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REVIEW

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Portfolio diversification myths: why pension funds need to rethink their strategies

by Nick Barisheff, President and CEO, Bullion Management Group Inc.

The performance of pension funds across North America has taken a distinct turn for the worse, and many are facing dire shortfalls. The Ontario Teachers' Pension Plan, for instance, saw its funding shortfall balloon to C$17.1bn in 2009, despite strong investment returns. The Mercer Index of 2010 showed that 33% of pension funds in Canada are struggling to meet liabilities (Figure 1).

The situation in the US is similar. The *Financial Times* reported earlier this year that, according to Orin Kramer, former chairman of New Jersey's pension fund, US public pensions face a shortfall of US$2,500bn that will force state and local governments to sell assets and make deep cuts to services.

This article attempts to explain why an industry with such highly educated and experienced investment managers has, across the board, got it so drastically wrong, and why the answer to reversing this industry-wide problem is to restructure asset allocation and include precious metals bullion.

I first wrote about this issue in 2008, and three years later little has changed. Pension fund managers continue to make the same mistakes over and over again while expecting different results - something Albert Einstein once defined as insanity. In fact, it isn't difficult to see where pension fund managers went wrong.

In 2000, an economic event occurred that only happens three or four times a century: a 20-year bull market ended. This unfortunate yet cyclical and normal event has been difficult to accept for those with an entrenched economic mindset, including fund managers and investors. It is human nature to deny that something that was so consistent and reliable for so long has ended, especially something so positive.

But the bull market in equities did end, and in spectacular fashion, with the banking crisis of 2008 ballooning into a full-blown financial crisis that nearly brought down the US economy. Then entered a secular bear market that, if history is any guide, will most likely last at least two decades. The next 20 years are going to look quite different from the previous 20 years.

While the bull market in equities raged, pension fund managers ignored precious metals; they had no reason to consider them. Stocks and bonds were performing well and pension fund liabilities were being met with ease. In truth, precious metals were not even in fund managers' thought processes. They were, and still are, largely ignored by the mainstream media and most educational courses in the investment world. In Canada, the Canadian Securities course (CSC), which is the foundation course for all investment professionals in

Figure 1: Mercer Pension Health Index

Source: YahooFinance, Stockcharts.com, © 2010 Bullion Management Group Inc.

the country, outlines on its website what budding investment professionals can expect to learn in order to "gain the knowledge you will need to make smart investment decisions, become a confident advisor: Financial instruments: fixed income, equities, managed products, structured products, fee based accounts and derivatives." No mention of precious metals, or any commodities for that matter. That excerpt was taken from the CSC website, not a decade or two ago as one might expect (before the gold price started to increase due to the monetary policies of the US Federal Reserve), but in March 2011. The comparable Series 7 course in the US also has no mention of precious metals or commodities in its syllabus.

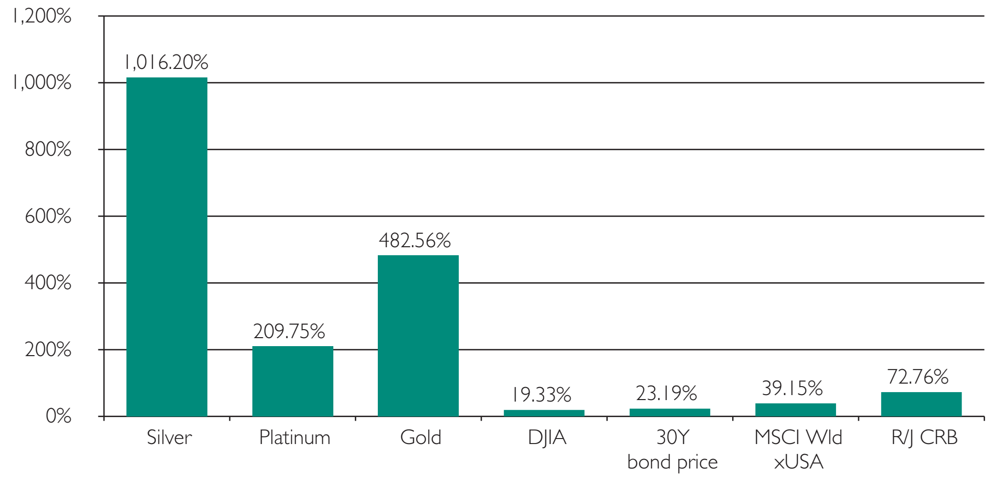
These factors – a long-term bull market in equities and an ignorance of the role precious metals in general and gold in particular play in a portfolio – explain why precious metals and gold in particular, despite being the best performer in the asset class that has outperformed all others over the last decade, have been largely ignored.

Fiduciary responsibility and rethinking asset allocation

Figure 2 should be of great concern to pension fund managers, as they have a fiduciary responsibility to meet liabilities for plan members by managing the funds in a responsible and competent manner. They achieve this, in part, through asset allocation. To completely ignore the best-performing asset class year after year may even expose consultants and trustees to legal liabilities.

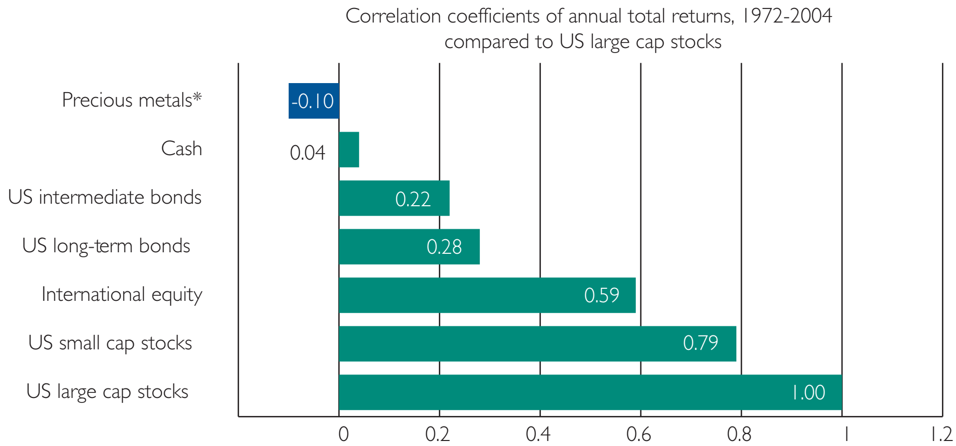
Pension fund managers, like all investment professionals, use asset allocation to achieve diversification in order to reduce risk, maximise performance and thus responsibly manage their funds. However, even if we put aside gold's performance

Figure 2: Gold vs. investment indices performance April, 2001 – April, 2011



Source: YahooFinance, Stockcharts.com, © 2010 Bullion Management Group Inc.

Figure 3: Most negatively correlated asset class



*Equally weighted composite index using gold, silver and platinum bullion for comparison

Source: Ibbotson Associates, Portfolio Diversification with Gold, Silver and Platinum, 2005 over the last decade for a moment, the traditional view of three asset classes, usually stocks, bonds and cash, as being enough to achieve diversification is simply incorrect. We can see from Figure 3 that precious metals offer negative correlation to stocks, bonds or cash. A portfolio that consists of positively correlated asset classes is not balanced or diversified.

However, the conventional mindset is slow to change. Most financial websites still refer to portfolio diversification being achieved through asset allocation to the traditional three classes. The Securities and Exchange Commission's (SEC) own website lectures on the importance of diversification, then goes on to examine the characteristics of what it calls the 'three major asset categories' - stocks, bonds and cash - with barely a mention of any other classes. Investopedia calls the three main asset classes 'stocks, bonds and cash', and describes a balanced investment strategy as generally divided between equities and fixed income securities. There are countless other examples of financial websites virtually ignoring the best-performing asset class – precious metals – for over a decade.

The Canadian Banks Forum is an exception; it correctly defines asset allocation as a process whereby an investor diversifies his or her portfolio with different classes of assets such as stocks, bonds, cash investments, foreign currency, real estate, collectibles, precious metals, natural resources and life settlements. It states that, because markets are constantly changing due to the unstable global economic climate, investors should examine and, if necessary, rebalance their asset allocation annually.

The concept of holding a certain percentage of a portfolio in cash for protection, the 'cash is king' philosophy, is equally flawed. Figure 4 shows the dismal performance of all the major currencies versus gold since the turn of the century.

In truth, cash in the form of all major currencies has been depreciating for many decades when measured against gold ounces – real money.

'Money' can be defined as a medium of exchange, a unit of account and a store of value. Gold meets all these criteria today, as it has for centuries. Quite simply, gold is money. The world's largest investment houses already recognise this fact. Gold is traded on the currency desks of all the major banks and brokerage houses, not the commodity desks.

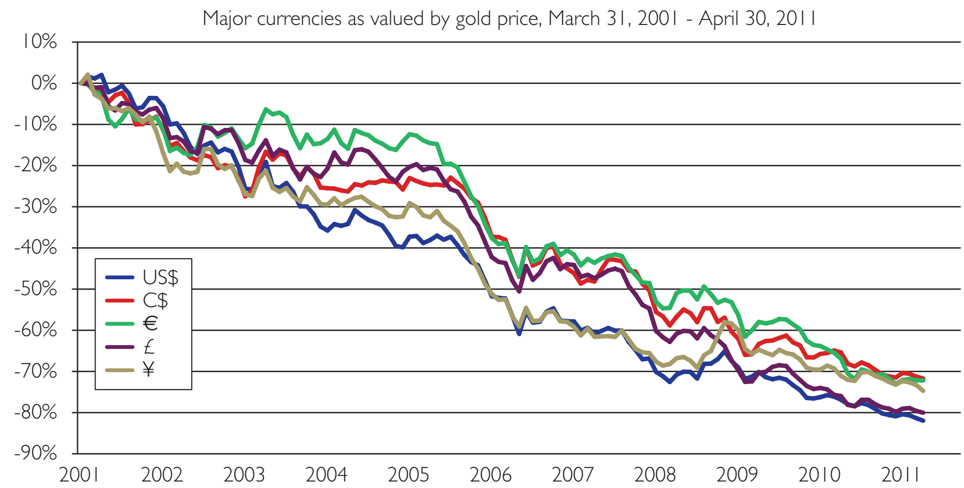
Gold has been overlooked by many investors and advisors because of a long-term bull market in equities, the difficulties involved with changing an entrenched mindset and ignorance regarding gold's role in a portfolio. Bearing this in mind, we can broaden our mindset away from the traditional idea of three asset classes and begin to look at gold with an open mind.

How to invest in bullion

Gold bullion should form the foundation of a portfolio. It is the bedrock that protects the rest of the portfolio and preserves an investor's wealth.

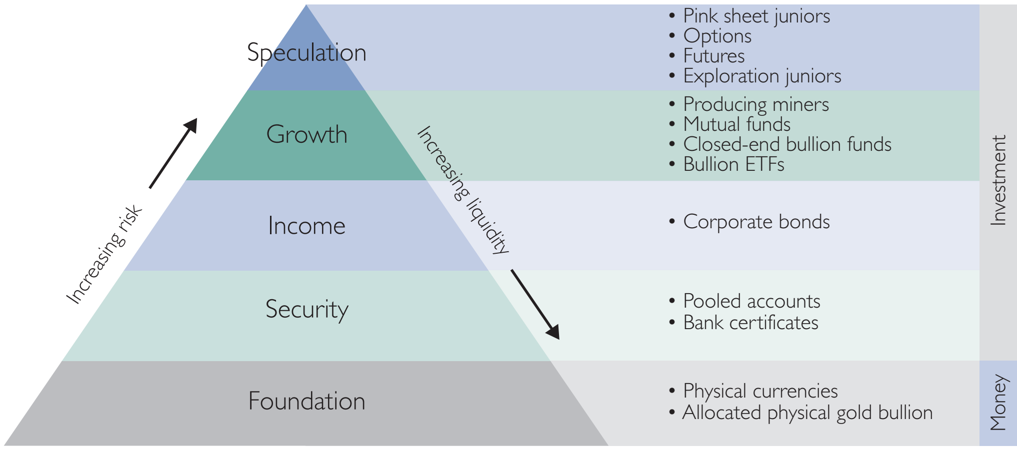
Figure 5 shows the different precious metals investment vehicles based on inherent risk; each carries a different risk/reward profile. During periods of economic uncertainty, wealth preservation is critical, and unnecessary risk should be avoided. That is why gold certificates and gold ETFs are not appropriate substitutes for direct, physical bullion ownership. These derivative vehicles have raised many unanswered questions, and have come under growing scrutiny from the precious metals community in recent months.

Figure 4: Currency decline



Source: fx.sauder.ubc.ca © 2010 Bullion Management Group Inc.

Figure 5: Precious metals investment pyramid



Source: Bullion Management Group Inc. ©2005

The best investment strategy for long-term investors seeking low risk with secular growth potential is unencumbered physical bullion. As we can see, bullion forms the foundation of the Precious Metals Investment Pyramid, because it offers the lowest risk.

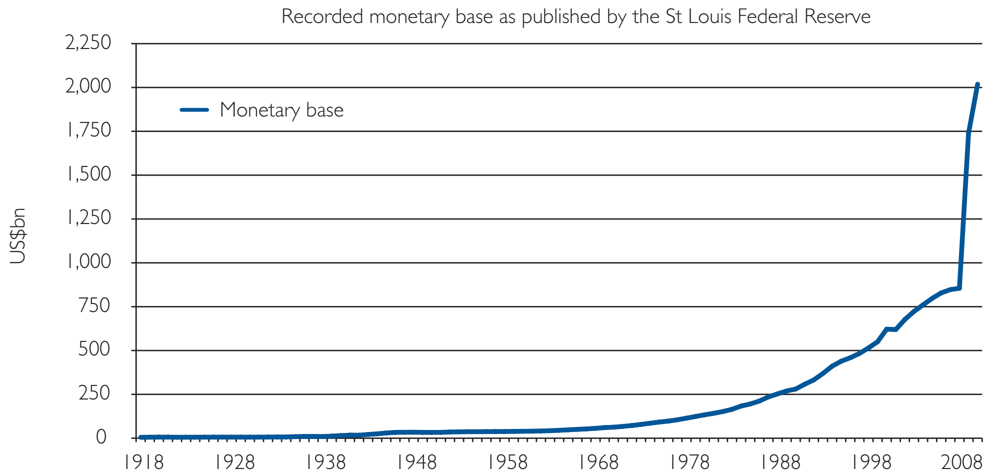
Central bank buying and currency debasement

In 2009, central banks became net buyers of gold for the first time in two decades. In 2010, China, Iran, Russia and India were all significant buyers as they moved their cash reserves to gold. Chinese officials have stated publicly that China would like to acquire at least 6,000 tonnes of gold. These countries have a different mindset than the Western world does, a gold mindset. They understand that gold is money.

One of the main reasons these countries are building their gold reserves is that they recognise the world's currencies are in an ongoing decline. Figure 4 illustrates that the US and Canadian dollars, the euro, the British pound and the Japanese yen have lost over 70% of their purchasing power against gold over the last 10 years. This kind of currency debasement isn't a recent phenomenon. For decades, since the elimination of the gold standard, governments around the world have been debasing their currencies to cover excessive spending and mounting debt.

Not too long ago, all the world's major currencies were backed by gold because it was a universally recognised store of value. The gold standard imposed fiscal and monetary discipline, since a country's ability to create currency was limited by the amount of gold

Figure 6: Monetary base



Source: www.stlouisfed.org © 2010 Bullion Management Group Inc.

it held. That is no longer the case; the ending of the gold standard by America's President Nixon in 1971 changed everything. Government spending around the world exploded and continues to do so.

Fiat currency supply, along with government debt in the world's major economies, is spiralling out of control (Figure 6). The US response to the financial crisis of 2008 was to accelerate this currency debasement. Through quantitative easing, the Fed decided to expand the currency supply even more. This may have temporarily delayed the inevitable, and artificially propped up the markets, but it will lead to higher inflation and even further devaluation of the US dollar.

The more dollars that are created, the less each one is worth. A shrinking dollar means rising inflation and falling wealth. This is crucial to understand, since most portfolios are measured in depreciating dollars, which means the real value of portfolios is declining every year as decades of inflation steadily erode the value of accumulated wealth.

Gold is the best hedge against inflation. In 1971, one could buy a car for 66 ounces of gold, buy a house for 703 ounces and 'buy' the Dow for 25 ounces. Today, the same amount of gold will purchase several cars and several houses, while one can buy the Dow with less than half as much gold. It is not gold that is rising in value; fiat currencies are falling in value.

Gold is low risk

We can see that gold provides the best protection against currency debasement and inflation, that it offers true portfolio diversification and that it has been the best-performing asset class for over a decade, but what about risk? A prevailing myth about gold is that it is risky and volatile. Again, if we approach this with an open mind and analyse the data, we find the opposite is true.

Standard deviation is the most commonly used measure of risk. It calculates the total risk or variance associated with the expected return. Simply put, it measures how volatile or widely spread an investment's returns are from its mean, over a period of time. When annual compounded returns are plotted against standard deviation, the individual Dow stocks are all more volatile than gold, and all but one of the Dow stocks have poorer performance than gold, silver, and platinum over the past 11 years (Figure 7). If we use other common methods of risk/return measurements, the Sharpe Ratio and the Sortino Ratio, we get the same results. Gold is less risky and performs better.

The Dow:Gold Ratio

Another indicator supporting an allocation to gold is the Dow:Gold Ratio, which measures trend changes in the price of gold versus a basket of stocks as represented by the Dow.

The Dow:Gold Ratio divides the Dow by the US-dollar gold price. Figure 8 shows that when the Ratio is rising, as it did in the 1920s, the 1960s and the 1990s, portfolios should be overweight equities. When the Ratio is falling, as it did in the 1970s and is doing today, it tells us that we should be overweight precious metals. Currently the Ratio is less than 9:1 and, equally important, it is falling, meaning there is still plenty of time for investors to rebalance into gold and precious metals. It is vital to rebalance your portfolio when a major trend change occurs, not only to reduce risk but also to maximise returns.

Rebalancing doesn't typically happen because the cycles (as depicted in Figure 8) are very long, almost generational, and continue for plus or minus 20 years. Once again, we are looking at how difficult it is to change a dated mindset.

Figure 7: Volatility and return – Dow components and precious metals

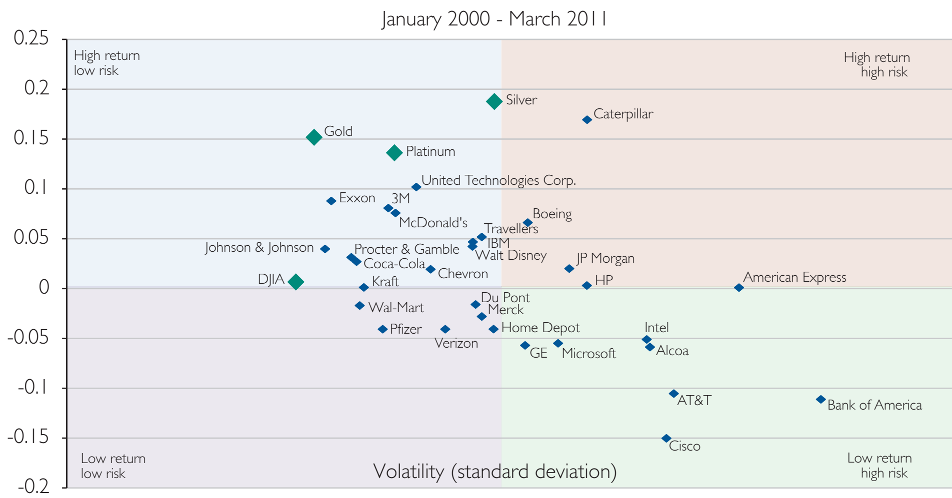


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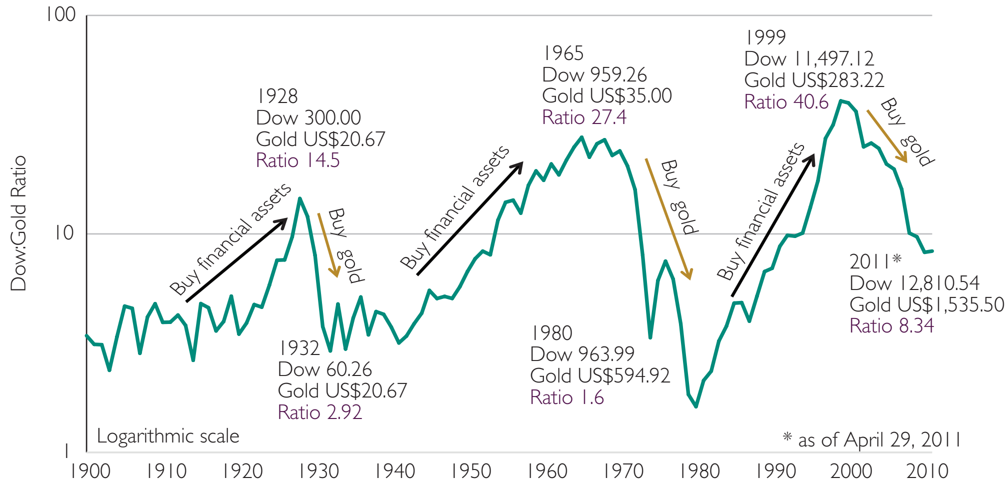
Figure 8: The Dow: Gold Ratio



Source: YahooFinance © 2010 Bullion Management Group Inc.

An appropriate allocation

So we have effectively seen that once an open mindset towards gold is adopted, common misconceptions can be broken down, and it becomes clear that gold should form the foundation of an investment portfolio. The question then becomes, how much gold should be allocated?

If we look at the current allocation to bullion by pension funds, we can see that, at present, virtually no funds are allocated to gold.

Global pension assets are estimated to be US$31.1 trillion according to 'The Pensions Market Report' from The City UK. That is more than twice the size of last year's GDP in the US (US$14.7 trillion). According to estimates by Shayne McGuire in his new book, 'Hard Money; Taking Gold to a Higher Investment Level', the typical pension fund currently holds about 0.15% of its assets in gold. Even if we include gold mining stocks, the total is still only 0.3%, of assets committed to the gold sector (Figure 9).

There are, however, green shoots of change with respect to adopting a gold mindset. The University of Texas Investment Management Company (UTIMCO) manages the endowment for the Texas Teachers Pension Fund. According to UTIMCO Chief Investment Officer Bruce Zimmerman, the Fund has placed 5% of its assets in gold bullion. This represents a purchase of US$1bn of gold bullion, or in excess of 650,000 ounces at today's prices.

This trend will accelerate as the global economic reality we live in becomes more widely understood.

According to a 2005 Ibbotson Associates study, a 7% allocation to gold is needed in a mainly conservative portfolio, and a 16% allocation is required for an aggressive portfolio. Those amounts are required simply to have a balanced, diversified portfolio during stable times, or what may also be known as strategic allocation.

From a tactical allocation standpoint, Wainwright Economics looks to gold as being a leading indicator of future inflation. In a high inflation environment, which the ongoing currency creation around the world all but guarantees, their conclusion is that you need 15% in a bond portfolio and the same percentage in an equity portfolio just to insure your investments against further inflationary damage.

Pension funds at present are far below these recommended levels. What is especially interesting to note is that if pension fund managers decide to allocate just 5% of their assets to gold, it would represent an amount of US$1.5 trillion at today's

Figure 9: Percentage of gold holding in a typical pension fund

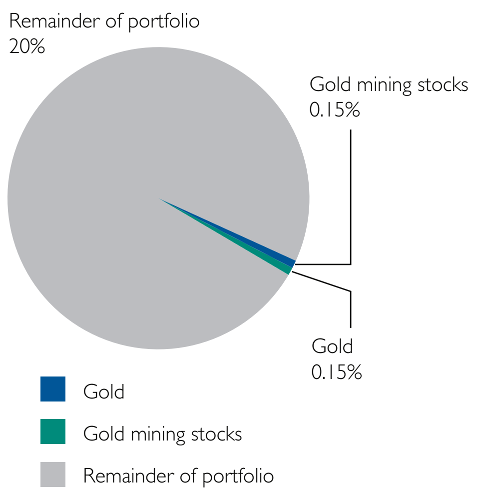


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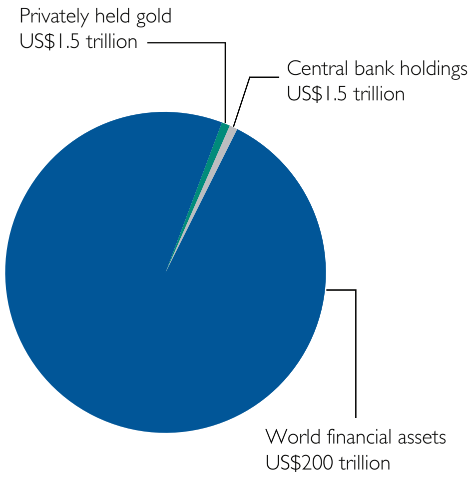
Figure 10: Gold vs. Financial assets



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price. That sort of movement into gold would certainly drive the price much higher. In fact, this is already beginning to happen.

When you consider that total global financial assets are estimated at over US$200 trillion, but total global above ground gold is a modest US$3 trillion, with about half of that owned by central banks and half privately held by the world's richest families and not for sale at any price (Figure 10), it is easy to see that when pension funds begin to move into gold, the price could quite conservatively trade at US$5,000 an ounce.

Even with all this compelling information and the gold price up 450% since 2000, some managers might be wondering whether they have missed the boat; surely there can't be much farther to go in this rising gold market? Well, apart from the Dow:Gold Ratio, which shows that as long as governments continue their currency creation, the Ratio will decline as gold prices rise, we can also look at key irreversible trends that compound the need for gold and reaffirm that there is indeed a lot more room on the upside.

Mid- and long-term trends

Recently I gave a speech at the Empire Club in Toronto, where I was asked to discuss the outlook for gold and precious metals in 2011 and beyond. I focused on the three dominant mid-term trends that will fuel the gold price this year: central bank buying; movement away from the US dollar; and the effect of China. The Chinese are one step ahead in terms of gold. They already see the value of gold and have adopted a gold mindset; they realise it is a wealth-preserving asset. In the first two months of 2011, the Chinese imported 200 tonnes of gold, or as much as in the entire previous year. And this is just individual investor demand, not central bank demand which, as we have already discussed, is also growing.

As well as these mid-term trends, which are likely to sustain the gold price this year, there are three longer irreversible trends that will support the price of gold for decades.

First, we have the issue of an ageing population. The baby boomers are just starting to enter retirement age; as people age, they spend less and downsize, thus GDP and tax revenues are reduced. This will lead to further debasement of currencies as governments print more money in an attempt to meet liabilities such as social security benefits and fund debt repayments.

Second, there is outsourcing, which has almost eradicated the manufacturing sectors of the US, Canada and much of Europe. The West simply cannot compete with the labour costs in China. As more and more factories move offshore, unemployment will continue to rise. Without jobs, GDP and tax revenues will continue to fall and governments will be forced to go even deeper into debt and further debase their currencies.

Finally, we have the issue of peak oil, a serious threat to the global economy. As we know, the world is heavily dependent on cheap fossil fuel; however, the peak discovery of oil has already occurred and we are approaching peak production of reasonably priced oil. Expensive oil, or switching to alternative fuels, will have a negative impact on global GDP. According to the International Monetary Fund, a US$10-per-barrel increase in the oil price reduces US GDP growth by 0.5 percentage points. Higher fuel costs will also lead to higher prices for most goods and services.

For a full transcript of my Empire Club speech ('Gold in 2011: Irreversible Upward Pressures and the China Effect'), with more details on the mid- and long-term trends affecting the gold price, please visit: www.bmgbullion.com/document/806.

Bullion Management Group offers two open-end mutual fund trusts that do not compromise the fundamental attributes of bullion (highly liquid, no counterparty risk, independent of management skills): BMG BullionFund invests equal dollar amounts into gold, silver and platinum, while BMG Gold BullionFund invests wholly in gold. BMG also offers BMG BullionBars, which enables investors to purchase and store certified, investment-grade, good delivery standard bars of gold, silver and platinum on an allocated and insured basis.

For US pension fund managers who want the benefits of bullion ownership without actually owning physical bullion for compliance reasons or otherwise, Alliance Trust Company (ATC) out of Nevada provides that service. ATC offers ERISA qualified retirement plans, non-profit companies, institutions and endowments the only secure method of purchasing and allocating a segment of their assets to insured unencumbered physical bullion through its open end Common Trust Funds. For more information on ATC, please visit their website: www.alliancetrustcompany.com.

It is only a matter of time until the issues discussed here become accepted as economic reality. As this occurs, the safe haven protection afforded by gold, silver and platinum will be in great demand. Savvy pension fund managers and investors alike can benefit by protecting their portfolios and ensuring their future liabilities can be met by allocating to precious metals bullion now, before the price rises and while there is still enough supply available to meet pension fund needs.

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