Gregory Mthembu-Salter

Thank you very much, Shane. We move on now to Dr Graham Birch, who is the former Head of Natural Resources at BlackRock. He began his career as a geologist, gaining a PhD from Imperial College back in 1984. He then became a gold analyst with sell side broking firms before joining Julian Baring at Mercury Asset Management, now BlackRock, in 1993. There he helped launch the Mining Trust, the largest investment trust float at the time, and broadened the fund range into areas such as energy, alternative energy and agriculture. Gold remained a focus though and Graham won numerous performance awards as manager of a $3 billion BlackRock Gold and General Fund. Under his leadership, natural resources funds at BlackRock grew from $2 billion to around $50 billion in total. Since retiring from BlackRock earlier this year he has become a non-executive director at Petropavlovsk and is vice-chair at Rothamsted Research, as well as venturing into farming. He will now address the related topic of institutional investment in gold.

Institutional Investment in Gold

Graham Birch

Former Head of Natural Resources, BlackRock

I. Preamble

Thanks very much for that introduction, Gregory, and thanks to Shayne for setting the scene for my comments on institutional investment in gold.

II. Why Do Investors Like Gold?

Before I say too much about that, though, I do think it is worth just recapping over the thing that most of you already know, which is why do investors see gold as an investment, because they do not see all commodities in that way.

- I am afraid the most boring and obvious thing is that it is a store of value. It has a fantastic track record over many hundreds of years or, indeed, thousands.
- It is also one of the few major financial assets today that remains, if you want it to be, outside the banking system.
- As Shayne has already alluded to, it is an asset, not a liability pretending to be an asset like all those equities and bonds are.
- It is invisible to prying eyes. We are in an environment now where governments are seeking to tax everything they can and it is difficult for them to do that if they do not know you have it.
- Of course, looking at all of you here, you know that it is freely exchangeable all around the world.
That makes gold a great asset for people who are rich who want to stay rich. It is not so suitable for people who are poor who want to become rich, although it has not been too bad in the last year in that regard.

III. Gold’s Value Is Not Always Valued

However, people do not always see gold’s attributes. You do not really need gold if you think inflation is dead or if governments are benign or if taxes are very low or if currencies seem solid or if markets are booming. When market returns are high and they do not seem risky, then people tend to sell their gold, but that is not what they are doing now.

IV. The Bull Market Has Deep Roots

Everyone acknowledges we are in a bull market for gold and people connect that with the credit crisis, but this bull market for gold has much deeper roots than the credit crisis. You have to go back into the 1990s to see this, when we had disorderly selling by central banks dumping their gold. We had hedging by mining companies who also did the same thing and the mining companies could not really earn a return out of mining gold, so they slowed down construction of new mines and that has led to a subsequent reduction in output. Thus, by 1999, the gold market was so far out of equilibrium that it needed continuous disinvestment in order to prevent the price from rising and although the central banks probably had no intention of doing this, when they launched the Central Bank Gold Agreement they fired the gun for the bull market that we are now in.

V. Central Banks Should Be Thanked

We should thank the central banks because a previous generation of central bankers roughly 100 years ago perpetrated a massive theft and they swapped all the gold coins in circulation for pretty coloured bits of paper called bank notes. That was less than 100 years ago: 1919 was the last time you could swap a pound note in the UK for a sovereign. Today, a sovereign will cost you £200 or more from the Royal Mint, so that is depreciation of 99.5% of Sterling compared to gold. This was a fantastic deal, swapping the gold for coloured paper, but then along came a new generation of central banks who swapped it back again and of course this particular man lived to regret it and this may have helped contribute to his downfall in the end.

When Gordon Brown sold Britain’s gold the Treasury said that it was a long-term move designed to reduce risk and get a more balanced portfolio. At the time, the institutions should have said, ‘Wait a minute, we are the opposite of that. We do not own any gold, therefore, if we buy the gold we will ourselves reduce risk and have a more balanced portfolio’, but did they do it? No, they did not. I think I was probably one of only a few institutional investors who bought gold in the UK government auctions. It was not really until 2005 when the pension fund Hermes in the UK pioneered investment in the Goldman Sachs Commodity Index that pension funds in the UK started to take commodity investment seriously. However, as Shayne has said, the pension funds in the UK did not invest in gold directly. Unit trusts, SICAVs and other collective investment schemes probably would have liked to invest in gold, but were prohibited by regulations from UCITS, which prevent ownership of physical assets.
VI. Growth of the Gold Funds and Emergence of the ETFs

After 9/11 and through the mid-2000s, gold equity funds were the route in which institutions which wanted gold exposure bought that gold exposure. The reason they did that was because they liked the fact that gold funds, like the ones I ran at BlackRock, were equity funds. In the early and mid-2000s those equity gold funds gave a roughly three to one leverage to the gold price, which was another attractive feature. Slowly, through that period, European wealth managers began to make gold a part of their tactical asset allocation mix, not very much, just a tiny amount, but that was all it needed because they had none to start with. Through this period, UK and European pension funds still lagged far, far behind though.

The equity gold funds began to lose their attraction as cost pressures in the gold mining industry pushed up the cost of producing gold and reduced the leverage to movements in the gold price. Hence the stage was set for the ETF market to take hold, because why would you buy a gold equity if you could buy a gold ETF, which had similar exposure and less risk? As we went through the 2000s, by the time the credit crisis struck gold and commodities were a sizeable side bet for wealth managers and some of the braver pension funds and the gold ETF was the perfect opportunity for them to own it. We have seen a different version of this slide already. The gold ETF feels like an equity to investors, but of course it is physically backed.

VII. Post-Credit Crisis Environment for Gold Investors

After the credit crisis there was a seismic shift in attitudes towards risk. People began to focus on the return of their investment rather than the return on their investment. There was an acceptance that returns generally would be lower. Counterparty risk became acknowledged. Cash started to give very poor returns indeed and still does, and there was much less use of leverage. I think many investors began to see the attractions of true diversification as opposed to what Gordon Brown did for the UK, which was di-worse-ification rather than diversification.

VIII. What is Driving Gold Investment Today?

Gold regained its role to some degree as a store of value and gold equities began to gain in popularity. The investors buying gold did not really care that gold was not as efficient as some paper instrument might be in hedging the risks that they faced and they thought that was okay because gold does not share the contagion risk that all those clever structured products invented by investment banks have. Amazingly, central banks, who had been so keen to sell gold at very low prices in the late-1990s, have started to buy gold again. In fact, in the year that has just gone off the Central Bank Gold Agreement I hear that only 6.2 tonnes of gold were sold under the Agreement, which is a drop of 96% – so just the gold price being high seems to have put them off from selling for the benefit of the citizens.

IX. ETF Fund Flows – Investor Attitudes

Coming back to those ETFs, because they really are the key to this, ETF Securities told me that investors who buy these ETFs have become relatively insensitive to the gold price moves. These people are typically large institutions and they are taking a medium to long-term view. Crucially, since these institutions are much more used to the equity market, they are very tolerant of volatility, because equity market volatility is very, very high and so they do not really mind that much if the price of gold drops by 5% in a month or something like that. That is totally
different from the trading mentality that used to be in the gold market 10 years ago, where very tiny moves in the gold prices were much more important.

The other thing that is different about investors today is they are trying to hedge against things that you cannot easily hedge any other way, like currency depreciation, inflation or events related to global fiscal crisis. When the Greek crisis emerged and the Euro was under a lot of pressure and the Dollar was strong, people in Europe were buying gold as a hedge against the falling Euro and that is another key difference today, because in the old days when the Dollar was strong gold was typically weak. Now you can have a situation where the Dollar can be strong and gold can be strong as well at the same time.

X. Gold and Inflation

Gold is, of course, produced, money is printed. We heard from our economists earlier in the day that inflation is not really a problem. Well, the Bank of England’s 2% inflation target has been exceeded in 42 out of the last 51 months and investors, I think, who are buying gold today simply do not believe the rhetoric from central banks about quantitative easing.

XI. Bank of England Inflation Targets

Here we see the Bank of England’s targets for inflation. The chart on the right shows what you can call a ‘cone of probability’ and this is as the Bank of England saw the situation last May. They had quite a wide range of targets: inflation could have been less than zero to plus nearly four. On the right, you can see what happened: they could not even hit the barn door even with such a wide range of forecasts. So what did the Bank of England do in August? They widened out the range of probability outcomes to one that is now so big that even I think that I would have a pretty good stab at getting that one right. What this shows you though is inflation uncertainty and you can see a close correlation between open interest of gold on Comex and the US inflation TIPS yield.

XII. Bad Money Drives Out Good

Now I am going to turn for a moment to the currency market. Here in Germany, I see on the internet that people are sifting out their Euro bank notes. If you look at each of these notes you can see a little serial number and the letter at the front of that serial number designates which country issued those Euro notes. In Germany, they are swapping the ones that come from places like Italy and Greece for ones that come from Germany, but of course what they would really like is something like this in the bottom right-hand corner, which is a gold coin minted here in Berlin in the 19th century, but they cannot have that.

XIII. What Happens Next?

What happens next and is gold in a bubble? I think that the situation we are in is going to continue in that price movements are going to be dominated by investment flows. Gold will continue to show characteristics of an equity in the way it behaves in the market and the institutional investment flows coming in and out of the ETFs and maybe funds like the one that Shayne represents can be very, very large, maybe thousands of lots of gold in seconds. That can have big price impact, so I think we are going to be in for a period of somewhat greater volatility in the gold price than perhaps some of you in the room are used to. However, as we have already
heard, gold remains extremely under-owned by institutions, so this process could go on for quite a long time.

XIV. Is Gold In A Bubble?

Central banks I think will remain net buyers of gold and that means that the implied, if you like, investment demand needed every day to maintain today’s gold price, which is something like $150 million a day, is probably achievable given the size of the world’s capital markets. However, there are risks to this: jewellery sales, if they continue to reduce, create an environment in which even more net investment demand would be needed to balance the markets. De-hedging from the gold mining companies is ending. This is something that I predicted would happen, that the gold companies would hedge their maximum possible amount at the bottom of the market and would end up with the minimum amount of hedging at the top. This is the exact opposite of what you in the room would do, I am sure, but they have managed to do it. In addition, of course, the higher prices encourage recycling of gold.

Is it a bubble? I do not think it is a bubble until the man in the street starts to participate and right now for the man in the street, as this advertisement shows, it is still much easier to sell your gold very cheaply than it is to buy gold. That recycling boom cannot go on, because once you have sold your gold for £6/gm, it has gone.

XV. Advice to Investors

My advice to people thinking about investing in gold at an all-time high in the price today of about $1,300 is to reflect on these issues. The current investment conditions probably will go on for quite some time, but remember the lessons of the past. Remember that gold is not an equity; it is in fact a way of deferring expenditure. It is a way of saving money; it is not like an equity. In fact, one of the examples of how it is behaving like an equity we saw only the other day when Gold Fields Mineral Services (GFMS) published their target of $1,300 or something and almost immediately the price went up towards that target. Now, GFMS I am sure have never had that power before. They are acting like stock-broking analysts. Anyway, gold is deferred expenditure and when you are structuring your investment portfolios you should take the time to compare it with the prices of other commodities that represent current expenditure or nearby expenditure, like wheat. Just because an asset is a safe haven it does not mean to say it is a cheap safe haven, so I would recommend that you look at gold in the context of a broader basket of commodities and try to also make sure that if you are diversifying your portfolio you are not di-worse-ifying it.

Thank you very much.