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WGC Vodcast Gold As A Tactical Inflation Hedge And Long-Term Strategic Asset Transcript and Power Point Presentation posted on www.spdrgoldshares.com

WGC Vodcast transcription:

Slide 1: Welcome to the World Gold Council s Vodcast examining the role that gold can play both as a tactical hedge against inflation and as a long-term or strategic asset, even in a low to medium inflation environment. The findings are based on a new WGC research paper, entitled Gold as a Tactical Inflation Hedge and Long-term strategic asset, a full copy of the report can be downloaded from the research section of WGC s website, at www.gold.org.

Slide 3: Begin by explaining the rationale and motivation for this research note.

We will then examine gold s historical relationship with inflation. After which we will look at how gold compares to other traditional inflation hedges as a strategic or long-term asset.

In order to do this we will compare each asset on three basis; real returns, volatility and correlation with other mainstream financial assets. We will then combine all three investment traits, using a portfolio optimizer to see which of the traditional inflation hedges has best enhanced the risk-adjusted returns of a typical US investor in a low to medium inflation environment.

Slide 4: 2009 has seen a growing number of investors express concern over the prospect of a resurgence in inflation. Their fears emanate aggressive policy responses that have been put in place around the world to deal with the financial crisis, alongside tentative signs that the worst of the recession might be behind us.

The Fed for its part lowered interest rates from 5.25% in mid-2007 to effectively zero and instigating an unprecedented quantitative easing (QE) program, Since the beginning of the financial crisis in August 2007 through to the end of May 2009, the Fed expanded its balance sheet from US $869 billion to over US$2 trillion.

Slide 5: These actions have been echoed around the globe. The Bank of England, Bank of Japan, Swiss National Bank and even the notoriously cautious European Central Bank have all cut interest rates sharply and embraced QE in one way or another.

But with signs that the worst of the global recession might be behind us, investors are growing concerned about Central Banks exit strategies.

Might those banks leave interest rates too low for too long? They will be keen to avoid the criticisms levied at the Japanese authorities in the 1990s, who were widely blamed for not doing enough to stave off deflation and reversing some of their policy actions too quickly. But central banks are walking a fine line. Pumping too much money into the world economy for too long, risks making today s solution into tomorrow s problem: a sharp rise in inflation.

Slide 6: If inflation is on the horizon it raises important questions for portfolio managers, as traditional assets like fixed-income bonds and equities are not known for their outperformance during high-inflation years. Investors instead tend to flock to real assets or assets that are specifically designed to track inflation. The four most commonly purchased inflation hedges are arguably: gold, commodities in general, real estate and inflation-linked bonds.

A cursory glance at gold s performance in the years since 1972, before which time the price of gold was fixed, shows an intuitive relationship between changes in the gold price and changes in the US consumer price index, peaks in the gold price tend to lead peaks in the CPI.

Slide 7: Gold s historical relationship with inflation can also be illustrated by contrasting the performance of the gold price during high inflation years with its performance in moderate and low inflation periods. Between 1974 and 2008, there were 8 years when US inflation was high which for the purposes of our paper, we define as an inflation rate of 5% or over there were 21 years where US inflation was moderate defined as an inflation rate of between 2% and 4.9% and 6 years where inflation was low or below 2%. In the low and moderate inflation years gold posted only mildly positive real returns, but in the high inflation years gold rose by an average of 14.9% in real terms.

Nonetheless, some investors may be reluctant to add an inflation hedge to their portfolio at this stage. After all, annual inflation is currently in negative territory and there are equally compelling reasons for inflation to remain low, not least the high levels of indebtedness that still exist in the household sector.

This leads us to ask whether any of the traditional inflation hedges can demonstrably enhance investors risk-adjusted returns, even in a low to medium inflation environment.

Slide 8: We examine gold s performance versus the Goldman-Sachs commodities index, Bloomberg s Real Estate Investment Trust index and Treasury Inflation-Protected Securities, we compare each asset on the basis of real returns, volatility and in their correlation to other mainstream financial assets.

The lack of a uniform start date for each of the time series meant we had to conduct the analysis over three distinct periods: 1974-2009, 1993-2009 and 1997-2009, however in many ways this was desirable as it helped to reduce any period dependency bias within the results.

Slide 9: We chose the starting date of 1974 for gold and commodities in general. A longer time series was available for both assets, but prior to this date, movements in the gold price were constrained by the existence of a two-tier market in gold that followed the United States closure of the gold window. It was not until November of that year that the two-tier system was finally abandoned. The inclusion of data prior to 1974 would, therefore, have distorted gold s return assumptions. Bloomberg REITS data became available in 1993 and the first TIPS were issued in 1997.

In the first period, between January 1974 and May 2009, the annualized real return in the gold price was 2.0% while the annualized real return in the S&P GSCI was 2.8%. Over the second period, gold posted an annualized real return of 3.6%, while the S&P GSCI rose by 2.1%. REITs were the worst performer, declining by an annualized 2.1% in real terms. In the final period, between March 1997 and May 2009, gold was the best performer, rising by an annualized 5.9% in real terms compared with a 0.2% increase in the S&P GSCI, a 3.8% decline in BB REITs and a 3.7% increase in TIPS.

Not surprisingly, TIPS showed the lowest volatility since inception 6.2% between March 1997 and May 2009. However, gold consistently delivered a lower average volatility throughout the three periods relative to the S&P GSCI and BB REITs. In the periods from 1993 and 1997 to date, gold s volatility was significantly lower; about 30% less than the others.

Slide 10: Of the four potential inflation hedges, gold proved to be the most effective portfolio diversifier against the assets held by a typical US investor, although the S&P GSCI came a very close second. In the first period, neither gold nor the S&P GSCI showed a statistically significant correlation with any of the major asset classes that were available from 1974 onwards, mainly US Treasury bonds, global corporate bonds, the MSCI US Index and the MSCI World index, excluding the US.

Slide 11: For the second and third periods we included the additional assets that had become common in US investors portfolios by that time; namely, emerging market bonds, high yield bonds, and emerging market equities.

The most noteworthy outcome from the second period was the poor performance of BB REITs as a diversifier. The index exhibited a correlation of over 0.4% with each of the equity indices (MSCI EM, MSCI World ex US Index and MSCI US), as well as strong relationship with high yield bonds. Gold had the lowest correlation, an average of 0.14% with the other assets, while the S&P GSCI had an average correlation of 0.2.

Slide 12: In the final period, when we introduced TIPS, they not surprisingly exhibited the strongest of any correlations, almost 0.7% with Treasuries and corporate bonds. But it was BB REITs that once again proved the worst diversifier, exhibiting an average correlation of 0.4% with the other assets, compared with 0.3% for TIPS. Gold and the S&P GSCI both showed an average correlation of 0.17 with the other assets. In summary, gold proved a far superior diversifier to either TIPS or BB REITs, but only a marginally better diversifier than the S&P GSCI.

Slide 13: We then analyzed each inflation hedge in the context of portfolio optimization. We used the historical performance of US Treasury bonds, global corporate bonds, the MSCI US Index and the MSCI World index ex US Index, as a benchmark for an investor s portfolio. Then, using the Resampled Efficiency Optimization developed by Michaud and Michaud, we examined the expected efficient frontier produced by those four basic assets. Subsequently, gold was added to the mix and the frontier was recomputed. Then gold was removed and replaced by the S&P GSCI to produce a third efficient frontier. The study went on, when data permitted, to look at the impact of including REITs and TIPS.

In two of the three historical scenarios, gold proved more effective than commodities, real estate and TIPS at achieving both the maximum reward-risk portfolio and the minimum-variance portfolio. The required allocation to gold in the portfolio mix to attain the minimum variance ranged from 4.0 to 6.3%, while the allocation required to achieve the maximum reward-risk ranged from 7.0% to 9.9%. But because historical returns may not be enough to assess the effectiveness of the proposed inflation hedges, we conducted a portfolio optimization based on projected returns combined with historical estimates for the covariance structure.

In this optimization we used conservative real return projections for the four inflation-hedge assets to construct a baseline scenario for low- to medium inflation.

Namely, we assumed 2.0% real returns for gold, commodities and REITs and 4% for TIPS.
Slide 14: As seen on this chart, in the projected scenario, gold once again proved the asset more likely to help investors achieve the maximum reward-risk portfolio, based on a 6.9% allocation to gold. TIPS came a close second and the S&P GSCI somewhat behind.
Slide 15: Including TIPS produced the minimum variance portfolio by switching out of Treasuries, but the risk-return structure was not as appealing, this is because TIPS are highly and positively correlated with Treasuries and corporate bonds and therefore do not offer the same diversification benefits as either gold or commodities. In other words, an investor needs to sacrifice more return to achieve that lower variance with TIPS than they would with gold.
Slide 16: Lastly, we ran a portfolio optimization for the case of an investor who already has an allocation to TIPS. We found that adding gold to such a portfolio is still beneficial, as the investor would take advantage of the diversification properties of gold to obtain lower potential variance and higher reward per unit of risk. The optimal allocation to gold in this case varies from 7.6% to 3.5% in the minimum variance and maximum reward/risk portfolio, respectively.
Slide 17: To summarize, in two of the three historical scenarios, gold proved more effective than commodities, real estate and TIPS, in achieving both the maximum reward-risk and the minimum-variance portfolio. The required allocation to gold in the portfolio mix to attain minimum variance ranged from 4.0 to 6.3%, while the allocation required to achieve the maximum reward-risk ranged from 7-9.9%
A 6.9% allocation to gold produced the highest risk-reward portfolio in the forecast scenario, while an allocation to TIPS produced the lowest minimum variance portfolio. We also found a strategic case for gold in the portfolio of an investor that already hold TIPS due to the addition or diversification benefits gold brings to a portfolio.
Thus, including gold in a portfolio can help to enhance risk adjusted returns, even in a low to medium inflation environment. Due principally to the benefits of diversification, yet at the same time it can give an investor the peace of mind that they have an asset in their portfolio that history suggests should perform well if inflation does accelerate.
For more information on SPDR gold shares, please visit www.spdrgoldshares.com.

SPDR® GOLD TRUST has filed a registration statement (including a prospectus) with the SEC for the offering to which this communication relates. Before you invest, you should read the prospectus in that registration statement and other documents the issuer has filed with the SEC for more complete information about the Trust and this offering. You may get these documents for free by visiting EDGAR on the SEC Web site at www.sec.gov. Alternatively, the Trust or any Authorized Participant will arrange to send you the prospectus if you request it by calling toll free at 1-866-320-4053 or contacting State Street Global Markets, LLC, One Lincoln Street, Attn: SPDR® Gold, 30th Floor, Boston, MA 02111.