Why Gold?

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Gold, with its enduring value and lustre, has managed to capture and retain the fancy of both prince and pauper alike, for centuries. It is a precious metal that indicates wealth, power, and prosperity. When it comes to India and Indians, the relationship becomes more personal. Indians have always had a close relationship with gold. The amount of gold an individual or a family holds, is considered to signify his/her wealth and standing in the society. Further, in India, gold is gifted on celebratory occasions like the birth of a child or marriage. Gold also has religious connotations with a vast majority of people purchasing gold on auspicious occasions like Diwali, Dusshera, Akshay Tritiya, etc. Given the household proclivity towards gold, it is important to underscore the factors that lend gold its shine and evaluate how investors can take seamless exposure to this asset class.

Lending it a shine

Historically, gold has been used as a currency, i.e., a medium of exchange, as it is assumed to be a store of value. Globally, gold gets this valuable stature because of its properties viz. scarcity, difficulty in extraction, durability, non-corrosive nature, and decorative appeal. Correspondingly, gold also has industrial applications and is used in various industries such as electronics, dentistry, defense, aerospace, automotives, etc. The key factors that lend gold its shine include:

Gold is perceived to be the highest quality of cash

Gold has always been an integral part of international monetary systems – in most countries across the globe, gold is considered either as a substitute for cash or is accepted as a universal currency. Before the introduction of paper money, gold was circulated as currency in many countries, and even after paper money was introduced, currencies still maintained an explicit link to gold (the paper being exchangeable for gold on demand). More importantly, it is the only monetary asset without any counterparty liability/credit risk. Take for example the current fiat monetary system which is debt based. Quantitative Easing (QE) by central banks has allowed mispricing of credit throughout the global financial system. If the current debt-based fiat monetary system that is boosted by QE goes bust, investors with adequate exposure to gold in their portfolios would be able to protect their purchasing power. This is clearly exemplified by the World Gold Council report on gold demand and supply. It shows that during crises, the demand for gold by central banks and other large institutions tends to increase.

Table 1 : Demand for gold by central banks, institutions, and other investors (2022)

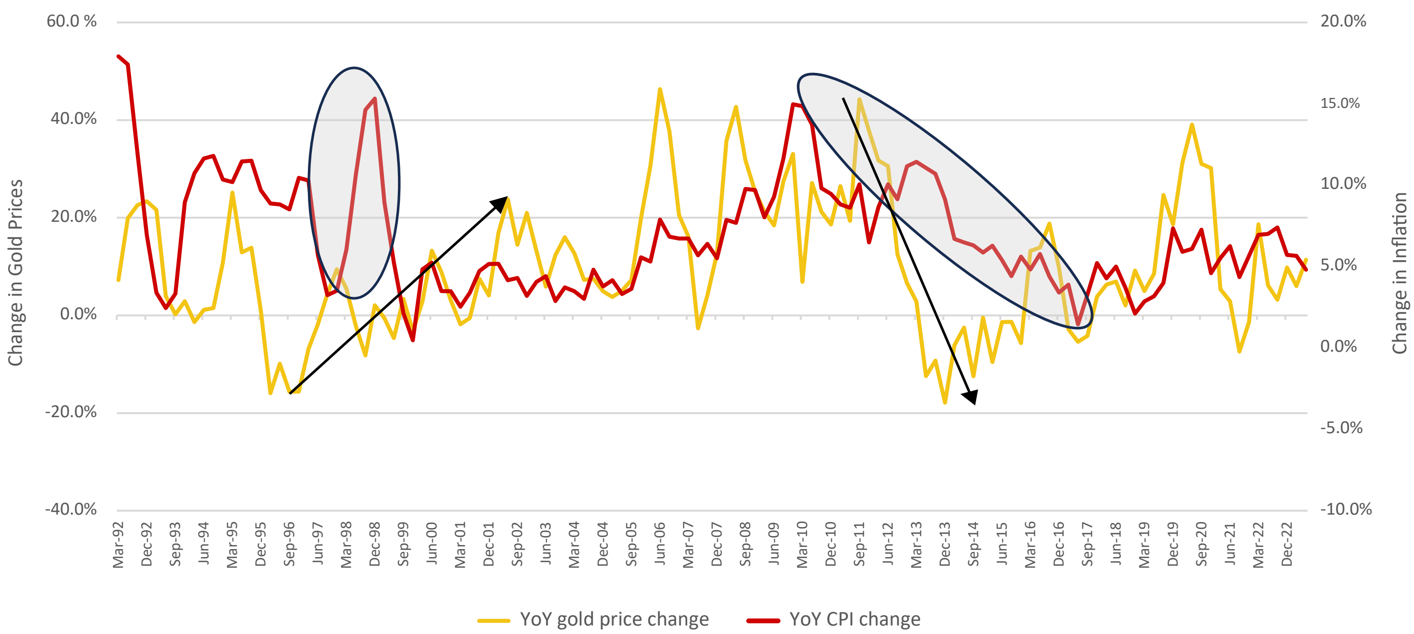
Investment demand for gold by Central Banks, Institutions and Investors	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Demand in Tonnes	1,617	1,744	1,621	798	901	967	1,614	1,315	1,164	1,271	1,798	1,004	1,127
YoY increase	38%	37%	34%	18%	21%	22%	37%	31%	26%	29%	49%	25%	24%
As a percentage of total demand		8%	-7%	-51%	13%	7%	67%	-19%	-11%	9%	41%	-44%	12%

Source: World Gold Council: Gold Demand Trends

Gold acts as an excellent hedge against both inflation and deflation

In an inflationary or hyper-inflationary scenario, gold as an asset class tends to outperform other asset classes while maintaining its purchasing power. Since gold is considered a store of value and has multiple applications, its ability to maintain value through various macro-economic scenarios trumps those of other asset classes. Similarly, in deflationary periods, other asset classes viz. equities, corporate bonds/debentures, and real estate decline significantly whereas gold maintains its nominal value. Thus, gold is considered as insurance against both inflation and deflation. The exhibit below compares gold prices with inflation rates as captured by the Consumer Price Index (CPI). It shows during periods when CPI numbers spiked (for eg. when the change in inflation is greater than 10%), gold prices showed a corresponding increase and when CPI dipped, gold prices showed a drop.

Exhibit 1: YoY change in Consumer Price Inflation and Gold Price (INR)

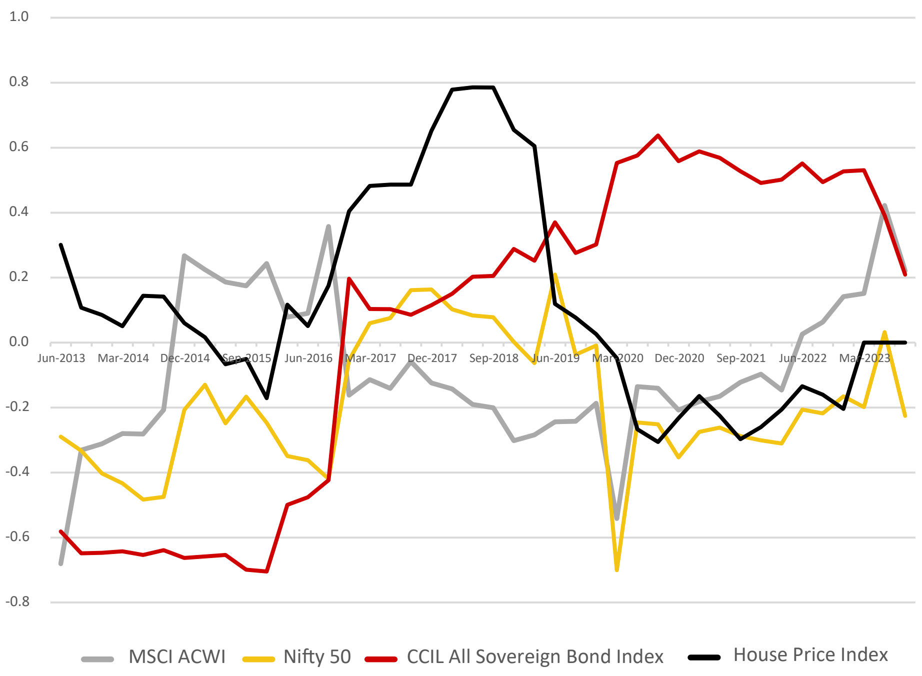


Source: RBI's Database on India Economy, FactSet

Gold is a 'safe haven' asset

It has already been established that gold acts as a good hedge against inflation. Additionally, gold has low to negative correlation with other asset classes like debt, equity, other commodities, real estate, etc. This means that when other asset classes respond to negative developments and witness price corrections, gold prices tend to be stable or even move upward. The chart below showcases the correlation of gold with other Indian assets.

Exhibit 2: 39-month moving correlation of gold with Indian assets

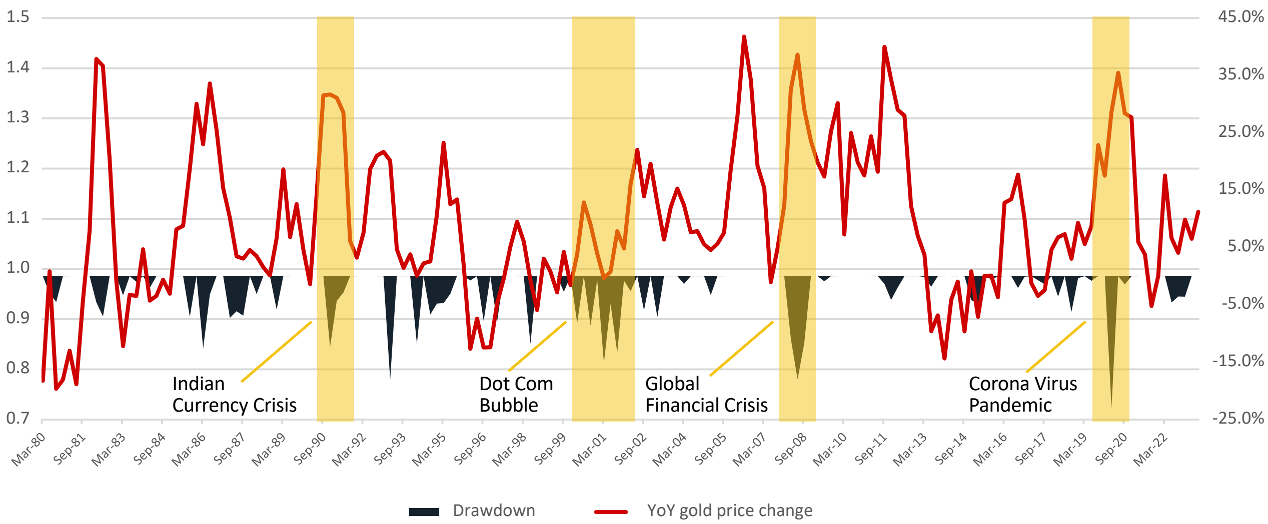


Factset, RBI's Database on India Economy, Clearing Corporation of India Ltd

As a result, gold is widely perceived as a safe haven asset, protecting portfolio downside. Further, gold is a highly liquid asset and can offer investors liquidity, a factor which holds heightened appeal during periods of crises.

The exhibit below highlights Indian gold prices appreciating in times of geopolitical and economic strife.

Exhibit 3: Drawdowns in BSE Sensex Vs. Changes in Gold prices

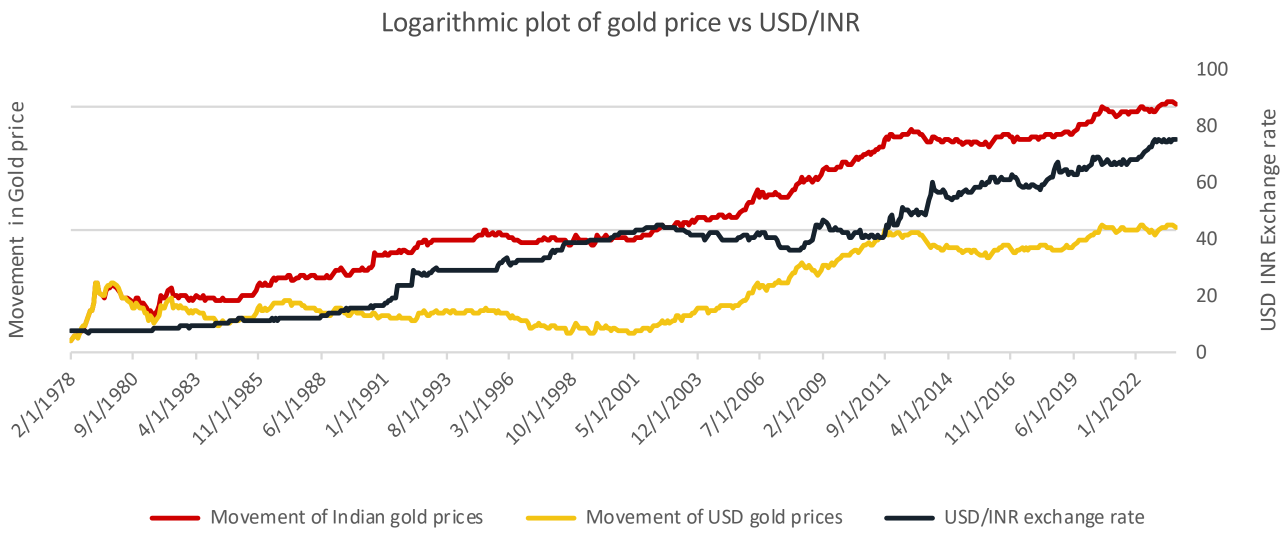


Source: FactSet, Yahoo Finance

Hedge against currency depreciation

Gold prices are denominated in U.S. Dollars in the global market. Consequently, the price of gold in India is highly influenced by the USD – INR relationship. Historically, the INR has depreciated against the USD primarily due to higher inflation in India. In such a scenario, gold has acted as a hedge against the depreciating INR. Over the years, Indian Rupee has depreciated considerably against the U.S. Dollar due to higher inflation in India. As the chart below indicates, depreciation in INR corresponds with stronger gold prices in INR terms.

Exhibit 4: Depreciation in USD-INR vs gold prices.



Source: FactSet

The above factors act as strong pillars of support for gold prices, contributing to the asset's strong and enduring appeal.

Gaining exposure to gold

Historically, the only issue that has plagued gold investment is the cost of holding and storing the asset. Indian households hold gold primarily in physical form, i.e., as jewellery, gold bullion or gold coins. Despite these avenues being the first choice for Indian households, there persist several challenges to holding gold in physical form. In the case of gold jewellery, there are additional costs like making charges, storage and insurance cost, Goods and Service Tax (GST), impurity issues, etc. Further, there is also high emotional value attached to gold jewellery, making it illiquid. Gold bullion and coins are more liquid than jewellery but also have issues related to storage cost, insurance, Goods and Service Tax (GST), etc. In such a scenario, individuals are increasingly evaluating taking exposure to gold as a financial asset. There are several ways in which this can be achieved:

- **Gold Exchange Traded Funds (ETFs):** Gold ETFs are mutual funds that invest in gold. These funds create units of gold which investors can buy and sell in demat (dematerialised) form on stock exchanges just like their equity investments. Generally, one unit of ETF represents one gram of gold but this may vary across fund houses. Since they are listed on the stock exchange, they are highly liquid. Further, they are backed by physical gold and track actual gold prices.
- **Sovereign gold bonds:** Sovereign Gold Bonds (SGBs) are issued by the Reserve Bank of India (RBI). These bonds track gold prices and also provide a bi-annual interest payout (currently 2.5% p.a. on the value at time of issue). SGBs give investors exposure to gold without having to own physical gold.

- **Gold futures contracts:** Gold futures contracts are standardised derivatives contracts that are traded on the Multi Commodity Exchange (MCX) and National Commodity and Derivatives Exchange (NCDEX) in India. Gold prices are the underlying for such contracts and investors can go long or short on gold. Further, investors can use leverage to trade in gold futures contracts. Generally, these contracts are high risk in nature and are more suitable for traders rather than investors.

- **Digital gold:** Investors can buy and sell digital gold through any fintech platform. Such platforms allow investors to purchase 99.99% pure 24 K gold units stored securely. The entire journey on fintech platforms is seamless, enabling investors to easily purchase and redeem their digital gold investments.

Gold as an asset class provides myriad unique benefits to investors. Due to the financialization of gold, investing and holding gold has now become easier than ever before. Ideally, Indian investors should consider having between 5% to 15% exposure to gold in their portfolios, especially in order to harness the safe haven and inflation protection benefits of gold.

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