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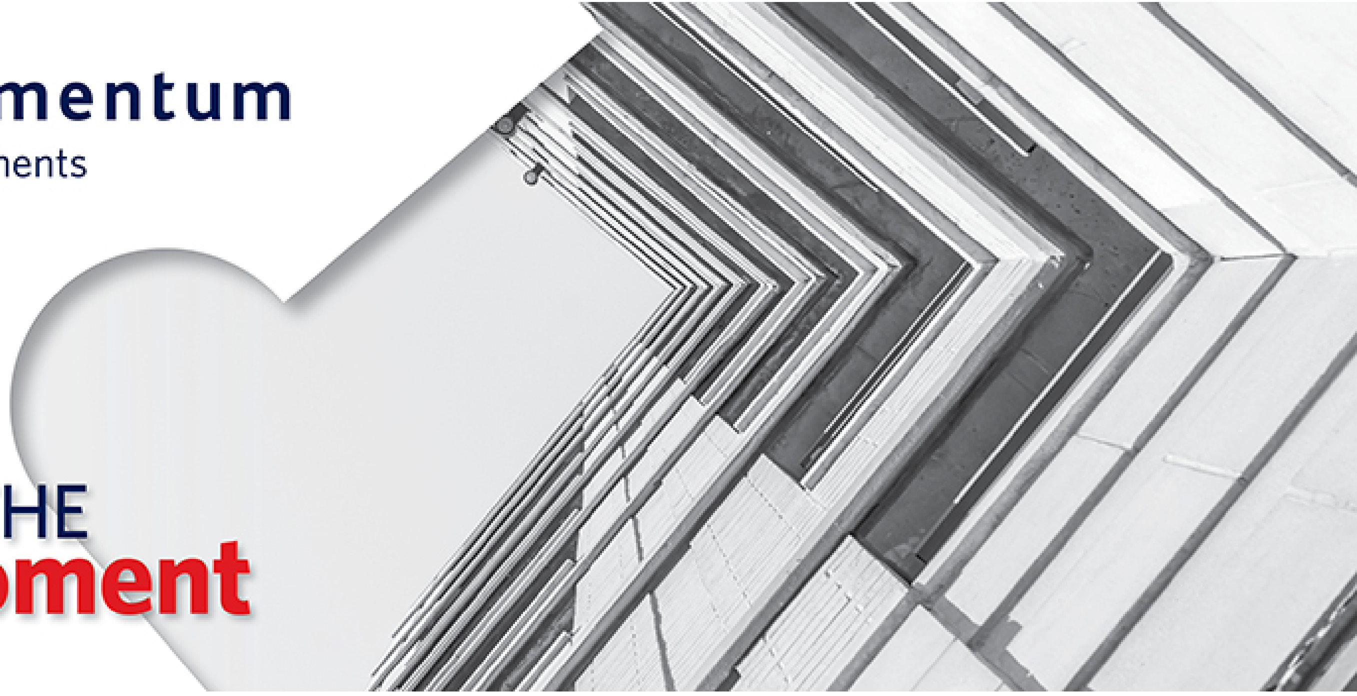
IN THE moment



Gold in the time of COVID-19

Introduction

There is something rather strange about gold. In effect, it is essentially a useless metal (apart from being used for jewellery and electronics), but for thousands of years it has been the basic example of a currency.

The definition of a currency is that it is uniform, durable, easily transportable, transferable and, most importantly, limited in supply. Gold's acceptability as such is unparalleled – by time and geography. However, modern financial developments – most notably the use of fiat currency[1] – have challenged its pre-eminence in use as a currency. John Maynard Keynes referred to the gold standard as a 'barbarous relic' in his 1924 book on the reform of monetary systems (which were then mainly gold-based). This term has often been applied to gold as an asset class itself.

From an investment perspective, gold is certainly an unusual asset. It generates no income and has very little value in use. However, its ability to act as a store of value has always attracted investors in times of crises and, as exhibited by recent returns from this asset class, this appeal continues to this day.

In this article the investment characteristics of gold from a South African investor's perspective in the first three months of 2020 is reviewed. This shows that gold (in South African rand terms) offers significant local equity-market crisis-hedging characteristics. However, the relationship can be volatile through the event, and the performance of the rand against the US dollar is key to local investors benefitting from holding this investment.

A review of the returns from gold in the COVID-19 crisis

The onset of the COVID-19 pandemic and its extremely negative effect on global financial markets started in the first three months of 2020. Using the MSCI World Index as a proxy for global equity markets, the returns since the beginning of the year to early April 2020 are presented in chart 1 with the price of gold (all in US dollars terms).

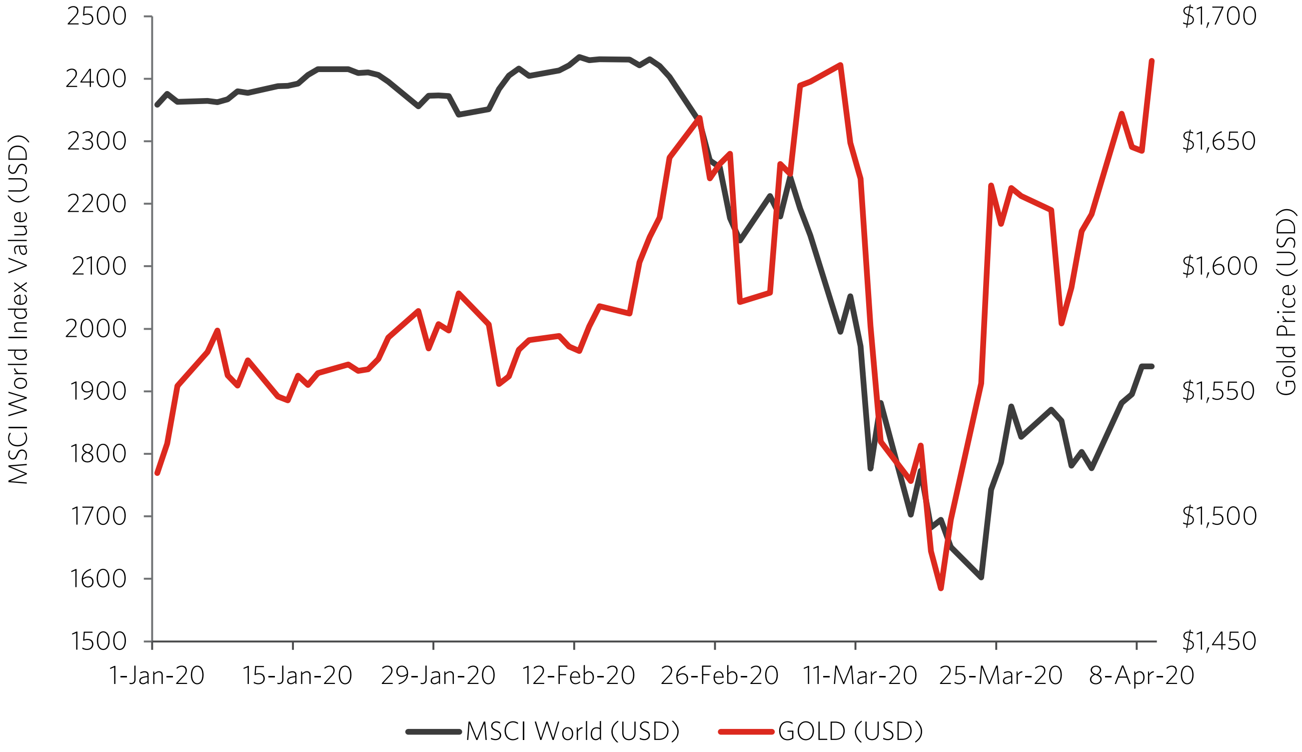
Two key points can be made based on this data. Firstly, with the exception of the period leading up to the start of the financial crisis at the end of January, the returns from gold as an investment closely mimicked that of global equity markets. In fact, the gold price had a positive correlation with global equity markets in this period, and therefore provided limited

Key:

1. Fiat currency is the use of (specially printed) paper as currency. This meets all the requirements of a currency as long as its supply is limited. This is the responsibility of the Central Bank through the Mint, and (far more importantly) its management of the banking system's ability to create money through loans by maintaining the fractional reserve requirement system and being the lender of last resort.

diversification benefits. However, while the pattern of returns is similar, gold has provided relative protection for equity holders in the crisis period. The gold price bounced back more aggressively than global equity markets and ended these three months up by almost 11% (compared to the 18% decline in the equity markets). This represents almost a 30% relative outperformance.

Chart 1: Global equity market (MSCI World Index) levels and the gold price (both in US dollars)



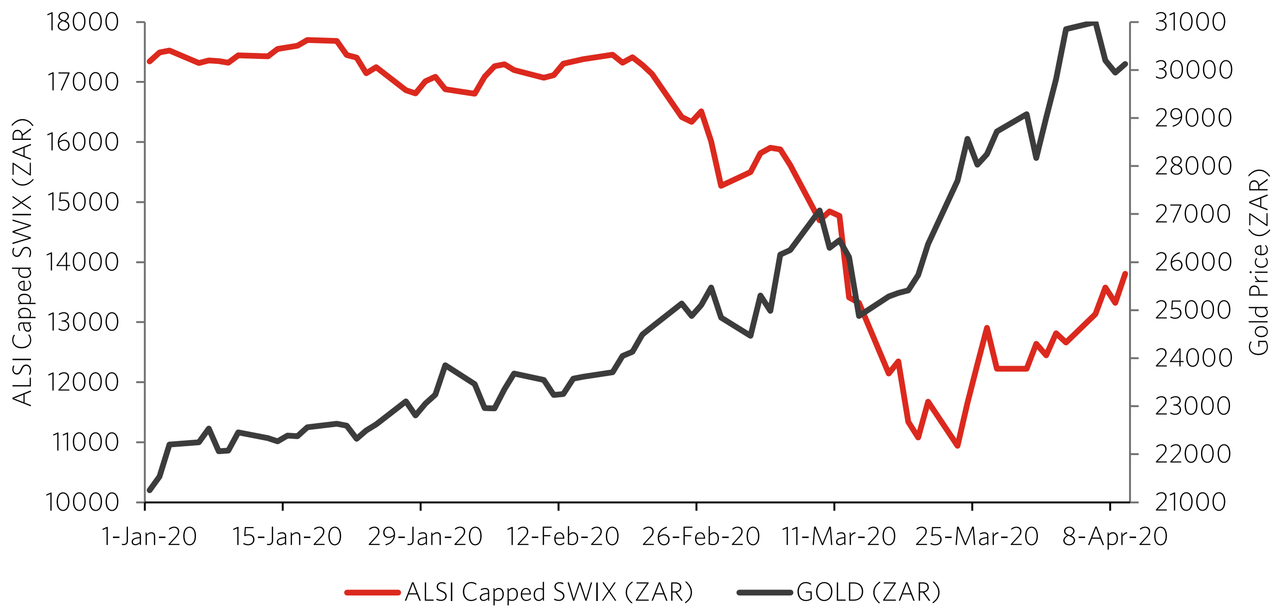
Source: Momentum Investments

When looking at gold from a rand perspective, the picture is very different, as illustrated in chart 2. Gold's return was negatively correlated with the local equity market's index levels in this crisis period, and the relative outperformance is more than 60% for the period (gold returned 42% in rand terms for this period, while the FTSE/JSE All-Share Capped Shareholder Weighted Index (Alsi Capped Swix) lost 18%). Gold's hedging effects are thus significantly greater for South African investors.

Why the difference? The returns from gold in rand terms are directly affected by the returns from the currency in the same period. The rand/US dollar rate depreciated by 28% in this crisis. This significant change boosted the 11% growth of gold's price in US dollars in this period from an SA investor's perspective.

This is the usual pattern of the local currency's response to a crisis of this magnitude. It clearly illustrates that the rand-hedge element of gold provides significant protection over and above the positive price move in the US dollar price of gold.

Chart 2: SA equity market (Alsi Capped Swix) levels and the gold price (both in rand terms)



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Exposure in outcome-based solutions

We truly believe in the risk diversification you can achieve through spreading risk and exposure among asset classes that are sound investments in the longer term and provide different sources of return in the short term. This does not only ensure a less concentrated portfolio to any one asset class but also provides for risk management in times of severe bear markets when asset classes tend to correlate to 1.

The exposure to gold in the multi-asset-class outcome-based solutions, in particular the Momentum Investments Focus Fund of Funds Range for individual investors and the Factor Series of portfolios for business investors, varies between 1% and 3%. Even though the exposure seems small, the effect of this small exposure on a portfolio can be significant.

If we relate this back to the relative difference in the returns from equity and gold, this accounted to about 60% for the severe market drawdowns in the first quarter of 2020. Having 3% gold exposure in a portfolio, this contributed 1.8% in a market where most other asset classes delivered negative returns.

Diversified exposure to asset classes like gold, being underweight risky asset classes, including equity and property, as well as implementing other protection overlays like equity protection in a portfolio, significantly contributes to the downside risk management in periods of significant market drawdowns. All of these have contributed positively to the returns from the multi-asset-class outcome-based portfolios.

Conclusion

Gold's fundamental appeal to a South African investor is that it provides relatively reliable and effective protection against local equity market weakness in times of crisis. This protection is a function of two things – firstly, it is an excellent rand hedge, and the rand tends to depreciate in these times of crisis, and, secondly, gold's price tends to increase (or at least holds up) when the crisis is sufficiently severe on a global scale. From a local investment perspective, gold has the added attraction that, while it is deemed to be a local investment, its rand-hedge characteristics mean that it acts like a global investment. This gives enhanced risk protection to the portfolio.

The appeal of gold in a crisis is apparent, if we look at the recent COVID-19 crisis, where gold outperformed local equities by 60% in the first three months of this year. This relative return is because of local equities falling by 20% and gold's value in rand terms increasing by 40%. About three quarters of this increase is due to the rand weakening. It is interesting to note that, in US dollar terms, the price of gold behaved similarly to other asset classes through this crisis. Its value did, however, not fall in the same way these investments' value has, which gives it its strong relative returns.

Gold has contributed in this environment to clients invested in our multi-asset-class outcome-based portfolios. We believe gold should be considered in a diversified portfolio, for the reasons illustrated in this article. It certainly enhances the profile of an overall portfolio, especially in times of crisis. It may be a 'barbarous relic', but during times like these, it can be a very good one.

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