

The Investment Case for Gold

July 2010

Introduction

Gold has been used for thousands of years as a store of wealth for governments, central banks and individual investors alike. The precious metal has some unique characteristics that have traditionally made it very appealing as an asset class; it is both tangible and durable and it is easily traded across global markets. Gold has also been widely used as a safe haven investment option, especially when economic conditions become unstable and during times of political uncertainty and periods of high inflation.

This may explain why we have seen renewed interest in gold as an investment option over the last few years. The global financial crisis and worldwide recession of 2008/09 has been compounded by continued uncertainty in 2010 as major concerns surfaced over European sovereign debt and the potential breakup of the Euro zone. During this time many investors have sought to protect their portfolios and hedge themselves against the possible effects of monetary destabilisation and inflation through an exposure to gold.

There are a number of reasons why investors should consider holding an allocation to gold in a diversified portfolio. Some investors may have bought gold for tactical reasons because they see positive pricing signals associated with strong demand and tight supply conditions. Others may have bought gold as a long-term or strategic asset seeking to take advantage of its unique investment characteristics. In this paper we look at the history of gold as well as the current and future drivers of the gold price and its unique investment characteristics.

1. A short history of gold

Gold has long played an important role in supporting the world's monetary system due to its scarcity, durability and general appeal. Gold's early uses were no doubt ornamental, and the metal's physical properties (it neither corrodes nor tarnishes) has linked it to both religious purposes and royalty in early civilisations. The extraordinary efforts made to obtain it throughout history demonstrate that great value was placed on the precious metal, even before it was used as money. Prospecting for gold was a global effort going back thousands of years, even before the first money in the form of gold coins appeared around 700 B.C., by the command of King Croesus of Lydia (modern day Turkey)¹.



In more recent economic history gold has been used to benchmark many currencies and as a method to transfer and distribute wealth between nations. Until just last century paper currencies were convertible into a fixed quantity of gold – under the gold standard system. This system started to break down in the 1930s as one by one Great Britain, Japan and eventually the US abandoned the gold standard in order to have the economic flexibility to counter the effects of the great depression.

After the Second World War, the Bretton Woods system pegged the value of the United States dollar at US\$35 per troy ounce of gold. Other currencies were also pegged to the US dollar at fixed rates, effectively establishing the US dollar as the world's reserve currency. The US then agreed to redeem dollars in gold to other central banks. Trade imbalances were corrected by gold reserve exchanges or by loans from the International Monetary Fund. This system in turn collapsed when the United States government ended

¹ Ehow.com

the convertibility of the US dollar for gold in 1971; however, today many nations still hold gold as a reserve asset.

2. Gold price history

Under the gold standard system, the price of gold was artificially pegged at a fixed value. When the US government ended the fixed convertibility between the US dollar and the gold price in 1971, market forces were again able to dictate the gold price. This led to a steady appreciation of the gold price throughout the seventies, fuelled by a number of important factors that led to a sharp spike throughout 1979 before peaking in January 1980.

Chart 1. Nominal price of gold in US dollars



Between November 1979 and January 1980, the price of gold doubled; however, it is important to remember the economic conditions at the time. During 1979 oil prices rose from US\$15 to US\$40 per barrel, the US dollar was falling rapidly and inflation in many countries was running in double digits. From its 1980 peak, the price of gold subsequently declined to trade mostly in a US\$250-\$500 range for the next two decades.

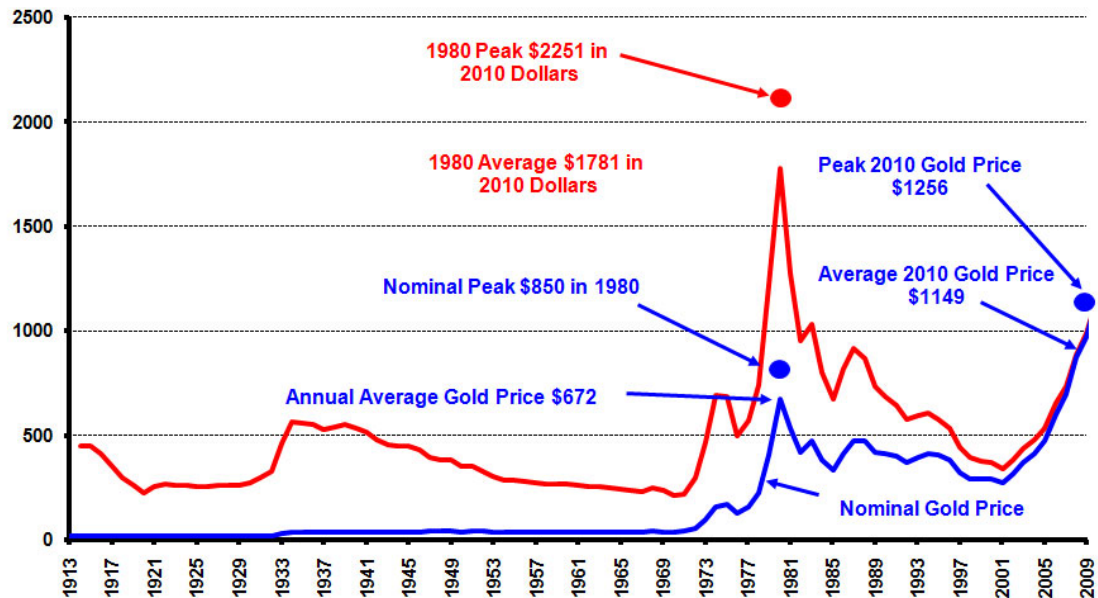
Recent price increases

At the start of the new millennium the price of gold was already beginning to trend upwards as economic growth faltered and sharemarkets entered a three year bear period following the bursting of the technology bubble. Over the last few years the gold price has been driven sharply upwards as capital flowed into safe-haven options leading up to, and during, the worst financial crisis since the Great Depression. The credit crisis, which began in mid 2007, developed into a full blown financial and economic crisis over the rest of the year and into 2008, sending the value of most financial assets spiralling downwards.

Gold, true to its reputation as a safe-haven investment, increased in value during this period; however, there were a number of additional factors, including strong supply and demand influences, that also directly drove the price of gold during the last decade (i.e. market uncertainty alone does not account for the steep increases in price in 2006 and early 2007). Throughout 2009 gold continued to appreciate steadily in value during a recovery in global sharemarkets. In mid 2010, confidence in global markets was once again shaken, this time by a sovereign debt crisis in Europe and uncertainty about the strength of the US economic recovery.

Gold reached a record of US\$1,261 per ounce on 28 June 2010². Currently the spot gold price is ranging between US\$1,180 - US\$1,220 per ounce. Therefore, in nominal terms at least, the price of gold is at an all time high. However, if we look at gold's real value in inflation-adjusted terms we can see that the real price of gold is still around 45% below levels it reached in 1980 of around US\$2,251 per ounce³.

Chart 2. Inflation-adjusted annual average gold prices 1914-2010 (in May 2010 US dollars)



Source: Inflationdata.com

3. What drives the price of gold?

Gold is a commodity and like all commodities the pricing market is subject to the powerful forces of supply and demand. There are also a number of other fundamental factors supporting the price of gold at current levels, including:

- increased accessibility to the gold market
- a weak US dollar
- inflationary concerns
- equity market uncertainty
- renewed geopolitical tensions

3.1 Supply

Like other commodities such as oil and industrial metals, supply is impacted by the ability of producers to deliver new material to the market. Unlike these other commodities, gold has very little utility and so most gold is not consumed or destroyed as it is used; therefore much of the gold produced is still in existence. It is estimated that around 159,000 tonnes of gold has been extracted in total, of which around 65% has been mined since 1950⁴. Since 2001 we have seen the production of raw gold decline on an annual basis with traditional gold producing countries like South Africa and Australia forced to go over their existing brownfield reserves to try and extract gold ore pockets missed during the initial mining process.

In addition, it is very difficult, time consuming and expensive to start new mines. Increasing labour, energy and raw material costs have increased the all inclusive cost of extracting and processing gold from around US\$228 per ounce in 2001 to US\$655 per

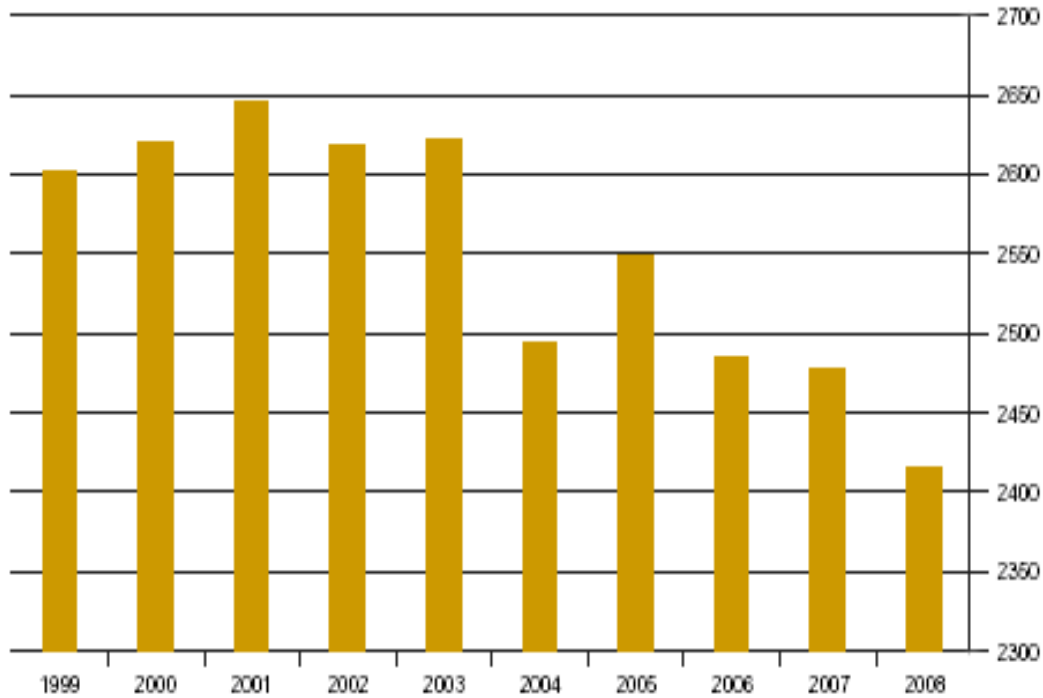
² Bloomberg

³ Inflation data.com

⁴ World Gold Council

ounce by 2008⁵. The rise in production costs has contributed to putting a higher floor underneath the gold price in recent years.

Chart 3. Mine production (tonnes)



Source: GFMS

It is estimated that it takes on average seven years from when initial exploration consent is sought before new mines finally come into full production. While some of the fall in annual production is being made up by recycling old gold, recycling activity is also being subdued by the lack of ready market supplies of old gold, after a surge in selling-back during 2009 cleared out much of the gold holdings that were available for these purposes.

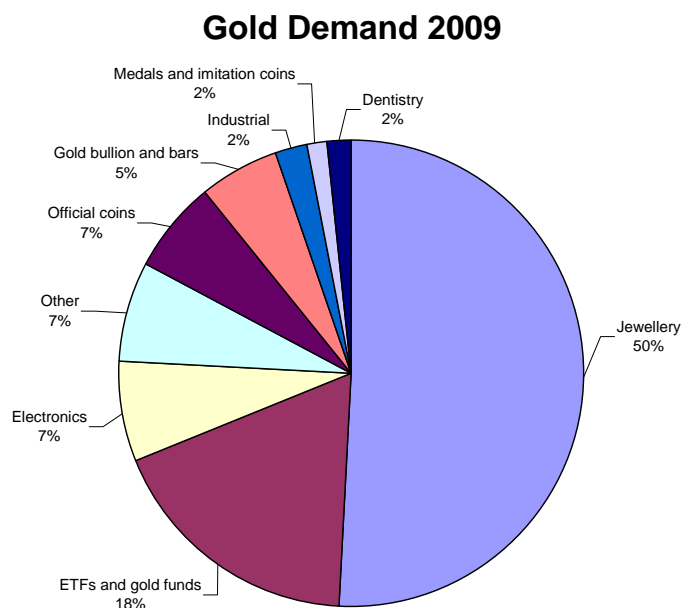
3.2 Demand

Gold demand typically comes from three main sources; the jewellery industry, investment and gold used for industrial purposes.

Jewellery demand

The majority of gold consumption can be attributed to the jewellery industry, which consumes between 50-70% of the annual production of the precious metal. Over the last five years 53% of jewellery demand has come from just four countries: India, China, Turkey and the US⁶.

While we have seen a general recession in developed countries in recent years, many large emerging markets have continued to boom, led in large part by India and China. These two countries have very strong cultural traditions about buying and gifting gold and that has served to underpin gold demand. India in particular remains the cornerstone of the global gold market



Source: World Gold Council

⁵ World Gold Council

⁶ World Gold Council

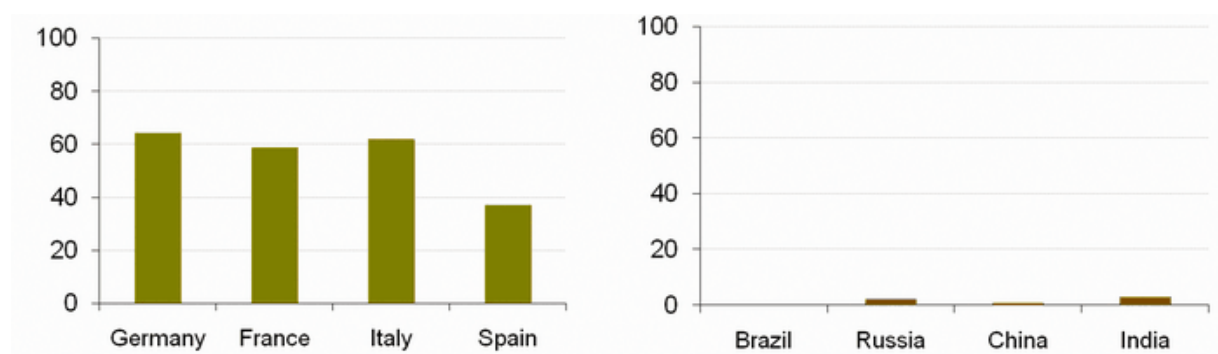
accounting for 25% of gold jewellery consumption, 19% of total net retail investment demand and 17% of industrial and decorative demand. The Indian economy is expected to grow by 8.4% in 2010, continuing a strong run of economic prosperity that has resulted in rising average income levels but high levels of inflation⁷. These conditions suggest ongoing support for gold demand in that region.

Investment demand

Investment demand accounted for around 20% of total gold demand over the last five years. Since 2000, total investment demand has increased from 4% of overall demand to 32% in 2009⁸. From 2003 to 2007, the increase in investment was driven mainly by an increase in demand from Exchange-Traded Funds (ETFs) and related products, as the launch of these new gold-backed products around the world released pent-up demand. Interestingly, many of these relatively new gold ETFs are yet to be launched in Asia, the largest gold market in the world. Throughout 2008 and 2009 we have clearly seen a flight to gold as investors seek the security of the precious metal during a period of quite severe economic turbulence.

In addition, some investors and sovereign nations appear to have lost faith with the US dollar and now the Euro as a reserve currency, and so have turned to gold as an alternative currency asset. Central banks, particularly India and China, are now net purchasers of gold as they look to build up their foreign currency reserves (for example, India purchased 200 tonnes of gold in from the IMF in 2009). To put this into perspective, the US holds around 68% of its foreign reserves in gold, Germany 65% and France 64%, while India holds just 7.5% and China only holds around 1.6%⁹.

Chart 4. European versus BRIC gold reserves



Source: World Gold Council, December 2008

Industrial demand

Although declining on a total basis in 2009, industrial gold demand accounted for around 12% of total average demand over the last five years. Most of this demand is used in electronic applications due to gold's high electrical conductivity and its resistance to corrosion. A key factor influencing gold demand for use in electronics is the prevailing economic environment, which in turn determines the strength of the market for electronic goods. In this respect, industrial (including dental demand) was up 31% YOY in the March 2010 quarter, mostly attributable to a recovery in the electronics industry as economies began to emerge from recession and consumers became more willing to spend money on discretionary items¹⁰. On the other hand, in the current high gold price environment, dental demand actually declined slightly in the first quarter of 2010 as people opted for lower cost alternatives.

⁷ CIA World Factbook

⁸ World Gold Council

⁹ International Monetary Fund International Financial Statistics, June 2010

¹⁰ World Gold Council

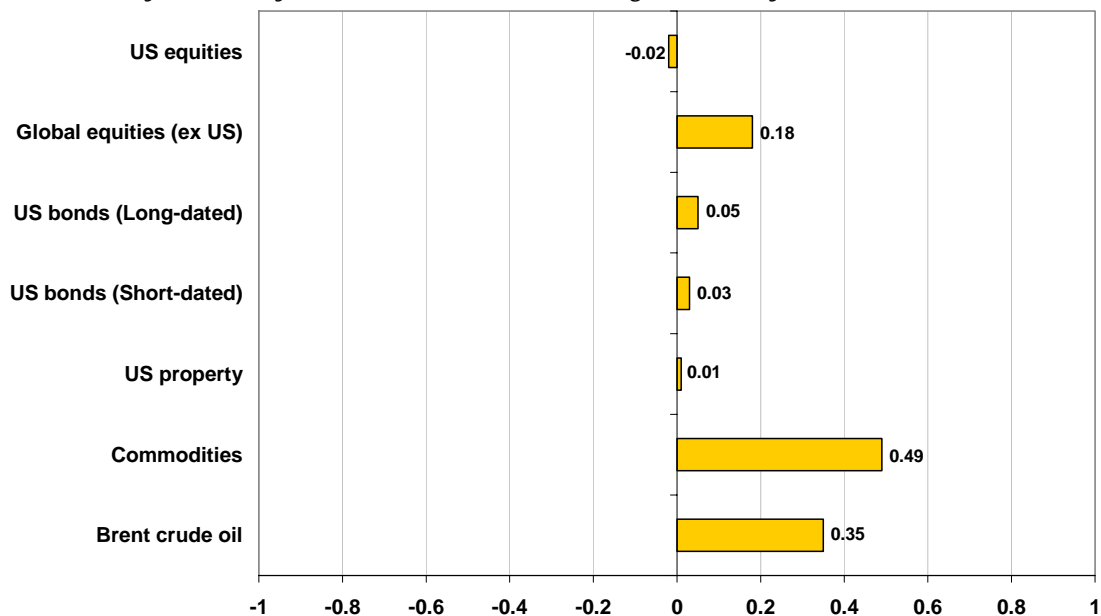
4. The investment characteristics of gold

4.1 Portfolio diversification

Gold is often used when constructing an investment portfolio to provide some additional diversification beyond the four main traditional asset classes. Diversification is an important consideration because different assets perform well under different financial, political and economic conditions. Gold has historically demonstrated a low correlation with other asset classes, especially shares, meaning that gold tends to benefit when conditions are uncertain and sharemarkets are volatile, but may suffer during times when economic conditions favour other asset classes i.e. during a bull sharemarket period.

As we can see from the chart below, over the last five years there has not been a strong correlation between the main asset classes and gold. It is also worth noting that, contrary to popular belief, there is no stable correlation between gold and oil prices; at times the price of the two commodities move in the same direction, but at other times they do not.

Chart 5. Five year weekly return correlation between gold and key assets in US\$



Source: Global Insight, Barclays Capital, World Gold Council. S&P 500, MSCI World Index ex-US, Barclays Capital US Treasury Aggregate Index, Barclays Capital US 1-3 month Treasury Bills, Dow Jones Wilshire REITs, Dow Jones UBS Commodity Index, Brent Crude Oil (US\$/bbl) March 2010.

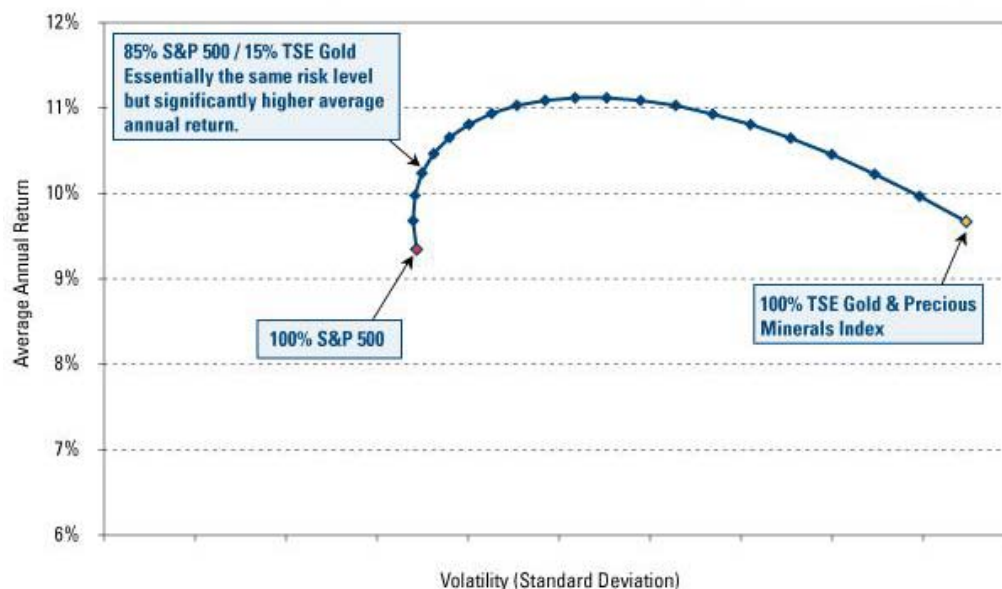
The 2008 paper 'Gold as a strategic asset for UK Investors' by the World Gold Council showed that an allocation to gold is statistically significant in reducing volatility for low and medium risk investors. That study indicated an optimal allocation of 6.7% to gold in a diversified portfolio that included UK cash, equities and bonds. The paper also noted that the unique qualities that gold adds to an investment portfolio cannot be duplicated through a broader commodity exposure.

In 2009, U.S. Global Investors updated some well-known research on gold investing conducted by Jeffrey Jaffe, a finance professor at the Wharton School that was originally published in the Financial Analysts Journal in 1989. The Jaffe study concluded that adding gold and gold stocks to a large portfolio can increase both risk and return, but that the additional return from these non-correlative assets more than compensates for the additional risk.

The U.S. Global Investor research used an index of gold companies to create an efficient frontier series in order to establish an optimal portfolio allocation between gold stocks and the S&P 500. As shown in the chart below, the study shows that a portfolio holding 85% S&P 500 and 15% gold equities has essentially the same volatility as the S&P 500 but

delivered a higher return. Between September 1971 and May 2009, the S&P 500 averaged a 9.34% annual return - a 15% allocation to gold equities, with annual rebalancing, would have yielded on average an additional 0.89% per year. A 10% allocation to gold equities, with annual rebalancing, would have yielded on average 0.63% more than an exclusive S&P 500 portfolio.

Chart 6. Efficient frontier series of S&P 500 TR Index and Toronto Gold and Precious Metals TR Index (1971 – May 2009)



Source: Bloomberg, U.S. Global Investors

4.2 Inflation hedge

Gold has long been viewed as an effective hedge against inflation. As a commodity asset gold has a tendency to rise in value along with inflation and maintain its purchasing power relative to other asset classes. Since 1971, when the price of gold became free floating, gold has delivered a real rate of return of 1.8% pa above the US Consumer Price Index. In addition, gold has tended to see its strongest price rises in years of high inflation (such as 1979) providing an average real rate of return of 14.9% in years which the US CPI has been above 5% pa¹¹.

There are two main reasons why gold acts in this way as a hedge against inflation. First, gold has historically used as a form of money, but unlike paper currencies its value cannot be easily debased. In the aftermath of the 2007/08 financial crisis there has been some concern that the large amount of fiscal stimulus that was pumped into distressed economies around the world may lead to higher inflation. Many governments adopted stimulatory monetary policies (cutting interest rates and increasing the amount of money in circulation) in order to keep their banks afloat. Any large increase in the monetary base typically creates 'demand-pull' inflation by boosting demand, and therefore the price, of goods and services.

Secondly, commodities are often the root cause of inflation, with increases in the price of energy, base metals and other raw materials used in the production process passed from producers to consumers, creating what economists term 'cost-push' inflation. This is particularly relevant to gold mining, which requires the use of many other types of commodities and where costs have been rising since 2002¹². A rise in commodity prices puts direct pressure on the cost of extracting gold, which in turn puts a higher floor underneath the gold price.

¹¹ State Street Global Advisors

¹² World Gold Council

4.3 US currency hedge

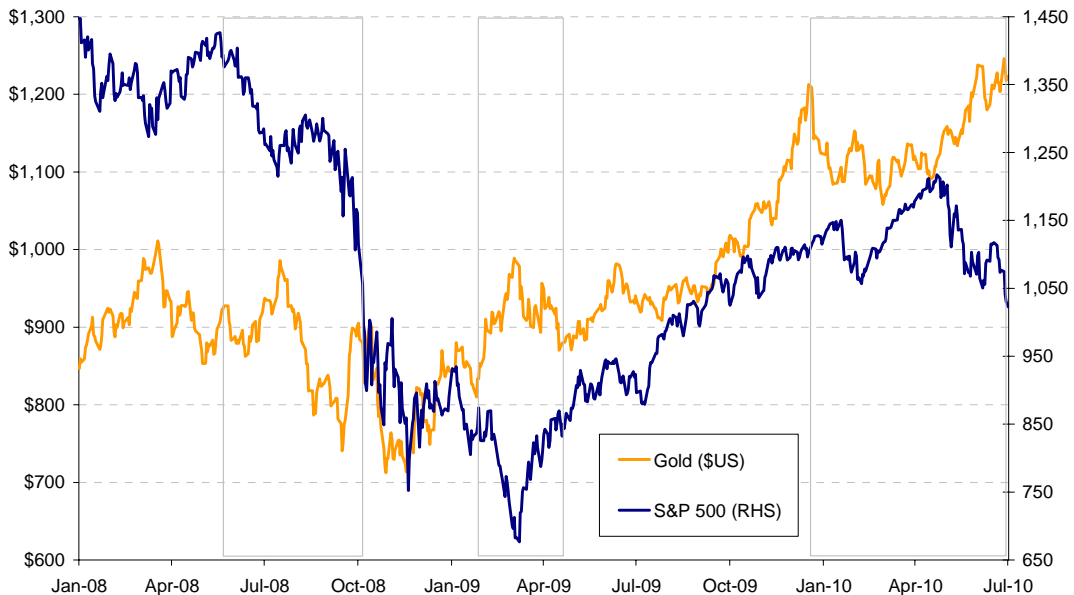
Gold has historically demonstrated an inverse relationship to the US dollar (over the past 10 years the correlation of gold to the US Dollar Index was -0.49)¹³. Gold is traded in US dollars, so any decline in the value of that currency, typically causes the price of gold to rise. In recent times the US dollar has fallen in value relative to many other major currencies due to a vulnerable US economy that is struggling to come out of a deep recession.

The US dollar's status as the world's reserve currency is also being questioned following its prolonged weakness. In late 2007 former US Federal Reserve Chairman, Alan Greenspan, suggested that the Euro could replace the US dollar as the world's primary reserve currency by 2020¹⁴. Euro reserves have been increasing steadily since 1999, although faith in the Euro has since been shaken by the sovereign debt crisis in Southern Europe¹⁵. Recently there have been calls, most notably from China, for the IMF's Special Drawing Rights (SDRs) to replace the US dollar as the main reserve currency - SDRs are an alternative IMF reserve asset based on a basket of currencies. Needless to say, any move away from the US dollar as the primary reserve currency would have a significant effect on demand and therefore its price.

4.4 Crisis hedge

When markets are gripped by fear and other assets crash in value, physical gold is often seen as the ultimate safe-haven investment because it is tangible and, unlike some other assets, does not ultimately represent a liability. During the last few years we have seen a flight to gold as investors seek the solidity and stability of this asset over other more volatile assets. While the price performance of gold relies on a number of important supply and demand factors, unlike holding shares, with physical gold there is no risk that a company will go bankrupt, and unlike bonds, there is no risk that a coupon or final payment will not be made.

Chart 7. Performance of gold versus S&P 500 (2008-July 2010)



Source: Global Insight, Yahoo Finance

¹³ State Street Global Advisors

¹⁴ Reuters

¹⁵ International Monetary Fund

4.5 Gold volatility

Gold has certainly been subject to some extreme volatility in the past, in particular during the late 1970s. Volatility in the gold price increased sharply in the run-up to the January 1980 peak. Between November 1979 and January 1980, the price of gold doubled; however, as noted above, it is important to remember the economic environment of very high inflation at the time.

During the last 20 years gold has consistently been less volatile than oil and most other precious metals (as measured by the 22-day average volatility between 1988 and 2008). It has also on average been less volatile than several major equity indices, including the S&P 500, FTSE 100 and the S&P GSCI Commodities Index. Gold price volatility has increased over the last few years, especially in late 2008 along with sharemarket volatility; however, it still remains less volatile relative to many other assets.

Table 1. 20 year volatility of gold versus other assets (1988 – 2008)

Asset	22-day average volatility
Gold	12.7%
S&P 500 Index	14.6%
FTSE 100 Index	14.7%
Nikkei Index	20.4%
DAX Index	19.4%
GS Commodity Index	17.9%
Silver	23.9%
Oil	35.6%

Source: World Gold Council

Summary

Investors have long used an exposure to gold to help control risk in a diversified portfolio as it has a low, sometimes negative, correlation and tends to be less volatile than other assets. Gold has a number of important investment characteristics that make it particularly attractive during periods of economic uncertainty, periods of high inflation and when there is concern about currency devaluation, as the price of gold tends to hold its purchasing power relative to other traditional asset classes.

There is some fundamental support for the gold price at current levels due to the strong supply and demand forces currently operating in markets. Global gold production has been falling every year since 2001 and some historic gold producers are now believed to be near exhausting their reserves. The slack has been taken up through recycled gold and the establishment of new mining projects, but new gold facilities are often both expensive to establish and take a long time to become operational. Meanwhile, demand is coming from three key sources; the jewellery industry, for industrial use and from investors. It is important to note that as these critical supply and demand forces currently serve to underpin the gold price, any major change in these factors could have a significant impact on the gold price, either negatively or positively.

Increasing worldwide demand for gold for investment purposes during the global financial crisis has certainly helped to push the gold price up; however, in inflation-adjusted terms, gold still has some way to go to reach the highs of 1980. Much of this current demand has come about due to the emergence of new investment vehicles, like exchange traded funds, through which investors can access gold. With gold now a more accessible investment option, investors have been able to build their exposure to the precious metal in order to help protect their portfolios during times of market and economic uncertainty.

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