Gold in Institutional Portfolios: FAQs

Many of the diversified equity portfolios managed by First Eagle's Global Value team maintain a strategic allocation to gold and gold-related securities.

Driven by our belief that the permanent impairment of capital is the greatest risk facing investors over the long term, gold serves as a long-duration potential hedge that we believe can provide portfolios with a source of resilience across a wide variety of adverse circumstances—including both inflationary and deflationary environments as well as equity bear markets and sharp near-term selloffs—while also supporting real purchasing power across market cycles.

After decades of persistently low interest rates and periodic bouts of extraordinary stimulus, recent years have been marked by the emergence of a decidedly less accommodative policy regime. Amid tighter financial conditions, investors today also face a litany of acute risks, including massive sovereign debt levels, ongoing fiat currency debasement, complex political and geopolitical dynamics, and general systemic fragility—all of which we believe highlight the value of a potential hedge like gold.

Despite what we believe is a compelling use case for gold, the percentage of institutional investors with a strategic allocation to gold and gold-related securities remains relatively low; a recent survey of 400-plus institutional investors found that only about 15% owned gold.[1] Our conversations with institutional clients and consultants have revealed increased interest in the metal, however, and this paper responds to some of the questions we are asked most frequently when discussing gold and its application in institutional portfolios.

1. "The Use of Gold in Institutional Portfolios," Coalition Greenwich, World Gold Council (October 2022).

KEY TAKEAWAYS

- For investors with long time horizons, like many institutions, gold's differentiated risk-return characteristics have enabled it to maintain its real value across disparate macroeconomic environments and through existential disruptions to markets, a feat we consider truly rare.
- Institutional investors seeking the potential hedging features of gold may find different levels of exposure and different asset mixes suitable, depending on their risk-return objectives and macroeconomic and market expectations.
- First Eagle's Global Value team views bullion and gold-related equities as complementary methods to gaining gold exposure. We actively but patiently manage our relative allocations to gold bullion and gold stocks from the bottom up.
- Given the inherent uncertainty of the gold market and the many complex factors that drive its movement, we believe a strategic allocation to gold in certain of our portfolios is the most compelling way to gain exposure to its characteristics as a potential hedge against adverse market conditions.

Q:

How can institutional portfolios potentially benefit from gold?

We believe the differentiated risk-return characteristics of gold make it a potential all-weather hedge against a variety of market, macroeconomic and geopolitical disruptions, as well as a store of value across these same conditions. With a low correlation to most major asset classes since 1971— when it began to trade freely following the collapse of the Bretton Woods system—gold historically has served as a diversifying complement to portfolios under a range of circumstances and has been supportive of long-term investment, based on our research.

The most recent edition of the biannual survey of institutional investors performed by Coalition Greenwich and the World Gold Council found that only about 15% of the 400-plus investors surveyed owned gold, though those that did had an average allocation of 4% and the vast majority expected to increase or maintain what they viewed as a strategic allocation. Of the gold owners, more than 85% cited its diversification potential as the reason they hold it, with more than 70% saying that its value as a potential inflation hedge drove their positioning.

Q:

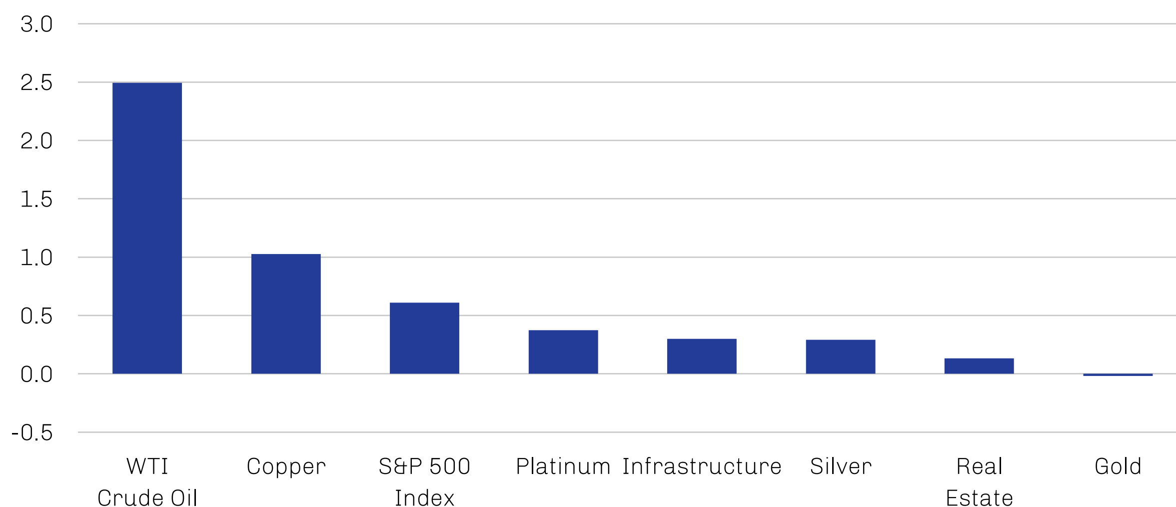
Should gold be viewed as a potential hedge against inflation or against tail risk? How does it compare with other potential hedges?

For long-term investors, gold has maintained its real value across disparate macroeconomic environments and through existential disruptions to markets, a truly rare feat in our view. Over the past two centuries alone, gold has withstood inflationary episodes and deflationary spirals, political revolutions and rapid technological evolution, localized conflicts and world wars, pandemics and treatments for them.

Unlike other commodities and real assets that investors may consider for their inflation-hedging potential—such as copper, oil, silver and platinum—gold has limited industrial application and thus virtually no beta to business activity, as shown in Exhibit 1. While these assets share gold's relative limited supply and history of retaining their real value during periods of inflation as the value of fiat declines, their sensitivity to economic activity impairs their reliability as hedges in periods of economic weakness and/or deflation.

Exhibit 1. Gold Has Limited Beta to Business Conditions

Beta to US Economic Activity (as Represented by Institute for Supply Management's PMI), December 2009 through May 2024



Note: Commodity prices are represented by the generic front-month futures contract on the respective underlying commodity. Infrastructure = S&P Global Infrastructure Index; Real Estate = FTSE Nareit All Equity REITs Index.

Source: Bloomberg; data as of May 31, 2024.

Gold's qualities also are differentiated from financial assets that investors often consider as potential hedges. Massive levels of sovereign debt in the developed world have significantly increased the risk government bonds now carry even as both nominal and real yields have returned to levels not seen since the global financial crisis of the mid-2000s, while structural issues also impair the use of government bonds as a long-duration potential hedge. Options and other derivatives contracts are another financial alternative but come with their own set of limitations, including implementation expense, relatively limited liquidity and counterparty risk.

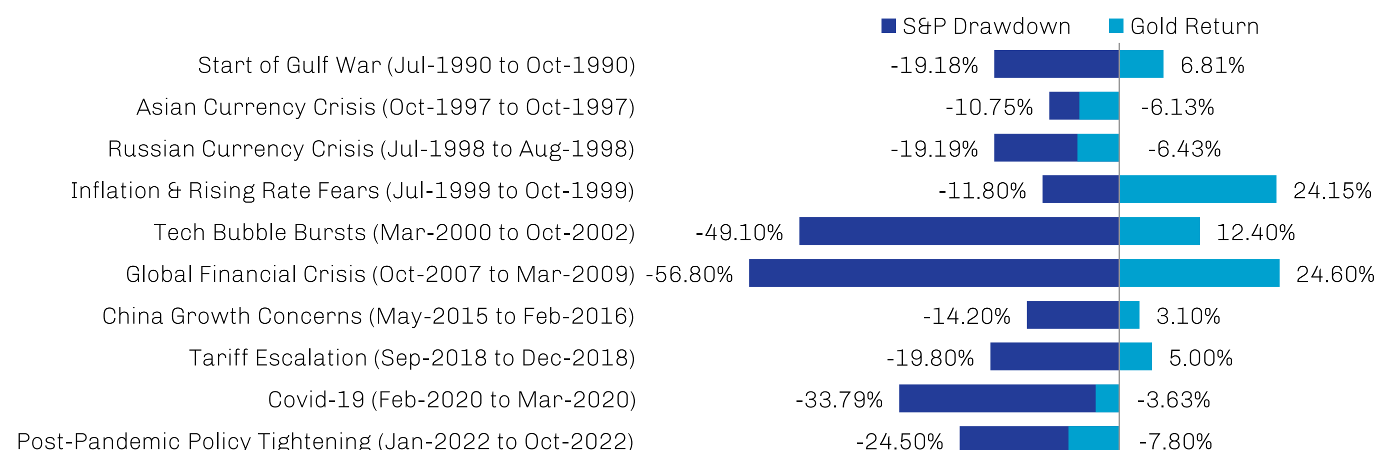
> Gold's countercyclical tendencies have been particularly evident during periods of extreme market distress.

Cryptocurrencies are another asset class that in recent years has entered the potential hedge discussion—so much so that many of its backers refer to bitcoin, the world's largest cryptocurrency by far in terms of market value and trading volume, as "digital gold."[2] For all of their broadening appeal, cryptocurrencies represent a very young asset whose behaviors across varying macroeconomic and market regimes are theoretical at best; in our view, they can be more accurately described as an option on becoming digital gold. In contrast, actual gold has served as a store of value for millennia, and its differentiated risk-return characteristics have enabled it to maintain its real purchasing power over time across disparate environments and through numerous existential threats, providing investors a perceived "safe haven" in times of need.

In terms of tail risk, gold's countercyclical tendencies have been particularly evident during periods of extreme equity market distress; gold's history as a perceived "safe haven" asset is illustrated in Exhibit 2.

Exhibit 2. Gold Exposure Has Mitigated the Impact of Recent Market Corrections

Price Changes During All 10%-Plus Drawdowns in the S&P 500 Index Since 1990



Note: Gold returns are represented by the Bloomberg gold spot price in US dollars per troy ounce. All returns calculated daily.

Source: Bloomberg, FactSet; data as of May 31, 2024.

Past performance does not guarantee future results.

2. Source: Bloomberg; data as of November 3, 2023.

Q:

How much gold is needed to achieve a potential hedge? What investment "bucket" should it be in?

There doesn't seem to be a "one size fits all" approach to gold allocation among institutions. Investors seeking the potential hedging features of the metal may adopt different levels of exposure and different asset mixes, depending on their risk-return objectives and macroeconomic and market expectations.

For reference, the Coalition Greenwich/World Gold Council study referenced earlier found that the average allocation among institutions to be around 4%. Generally speaking, portfolios with higher levels of risk require higher allocations to gold to harness its attributes as a potential hedge. For example, a well-diversified portfolio of 100% equities may require a greater gold allocation than a traditional 60/40 portfolio, while a concentrated equity portfolio or a portfolio of illiquid assets may need more than both.

Achieving a meaningful level of gold exposure likely would require a standalone allocation rather than secondary exposure through other broad investment vehicles. For example, gold comprises 3.7% of the S&P GSCI, a popular production-weighted index based on futures contracts for physical commodities.[3] This suggests that a multi-asset portfolio with 10% of its assets benchmarked to this index would achieve a gold allocation of less than 0.4%, a level too small to have a material impact.

Q:

How do you view the various types of gold exposure? How do you manage your relative allocation of bullion and miners?

There are several ways to gain strategic exposure to gold, all of which have different risk-return profiles and liquidity characteristics. As investors, the Global Value team views bullion and gold-related equities as complementary methods to gaining gold exposure. We actively manage our relative allocations to gold bullion and gold stocks from the bottom up in an extremely patient way. Generally, we seek to own gold companies we view as undervalued based on the current gold spot price and our assessment of their quality, and we will keep client capital invested in bullion until such opportunities emerge.

> Depending on price, gold in the dirt can be as useful as gold in the vault.

Gold bullion is viewed as one of the most conservative forms of gold ownership because it tends to carry the least risk; the asset is already out of the ground, so it is free and clear of mining risk, and it has minimal counterparty risk. On the other hand, a bar of gold offers no yield and costs money to store, which means that gold bullion may not always be the most cost-effective way to invest in gold ounces. Our preference is to own the physical asset directly in an allocated account (as local jurisdictions permit). While physical ownership entails storage expenses, bullion—unlike ETFs, futures or any other gold-proxy structures—does not have any counterparty risk, which we consider a key benefit during times of stress.

Gold in the dirt can be as useful as gold in the vault, and we believe buying shares of gold-related equities—including miners and royalty and streaming companies—can sometimes be a cheaper way to gain exposure to the metal than buying bullion. This approach comes with increased risk and volatility, however, as the performance of gold-related stocks has tended to be leveraged to the price of gold, meaning that changes in the price of the underlying metal can have an outsized impact on stock prices.

Miners face the operational risk of getting gold out of the ground and potential political risks related to the countries in which mines are located, among other challenges common to industry participants. Nonetheless, gold-mining stocks may offer investors differentiated opportunities; historically, the ability of certain higher-quality gold miners to increase their production per share and/or gold reserves per share over time—whether through operational execution, countercyclical capital allocation or exploration success—has added value for shareholders and highlighted the importance of stock selection when investing in this space.

3. Source: Standard & Poor's; data as of January 8, 2024.

As they provide financing to miners in exchange for an ongoing economic interest in the mineral production of a property, gold royalty and streaming companies face the same risks as miners, but to a lesser degree. These companies typically diversify their risk exposure by having agreements on multiple mines at various stages of production or development, and historically have demonstrated less price volatility than miners as a result.

Q:

Should gold exposure be managed tactically or strategically?

Given the inherent uncertainty of the gold market and the many complex factors that drive its movement, we believe a strategic allocation to gold is a compelling way to gain exposure to its characteristics as a potential hedge against adverse market and macroeconomic conditions.

The Global Value team takes the humble view that while disruptive episodes are inevitable, they also are impossible to predict. Because of this, many of our diversified portfolios maintain a strategic allocation to gold as a long-duration potential hedge against adverse outcomes. Of all the available potential hedging options, both real and financial, we believe gold's differentiated risk-return characteristics enable it to serve as a source of resilience in the widest variety of adverse circumstances—including both inflationary and deflationary environments as well as in equity bear markets—while also supporting real purchasing power across market cycles.

> While disruptive episodes are inevitable, they are also impossible to predict.

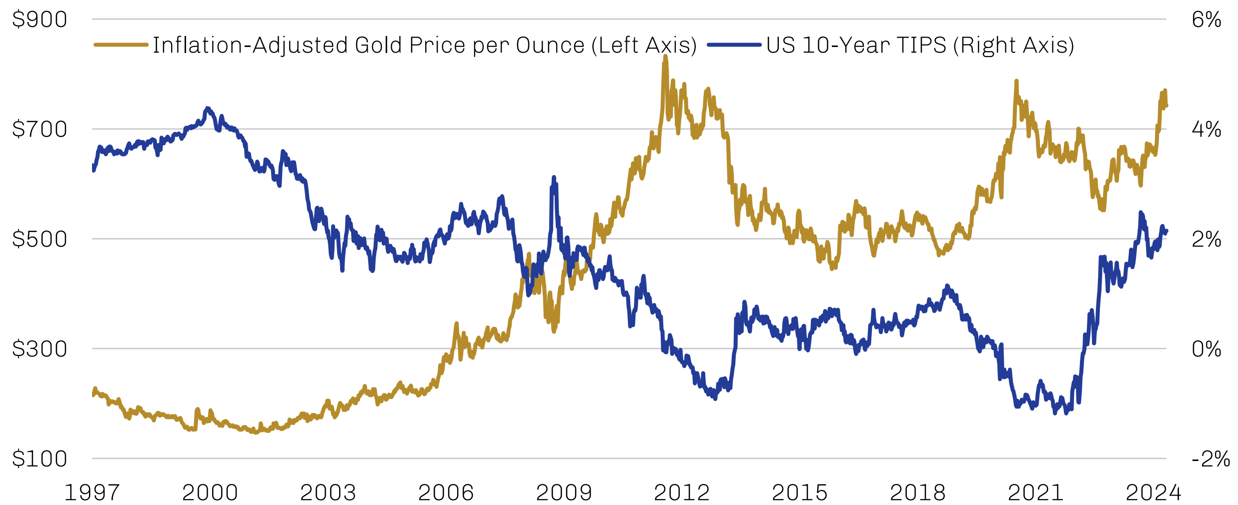
Q:

How has gold performed over time?

While First Eagle's strategic approach to gold allocation relieves us of the impossible task of forecasting gold prices, certain lessons can be gleaned from the historical movements in the price of gold.

Most notable of these is gold's inverse relationship with real interest rates (i.e., the difference between nominal interest rates and inflation). While there can be short-term aberrations in this relationship, we believe real interest rates are the most important driver of the gold price over the medium and long term. Throughout history, gold prices have tended to be at their highest—and real interest rates at their lowest—when the economy is weak and/or experiencing inflation, periods that have tended to coincide with low levels of confidence in the economy and government and thus a greater inclination among investors to hold a universal currency like gold rather than its man-made substitute. As shown in Exhibit 3, when real interest rates have moved lower, the gold price, despite some lead/lag effects, historically tended to move higher and vice versa.

Exhibit 3. Gold Historically Has Been Inversely Related to Real Interest Rates
January 1997 through March 2024; Consumer Price Index, 1982–84 = 100



Source: Bloomberg; data as of May 31, 2024.
Past performance does not guarantee future results.

Though the years do not align perfectly with inflection points, as depicted in Exhibit 4, it may be helpful to consider the pricing dynamics of gold by decade.

1970s: Untethered from the US dollar in 1971 upon the demise of the Bretton Woods agreement, gold rallied sharply for the rest of the decade to reach its inflation-adjusted peak in January 1980. Across a decade marked by inflation, oil shocks and geopolitical turmoil, gold posted a cumulative return of more than 2,000%.

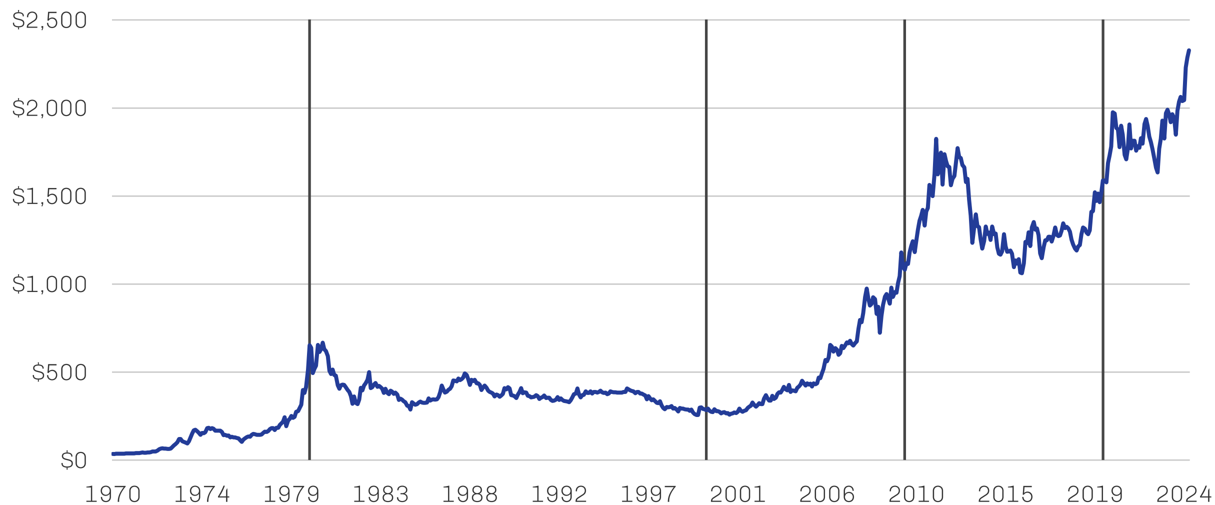
1980s/90s: The Fed's extraordinary efforts to combat inflation in the early 1980s pushed real interest rates sharply higher and brought an end to gold's post-Bretton Woods rally. The re-emergence of confidence in the monetary regime left investors with little interest in a perceived "safe haven" like gold for the rest of the century, while some central banks concluded that gold was no longer critical to their foreign reserves and sold it in large quantities. By 1999, the gold spot price had swooned to around $250, reinforcing the widespread skepticism about the utility of gold prevalent at the time.

2000s: Gold returned to prominence early in the twenty-first century, as economies and equity markets were battered by a variety of adverse events, including the bursting of the dot-com bubble in the early 2000s and the global financial crisis of 2007–09, the aftermath of which pushed real interest rates steadily lower and ultimately into negative territory.

2010s: While gold's strength persisted through the first few years of this decade as economies globally struggled to reflate their economies, a rebound in interest rates sent its price to a post-financial crisis bottom in 2015. It bounced around slightly above that level for several years before embarking on another leg higher in late 2018 as evidence of a cooling economy forced the Federal Reserve to pause—and ultimately reverse—its policy tightening.

2020s: Though not even halfway complete, the current decade has been a rollercoaster ride for the price of gold. Fueled by the suppressed interest rates that resulted from the massive fiscal and monetary policy response to the Covid-19 outbreak, gold established a new all-time nominal high above $2,000 per ounce in August 2020 before pulling back considerably with the rollout of vaccines and renewal of economic optimism. Gold spent much of 2021 in a trading range as investors sought to get a read on the direction of monetary policy. Russia's invasion of Ukraine in early 2022 sparked a sharp rally that had the gold price again testing the $2,000 level before the mid-March commencement of the Fed's rate-hike cycle brought it to a quick end; by autumn gold was trading in the mid-$1,600s. However, a resurgence in central bank buying, first reported in November 2022, sparked a renewed rally in the metal even as real interest rates continued to climb and has continued to provide massive support to the gold price. We discuss current gold-market dynamics in more detail in the next question.

Exhibit 4. Gold Price Regimes Have Varied over Recent Decades
Gold Spot Price per Ounce at Month-End, January 1970 through May 2024



Source: Bloomberg; data as of May 31, 2024.
Past performance does not guarantee future results.

Another way to consider the performance of gold over time is to view its price changes in the context of money supply growth. In that respect, we believe gold has unequivocally shined. Gold supply growth has tended to be steady at levels well below that of fiat currency and, thus, the nominal demand for gold. Gold production from 1900 to 2021 compounded at a rate of less than 2% per year, for example, while M2 money supply in the US has posted a compound annual growth rate of close to 7% over the past 50 years.[4] As a result, the purchasing power of gold has increased as that of fiat currencies has continued to erode.

Q:

What is fueling the recent surge in the gold price?

The real interest rate has increased by about 300 basis points since the Fed began hiking its policy rate in March 2022; despite this apparent headwind, the gold price increased about 20% over the same period.[5] While the gravitational pull of real interest rates is strong, gold's resilience throughout the current rate-hike cycle highlights that numerous factors are capable of impacting movements in the gold price, particularly over the short term.

The gold market sometimes serves as the metaphorical canary in the coalmine, sussing out potential dangers before they manifest in asset prices more broadly.

It's been our experience that the gold market sometimes serves as the metaphorical canary in the coalmine, sussing out potential dangers before they manifest in asset prices more broadly. We believe such dangers are plentiful in today's environment. The massive accumulation of debt by governments worldwide, for example, may support increased interest in an asset like gold with a track record as a potential hedge against currency debasement. Investors interested in potential "safe havens" in uncertain times, meanwhile, have ample reasons to consider gold amid a geopolitical backdrop—from Russia/Ukraine to the Middle East to China—that continues to deteriorate. And with federal elections scheduled in more than 70 countries during 2024, including in the US, local politics also may spawn unforeseen policy shifts.[6]

4. Source: World Gold Council, Bloomberg; data as of May 31, 2024.
5. Source: Federal Reserve Bank of St. Louis; data as of September 30, 2023.
6. Source: *The Economist*; data as of November 13, 2023.

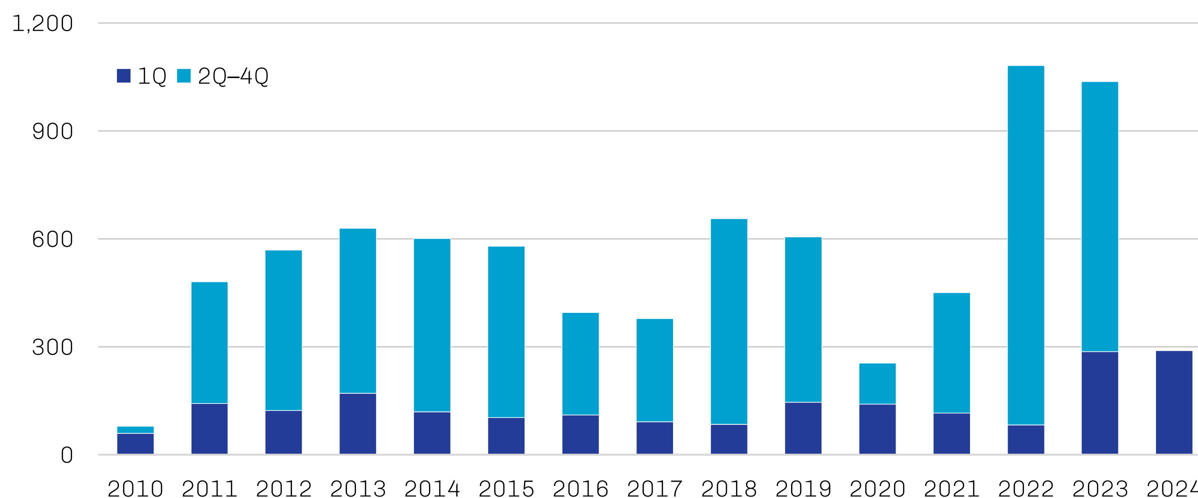
These issues may also be stoking the demand from global central banks that has been a key source of support for the gold price over the past 18 months or so.

At 1,037 tonnes, net purchases of gold by central banks in 2023 was second only to 2022's record level of 1,082 tonnes. As shown in Exhibit 5, buying has remained robust in 2024, with central banks adding an additional 290 tonnes to their coffers in the first three months of this year—a new first quarter record. Notably, emerging market central banks have been the primary buyers in recent years, led by China, Turkey and India.[7]

Demand from global central banks has been a key source of support for the gold price over the past 18 months or so.

Exhibit 5. Massive Central Bank Gold Buying Has Helped Buoy Prices

Central Bank Net Purchases in Tonnes, January 2010 through March 2024



Source: Metals Focus, Refinitiv GFMS, World Gold Council; data as of March 31, 2024.

In contrast with central banks, financial buyers have been more reticent to increase their exposure to gold. Globally, physically backed gold ETFs, which capture investment demand from both institutional and individual investors, have seen outflows for eight consecutive quarters. Flows have varied by region during this period, however, with Asia seeing consistent inflows, Europe consistent outflows and North America fluctuating between the two.[8] Moribund investor demand may help explain the large dispersion in performance between gold bullion and gold stocks during this year.

7. Source: World Gold Council; data as of April 30, 2024.
8. Source: World Gold Council; data as of April 20, 2024.

Q:

What are the ESG (environmental, social and governance) considerations of gold investment?

We view sustainability as a key element of a gold mining company's long-term viability and ultimately its value to investors. To operate a mine effectively, miners may require not only formal approval from the governing bodies responsible for the jurisdiction in which the mine is located but also an informal "social license" from a variety of local stakeholders, including community members, employees and unions. These stakeholders stand to most directly benefit from—or to be most adversely impacted by—a miner's practices during and after the mine's productive life. We've observed that in order to obtain and maintain these social licenses, ethical miners may seek to demonstrate respect for the rights and needs of the local population and employees, protect the local environment during mining operations, and develop site-specific plans to mitigate environmental impacts upon the end of the mine's productive life. High-quality governance is essential to nurturing these relationships.

A number of prominent miners have acknowledged the carbon intensity of their activities and have proactively sought—either singly or through organizations like the UN Global Compact, the World Gold Council or National Mining Association—to mitigate their footprint through new technologies and processes. In terms of issues related to climate change, the calculus around bullion ownership may be somewhat different than it is for miners, as the vast majority of gold in existence has already been mined and the emission intensity of storing it is low; as of end-2023, there was approximately 212,582 metric tons of gold above ground in one form or another, a volume that has compounded at an annual rate of less than 2% for more than a century.[9] This was among the reasons that led the World Gold Council to conclude that an allocation to gold (or gold-backed investment products) may reduce a multi-asset portfolio's carbon footprint, increase its alignment with climate-decarbonization pathways and reduce its vulnerability to climate-transition risks—all without adversely affecting the portfolio's risk-return profile.[10]

Ultimately, gold investors need to make judgments on the opportunities and risks that ESG factors represent and how they align with their unique portfolio goals and guidelines. As with the evaluation of any intangible asset, we believe this is best done through analysis and reflection.

9. Source: World Gold Council; data as of February 1, 2024.
10. "Gold and Climate Change: Decarbonizing Investment Portfolios," World Gold Council in collaboration with Urgentem (September 2021).

Environmental, social and governance (ESG) issues may be factors, among many, that are considered as part of our fundamental research process. However, we do not seek to invest in companies based on performance on ESG criteria.

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Risk Disclosures

All investments involve the risk of loss of principal.

Investment in gold and gold-related investments present certain risks, including political and economic risks affecting the price of gold and other precious metals like changes in US or foreign tax, currency or mining laws, increased environmental costs, international monetary and political policies, economic conditions within an individual country, trade imbalances and trade or currency restrictions between countries. The price of gold, in turn, is likely to affect the market prices of securities of companies mining or processing gold, and accordingly, the value of investments in such securities may also be affected. Gold-related investments as a group have not performed as well as the stock market in general during periods when the US dollar is strong, inflation is low and general economic conditions are stable. In addition, returns on gold-related investments have traditionally been more volatile than investments in broader equity or debt markets. Investment in gold and gold-related investments may be speculative and may be subject to greater price volatility than investments in other assets and types of companies.

Strategies whose investments are concentrated in a specific industry or sector may be subject to a higher degree of risk than funds whose investments are diversified and may not be suitable for all investors.

There are risks associated with investing in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates.

Bear market refers to a period during which a market experiences a prolonged decline in price.

Beta is a measure of an asset's price volatility (or risk) relative to that of a designated benchmark. The higher the beta, the more the price of the asset is expected to change in response to a given change in the benchmark.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

One cannot invest directly in an index. Indexes do not incur management fees or other operating expenses.

FTSE Nareit All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of US equity REITs. Constituents of the index include all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property.

S&P 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy. Although the S&P 500 Index focuses on the large cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

S&P Global Infrastructure Index is designed to track 75 companies from around the world chosen to represent the listed infrastructure industry while maintaining liquidity and tradability. To create diversified exposure, the index includes three distinct infrastructure clusters: energy, transportation and utilities.

S&P GSCI Index is one of the most widely recognized benchmarks that is broad-based and production-weighted to represent the global commodity market beta.

TIPS (Treasury inflation-protected securities) are a type of US Treasury security whose principal value is indexed to the rate of inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Bureau of Labor Statistics Consumer Price Index for All Urban Consumers (CPI-U).

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