The Big Theme January 23 2020

The right routes to gold and property

By Dave Baxter

Equities have had an encouraging start to the year, but market valuations are a good reminder of why investors need to diversify. Just a few weeks into the year, positive developments including an easing of the US/China trade war have helped push stock markets in the US and elsewhere to fresh highs. So equities have a long way to fall if there is an upset – even if conditions look relatively benign for now.

However, traditional sources of diversification seem less reliable than they once did. Defensive bonds such as gilts (UK government bonds) and investment-grade corporate debt appear expensive after a period of high demand and strong returns. So other defensive assets are worth considering even if they only represent a small element of your portfolio. Real assets such as property and commodities, for example, can behave differently to traditional markets, make good returns and hold up well if inflation increases. The latter could be a real possibility if developed market governments carry out fiscal stimulus this year.

However, investing in such assets is more complicated than, for example, equities, because there are different ways in which you can get exposure to them. In particular, you need to consider whether you want exposure to the underlying asset itself or shares in companies involved with it.

Gold

Gold has traditionally been viewed as the ultimate safe haven asset and recently returned to form after underwhelming performance for much of 2018, picking up in the volatile final quarter of that year. For example, **iShares Physical Gold ETC** (SGLN), which tracks the gold price, made a sterling loss of 1.3 per cent in the first half of 2018, but gained 6.1 per cent in the second half of that year at the same time as MSCI World, an equity index, lost roughly the same amount.

A strong desire for diversifying assets saw the precious metal soar in price over the course of 2019. The World Gold Council, the market development organisation for the gold

industry, noted that gold-backed exchange traded commodity (ETC) holdings grew 14 per cent last year, reaching record highs. This has translated into good returns for such funds with, for example, iShares Physical Gold ETC making a sterling return of nearly 14 per cent in 2019.

However, the high price of this precious metal may fuel investor scepticism about future gains. In US dollar terms the gold price is at a level not seen since 2013, but concerns about a sell-off in markets – among other factors – could still be beneficial for gold this year.

Chris Forgan, a multi-asset manager at Fidelity, argued in late 2019 that the metal's appeal could endure in the year ahead. "We have seen heightened valuations in recent months and strong price appreciation but, based on our thesis, we think gold is still attractive," he said.

Mr Forgan says that three main factors should drive gold's performance: overall risk sentiment, the strength of the US dollar and the level of interest rates after inflation. Gold tends to suffer when the US dollar, the currency in which it is valued, rises. It also performs badly if yields on bonds and other assets rise, because gold pays no income so looks less attractive. But further loose monetary policy in the US could mean that yields remain low and that the US dollar weakens against other currencies, as some analysts have predicted.

Also, if the length of the equity bull market and high prices mean investors remain nervous and continue to back defensive assets, gold's strong performance could continue.

The metal could perform well if there is a surge in inflation. Research carried out by asset manager Unigestion found that between 1974 and 2017 gold delivered an average return of 10 per cent during periods of inflation. However, if inflation increases it could prompt central banks to raise interest rates, which would be detrimental to its performance further ahead.

There are two main ways to get exposure to gold: an exchange traded fund (ETF) or ETC that tracks the gold price, or a fund that buys shares in companies that mine gold and maybe other metals.

The first table shows how active funds with a focus on gold and iShares Physical Gold ETC have performed. We have also included FTSE Gold Mines index as a comparison for the active funds, and the MSCI World and Bloomberg Barclays Multiverse indices as a broad indication of how equities and bonds have performed. The funds and benchmarks are listed according to their five-year total returns, from high to low, to give a longer-term view of performance.

Fund/index	1-year total return (%)	3-year cumulative total return (%)	5-year cumulative total return (%)	10-year cumulative total return (%)
LF Ruffer Gold	44.44	36.21	169.64	-15.5
FTSE Gold Mines index	36.94	31.32	111.09	
Investec Global Gold	37.11	36.29	104.09	18.61
HC Charteris Gold & Precious Metals	51.96	11.33	84.61	
MSCI World index	22.74	33.06	78.95	201.24
BlackRock Gold & General	32.54	14.38	68.71	-5.5
Smith & Williamson Global Gold & Resources	32.09	1.02	60.49	-7.6
iShares Physical Gold ETC	13.96	21.64	47.62	
MFM Junior Gold	18.09	-15.29	37.08	-70.54
Bloomberg Barclays Multiverse index	3	6.14	33.22	58.81
ES Gold and Precious Metals	13.07	-14.73	15.33	-66.53

Source: FE, as at 31 December 2019

Although most of the active gold equities funds have not beaten FTSE Gold Mines index, many of them are ahead of iShares Physical Gold ETC over one and five years. **LF Ruffer Gold** (GB00B8510Q93) is among the top performers over most time periods and could belatedly benefit from last year's rise in the gold price. At the end of 2019, its managers said that the vast majority of gold mining stocks did not yet account for the increase in price. "The fund holds positions which should appreciate if the current gold price persists and offer an attractive risk/reward profile relative to gold," they explained.

The fund is geographically diversified, with 34.5 per cent of its assets in North America, 31 per cent in Africa, 13 per cent in Australia and 11.5 per cent in Asia at the end of last year. This spread could protect the fund from country-specific problems.

HC Charteris Gold and Precious Metals (GB00BYQ2JY43) performed very strongly while gold was rising and offers some diversification across different metals. It had 45.2 per cent of its assets in gold stocks at the end of September and more than half in silver, as well as a small allocation to palladium.

However, you should consider the risks before piling into funds that buy precious metal stocks. Gold miners tend to perform better than the gold price itself when the metal is in demand, but suffer greater falls in times of decline and are generally more volatile. Calendar year returns demonstrate these extremes. For example, in 2016, when a tumble in sterling amplified the value of gains denominated in overseas currencies, FTSE Gold Mines index was up 91.5 per cent compared with a 29.8 per cent return for iShares Physical Gold ETC. But in 2013, when the gold price tumbled from previous elevated levels, FTSE Gold Mines index fell around 53 per cent. iShares Gold Mines ETC fell by a lesser amount of 29.3 per cent. But in other years FTSE Gold Mines index has fallen while iShares Gold Mines ETC has made modest gains.

Tracking the gold price with a physically replicating ETC has provided less phenomenal but often steadier returns, and is a cheaper way to maintain exposure when gold isn't performing as well. A pure play on gold is also likely to provide more diversification from equity markets than a gold equities fund. Over three years iShares Physical Gold ETC has a correlation of just 0.03 to MSCI World index, according to FE – a perfect correlation is 1. All the other funds in our analysis have a higher correlation to the equity index, albeit still relatively low.

So for more predictable returns a physical gold ETC could be an option.

Property

Property is also valued for its diversification benefits when equities are falling. In recent years, funds in the Investment Association (IA) Property Other sector, which invest in the shares of property companies, have, on average, outperformed funds in the IA UK Direct Property sector, which buy actual buildings. However, the performance differential was less clear and less consistent in the years prior to the referendum on EU membership in 2016, which has shaken the UK direct property market.

Also be aware that the average open-ended fund with a focus on property shares displays some correlation with equities so may not be a good diversifier. In 2018 and 2011, the last two calendar years when the MSCI World equity index made a sterling loss, the IA Property Other fund sector average was also down. But the IA UK Direct Property sector average was a modest gain in each of these years.

However, open-ended property funds that offer daily dealing could struggle to sell their holdings quickly. For example, they experienced heavy outflows in 2019 at a time when factors including Brexit uncertainty made it difficult to sell commercial buildings, resulting in **M&G Property Portfolio**'s (GB00B89X8P64) suspension from trading in December.

If you want some diversification with less risk of your fund being suspended from trading, options include **BMO Property Growth & Income** (GB00BQWJ8794), an open-ended fund that invests in both physical property and the shares of property companies. It had around a quarter of its assets in physical UK commercial property at the end of September, 5 per cent in cash, and around 70 per cent in European and UK property shares. The fund has made better returns than funds that only invest in physical property and it has a yield of more than 4 per cent. But its diversification effects are unlikely to be as great as those of a fund that only invests in physical property.

Investment trusts that invest directly in property are an option – if you have a long time horizon. This is because issues in the UK property market have in many cases translated into share price weakness that could take some time to reverse. And other problems, such as challenges in the retail sector, persist.

Options include **Ediston Property Investment Company**(EPIC), which was trading at a discount to net asset value (NAV) of 15.9 per cent as of 20 January, compared with its 12-month average of 14.4 per cent. But it is not as cheap as it has been recently – the discount has come in from around 19 per cent in early December 2019. The trust has encountered difficulties because of its exposure to the retail sector, but investors may be overlooking the fact that it focuses on retail warehouses rather than the troubled high street. The trust has a yield of about 6.5 per cent.

Other trusts that seem to be out of favour could fare well in what remains an uncertain environment. Analysts at broker Winterflood recently highlighted **BMO Commercial Property Trust**(BCPT) as a core source of exposure to this sector. They like the trust's experienced investment management team, liquidity levels and ability to take advantage of opportunities in difficult times. BMO Commercial Property Trust was on a discount to NAV of 15.6 per cent as of 20 January, but Winterflood analysts said that, prior to around two years ago, the shares had traded on a premium for much of the past 10 years.

Fund/benchmark	1-year total return (%)	3-year cumulative total return (%)	5-year cumulative total return (%)	10-year cumulative total return (%)	Ongoing charge (%)
HC Charteris Gold & Precious Metals	51.96	11.33	84.61		1.61
iShares Physical Gold ETC	13.96	21.64	47.62		0.25
LF Ruffer Gold	44.44	36.21	169.64	-15.5	1.24
FTSE Gold Mines index	36.94	31.32	111.09		
BMO Commercial Property Trust share price	-2.46	-3.08	5.98	113.34	1.29
BMO Property Growth & Income	16.85	27.46	44.43	120.48	1.03
Ediston Property Investment Company share price	-12.24	-3.11	10.54		1.29
IA Property Other sector average	19.21	23.44	40.83	101.65	
IA UK Direct Property sector average	0.21	12.3	22.03	66.88	
AIC Property - UK Commercial Property sector average share price	7.87	14.09	30.83	92.92	

Source: FE, as at 31 December 2019