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Gold as the New Government Bonds 2/21/16

A summary for the wealth management clients of Gold Bullion International

By Dan Tapiero, co-founder GBI/ Global macro portfolio manager

- **Modern Portfolio Theory:**
  - 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; with the assumption that a collection of investment assets has collectively lower risk than any individual asset.
  - Traditionally, portfolios have been constructed using equities, fixed income, and cash – and more recently, sophisticated investments like real estate, commodities, hedge funds, etc (all reasonably correlated to equities). However, equities and fixed income have always been the largest allocations.

- **Why investors have traditionally bought government bonds:**
  1. Bonds have performed well in all (strong/weak) markets – equities generally decline during recessions, so a long allocation to bonds has been an effective hedge for a long equity position. Furthermore, the long bond position has not necessarily had a negative correlation to stocks (they have both gone up in certain years).
  2. Yield – In addition to allowing for capital appreciation, bonds have always 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 amongst most liquid financial instruments in the world. Investors can exit positions quickly with minimal transaction cost.

- **ZIRP (and potentially NIRP) – the game-changer for fixed-income:**
  - 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. Also, several recessions, the Great Recession and market collapse of 2008, not to mention the near unlimited purchases of treasuries by the Federal Reserve and other central banks has reduced yields to near zero.
  - The bond bull market has created the perception amongst modern investors that, over time, bond prices usually go up, especially during periods of economic turbulence.
  - However, with the Fed Funds rate currently at 50bps (and the market currently pricing in a negative real Fed Funds rate beyond 2020) – the upside for bond prices is essentially capped. In theory, bond

yields can be held artificially low forever by the Fed, but profits from appreciation and yield will be minimal.

- Therefore, portfolios traditionally considered "balanced" will have major exposure to a decline in the stock market or a slowdown in economic growth. The amount of appreciation in a fixed-income portfolio will be mostly capped by the zero-bound. Therefore government bond returns cannot act, as they have historically, as an offset to losses on the equity side. Similarly, during an economic and stock market up-cycle, the fixed-income portion of the traditional "balanced" portfolio will provide small if any gains.

- **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 rates but can still stimulate the economy by expanding its balance sheet and the monetary base with infinite bond purchases; thereby injecting liquidity to the financial markets in the hope of creating economic activity. In this scenario, gold would outperform any fixed-income product as investors would likely consider such excess liquidity as equivalent to currency debasement. Also, in theory, gold, which has already rallied 15% this year, could rally 50% or more given the development of certain events; the upside potential is not capped at all. On the other hand, regardless of scenario, Treasuries will have a more limited upside (as a result of the zero bound and the limit to negative rates).
    2. Yield/Return – Gold has never offered a specific annual yield. The compounded annual gold return, from January 2000 until today, has been roughly 10%, much larger than the yield and total return of both stocks and bonds. Investors now need to move far out along the yield curve to find bonds with even a positive real yield. Corporate, junk, and mortgage bonds have higher yields but are unreliable hedges in times of stress. (In Germany, where 2yr government bunds now yield -50bps, gold stored in a vault is actually cheaper to hold; moreover, long physical gold/short 2yr Bunds has become a positive carry trade!)
    3. Counterparty risk – gold bullion is one of the few assets in the world with zero counterparty risk because it is a physical, allocated, and universally-accepted asset. Remarkably, 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 securities or assets are 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 under many different market scenarios including: inflation, disinflation, USD weakness or strength, sovereign default, equity bull market, and equity bear market. Sustained deflation is the only environment where bonds theoretically should outperform gold, and even that is debatable. 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:**
    - Real Estate – Several 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.

- Hedge funds – Some financial advisors recommend reducing the fixed-income portion of the portfolio in order to allocate money to hedge funds. As we have seen in the recent downturn, most hedge funds lose money when the equity market drops. Also there are other problems with this approach including: performance risk, high fees, illiquidity, and major counterparty risk (hedge funds fail all the time).
- Commodities – (Assuming commodities are equivalent to a basket of metals, agriculture, energy, etc.) These products are volatile and not necessarily driven by economic fundamentals: Many are 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.

- **Gold will provide the protection that bonds used to provide plus the added bonus of optionality to other potential long term macro fundamental developments:**
  - We have discussed how gold will provide treasury bond-like exposure now and into the future, but gold will also benefit from numerous macro trends that are not linked to the fundamentals which usually support fixed-income prices.
  - The gold price will also benefit from: growth in emerging market wealth, emerging market demographics, excellent supply/demand fundamentals, central bank buying, monetary system instability, negative rates in China etc.

- **Conclusion:**
  - Wealth managers should not replace their entire fixed-income allocation with gold. 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 government bond 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.