Gold as the New Fixed Income
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• Modern Portfolio Theory:

  1) MPT is a financial theory from the 1950’s that attempts to maximize portfolio expected return for a given amount of risk by carefully choosing the percentage exposure to various assets.

  2) The assumption is that a collection of investment assets has collectively lower risk than any individual asset.

  3) Traditionally, portfolios have been constructed using equities, fixed income, and cash.

      – Recently, sophisticated investments like real estate, commodities and hedge funds have been included, but all are reasonably correlated to equities

• Why investors have traditionally bought fixed income:

  1) **Performance** - Bonds have performed well in virtually all markets.

      – Equities generally decline during recessions, so a long allocation to bonds has been an effective hedge for a long equity position

      – Unfortunately, the long bond position is not always negatively correlated to stocks (they can both go up in any given year)

  2) **Yield** – In addition to allowing for capital appreciation, bonds have historically provided a steady source of income – hence the categorization, fixed-income.

  3) **Minimal Counterparty Risk** – For years, US treasury yields have been considered the “risk-free rate” because the US government was considered zero credit risk.

  4) **Valuable Collateral** – Since treasuries have been perceived as a “risk-free” asset, the ability to borrow money backed by UST’s has always been easy and cheap relative to other assets.

  5) **Liquidity** – UST’s are the most liquid financial instrument in the world. Investors can exit their position quickly with minimal transaction cost.
**ZIRP – the game-changer for fixed-income:**

1) Bonds have been in a bull market for 30 years, beginning in the ex-Fed Chairman Volcker era.
   - Since then, the downtrend in inflation has reduced the yields of all fixed-income products
   - Yields have also come down during this period as a result of the worldwide labor surplus which has driven down wages, the primary source of inflation
   - Several recessions, the Great Recession and the market collapse of 2008, along with the near unlimited purchases of treasuries by the Federal Reserve and other central banks, have reduced yields to near zero

2) The bond bull market has created the perception amongst modern investors that, over time, bond prices always go up, especially in periods of economic turbulence.

3) The Fed Funds rate is currently at 0-25bps (and the market is currently pricing in a negative real Fed Funds rate until 2019).
   - The upside to bond prices is essentially capped
   - In theory, bond yields can be held artificially low forever by the Fed, but potential appreciation and yield will be minimal

4) Portfolios traditionally considered “balanced” will have major exposure to a decline in the stock market or slowdown in economic growth.
   - Fixed-income returns cannot act, as they have historically, as an offset to losses on the equity side
   - The maximum amount a fixed-income portfolio can appreciate will be capped by the zero-bound (i.e. rates cannot go below zero for any long period of time, though the real rate can be held negative for many years as it has in the past)
   - During an economic and stock market up-cycle, the fixed-income portion of the traditional “balanced” portfolio will not be able to experience gains as in the past given the zero bound
• **How Gold fills the void left by bonds in a portfolio:**

1) **Performance in an Economic Downturn** – A portfolio with the traditional 55% equity / 40% bond / 5% cash allocation will be more exposed to an economic downturn than ever before.

   - Historically, when the economy has slowed, the Fed has cut rates to offset economic weakness, which boosted bond prices. Today, the Fed has no room to maneuver with rates, but can still stimulate the economy by expanding its balance sheet and the monetary base with infinite bond purchases.
   - Injecting liquidity into the financial market with the hopes of creating economic activity is good for gold.
   - Gold would dramatically outperform any fixed-income product as investors begin to consider excess liquidity as equivalent to currency debasement.

2) **Yield** – Gold has never offered a yield; however, for the first time in a long time, the real gold yield is above the real treasury yield.

   - The gold price need only stay unchanged for it to outperform treasuries.
   - That being said, the gold price has yielded 17% annually from 2002-2012, outperforming the return on treasuries.
   - Further, investors now need to move way out along the yield curve to find bonds with a positive nominal and real yield.
   - Corporate, junk, and mortgage bonds have higher yields, but are driven less by economics and are much more difficult to forecast. Even so, the real yield on junk bonds is only 2-3%, a historic low.

3) **Counterparty Risk** – Gold bullion is one of the few assets in the world with zero counterparty risk.

   - It is a physical, allocated, and universally-accepted asset.
   - Gold now holds even less counterparty risk than treasuries.

4) **Valuable Collateral** – Gold is equivalent to UST’s as a form of collateral.

   - The Basel III accord lists gold as a tier-1 collateral asset, on the same level as UST’s and other cash instruments.
   - JPMorgan has accepted gold as collateral for a few years.
5) **Liquidity** – As mentioned previously, no security or asset is as liquid as UST’s, but liquidity in the physical gold market is more than sufficient to support an institutional allocation.

6) **Performance in Various Macroeconomic Scenarios** – Going forward, we believe that gold should outperform bonds (and in some cases equities) in many market conditions including:
   - Inflation
   - USD weakness
   - Sovereign default
   - Equity bull market
   - Equity bear market

   Sustained deflation is the only environment where bonds theoretically should outperform gold, and even that is debatable.

7) Portfolios that we have priced using our proprietary models show that even a 10% allocation to gold can have a meaningful impact on potential returns.

- **Why other alternative investment assets are not viable as a replacement for bonds:**

  1) **Real Estate** – Many investment advisors are now advocating REIT’s because of the substantial fall in real estate prices since 2007. However, the real estate market is usually highly correlated with the equity market and not a useful hedge if equities were to fall. Also, real estate can be an illiquid investment and fees are considerable.

  2) **Hedge Funds** – Some financial advisors recommend reducing the fixed-income portion of the portfolio, and allocating that money to hedge funds which can net out duration risk in fixed-income instruments and make money on spread products. There are several problems with this approach including: performance risk, high fees, illiquidity, and major counterparty risk (hedge funds fail all the time).

  3) **Commodities** – (basket of metals, agriculture, energy, etc.) These products are volatile and not necessarily driven by economic fundamentals: Many are even driven by the weather and supply/demand fundamentals (unpredictable). Commodities are a less than ideal hedge for the equity portion of a portfolio and often have poor liquidity. Also, most commodities cannot be used as collateral. Further, gold can be considered a currency because it is not truly consumed.
• **Gold will give the protection that bonds used to give with optionality to other macro fundamentals:**

1) In this environment, gold will provide bond-like exposure now and into the future, and it will also benefit from numerous macro trends that are not linked to its fixed-income-like characteristics.

2) The gold price may also benefit from:
   - Growth in emerging market wealth
   - Emerging market demographics
   - Excellent supply/demand fundamentals
   - Rising costs of production
   - Central bank buying

**Conclusion**

- Wealth managers should not replace their entire fixed-income allocation with gold, but many prominent investors and strategists recommend an allocation to gold of between 5-15% of the portfolio.

  - As Ray Dalio has recommended, “most people should have roughly 10% of their assets in gold, not only as a good, long-term investment, but also for its effectiveness in diversifying the other 90% of assets people hold.”

- In the future, investors will realize that their fixed-income allocation will not provide the return characteristics that they are looking for, given certain macro environments. In almost all of those macro environments, positive or negative, even a small 10% allocation to gold can have a positive impact on a portfolio return.