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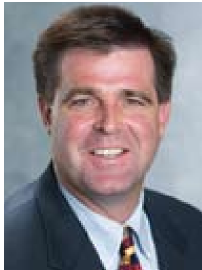
Investment Viewpoints



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Gold and the Decade to Come

October 2010

Key Points

- While returns for stocks and credit-sensitive bonds are tied to improving business conditions, gold actually tends to do better during periods of economic and political uncertainty, providing diversification when investors want it the most.
- We believe that there are a number of factors lining up to support investment demand for gold over the next decade.
- Investors and central banks concerned about the health of the world's paper currencies are turning to gold.

Relying on more than 20 years of experience investing in the gold sector, we offer a perspective on the role gold plays in a diversified portfolio as well as our observation of the supply and demand forces at play that will affect gold investments over the next decade.

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Drivers of Gold Demand

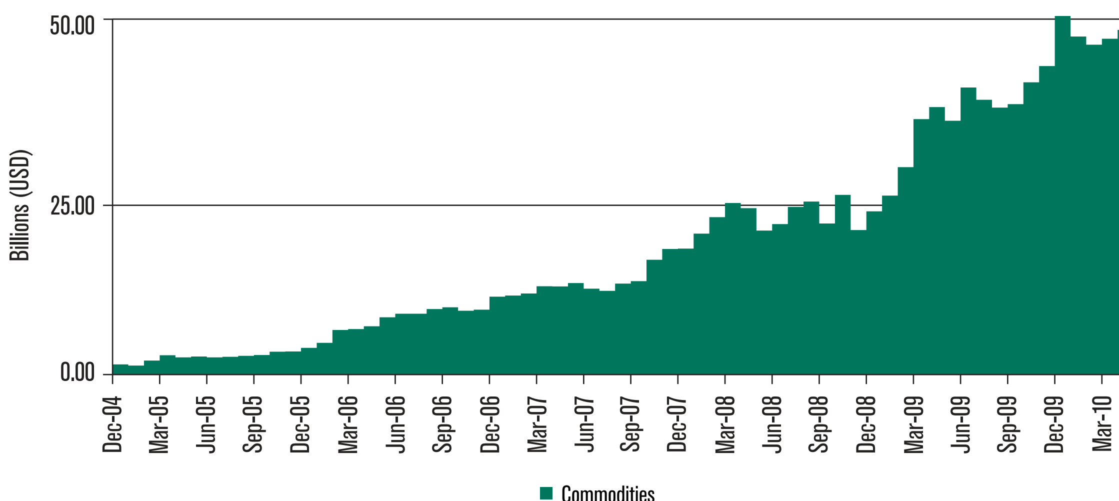
Unlike traditional commodities, whose fortunes are closely tied to the economic cycle, gold has historically performed well under differing economic and market conditions, mirroring its diverse sources of demand. Gold enjoys four distinct sources of demand that fall into two broad categories:

1) Economy-related demand
   a. Industrial
   b. Consumer/jewelry

2) Safe-haven demand
   a. Investment
   b. Alternative currency

While industrial and/or consumer demand are common to most commodity assets, safe-haven demand is unique to gold. Safe-haven demand is typically most pronounced during times of crisis. As investors become concerned about a decline in value of paper assets, they often turn to physical assets and gold is a perennial favorite. This form of demand has the desirable effect of providing price support for gold precisely when most other (paper) assets are struggling, and it is one reason gold may serve as such a powerful diversifier within a portfolio. In recent years, safe-haven investment demand has grown significantly.

Figure 1: Assets Under Management (AUM) of Gold ETFs Over Time



Source: Morningstar, American Century Investments

Alternative currency demand stems primarily from central bank activity. Most sovereign nation central banks hold sizeable, sometimes massive, reserves. Often those reserves are held in dollars and other prominent currencies, but we're seeing central banks moving more and more of their reserves to gold, creating additional demand for the metal.

Gold Performance in Differing Markets

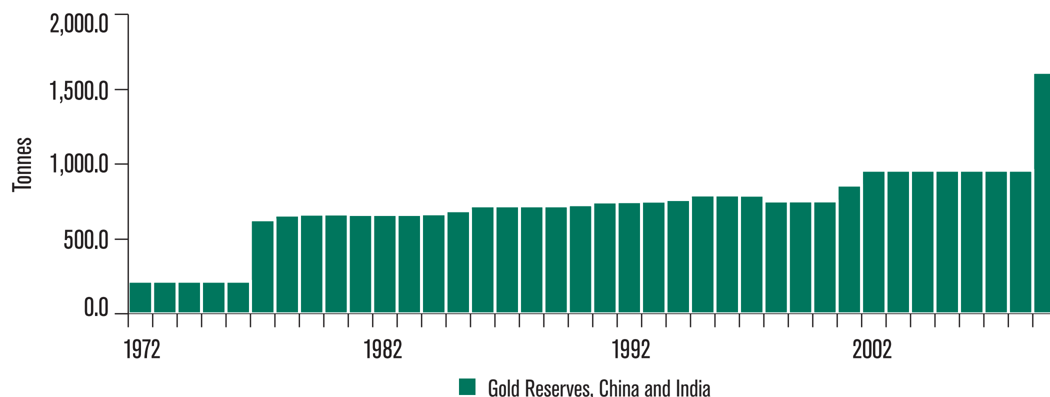
To see how its unique supply and demand dynamics affect gold in different economic and market environments, we look at the performance of gold relative to U.S. stocks, bonds, and cash under three different historical periods: 1) hyperinflation, 2) low inflation, and 3) financial system crisis. We have intentionally chosen favorable comparisons for gold to illustrate our point that gold has the potential to outperform mainstream assets across diverse environments.

Central Banks, Gold, and the Next Decade

While all four sources of demand ebb and flow over time, we see a longer-term trend emerging that we believe will continue to effect gold for many years to come. Expansion of U.S. public debt and unprecedented fiscal and monetary stimulus policies are causing a diminution of the dollar as the world's reserve currency. As a result, we believe the global financial system is gradually reducing its reliance on the dollar as the preeminent reserve currency. This trend appears to be well under way, with central banks in a number of economies already shifting some of their dollar reserves to gold in anticipation of such an eventuality.

In particular, we have seen a strong uptick in the demand for gold by the world's fastest-growing economies, including China, India, and Russia. These countries hold massive foreign exchange reserves. Ongoing purchases of gold by these countries indicate a steadily increasing allocation to gold as a percentage of their overall reserves, and a downward trend in the percentage allocated to paper currencies. These changes suggest a strong secular trend of increasing demand for gold over time.

Figure 2: China and India Growing Gold Reserves



Source: WGC calculations based on IMF data and national sources.

In addition, central banks of developed European countries have sharply curtailed sales from their sizable gold reserves built up in the period of the Bretton Woods agreement (the international monetary regime in place from the end of World War II to 1971 that fixed the value of currencies in relation to one another and to gold). Excess above-ground supply was a persistent negative for gold in the 1990s, when European central banks reduced their exposure to the precious metal in favor of interest-bearing assets. According to analysts at commodity research firm GFMS, however, the gold market passed a crucial milestone in early 2009, when central banks became net buyers, rather than sellers, of gold. This is a remarkable, positive development for gold.

At this point, we believe that gold has crossed a tipping point and gone from a traditional commodity (deriving most of its demand from jewelry consumption) to an alternative currency, wherein central banks have swung from net sellers to net buyers. This trend is slow moving and, in our opinion, likely to continue in the same direction for years to come, providing a steadily increasing demand for gold.

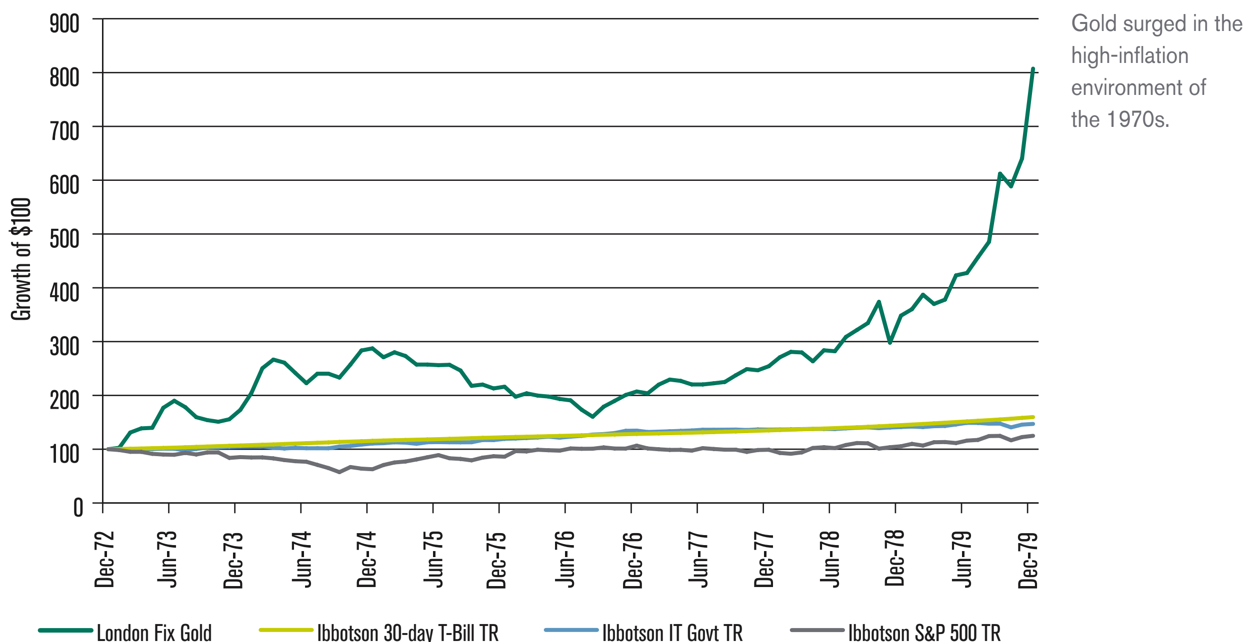
While these demand characteristics are compelling, it's important to understand how gold's unique sources of demand influence its performance in differing markets.

Hyperinflation

Gold benefits in periods of inflation from its historic ability to maintain its purchasing power even as prices for other goods and services rise. Meanwhile, the value of paper currencies is not tied to tangible assets, leaving this money vulnerable to declines in purchasing power. Indeed, we begin the data series for Figure 3 in the early 1970s because prior to that time, gold's price was pegged to the dollar at $35 an ounce. Since that decoupling, the value of the dollar (and all paper currencies) has declined sharply relative to the precious metal. Said differently, gold provides some certainty in inflationary periods when the value of paper currencies—and assets priced in them—is declining.

These characteristics make gold attractive to investors concerned about the potential inflationary effects of the extraordinary monetary and fiscal policies enacted by governments around the world to combat the credit crisis. We believe gold's inflation-hedging characteristics will prove a strong source of demand going forward.

Figure 3: Gold Performance During Hyperinflation (1973-79)



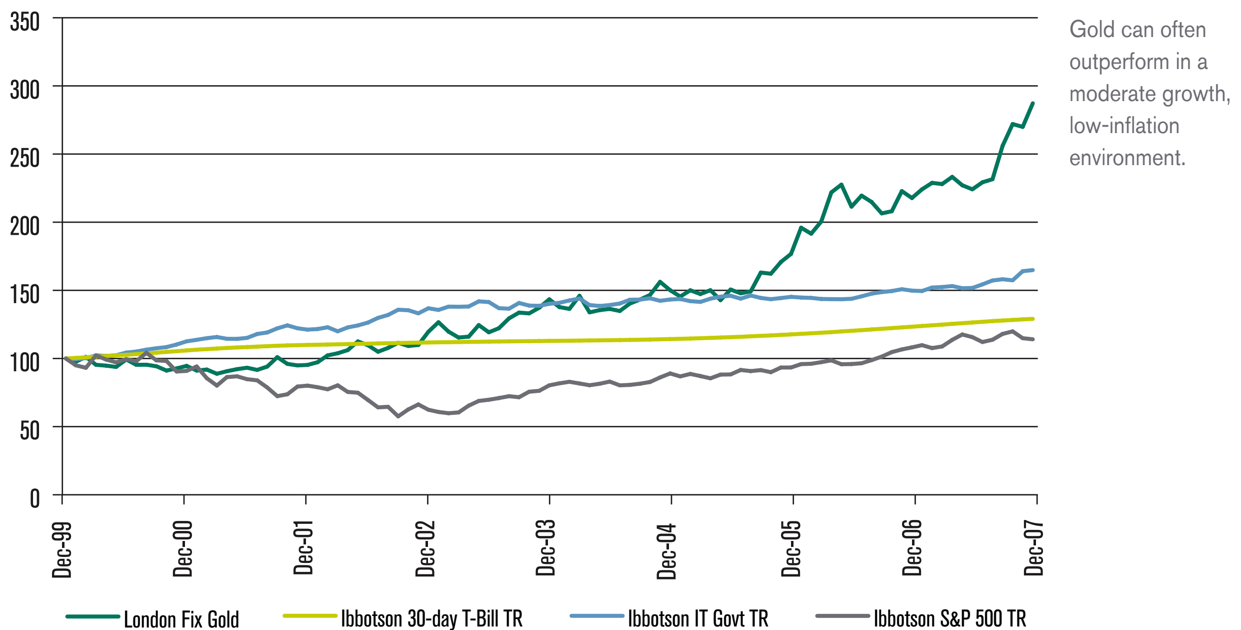
Source: Ibbotson, Zephyr

Low Inflation

We believe gold's performance in the 2000s before the financial crisis of 2008-09 is indicative of the positive price performance the precious metal can deliver even in periods of moderate

economic growth and low inflation (as seen in Figure 4). An important factor in gold's strong performance in the past decade was the rapid growth of emerging market economies, whose citizens tend to be predisposed to putting their savings in the precious metal, partly due to cultural factors, but also because of a comparative lack of alternative savings vehicles. In addition, strong income growth in emerging market countries such as India, where gold is a powerful symbol of prosperity, provides a key price support for gold as consumers find the precious metal increasingly within their reach. Finally, it's important to note that the period included a number of political and economic shocks that sent investors looking for the safety of gold. This point cannot be stressed enough—even in periods of relative economic stability and prosperity, potential geopolitical shocks make gold attractive for its safe-haven attributes.

Figure 4: Gold Performance in a Low Inflation Environment

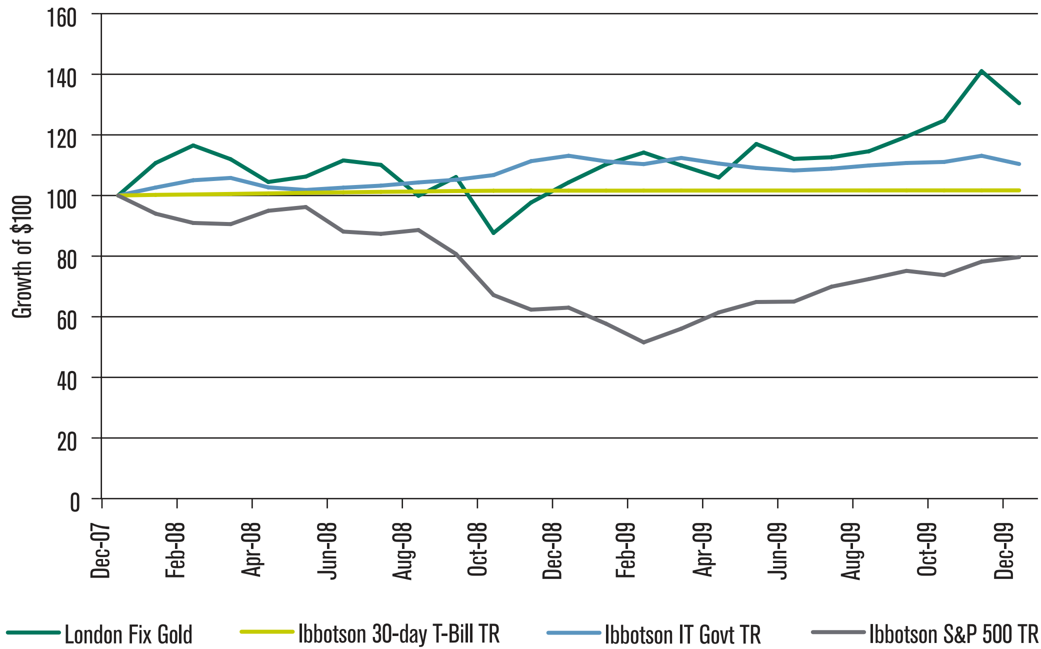


Source: Ibbotson, Zephyr

Credit Crisis

It is particularly instructive to note that gold has fared well in periods of stress in the political and financial system—precisely when mainstream financial assets struggle. This can be seen clearly in gold's performance amid both legs of the financial crisis, first in the U.S. in late 2008 and in Europe in early 2010. Investors are turning to gold because of fears of *deflation* and sovereign credit risk—there is tremendous concern about the health of the world's paper currencies as a result of the unprecedented fiscal and monetary policies many countries employed to prop up their economies and financial systems.

Figure 5: Gold Performance During the Credit Crisis (2008-10)



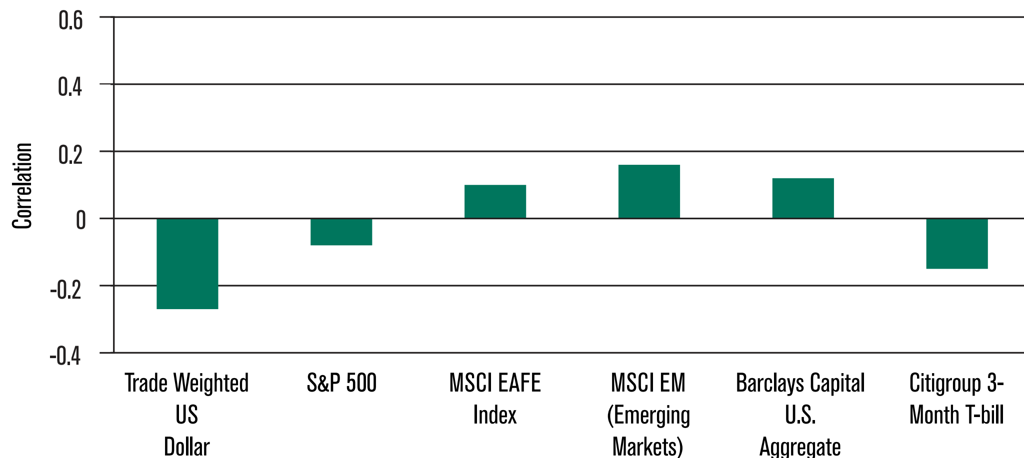
Source: Ibbotson, Zephyr

Gold fared well during the Credit Crisis, a period of systematic stress.

Gold: A Compelling Portfolio Diversifier

As the supply and demand dynamics and the performance patterns above suggest, gold has low, or in some cases negative, correlations with traditional financial assets (see Figure 6). As a result, it can have a particularly powerful diversification effect on a portfolio. While returns for stocks and credit-sensitive bonds are tied to improving business conditions, gold actually tends to do better during periods of economic and political uncertainty, providing diversification when you want it the most. Interestingly, a look back at the last decade alone shows that such periods of uncertainty are regrettably common, capturing the bursting of the Internet stock bubble, the recession of 2001, 9/11, the Afghan and Iraq wars, the credit crisis, and the Great Recession. Indeed, history and the financial markets have shown us time and again that it is prudent to expect and prepare for such unanticipated events. A modest allocation to gold can be central to hedging against that uncertainty.

Figure 6: Correlation with London Fix Gold



Source: Zephyr. Data from 1/1/1990 – 6/30/2010.

Low correlation to traditional asset classes makes gold a compelling diversifier.

Conclusions

Gold is an asset class unto itself. It is not only a barometer of confidence in governments and the financial system, but also a reserve asset, an alternative currency, and a store of value. Those characteristics make gold an ideal diversifier because it has low correlation to most financial assets, both in expansionary and recessionary periods. Indeed, the return pattern to gold investments is not only uncorrelated to most traditional financial assets, but makes gold uniquely positioned to outperform when you want diversification the most—during periods of crisis.

As geopolitical tensions persist and the global financial situation continues with sovereign government debts and deficits threatening entire economies and currency regimes, now may be the time to consider adding a modest allocation to gold to a diversified portfolio. Despite the recent increase in the price of gold, we believe the precious metal is well positioned for future long-term gains. The metal also could have near-term upside potential if we remain in an environment characterized by geopolitical risks, extraordinary fiscal and monetary policies, and uncertainty in the financial system.

The opinions expressed are those of William Martin, CFA, and are no guarantee of the future performance of any American Century Investments portfolio. Statements regarding specific holdings represent personal views and compensation has not been received in connection with such views. For educational use only. This information is not intended to serve as investment advice.

Diversification does not assure a profit or protect against loss in a declining market.

Due to the limited focus of the Global Gold strategy, it may experience greater volatility than strategies that invest more broadly. It is not intended to serve as a complete investment program by itself.

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