PRECIOUS METAL

DON'T UNDERESTIMATE THE VALUE OF GOLD WHEN YOU'RE HEDGING AGAINST CURRENCY RISK, SAYS JUAN CARLOS ARTIGAS

The opportunity posed by the rapid growth of emerging economies has meant that many companies now do business across multiple territories around the world. As a result, they have an increasing exposure to potentially volatile currencies.

While involvement in emerging markets has proved attractive for many businesses, it has also brought new risk factors for corporate treasurers to consider. Companies with exposure to foreign markets must consider how to protect themselves against the possibility of crisis events and how best to manage FX risks.

Traditionally, currency baskets have been used to hedge against the risk posed by interest rate fluctuations. But an important question to ask is whether there are more cost-effective methods of doing this. Gold can play an important role as a currency hedge, and while this is not news, it is surprising how few treasurers currently use it. With gold becoming more widely accepted as a source of collateral and a high-quality liquid asset, companies should be aware of how it can fit into their existing arsenal for managing currency risk.

The features of gold

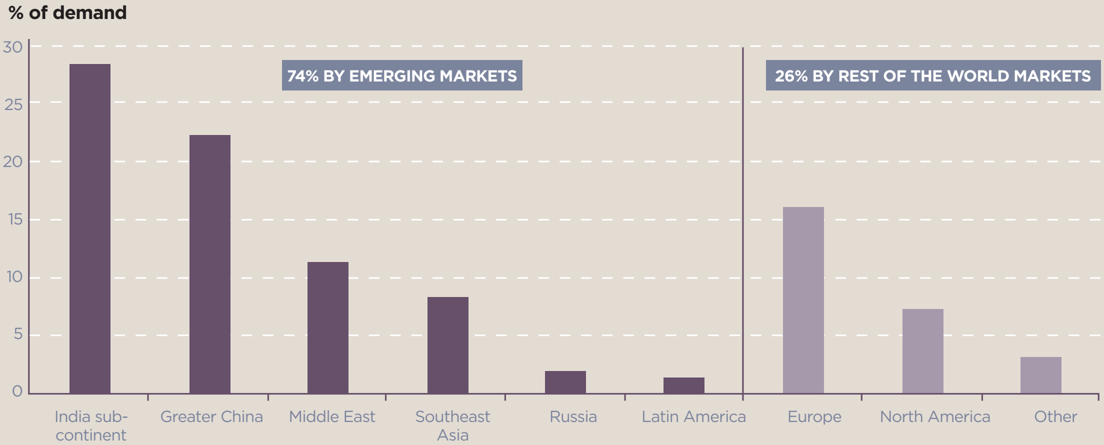
There are four main characteristics that make gold attractive as a hedge against currency risk: its economic relationship with emerging markets growth; its negative correlation to the US dollar; the fact that its conditional correlation protects it against extreme moves; and its cost advantage.

The significance of gold's close relationship to the emerging market growth cycle is integral to gold's role in FX hedging. This link comes from the fact that recently – and particularly over the past 12 years – a large portion of demand for the yellow metal comes from markets such as China, India, Turkey, Vietnam and the entire Southeast Asia region. Such countries have a deep cultural affinity with gold, which means that the asset is not directly correlated to emerging currencies, but is positively correlated to growth in these countries. Emerging markets have shown strong growth potential, and are currently experiencing significant financial, economic and social expansion that will only serve to provide a lasting source of demand. As population and disposable income increases in these economies, there is likely to be increased demand for gold in the form of investment and jewellery, and indirectly through increased purchasing of electronics that contain gold components.

Another key feature of gold as a hedge against currency risk is the established fact that a depreciation of the US dollar against a basket of currencies typically translates into higher gold prices due to a negative correlation. While the strength of the relationship between gold and the US dollar – measured against a trade-weighted basket of other currencies – has fluctuated over time, it has remained persistently negative in the longer term, and this concept also applies to other major developed market currencies.

The role that gold can play in reducing the impact of sudden market events is also an important consideration. This is particularly the case for treasurers who are managing exposure to emerging markets, as developing economies have

REGIONAL DISTRIBUTION OF GOLD DEMAND IN 2012*



*Gold demand includes bar and coin, jewellery and exchange-traded funds. Middle East includes Turkey. Other category aggregates country demand for which no individual country data is available.

SOURCE: THOMSON REUTERS GFMS, WORLD GOLD COUNCIL

SUMMARY OF PORTFOLIO PERFORMANCE ACROSS MULTIPLE PERIODS*

Portfolios (December 1987 to December 2001)	Return	Volatility	Information ratio
Portfolio with unhedged EM	9.65%	7.19%	1.342
Portfolio with 100% FX	11.59%	7.17%	1.615
50% FX hedged + 50% gold overlay	10.18%	7.15%	1.462
Portfolios (January 2002 to October 2012)			
Portfolio with unhedged EM	6.80%	8.84%	0.769
Portfolio with 100% FX	6.33%	8.30%	0.762
50% FX hedged + 50% gold overlay	7.39%	8.88%	0.833
Portfolios (December 1987 to October 2012)			
Portfolio with unhedged EM	8.40%	7.95%	1.058
Portfolio with 100% FX	9.29%	7.71%	1.206
50% FX hedged + 50% gold overlay	8.96%	7.95%	1.128

*The portfolios used for comparison are similar in all respects except for the emerging market (EM) asset – which changes from unhedged to a 50/50 mix between currency hedging and a gold overlay. The returns for the 50/50 hedged EM asset are computed by weighing a 50% unhedged EM index with a 50% currency hedged EM index and a 50% overlay to gold. Assuming there is a 10% allocation to emerging market equities, the 50% gold overlay would result in a 5% cash borrowing to arrive at a 5% allocation to gold, creating a 105% long, -5% cash portfolio. Unhedged EM is represented by a gross total return index, while the FX hedged EM is represented by a net total return index, which has a slight difference in return.

SOURCE: BARCLAYS, BLOOMBERG, WORLD GOLD COUNCIL

historically been susceptible to unexpected downturns. Over the past 25 years, emerging market currencies fell by more than two standard deviations (or 3.6%), slightly over 3% of the time, as measured by monthly returns. In 1.3% of the instances, the fall was greater than three standard deviations (or 5.4%); while the worst monthly return saw emerging market currencies shed 8.2%. Clearly, when these so-called 'tail risk' events occur in emerging markets they tend to be more severe and volatile exchange rates can quickly turn a positive return in local terms into a negative one for the investor. Gold is one of the few assets that displays low long-term correlation to most assets, but often correlates negatively when risk-hedging needs are greatest. Unlike other forms of portfolio insurance, gold also shows low and positive correlations during periods of economic growth. As a result, if there is a pull back or systemic risk in the global economy that creates a flight to quality, the price of gold typically benefits.

The issue of cost is, of course, paramount when assessing potential tools for hedging against FX risks. To put up a position using currency baskets, it is necessary to borrow at that country's interest rate, which can be a costly process. When using gold, however, the only necessity is to borrow cash directly at your local cost, which is typically significantly lower. As a result, using gold as a 50/50 overlay with currency baskets can be a more cost-efficient hedging solution.

Benefits

Using an overlay of gold as a currency hedge can be cheaper than purely using currency baskets, but does it affect the performance of the hedge? Recent research conducted by the World Gold Council shows that the answer is no, with an overlay of gold to emerging market assets reducing portfolio peak-to-trough declines over the past decade. On average, this corresponded to a drop to 9.2% from a 12.5% decline in currency-hedged portfolios, and from 13.1% in unhedged portfolios.

Furthermore, portfolios using gold overlays can actually optimise risk-adjusted returns during periods of extreme market stress and heightened currency risk, due to gold's aforementioned 'tail risk' hedging properties. Analysis of portfolios over eight crisis periods revealed that an emerging market portfolio using gold as a hedge offered cumulative outperformance of 2.4% above an unhedged portfolio and over 1% above a currency-hedged portfolio.

A versatile tool

Doing business in emerging markets can offer much to companies, but to manage the currency risk that such exposure brings means that corporate treasurers need a versatile hedging tool. Because of gold's features and the fact it is integral to the foreign reserves of central banks, it has a natural role to play in managing the risks associated with FX exposure. It can also be a cost-efficient alternative option to using traditional currency hedges.

ABOUT THE WORLD GOLD COUNCIL

- **The World Gold Council is the market development organisation for the gold industry. Working with the investment, jewellery and technology sectors, as well as engaging in government affairs, its purpose is to provide industry leadership, while stimulating and sustaining demand for gold.**
- **The World Gold Council develops gold-backed solutions, services and markets, based on true market insight. Through this, the council creates structural shifts in demand for gold across key market sectors.**
- **Based in the UK, with operations in India, the Far East, Europe and the US, the World Gold Council is an association whose 23 members comprise the world's leading gold mining companies, representing approximately 60% of global corporate gold production.**

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