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Modest role for gold

Gold shares do have a role in a diversified investment portfolio, but they are secondary to gold bullion

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The plummeting U.S. dollar and rising inflation concerns as a result of more quantitative easing in the U.S. have highlighted gold shares as a portfolio option.

To assess the role of gold shares as an asset class, **Tacita Capital Inc.** has analyzed its returns and volatility (in Canadian dollars), compared it with gold bullion as an investment and surveyed the current product environment. In order to get a long-term picture of the performance of gold shares, we spliced the S&P/TSX global gold index, available only since October 2000, with the S&P/TSX gold index and the now discontinued S&P/TSX gold/silver index.

A meaningful analysis of gold shares starts in August 1971, when U.S. then-president Richard Nixon closed the gold window and ended the last vestige of the gold standard that once backed many currencies. From then to October 2010, gold shares had an annualized compound return of 10.3% — slightly better than the 10.1% and 10% returns of the S&P/TSX composite index and S&P 500 composite index, respectively. Importantly, gold shares outperformed gold bullion's 9.2% return.

Investors in gold shares have had an extremely volatile ride over the period covered in our study. The annualized standard deviation for gold shares has been an incredible 45.3%, two and half times more volatile than that of the major stock indices. Furthermore, gold shares were also

almost twice as volatile as bullion, with its 22.4% standard deviation.

In terms of drawdowns, a measurement of peak-to-trough monthly declines, gold shares have suffered 20 drawdowns in excess of 5%. This is similar in frequency to the 22 drawdowns of the S&P/TSX, but more recurrent than the 16 and 13 drawdowns, respectively, of the S&P 500 and bullion.

It is in the magnitude of drawdowns that the greater risk of gold shares is evident. The average decline during a drawdown period was 27.8% for gold shares, far greater than the 16.5% and 14.4% of the S&P/TSX and the S&P 500, respectively, and more than the 18.2% of bullion. Hence, on the important reward–to-downside risk metric measured by the Sortino ratio, gold shares ranked last.

The return gained from gold shares was highly episodic. When gold prices skyrocketed from August 1971 to September 1980, gold shares had a 32.8% annualized return, massively surpassing stocks in general. Over the next 20 years, however, as the greatest bull market in stocks played out, gold shares suffered an annualized loss of 1.1% — slightly better than the 3.2% annualized loss for bullion. Since then, the reverse has occurred. Gold shares have enjoyed a 15.8% annualized return, far ahead of the major stock indices.

Gold shares do provide diversification within a portfolio, but the effect is more much modest than for bullion. Whereas gold shares had a 0.44 and 0.12 correlation with Canadian and U.S. stocks, respectively, bullion's lower correlations of 0.07 and -0.11, respectively, are indicative of its greater diversification effect.

Nevertheless, in optimization runs, gold shares did earn a role in a broadly diversified portfolio, although modest and secondary to bullion. Gold shares do have a higher expected return than bullion — reflecting their leverage to gold prices in both an operating and a financial sense — so more aggressive portfolios had relatively more gold shares exposure. **IE**

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