Experts View

The Universal Appeal of Gold

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Gold has stood the test of time to remain one of the most traditional and preferred forms of investment. If the price increase witnessed in the yellow metal in the last few years is anything to go by, gold is likely to retain its preferred status in the time to come too.

The precious metal is universally seen as a wealth protector and finds place in practically every portfolio. As an asset, it is unique in more than one way. Unlike other asset classes, it has a global market-the size, depth and liquidity of which surpasses that of equities and bonds. Moreover, gold is seen to be relatively less impacted by the fluctuations in business cycles, on the contrary, the metal is known to flourish in the environment of economic uncertainty and low growths. Also, it is the only asset that does not possess a default risk as it is not linked to government or company finances. It differs from other commodities too as it is not susceptible to weather or geo-political risks. As such gold has been the virtually undisputed safe haven investment globally.

Gold features among the most investible asset as it can be easily obtained by one and all in various ways ranging from across the counter to commodity exchanges. This attribute of the metal adds to its appeal, in that it facilitates liquidity. Given its ever increasing appeal, gold is available in various forms too i.e. in physical forms such as coins, bars and jewelery as well as in the paper less form such as gold ETF's (exchange traded funds).

How does gold compare with other assets?

In terms of price increases and returns, other asset classes such as equities and bonds pale in comparison to gold. There are not many assets that can match the record of the steady rise in gold prices since 1990's. In the last decade alone, gold prices have risen from an average \$279/oz in 2000 to over \$1750/oz currently (upto Sept 2012), clocking a compounded annual growth rate (CAGR) of 15% during the period. In comparison, in the corresponding period the US Dow Jones Industrial Average (DJIA), the benchmark index of stock market activity, registered a CAGR of 1.41%. The returns on the other safe haven asset i.e. government bonds has been very low. The yield on the 10 year US treasury bonds, the most preferred "risk-free asset" is a mere 1.84 %.

Gold counts amongst the world's best investment option and has been witnessing healthy demand. Demand for the precious metals has been largely undeterred by the high prices and increased by over 10%

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in 2011 (to 4574 tonnes) from that in the previous year, despite prices being at record levels during the year.

Gold has being gaining importance as a monetary asset as in it is being increasing used as a collateral in financial transactions, often even replacing other high quality assets such as government securities.

What has been driving gold?

In recent times, gold has benefitted from the global financial turmoil and the associated economic downswing and uncertainty. The metal has gained in popularity following the increases in government debt and thereby high public debt ratio's in the post-crisis era, prompting investors to relook the "risk free and safest investment" status of government securities. In addition, the depreciation in currencies, especially the USD too has been aiding the attractiveness of gold for investors.

The waning investor confidence and low returns in other financial instruments/assets has resulted in investors crowding into safe haven investments like gold, which have been giving highest returns to boot. The extent of investor confidence in the metal can be guaged from the shift in the portfolio of central banks that are being adjusted in favor of gold over traditional investments of sovereign bonds and forex. The share of gold as a percentage of total reserves has seen a quantum jump from 55% in Q1 2000 to 75% in Q2 2012 for USA, according to World Gold Council (WGC) data. Likewise, during the same period the share of gold in total reserves increased from 33%, 41% and 46% to 72% each in case of Germany, France and Italy respectively, to cite a few.

Investor appetite for gold is also being fuelled by the metal's attribute of an inflation hedge. With the depreciating currencies and high commodity and input prices, that has been contributing to inflation, lowering investor returns across asset classes, investor seek preservation of their wealth for which they turn to gold based investment which have been delivering higher real returns.

Gold Trades

Although, physical buying and selling of gold constitutes a large portion of its trade, gold registers huge volumes of trade in the derivates market too world over. Going by the growth in trading volumes in the futures and option contracts in gold on the world's major exchanges, it can be inferred that there exists an active market (large participation) for the metal and that the price discovery mechanism is robust and effective. The gold contract traded on Nymex, MCX , TOCOM have recorded growth of 10%,71% and 32% respectively in 2011 over 2010 as per FIA data.

Asia (that includes Shanghai, Tokyo, Taiwan and Mumbai) dominates the world's gold futures trade. The dominance of Asia in gold futures is due to the volume of consumer demand in the region for the metal. The regions imports around 60% of the world's gold and exports 40%. The Asian regions dominance is likely to continue going by the consumption scenario that is likely to prevail globally. Given the weak financial and economic condition prevailing in Europe and the US, these regions are likely to see subdued consumption of the yellow metal.

Given the unlikelihood of dramatic changes in the global economic and finance space in the foreseeable future, the attractiveness of gold for investment is likely to remain unchallenged. It will continue to be one of the most widely traded commodity on the derivatives exchanges across the world.