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News & Views

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NEWTON REAL RETURN: WHY WE ARE NOT FAIR WEATHER GOLD BUGS

Gold's been in vogue so far in 2016, but Suzanne Hutchins, from Newton's Real Return team, thinks it can pay to hold the metal during times of lower popularity too.

Investing in gold has not always been well-received over the past five years, says Suzanne Hutchins, portfolio manager in the Real Return team at Newton, a BNY Mellon company, but the asset still has a place in an absolute return portfolio, she believes.

The Real Return strategy has exposure to precious metals through owning an ETC, an ETF and some gold-mining companies. Historically the range for gold exposure within the strategy has been between 6% and 13%, with an average position size of 9% since 2010.

As at 12 February 2016, the position size is around 9.6% of which 5.3% is physical gold exposure and the rest exposure to gold miners.[1]

Hutchins says exposure to gold and other precious metals has meaningfully helped protect the capital and the volatility of the return seeking core of the strategy particularly since the start of 2016. So far in 2016 exposure to gold and other precious metals has generated a positive return as the price of gold climbed over 16.1% in US Dollar terms. Gold contributed c.1.8% towards the strategy's performance over this period.[2]

"Our view on the use of gold within the portfolio has not significantly changed. Much of the polemic surrounding gold involves a comparison with other assets such as equities. The inference is that if you are pro gold, you are anti-stocks, anti-innovation and anti-prosperity. This is absolutely not the case.

All that glitters?

"We see gold as a non-yielding real asset that *should* act like a 'safe-haven' currency. It should not be grouped with other commodities that are consumed to create economic activity. It's the very fact that gold is not used like other commodities, but accumulates gradually over time without degrading (it has a high stock to flow ratio), that lends it the ability to be a monetary unit. This relatively low and stable production growth when compared to paper money confers gold some ability to appreciate over time," she believes.

For this reason the Real Return team does not hold gold to be in any way comparable with a risk asset that has a claim on the future cash flows from commerce. "From time to time, risk assets like credit and equities do become more risky, and with policy having driven valuations up and expected returns down, in an environment of slowing global growth and rising leverage, this seems to be one of these times," says Hutchins.

Hutchins continues: "Persistent use of loose monetary policy to tackle structural headwinds to global growth means the money many assets are denominated in is increasingly risky. This is of key importance to the absolute return investor.

"In an environment of increasing paper currency devaluation, debasement and volatility, it can make sense to denominate a portion of one's portfolio in a monetary asset outside the current credit driven financial system as a means of diversification. It is worth remembering that, although gold is no longer used to back currencies, nation

[1] Source: Newton, as at 12 February 2016
[2] Source: Newton, year-to-date as at 12 February 2016.

states continue to hold gold as part of their reserves as long-term financial insurance - it doesn't seem unreasonable to us for savers to do the same." she adds.

Outlook 2016

Hutchins says the situation the team sees unfolding leads it to believe that volatility (or, more accurately, the prospect of a permanent loss of capital) is more and more likely to develop.

"The one thing we cannot be certain about is the timing. With this in mind, we have throughout 2015 been de-risking the strategy. Having on average one third exposure to return-seeking assets has proved a difficult and painful decision to take at times, but one we have felt compelled to make on behalf of our clients."

The alternative, according to Hutchins, is to remain fully invested and, when downside volatility arrives, attempt to be first to reach the exit. In the event of such a situation this approach brings with it the very real danger that the exits may be blocked by other investors doing the same. "If this happens we believe there will prove no place to hide and this is a risk we are unwilling to take on our clients' behalf," she says.

- **Cash**

The team is currently demonstrating patience, with 2.7% of the strategy in cash and around 10% exposure to liquid short-dated US Treasuries.[3] "We believe that when downside volatility does present itself, fundamental analysis will again come to the fore (as opposed to markets being driven by official interventions). At this point we will be in a position to assert a much greater exposure to return-seeking assets with solid fundamental prospects and at much better valuation levels."

The team remains cautious and highly selective with regard to its investments, assuming the status quo. However, Hutchins does not view the opportunity set as static. Alongside volatility in risk assets is the expectation for price changes and new opportunities at more attractive valuation points than the team sees currently.

- **Equities**

"In equities, our emphasis remains on balance-sheet strength and the ability to compound cash flows from relatively non-cyclical business models. We continue to hold minimal exposure to commodities and energy, with a keen awareness that these assets could become attractive in due course, if the current supply glut diminishes.

"At a regional level, emerging market equities appear to be more promising than their US counterparts, on a valuation basis. Emerging economies are however, highly divergent, with some resilient and others facing tough challenges ahead. The prospect for broad-based capital outflows from the group may well present attractive opportunities in the year ahead."

- **Fixed income**

"As yet, in the credit markets, we do not see that the time is right to rebuild our exposure. Currently, high-yield bonds in particular entail excessive risks in view of the expected yields. However, in most developed government bond markets where real yields are positive, we are comfortable taking more interest-rate and duration risk than is the consensus. However, this positioning is tactical and dynamic given the low level of yields on offer.

[3] Source: Newton, as at 12 February 2016

Hutchins concludes: “We believe the risks of deflation outweighs an inflationary pick up shorter term though we are alert to policy response which could surprise and be perceived as inflationary. Certainly a US Federal Reserve tightening cycle is not on the cards right now. The investing environment is very risky and uncertain and so we try to focus on where we have greater certainty and that is by understanding what we own and why we own it.”