



The Refined Investor

What's with the TIPS?

Advisor Reluctance with Precious Metals Examined

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Four years ago the President of FidelityTrade was interviewed by our local newspaper about the benefits of investing in gold. The reporter then rightfully sought an alternate view from a local chief investment officer who proceeded to downplay gold as a viable investment stating one should just invest in Treasury Inflation Protected Securities otherwise known as "TIPS".

Last month, another investment strategist for a local trust advisor was fielding questions from his various trust clients. One of these clients asked his opinion about investing in gold. Once again, the answer was devoid of any benefit of owning gold with the exception of the protection against inflation. He then stated inflation linked bonds like TIPS are a better alternative.

With twenty years of investment experience including working as a performance analyst and a bond fund analyst, I don't understand the reluctance from my peers to promoting gold in a diversified portfolio. As holders of the CFA designation, we are all educated in the benefits of diversification guided by the Markowitz model known as Modern Portfolio Theory (MPT)¹. Maximizing portfolio return through diversification of good performing, low correlated, moderate risk assets has been the agreed upon approach to long term investment success. The CFA Institute and other investment researchers have written about the benefits of gold within a diversified portfolio but still the practitioners have been reluctant to offer it.

I want to use this edition of the *Refined Investor* to talk a little bit about what I believe is the rationale behind this reluctance bearing in mind that I still want to have lunch with these people from time to time.

Distribution Channels

In investment management, it's all about distribution channels. After all, it is a business of packaging products and advice and generating fees. Fees are generally based on a percentage of assets under management. Gold, being a tangible asset, was always structurally difficult to include in the context of developing investment products. Products and programs based on intangible assets can be developed with relatively few people; investments purchased, paid for and sold again with a press of a button. Tangible assets such as gold require storage, insurance, transportation, staff, monitoring and a whole array of things that these firms have no interest in doing. In order for firms to allocate toward the tangible, they would have to "farm out" the allocation thus reducing their client's assets under their control. Although the introduction of the gold ETF has helped this dilemma, its inclusion is still not widespread.

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The Model Portfolio

Investment firms advising individual and institutional clients typically begin the process with the asset allocation decision. An investment committee defines a variety of model portfolios with varying risk levels. Each portfolio possesses approved asset classes that exhibit a specific risk/reward benefit. These assets tend to have low correlation with each other, thereby reducing overall portfolio risk. The typical core holdings in a model portfolio will include large cap domestic stocks, small cap domestic stocks, large cap international stocks, fixed income, and possibly cash. Some firms may also offer other performance enhancing assets such as hedge funds, REITs, and emerging markets in their model portfolios. MPT allows for inclusion of riskier assets as long there is an appropriate reward. Firms tend to add new asset classes on the riskier end of the spectrum as opposed to the conservative end. Perhaps with its high liquidity, global acceptance and default free nature, advisors have always viewed gold as a conservative investment. With cash and short term bond investments already in the allocation, inflation was the only risk not protected by these offerings. Of course, if you were worried about inflation, they could always offer you some TIPS. Clearly, with this mindset, it would be difficult to find a place for gold in the allocation.

For gold to be included, it must be first accepted as a true asset class with its own unique characteristics. My view is gold has been mischaracterized as an asset class among my peers. It has the liquidity, global acceptance, and default free characteristics of a T-Bill, but it also possesses the risk return performance of U.S. small cap stocks and the low correlation similar to international stocks.ⁱⁱ Clearly, with my MPT glasses on, this makes for a viable asset class with its own distinct characteristics worthy of inclusion. The benefits of minor allocations of gold within a diversified portfolio are examined below.

Asset Allocation - Moderate Risk Portfolios (Percent)

Portfolio	Lg Cap	Sm Cap	Intl	Fixed Inc	Gold
A (No Gold)	35	15	15	35	0
B	30	15	15	35	5
C	25	15	15	35	10
D	20	15	15	35	15

Performance Summary as of April 30, 2009

	Actual Return			Annualized Return				
	1 Month	3 Months	6 Months	1 Year	3 Year	5 Year	10 Year	Std Dev (5 Yr)
Gold	-3.65	-4.01	24.09	3.02	10.84	18.12	11.97	5.37
S&P 500	9.39	5.68	-9.90	-37.01	-12.67	-4.65	-4.16	4.43
Portfolio A	6.66	4.58	-2.89	-22.70	-6.18	-0.56	-0.26	3.06
Portfolio B	6.01	4.13	-1.18	-20.61	-4.94	0.60	0.59	2.89
Portfolio C	5.36	3.67	0.53	-18.48	-3.71	1.76	1.43	2.77
Portfolio D	4.71	3.20	2.24	-16.34	-2.49	2.92	2.26	2.68

This performance highlights the added efficiency the portfolio's experience if you held a minor allocation of gold for sustained period of time. Clearly, portfolios B through D exhibit higher returns while assuming less risk.

Also, I should note, the cumulative interest on the 3-7/8% 10-Year TIPS for the period ending January 15th, 2009 is \$447.43ⁱⁱⁱ. That is a 3.77% annualized return. Gold ended the same 10-year period with a 12.48% annualized return. So, really, enough with the TIPS.

References

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ⁱ Morkowitz, H. 1952. "Portfolio Selection." *Journal of Finance*. Vol. 7, no.1

ⁱⁱ Risk vs. Return and Correlation results are in relation to the S&P 500.

ⁱⁱⁱ US Department of Treasury, Bureau of the Public Department