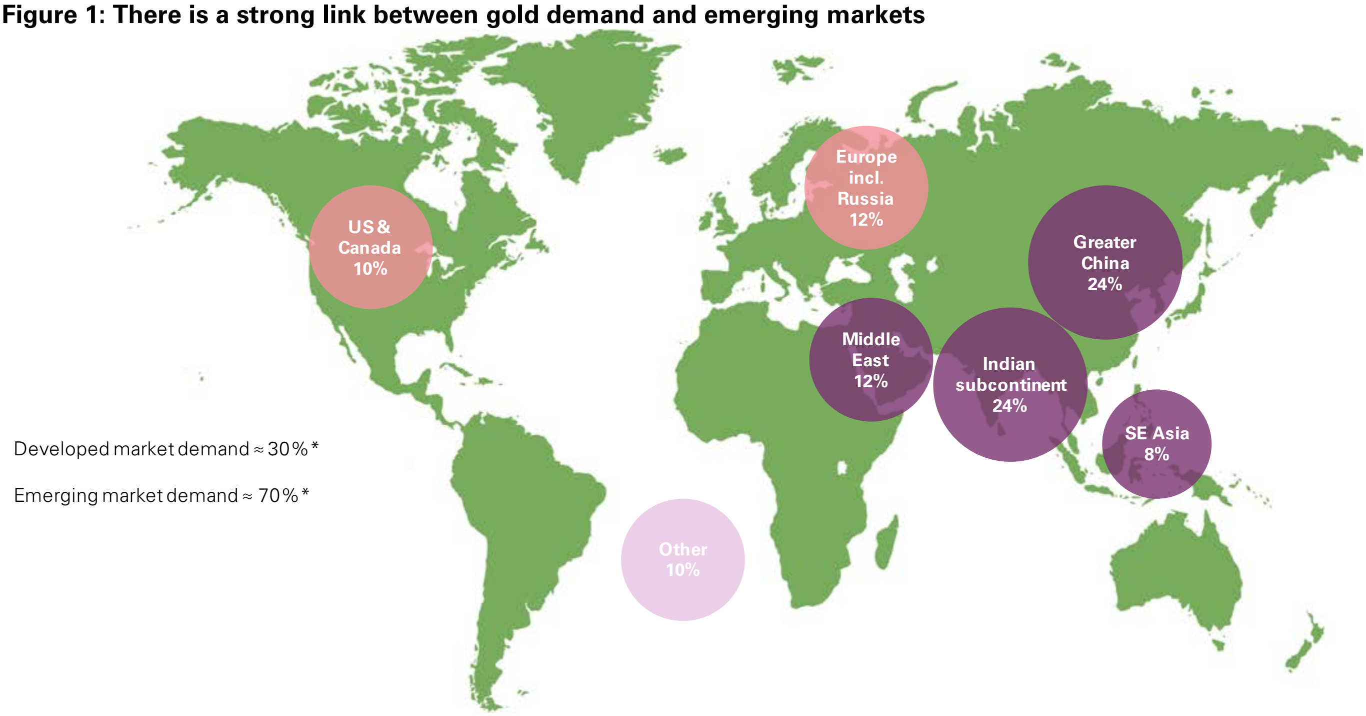
Chart 4: Approximate cost of hedging EM FX exposure*



*Based on the spread of the JP Morgan EMBIG Index yield over equivalent maturity US bond index.

Source: Bloomberg, JP Morgan, World Gold Council

Figure 1: There is a strong link between gold demand and emerging markets



*Based on 10-year average demand estimates ending in 2017. Includes jewellery, technology, bars, coins, and ETF demand. It excludes over-the-counter transactions and central bank purchases.

Source: Metals Focus, GFMS-Thomson Reuters, World Gold Council

Table 1: Performance of EM stocks with various hypothetical combinations of gold and FX overlays/hedges*

					EM stocks with overlay				Portfolio
		Gold (US$/oz)	EM stocks (US$)	EM stocks (local currency)	100% FX hedge	100% gold hedge	40% gold hedge	40% gold and 60% FX hedge	60% EM stocks and 40% gold
Annual avg.	15 years	10.3%	17.3%	15.8%	13.9%	28.5%	21.8%	20.2%	14.4%
	10 years	5.7%	7.3%	7.8%	5.7%	14.3%	10.2%	9.8%	6.4%
	5 years	-3.7%	5.8%	8.6%	6.1%	2.5%	4.5%	4.8%	2.1%
CAGR	15 years	9.1%	12.3%	12.6%	10.7%	19.0%	15.4%	15.2%	11.8%
	10 years	4.5%	1.7%	4.1%	2.2%	4.1%	3.2%	4.3%	3.6%
	5 years	-4.9%	4.3%	8.0%	5.4%	-1.8%	2.2%	3.1%	1.0%
	2017	12.7%	37.3%	30.6%	28.6%	52.2%	43.2%	37.8%	27.0%

*The analysis compares the performance of unhedged EM stocks based on the MSCI Total Net Return in US dollars to alternative hedging strategies. One includes an overlay (or hedge) based on FX, gold, or a combination of the two (for example, a 40% gold/60% FX hedge implies borrowing an equivalent to 100% of the allocation to EM and using that to establish a 40% position in gold and 60% in an EM vs US$ currency FX hedge). The other strategy involves simply distributing a long-only position between EM stocks and gold (for example, 60% in EM stocks and 40% in gold). See *Hedging EM risk? Think gold*, Gold Investor, March 2014.

Source: Bloomberg, World Gold Council

Gold is a strategic asset in EM portfolios

Adding gold to an EM portfolio generally produces higher absolute and risk-adjusted returns than a fully hedged or unhedged EM portfolio (**Table 1**).

Gold is different than traditional hedges. Because gold gives a US investor's EM portfolio positive correlation in a rising market and negative correlation in a falling market, gold has a dual nature for investment purposes – this quality is not seen in other traditional hedges.

Choosing whether to hedge the foreign currency or systemic risk of an EM portfolio is a crucial decision for a US investor. Regardless of the decision, having some gold exposure can provide an advantage for risk-adjusted returns compared to a portfolio with no gold exposure.

About the World Gold Council

The World Gold Council is the market development organisation for the gold industry. Our purpose is to stimulate and sustain demand for gold, provide industry leadership, and be the global authority on the gold market.

We develop gold-backed solutions, services and products, based on authoritative market insight, and we work with a range of partners to put our ideas into action. As a result, we create structural shifts in demand for gold across key market sectors. We provide insights into the international gold markets, helping people to understand the wealth preservation qualities of gold and its role in meeting the social and environmental needs of society.

Based in the UK, with operations in India, the Far East and the US, the World Gold Council is an association whose members comprise the world's leading gold mining companies.

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