Insights Into Investing in Gold

By Kevin Feldman, Managing Director of U.S. Marketing for iShares, Blackrock

Overview of the gold market

Rising market volatility, global economic uncertainty and geopolitical unrest have increased interest in gold as both a short- and long-term investment. In fact, during 2009, world investment in gold is estimated to have more than doubled from 2008 levels.[i]

The world gold market is active, with annual demand averaging 4,034 tonnes[ii] over the 10 years ending December 31, 2009. Key market participants include:

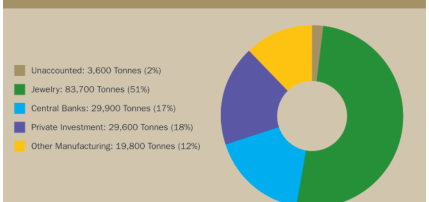
Mining companies and producers, including scrap merchants and recyclers

1. Bullion banks, which may offer services such as physical gold purchases and sales, hedging and risk management, inventory management for industrial users and consumers, and gold deposit and loan instruments
2. Central banks, such as the US Treasury, which hold gold bullion as a reserve currency
3. Professional and private investors, such as large hedge and mutual funds, day traders on futures exchanges, and retail-level coin collectors, and
4. Commercial and industrial users, such as the jewellery, electronics and dental industries.

Virtually all the gold that has ever been mined still exists today in one form or another. It is estimated that existing 'above-ground' stocks of gold (gold that has already been mined) amounted to 165,000 tonnes at the end of 2009, spread across multiple sources as shown in Figure 1.

Jewellery and central banks have historically been the largest stores of gold. However, private investments, through physical bullion and investment products, have become increasingly important. Indeed, during 2009, investor demand exceeded jewellery demand for the first time since 1980.[iii]

Figure 1: Distribution of "above-ground gold"



Source: Gold Survey 2010, GFMS Limited

The price of gold

Many factors influence the price of gold. Central banks have historically held large positions in gold; as a result, announcements and activities by those banks have influenced the supply and demand of gold. Fluctuations in the value of the US dollar, political uncertainties and economic concerns around the world, hedging activities by gold producers, and trading activities of speculators also help drive the price of gold. Figure 2 illustrates how the price of gold has changed in response to global and economic events since the US dollar was decoupled from gold and the price of gold was allowed to free-float.

Gold is a physical asset that is accumulated, rather than consumed. This differentiates it from investment assets such as equities and fixed income instruments (which are claims on future cash flows), other commodities such as oil (which are consumed), and paper money (which can be more easily destroyed). These traits are among the reasons why gold may perform differently than other investments.

There are several ways that investors may use gold as part of a larger investment strategy.

Potential 'safe haven' during political or economic uncertainty

1. Portfolio diversifier over both long- and short-term horizons
2. Inflation hedge and store of value
3. Hedge against a devaluing dollar.

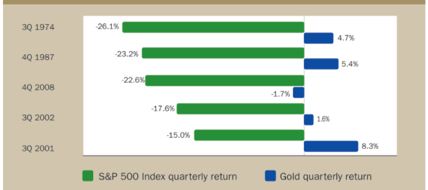
Potential 'safe haven'

Figure 2 illustrates how gold has historically maintained its value during times of economic or political uncertainty. Investors have also often retreated to gold when equity markets are struggling. As Figure 3 shows, gold exhibited positive performance during four of the five worst quarters of the S&P 500® Index's performance since 1973. In addition, gold exhibited positive performance during

Figure 2: Relationship betweeen gold and the US dollar

Sources: Bloomberg, as of 5/31/10. The Commex gold settlement price is determined from the input of Commex member firms; the spot price for gold is determined daily by the live member firms of the London Fix. Despite differing pricing processes and the New York/London time difference, the price of gold as measured by the two pricing methods had had a correlation of 0.9866 for the three-year period ending May 31, 2010.

Figure 3: Performance of gold during down quarters in the market



Source: Bloomberg, BlackRock, as of 4/30/10. Gold: London PM Fix

seven of the 10 worst quarters in the S&P 500® Index's performance since 1973.[iv]

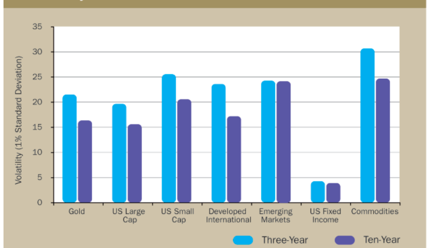
During these periods of market dislocation, gold has offered investors a safe haven and store of value.

Portfolio diversification

Many investors today already diversify their portfolios across styles, sectors and geographies. By including new asset classes that have low historical correlation to asset classes that are currently in their portfolio, investors can help further reduce portfolio volatility. Additional sources of diversification can be particularly helpful when equity correlations around the globe rise, as they did during the 2008 credit crises.

Gold has historically shown little to no correlation to major asset classes, including commodities. And while the price of gold is volatile, gold has historically displayed lower volatility than major asset classes over both long and short time periods (Figure 4). As a result, a small allocation to gold may help improve the risk/return trade-off of investment portfolios.

Figure 4: Gold has shown lower return in volatility than other major asset classes

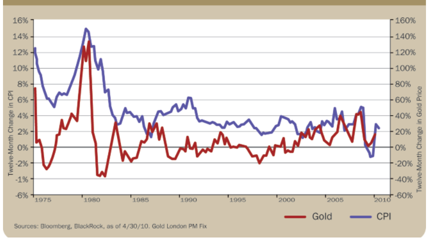


Sources: LBMA, S&P, MSCI, Barclays Capital, BlackRock. Three and ten year annualized volatility based on monthly returns, as of 4/30/10. Gold: London PM Fix: US Large Cap: S&P 500 Index: US Small Cap: S&P 600 Index: Developed International: MSCI EAFE Index: Emerging Markets: MSCI Emerging Markets Index: US Fixed Income: Barclays Capital U.S. Aggregate Bond: Commodities: S&P GSCI Total Return Index

Potential hedge against rising inflation

Rising inflation can be a result of two drivers, both of which may have an effect on the price of gold. Inflation can be the result of economic prosperity, in which case, increased consumer wealth may drive an increased

Figure 5: Gold and inflation



demand for luxury goods such as jewellery. In addition, inflation may be caused by relaxing monetary policy and increased money supply under times of economic distress. In this case, the price of gold may rise as investors seek to protect their wealth during economic uncertainty.

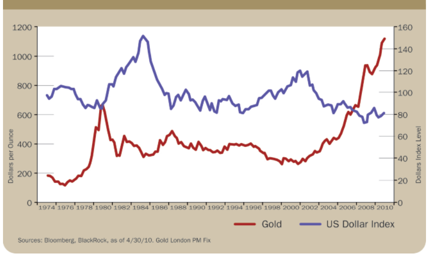
As Figure 5 shows, gold's price has generally moved as inflation has changed, making it a potential hedge against inflation concerns.

Potential hedge against devaluing dollar

The US dollar is widely viewed as the world's main trading currency. Gold has historically been regarded as a good hedge when the dollar weakens relative to other currencies.

Figure 6 shows the historical relationship between the price of gold and the US Dollar Index. The US Dollar Index is a measure of the value of the US dollar relative to a basket of foreign currencies. When the US Dollar Index is positive, it indicates a strengthening US dollar. As Figure 6 shows, a strengthening US dollar has historically been negatively correlated with gold.

Figure 6: Relationship betweeen gold and the US dollar



Traditional ways to access gold

Historically, investors looking to add gold to their portfolios had three primary options to choose from.

Physical gold

Holding bullion, jewellery, coins and gold certificates provides pure access to gold. These forms of gold exposure, however, generally are not as liquid as holding a security (like a stock or futures contract) and may be impractical or costly to store, buy and/or secure.

Derivatives and futures contracts

Derivatives and future contracts have predominantly been limited to large institutional investors with the resources and experience to administer these positions themselves.

Investments in the equities of mining stocks or in precious metal mutual funds

Prior to the introduction of exchange traded products, mutual funds presented the most viable option for individual investors or small institutions seeking to invest in gold, because mutual funds provide convenient access to gold-linked investments at generally reasonable costs and low investment minimums. There are approximately 20 mutual funds, encompassing over $29 billion in assets, providing exposure to gold.[v] Investing in the equities of mining companies, however, provides imprecise exposure to gold given that mining companies may hedge their exposure to the price of gold. The five-year average correlation of precious metal mutual funds to the gold spot price is 0.75, while the five-year average correlation of previous metal mutual funds to the S&P 500® Index is 0.41.[vi]

Exchange traded products

Exchange traded products represent a recent innovation for accessing the gold market. These investment vehicles typically offer the ability for investors to buy and sell their investment in gold through a brokerage account. Within exchange traded products, there are several approaches for delivering gold exposure.

Equities

These products typically gain exposure by investing in equities tied to the gold market, such as gold-mining companies. These products typically have less historical correlation to gold and higher historical correlation to the equity market than products holding physical gold or investing in gold futures.

Gold-based futures

These products hold gold futures contracts and typically roll those forward as necessary to avoid taking physical delivery of gold. While these products are more directly linked to the price of gold, they may diverge from the actual spot price of gold because of the roll costs associated with accessing gold via the futures market.

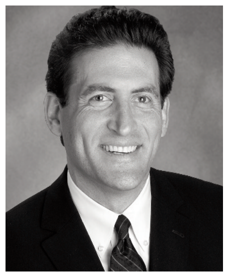
Physical gold

These exchange traded products, usually structured as trusts, offer investors participation in a trust that holds actual physical gold bullion. Because they hold physical gold, these products offer the most direct access to the current price of gold.

Conclusion

Investor demand for gold has been increasing amid global economic and political uncertainty. There are several options for investors interested in using gold as part of a short- or long-term investment strategy. Exchange traded products backed by physical gold offer investors an innovative way to access the price of physical gold.

[i] Source: GFMS, Gold Survey 2010. GFMS Limited is an independent precious metals research organisation based in London.
[ii] One 'tonne' is equivalent to one metric ton, which is equivalent to 1,000 kilograms or 32,150.7465 troy ounces.
[iii] Source: Ibid.
[iv] Sources: Bloomberg, BlackRock, as of April 30, 2010.
[v] Source: Morningstar, as of April 30, 2010.
[vi] Source: Morningstar, as of March 31, 2010.



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Before joining Vanguard, Kevin worked for Charles Schwab, where he held management positions in the retail, institutional and technology divisions.

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