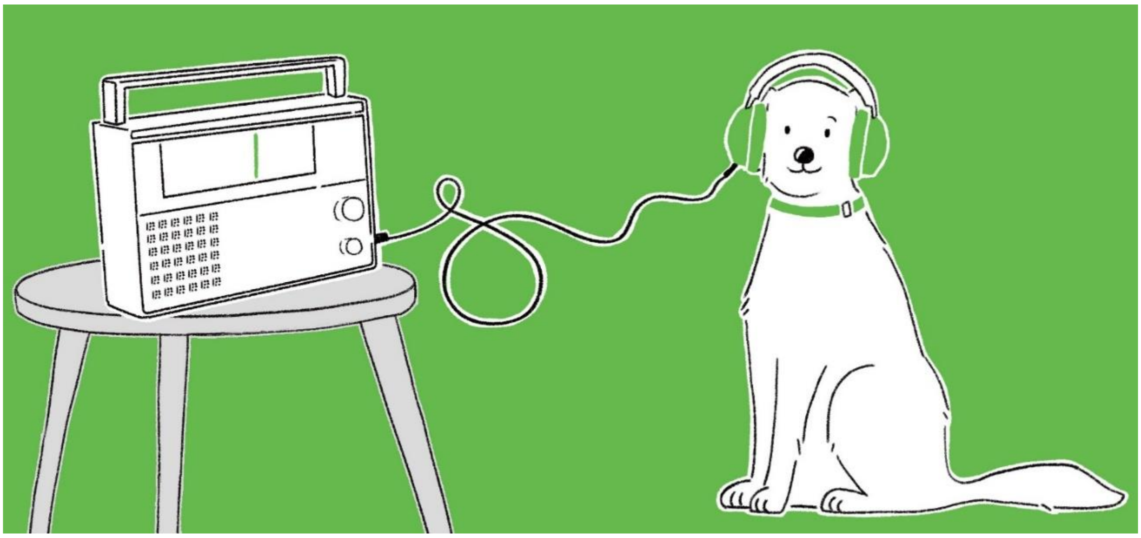
Ruffer Radio

Episode 3 – Gold Matters



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Rory McIvor

Welcome to Ruffer Radio. A series of podcast in which we'll be exploring the investment universe and sharing our interpretation of what's going on. Pharaohs were buried with it. Pirates lusted for it. And Lenin wanted lavatories to be made from it. Gold is the ultimate expression of wealth. It's enshrined in mythology. It's the subject of biblical idolatry. And it's an ever-present occupant in the human imagination.

Gold today commands a price as high as it has ever been.

With interest rates close to zero and volatility on the up, investors have sought refuge in the precious metal. But can this continue?

We've seen the gold price reach $2,000 per ounce. But what about $4,000 and beyond? Is all that glitters gold? Or is an alternative in the shape of cryptocurrency waiting in the wings?

I'm Rory McIvor and today I'm joined by John Wong, Co-Manager of the LF Ruffer Gold Fund and Jenny Renton, Investment Director and Co-Manager of the Charity Assets Trust. John and Jenny will assess the case for gold and share their thoughts as to its role in investors' portfolios.

A very warm welcome to you both.

John, in preparing for this podcast, we spoke about gold's durability through the time owing primarily to its unique physical characteristics. It's virtually impossible to destroy. You can't make it artificially and it doesn't tarnish. You think of gold coins discovered in the deep blue sea hundreds of years after a shipwreck and they are more or less in mint condition. So gold is special because it's unchanging.

But of course, Jenny, human relationships with gold haven't been consistent over the last few millennia.

Jenny Renton, Investment Director and Co-Manager, Charity Assets Trust

Yeah, to some extent. But what has been consistent is its use as a sign or indeed store of wealth. Initially, its primary use was for jewellery and ornaments. But for thousands of years now, gold has been used as money. And the first record of this dates back to around 700 BC. And gold has really outlasted any alternative currency since. Interestingly, it's actually thought that through the use of gold that banks were created so then the Knights Templar would deposit gold in an institution in one country and then draw an equivalent gold reserves when they travel to another. And it's this use of gold as money that was really market-driven. I mean there was no kind of global decree that gold should be used and exchanged for goods and services. But for the majority of the last 200 years, gold has been used to back up other currencies.

So for example through the use of the gold standard which I'm sure we'll chat about shortly. But since the gold standard was discarded as the back stop for the US dollar in 1971, we've been in the first period in history that all primary currencies in the world should be in fiat currencies so that's to say paper money not backed by anything other than a government promise

Rory McIvor

So what actually is it? Is it an asset or is it a currency?

John Wong, Co-Manager, Ruffer Radio Gold Fund

Well, I believe you can look at gold as both, Rory. In the first place, let me look at the currency. Gold is so often compared with a currency because it is seen to be a store of value just like other currencies. And its attractiveness is really a function of how you see the other major currencies. And in a time where the major currencies do not have a yield but in fact have negative real yield then gold is very attractive. Another way of looking at gold is as an asset class. And in this case, its attractiveness needs to be compared with other asset classes such as equities, bonds, property. And when you look at that, you have to say, how will these asset classes perform in your outlook for the economy and interest rates? And if you think it's negative then really that's very attractive for gold.

Rory McIvor

John, that's interesting. Really what you're saying is that gold's attractiveness is relative to other currencies and other asset classes. It makes me think of the Aztecs who of course liked gold, but give them to the rare bird feather and they take that any day of the week. So it's that relativity in the attractiveness of gold. Jenny, you promised that we'd talk about it but I'm going to turn to John. John, what is the gold standard?

John Wong

Look, the gold standard is actually a monetary system back in history where a country's currency has a value that's linked to a specific quantity of gold. And in addition, that currency is fully convertible to gold at the request of the holder. That's what it makes it gold standard.

Rory McIvor

And that interestingly, I think is the origin of the text on a £5 note which states I promise to pay the bearer of etc

John Wong

That's right.

Rory McIvor

I'm sure it's ore detailed than that, but I don't have one in front of me. Cash apparently is no longer king. John, was why gold standard introduced in the first place? Why was it invented?

John Wong

Well, this was at the time where the world was starting to trade more and more with each other. And the trading partners may not necessarily trust each other's currency. So when the currencies are freely convertible to gold, you take that trust issue away. And this actually facilitated global trade.

Rory McIvor

Jenny, what are the chances of a return to the gold standard either in that form or in an equivalent?

Jenny Renton

Well, in short, I think it's very unlikely. I mentioned earlier that since the gold standard was abandoned, we've had fiat currency. But what that allows the political class to do is print money and spend it and to stretch the limits of the conventional financial system.

A return to the gold standard would constrain central banks' ability to print money and government spending power. If we think back to when Nixon abandoned it in 1971, we've been through decades of financing wars with the prospect of more to come. Now wars may not be top of list at the moment but there are a lot of things to finance and with an ever-growing global sovereign debt burden. So really, it's hard to see authorities willingly reverting to it unless the alternative was unimaginable chaos. Gold's value and role in societies intrinsically link to systematic confidence so in a scenario where there's total loss in the confidence in the value of money, a return to the gold standard I guess may well be considered.

Rory McIvor

And John, with the gold standard, gold was a kind of super currency, wasn't it?

John Wong

Yes, it was. I mean, effectively under a gold standard, gold was the currency. And all goods and services are priced off the value of gold. Hence, governments had to be careful in managing the budgets on the basis of global trade. And this is I think Jenny's point.

Rory McIvor

Given the extraordinary range of assets and investment vehicles available to investors in the 21st century, why is gold still so attractive?

Jenny Renton

Well, if we take a step back, I think we can all agree, there's a lot of risk and uncertainty in the world so for those seeking a safe haven asset, gold is a store of value that sits out with the financial system. And as John mentioned it, it has scarcity value so governments can't just draw more out of thin air so it tends to perform when people are fearful about the future. And the second reason investors might be looking at it today is the role it can play in their portfolios?

Rory McIvor

And what do you mean by that exactly, Jenny? Is that referring to gold's correlation with other assets in an investor's portfolio and therein, its ability to offset these assets?

Jenny Renton

Yeah, essentially, thinking about gold as a protective asset. So if we think about traditional protective positions in portfolios, government bonds kind of top the list. But the appeal of holding bonds in the first place is partly to do with the way they perform and other risks assets are falling. But today, the ten year government bond yield in the US is 0.7%. So if you believe that yields in the US can't go below zero, there are a whole host of potential outcomes from here where government bonds don't give investors a return to protect their portfolios when equities are falling so investors need to look at other protective assets. And there's not really one that solely fills the shoes but golds can get pretty close with the safe haven qualities.

Rory McIvor

And it's this attractiveness presumably and these considerations that have driven the strong performance, the remarkable performance actually, of gold this year so far?

Jenny Renton

Yeah. So people buying it as a safe haven and also the interest rate dynamics are key to this performance year to date. In brief, in March, central banks intervened by squashing bond yields back down toward zero percent through both interest rate policy and also quantitative easing. And since then, they've continued to promise that interest rates aren't going up anytime soon. So golds got no challenge from ten year treasuries which are kind of the ultimate risk-free investment but yet bond yields are below inflation. So in other words, they real yield as negative so suddenly, gold looks even more attractive particularly if you believe that inflation could rise from here, ie those real yields could get more negative.

Rory McIvor

When we talk about investing in gold, many people will think of sort of gold bars you havelocked away in hidden vaults. I know I think about Gringotts in Harry Potter (laughter) where you sort of scooch down hundreds of miles below ground and there are these gold bars which are actually guarded by little goblins. But that's not the only way to invest in gold. And there are in fact a multitude of mediums. John, the gold fund predominantly invests in gold miners. Perhaps you could explain why miners are a neat way to play the gold price?

John Wong

Sure. When you're investing in a gold mining company, you're investing the company that mines gold and then sells it and hopefully at a profit. So the profitability of a gold miner improves as the gold price rises relative to its cost. And so in a rising gold price environment, the profitability of these companies tends to rise at a faster rate than the gold price. And hence, their shares tend to outperform. I guess another way of looking at this is that gold mining companies tend to outperform gold in a rising gold price environment because of their operational leverage but the reverse is also true.

Rory McIvor

So John, what is the current state of play in the gold miners market?

John Wong

Yeah, well, we've had a phenomenal run in the last six months. And actually, that has been led by the larger capital mining companies. So I think at this stage, I would say that those large capital mining companies are probably at a fair value. But actually, we still see a lot of value in selected mid and small cap companies which is where our portfolio is predominantly positioned right now.

Rory McIvor

Okay so we've heard the arguments in favour of the yellow metal but what are some of the arguments against gold. Gold is not without its critics as an asset class or as a currency. Warren Buffet, the 'Sage of Omaha', famously dismissed gold in a speech I think he gave at Harvard some time ago. He said, 'It get dugs out of the ground in Africa or some place then we melt it down. Dig another hole. Bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.' Jenny, what are these arguments against gold?

Jenny Renton

Well, I think it's interesting timing to reference that Buffet quote given in the last couple of months, he's actually been buying one of the large cap miners. But really, there's four key arguments against gold. Firstly, it's got no yield so you don't get paid to hold it. You're essentially buying gold because you believe someone will pay you more for it in real terms so after inflation in the future.

Rory McIvor

And there's also storage cost associated with those gold bars because you know unaccounted Gringotts can cost you some money. (laughter)

Jenny Renton

I'm so glad we've got Harry Potter reference in there. Yeah, absolutely. And there's also really no good way to value gold so it doesn't produce anything the way that a company can produce cash flow, earnings and dividends. It's thought as a good protection against inflation but history actually points to gold typically rallying long before high inflation appears and declining long before high inflation ends so you've got to be pretty active in managing your gold exposure. And finally, safe assets tend to be used in portfolio to dampen volatility. And that's not particularly a role that golds can claim to have fulfilled in the last decade so we just have to look back at March 2020 when it fell in 10% in a pretty short order.

Rory McIvor

That's interesting and referring specifically to gold performance in March. Instinct says that when the proverbial it hits the fan - you buy gold. So why at the peak of the storm in March with the coronavirus crisis did gold sell off as well?

Jenny Renton

Essentially, liquidity. So investors were selling what they could in the face of the turmoil we saw in equity markets.

Rory McIvor

Okay. So a key part of the positive case for gold is related to its limited supply. John, could you talk us through a little bit about those supply and demand dynamics for gold?

John Wong

Sure. Well, let me start with the supply side. If you look at mining supply, every year pretty much the last 10 years, the gold mining has produced about 3,000 tons of gold.

Rory McIvor

And for context, that's 3,000 tons a year adding to accumulative total of 197,000 tons of gold actually existing on the surface of earth at the moment.

John Wong

That's right so a very, very small percentage really and that's one of the positive arguments for gold. But even with mining supplies, you look forward, I would see that as quite challenge. And the reason I say that is because a lot of the easy gold has already been mined. What I mean by easy gold is the high-grade gold on surface or near surface in good mining jurisdictions. Most of these have been exploited already so what we're left with looking ahead are the low grade, very deep gold and probably in tough mining jurisdictions. Okay, so for me this is actually one of the challenges for the gold mining industry looking forward.

Rory McIvor

So John, what about the technology that is used to extract gold from the earth's crust? I mean we've had fracking really revolutionise gas supply. Can we expect an equivalent technology to change the way in which gold is mined?

John Wong

Yeah, well, when we look at technology, the only big change in gold mining in the last I guess number of decades now was in the 80s when in the US they came up with something called heap leach mining and that was a way of processing gold. In that time, left the mining supply a fair amount. But since then, there has been no real advances in mining so I don't see that as a major driver at least in the next five to ten years.

Rory McIvor

And John, what about the demand side? Who actually buys gold?

John Wong

Well, that's quite interesting. Because there are three major buyers of gold that affect the gold price. So the first one is the traditional market which are the jewellery market. So that's really still quite big. It's about 50% of the annual demand each year. And in terms of the jewellery market, the two big markets today are India and China with China marginally bigger. This group interestingly do not actually drive the gold prices higher. They tend to be there to support the gold prices when they fall and that's their style of investment if you like. The next group is the central banks so this group they've had gold forever and they use it as part of their reserve management. They've not always loved gold so sometimes in the 80s, 90s and early-2000s they were actually net sellers of gold. And the reason they did that was because they didn't think they needed it. But 2008, 2009 during the global financial crisis, that changed everything. And from that point on, they've continued to buy gold so they buy about 15% of the annual gold demand.

Rory McIvor

And which central banks are leading the pack in terms of buying gold?

John Wong

So the big ones that recently have been buying are the Russians and interestingly, the Chinese have started buying quite a lot of gold. So that's one thing to look at as well in the future. Well, the last group which actually do drive the gold price a lot is the investors so this group is very variable in the demand. It could be as low as 15% or as high as 40%. And it is this group that makes the marginal price for gold.

Rory McIvor

And that's the pillar of demand, as it were, that's driven the gold price this year clearly.

John Wong

That's right.

Rory McIvor

In previous podcasts, we've suggested that we're entering potentially a new regime for financial markets and that's a regime characterised by amongst other things higher volatility and higher inflation. Surely this means greater structural demand for gold amongst both investors and central banks.

Jenny Renton

Absolutely. So against the backdrop of low economic growth, we've transitioned into this regime of coordinated loose fiscal and monetary policy. So this spells out an even greater sovereign debt burden, the persistence of low interest rates and higher inflation so governments needs to find a way of managing this ever growing debt burden and growth doesn't look particularly likely from here. Currency default or austerity are not vote winners. And inflation meaningfully above interest rates is a way to de-leverage the economy but in a politically palatable way. And gold will be one of the few hiding places as we transition to a wealth of higher inflation with the interest rates kept necessarily low. So from an investor's perspective, a transition from low to high inflation historically spells disaster for equities and conventional bonds. And gold has kind of proven itself in this kind of environment in the past. But more specifically you ask about central banks. And John mentioned that they've been adding to their gold reserves. Well, we're in a world where policymakers continue to push the limits of conventional monetary and financial systems. So if that entire system collapses, the gold stock provides a collateral for central banks to start over. Essentially, gold gives confidence in the power of the central banks's balance sheet.

Rory McIvor

There are of course other assets which some people argue could or can substitute for, perhaps even improve upon gold. John, how does gold's little brother, silver fit into the picture?

John Wong

Yeah, well that's interesting because silver was also monetary metal and is often known as the poor man's gold. So there's a lot more silver in the cross by a magnitude of greater than 10 when compared with gold and so it is much cheaper than gold but it actually moves in the same direction as gold. Although sometimes with a lag. So I suppose in simplistic terms, I think of silver as a leverage position in gold so it moves in a greater percentage than gold in both directions.

Rory McIvor

And silver will have performed, on that rationale, even better than gold perhaps this year.

John Wong

That's right.

Rory McIvor

And what about the other asset classes comparable to gold? Jonathan Ruffer speaks of index link bonds as 21st century gold but there's also of course cryptocurrency. And cryptocurrency is a relatively new asset class and phenomenon but one which is increasingly capturing investors' attention.

John Wong

The cryptocurrency universe has become vast and is ever increasing. But for the sake of our discussion, I'm going to be talking about Bitcoin. The case for Bitcoin is exactly the same as that for gold. The invention of Bitcoin was a creation of a digital scarce asset as a store of value. All the properties that we have in gold are supercharged in Bitcoin but in a much more exact quantifiable fashion. For example, Bitcoin is scarce by design which is just like gold. In terms of supply dynamics, the increase in new Bitcoins relative to its existing Bitcoin base is tiny in percentage terms just like gold. Neither produce earnings or a yield and both are saleable across borders. I would argue that Bitcoin is much more favourable in this respect. However, Bitcoin's only difference is proven longevity. That is the key differentiator and the one that we're grappling with at Ruffer. Bitcoin and cryptocurrency more generally should not be dismissed without careful contemplation.

Rory McIvor

Jenny, perhaps you could give us a little bit of a background understanding of why index link bonds are compared to gold.

Jenny Renton

Sure. Well, inflation link bonds are certainly not outside the financial system like cryptocurrency. But they do share the inflation protection characteristics of gold so more specifically their price is determined by will yields, in other words that difference between inflation and nominal interest rates. And the last time we saw inflation meaningfully higher than interest rates was in the 1970s when gold did very well. Inflation link bonds went around then and in fact, Maggie Thatcher created them in response to inflation ravaging the UK so within this new regime we've spoken about of coordinated loose monetary and physical policy, if we see inflation move higher with interest rates kept low as we expect, inflation link bonds are sure to prove themselves as a necessity really for investors looking to preserve capital in real terms.

Rory McIvor

John, Jenny, we've covered a lot of ground there but I thought I'd give you each a final word on gold. John, perhaps you could kick us off.

John Wong

Sure. Look, I know I'm a bit biased but I do believe that gold is the ultimate long-term store of value so it deserves a place in one's portfolio especially when considering long-term wealth preservation.

Rory McIvor

And that's breaking news from the manager of the LF Ruffer Gold Fund (laughter) advocating gold in investors' portfolios. Jenny?

Jenny Renton

Yeah, agreed. I mean gold is going to be key as this new regime that we find ourselves and continues to unfold but it can be fickle friend so it's a position to keep a close eye on in portfolios.

Rory McIvor

So portfolio managers best be blessed with the Midas touch. Thank you, John and thank you, Jenny. And thank you for listening. If you'd like to be notified of the release of future episodes of Ruffer Radio, please subscribe wherever you get your podcast from.

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