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INVESTMENT
**INSIGHTS**

# Regaining its Glitter

## The role gold can play in institutional portfolios

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**George Milling-Stanley, head of gold investment strategy at State Street Global Advisors and one of the proponents of SPDR Gold Shares (GLD®), the largest physically-backed gold exchange-traded fund, reflects on the drivers of that precious metal's market and reveals why he finds gold "endlessly fascinating," even after being in the business since 1972.**

**P&I: How do macroeconomic factors such as supply and demand, market volatility, interest rates and political uncertainty drive the price of gold?**

George Milling-Stanley: The gold price is a complex mechanism, and many different things can have an influence on it. The most important influence is the balance between supply and demand. Then the foreign exchange markets, especially the dollar, as well as competing investments, specifically the U.S. equity market, can also be important, as can investors' perceptions of risk, both macroeconomic and geopolitical.

**P&I: What are some of the current influences on supply and demand?**

Milling-Stanley: China and India show very good jewelry consumption because their economies are doing well. China may not be growing at 11.5% anymore, but it's still China, it is growing a lot faster than we are in this country, or in Japan or Europe. India has started to pick up again, too, as we approach the end of the monsoon season and get closer to the festival season, followed by the wedding season. People are starting to buy in anticipation.

On the supply side, there are significant pressures. The average cost of being in the gold mining business in a sustainable manner is running somewhere in the $1,200 to $1,300 per ounce range, so it's not far below the price. We believe that mine production has probably plateaued over the last few years and is likely to move downward unless we get a significant increase in the gold price.

**P&I: How do the dollar and the geopolitical environment influence the price of gold?**

Milling-Stanley: Whenever the dollar strengthens, more often than not you will find gold prices going down, and whenever the dollar weakens, you tend to find gold going up.

However, the markets marked the dollar down to a four-month low on the announcement that the Fed rate hike in December would be only 25 basis points, and the dollar has basically been stable since then. So I think the dollar has been removed as a problem for gold in 2016, and that has been very, very beneficial for the price.

Add to that that there are still no signs of inflation, but if we start to see rising inflation, that would be just another reason for investors to turn to gold. Gold has a thousands-of-years-long track record as a protection against inflation.

With regard to political uncertainty, we still have the uncertainties around the outcome of the Brexit vote. We still have the major problem of ISIS, and broader problems in the Middle East, and we have

### ASSET CLASS RETURNS AND CORRELATIONS

| | RETURNS | | | CORRELATION TO GOLD | | | | |
|---|---|---|---|---|---|---|---|---|
| | Q2 (%) | Trailing 3-Mo. (%) | Trailing 12-Mo. (%) | Q2 Correlation | Correlation in Q1 | Q2 | Trailing 6-Mo. | Trailing 12-Mo. |
| USD | 1.65 | -2.52 | 0.69 | Weak | Moderate Negative | -0.01 | -0.26 | -0.32 |
| 10-Yr Treasuries | 2.79 | 7.58 | 9.27 | Moderate Positive | Weak Positive | 0.45 | 0.32 | 0.30 |
| Commodities | 15.65 | 20.02 | -15.13 | Weak | Weak | -0.06 | -0.07 | 0.00 |
| Equities | 0.26 | -0.02 | -5.72 | Moderate Negative | Weak Negative | -0.37 | -0.31 | -0.19 |
| Gold | 6.77 | 24.60 | 12.79 | — | — | — | — | — |

*Source: Bloomberg, SSGA.*
*Past performance is not a guarantee of future results.*
*Indices representing the above asset classes are as follows: Gold = LBMA Afternoon Gold Price as tracked by ICE Benchmark Administration Ltd., USD = The U.S. Dollar Index, 10-Year Treasuries = The ICE U.S. Treasury 7-10 Year Bond Index, Commodities = S&P Goldman Sachs Commodity Index, Equities = MSCI ACWI Index.*

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an increasingly acrimonious political situation in this country surrounding the election and a gridlocked Congress. Gold tends to do well amid political and macroeconomic uncertainties.

**P&I: How long should investors expect these trends to impact the price of gold?**

Milling-Stanley: I am optimistic on the gold price. We've had a good run already this year, with a 30% gain from the low of $1,050 [per ounce] that we reached in December. But I think there's still the potential for maybe another $50 or even $100 — I think that would be sustainable given the environment.

Investors can be reasonably confident that the trends that we've talked about are likely to remain in place and are likely to continue to impact the price of gold for the foreseeable future — at least a year, maybe two years, maybe longer than that.

**P&I: Where is gold in terms of the market cycle?**

Milling-Stanley: A bear market started in 2011 and ran until December of last year, and took us from $1,850 down to $1,050. I think that period has now ended and we are in a new bull market.

I think gold will eventually reach $2,000, I just don't know when that is likely to happen. But I think that we could move up relatively moderately each year for the foreseeable future.

**P&I: Why is gold viewed as a safe haven during times of uncertainty?**

Milling-Stanley: There is a lot of misunderstanding about that phrase 'safe haven.' Some people think that a safe haven means that when other assets go down in value, the safe haven is going to soar. I think of a safe haven as something more like an insurance policy for the whole portfolio. When other things in the portfolio go down, gold holds its value. That's the real importance of a safe haven asset.

**P&I: How should institutional investors think about gold?**

Milling-Stanley: A safe haven investment should not be a short-term investment. Gold should be thought of as a long-term safe haven investment. I believe a small strategic allocation to it will improve the risk-adjusted returns of any properly balanced portfolio. Gold offers a tremendous amount of diversification, it reduces the overall volatility of the portfolio, it offers a proven element of protection against unexpected events, and it has a proven track record as a protection against adverse currency movements.

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I feel comfortable with 5% as a strategic allocation in my portfolio, but some research shows that in periods of extreme market turbulence, it can be financially beneficial to double that allocation.

**P&I: Should gold be considered one component in a broader commodities or alternatives strategy? Or should it be considered a strategy by itself?**

Milling-Stanley: The correlation between gold and commodities is not strong mathematically. There have been times when gold and the commodity complex move together for quite a sustained period of time, but it doesn't meet my rigorous test for a correlation unless it happens over decades. If an investment institution has an allocation to commodities, it's going to make sense for that institution to have a separate allocation to gold.

As far as liquid alternatives are concerned, there are an awful lot out there that are not as liquid as the gold market. I think gold merits an allocation by itself. I don't know whether I would consider it a strategy by itself. I would consider it a strategic allocation in and of itself.

**P&I: In today's environment, most asset owners are struggling to find investments across portfolios that can deliver decent returns as well as income. How can gold play a role when these are the main objectives?**

Milling-Stanley: First of all, gold has proven it can provide yield. It is also possible to use options strategies to generate income on gold, for example by using covered calls in the options market for GLD, or for large holders of GLD, using the securities lending market to lend for short sales.

But in a world of negative real interest rates, the search for yield is very much a difficulty. The whole issue is keeping an awful lot of institutional portfolio managers up at night, and sometimes me as well.

**P&I: What's the best way for an investor to carve out an allocation to gold and invest in it?**

Milling-Stanley: I've often said there is no bad way to gain exposure to movements in the gold price, but most investors have voted overwhelmingly that the gold ETF is the easiest way to do it.

It is a very simple, very transparent, very secure way of investing in gold. I'm not going to knock any of the other ways. There are some people who want the pleasure of being able to handle their investment. But for most institutional investors, ETFs are the way to go. ❖

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