

Dr Graham Birch

Institutional Investment in Gold LBMA Berlin September 2010



Why do investors like gold?

- Its a store of value (boring but true)
- Its outside the banking system
- Its an asset not a liability
- Its invisible to prying eyes
- Its freely exchangeable globally

Gold has always been for rich people who want to stay rich – rather than for poor people who want to get rich.

Gold's values not always valued

You don't need gold when.....

- Inflation is dead
- Governments are benign
- Taxes are low
- Currencies are solid
- Markets are booming

If market returns are high and don't seem risky then nobody wants gold.

The bull market has deep roots

- The investment case for gold didn't start with "Credit Crisis".
- Foundations for bull market laid in the 1990s
 - Disorderly selling by Central Banks
 - "hedging" by miners
 - Mining companies stopped building mines
- By 1999, the gold market was far out of equilibrium.
 - continuous disinvestment was needed to hold gold down

The Central Bank Gold Agreement marked the start of the bull market.

Central Banks should be thanked

When Central Banks took gold coins out of circulation in exchange for paper currency the citizens were robbed. Amazingly another generation of Central Bankers swapped it back again!

**I LOST £6 BILLION
SELLING OFF
BRITAIN'S GOLD
VOTE FOR ME**

Or vote for change. Vote Conservative



Central Banks gave institutions an opportunity to buy gold at rock bottom. Did they take it?

"A long term move designed to reduce risk and get a more balanced portfolio of reserves" HM Treasury on Gordon Brown's terrible decision to sell 415t of UK gold in 1999.

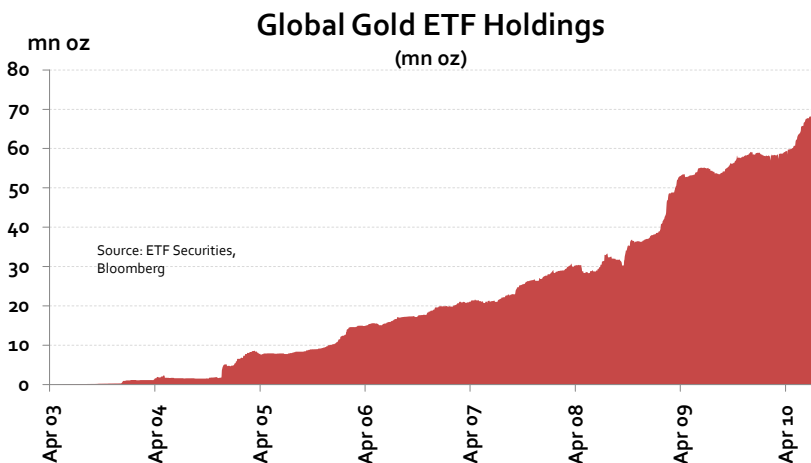
- Brown's "sell" decision was "diworsification". Institutions had no gold in the bear market so for them BUYING UK gold would have "reduced risk and balanced the portfolio".
- Certainly in the UK, institutions did not buy much of the gold.
- UK pension funds divide their portfolios into asset "buckets" and set "risk budgets". No risk budget for gold. Hermes pioneered GSCI investment in 2005.
- Unit Trusts and many collective investment schemes in UK/Europe barred from investment in physical assets by UCITS rules.

Growth of the Gold Funds and Emergence of the ETFs

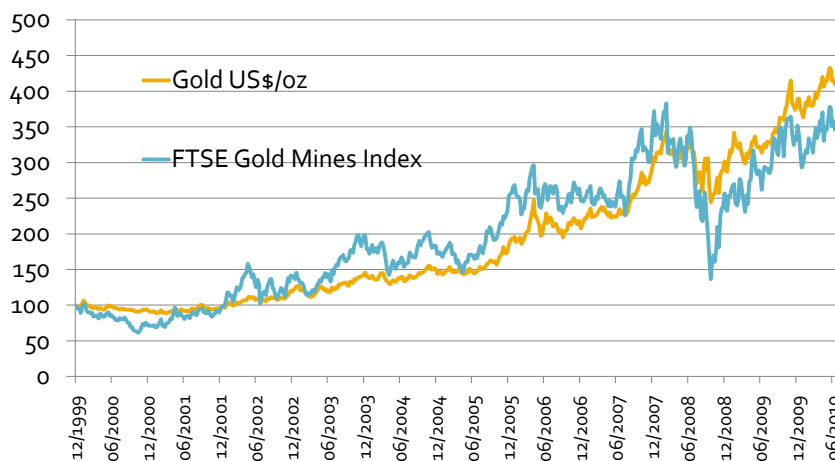
- 9/11 through the mid "noughties" gold equity funds grew fast. Institutions liked gold exposure AND the comfort of equities
 - Equities gave "leverage"
 - European wealth managers made gold a part of the tactical asset allocation mix
 - Pension funds lagged far behind
- Mining industry cost pressures rose and leverage went AWOL.
- Gold ETFs became the "go to" investment vehicle.
- By the time the credit crisis struck, gold & commodities were a sizeable "bet" for wealth managers and bolder pension funds.

Gold ETFs backed by physical seemed like equity

Gold ETFs – the "killer ap"



Gold did better than gold shares



Source Datastream

Post Credit Crisis Environment for Gold Investors

Seismic shift in attitudes towards risk

- Return on Investment/Return of Investment
- Acceptance that returns will be lower
- Counterparty risk acknowledged
- Very poor returns on cash
- Much less use of leverage
- More emphasis on true diversification

What's driving gold investment today?

"I'm Back"



- Gold regained its role as a store of value and gold equities popular again.
- Gold lacks efficiency compared to "instruments" but it doesn't share their contagion risk.
- Central Banks seem to have resumed purchases of gold.

ETF Fund flows – Investor Attitudes

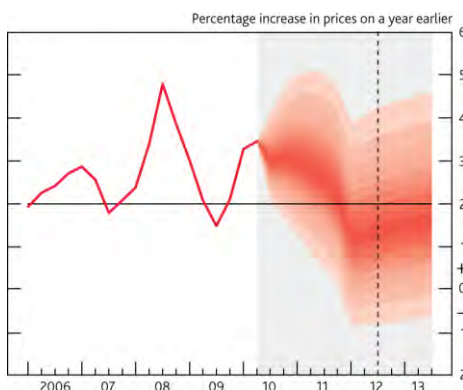
- Investors relatively insensitive to gold price moves. Investors are typically large institutions taking medium to long term view.
- Investors say they are hedging against currency depreciation; inflation or events related to global fiscal crisis.
- Greek crisis triggered a wave of gold investment from Europe much of which was reversed by success of stress tests. Not mirrored in US.
- Pension Funds though still cautious and more likely to focus on a commodity basket

Gold and Inflation

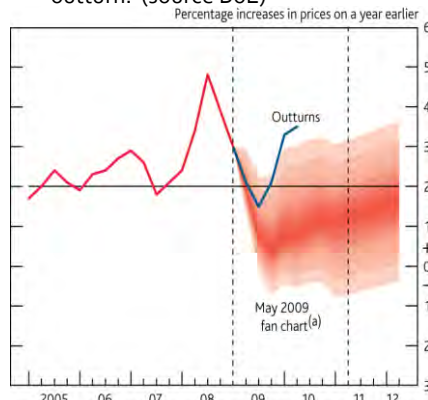
- Gold is produced – money is printed.
- Bank of England's 2pc inflation target has been breached in 42 of the past 51 months.
- Investors "simply don't believe the rhetoric from Central Banks" on QE.
- Will Central Banks be able to take away the economic stimulus?
- Inflation may not be a problem but uncertainty is widening.

BoE forecasts. Could you do worse?

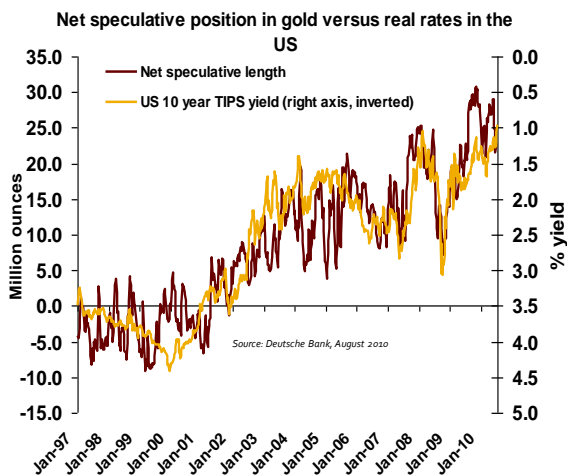
BoE August 2010 CPI forecast
(source BoE)



BoE May 2010 forecast with
outturn. (source BoE)



Why Gold: Inflation really is the key



High correlation between inflation expectations and gold investment

Long term relationship between gold and real interest rates remains

Thanks to BlackRock for this chart

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Bad Money Drives out Good

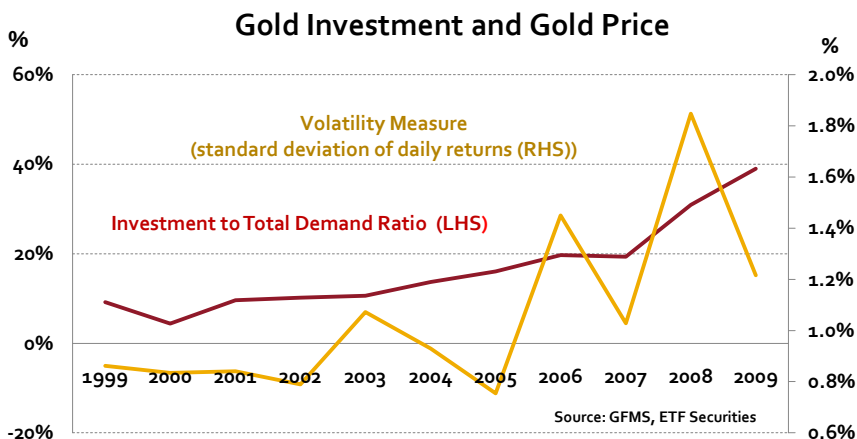
Can the Euro hold together?
 Who is in charge?
 Who issued your Euros?



So what happens next?

- Price movements dominated by investment flows. Gold showing "equity character".
- If jewellery sales reduce, then more net new investment flows are needed to balance the market
- De-hedging ending.
- High prices encourage recycling
- Institutional investment orders can be large (circa 5,000 lots moved in seconds) with significant price impact – pushing up volatility.
- Central Banks to remain net buyers
- Low real interest rates helpful.

Investment demand = volatility



Is gold in a bubble?

The old gold traders maintain gold is in a bubble – arguing that \$150m per day of investment flows are needed to balance the market..... yet.....

- given the size of the world's capital markets at circa \$200 trillion this is sustainable for the moment.
- Gold is still under-owned by institutions.
- Institutions remain worried about their lack of diversification and vulnerability to contagion
- The opportunity cost of gold remains minimal.
- Central Banks don't like dollars so much as before
- The "man in the street" is a seller

No bubble without the Man in the Street

•For the man in the street it is still easier to sell gold cheap than buy gold cheap.

•Ads like this have inspired recycling of 496 tonnes in 2Q 2010 (WGC)

•Recycling boom probably peaked in Q1 2009. When its sold its sold.

Advice to Investors

- Remember the lessons of the past.
- Investment in gold is “deferred expenditure”.
- Compare it with investments related to “current expenditure” i.e. Wheat.
- Diversification not diworseification.