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All That Glitters Has Not Been Gold

by Nino Boezio

Gold has been one of the worst performing investment assets of the last two decades, and it is not too puzzling as to the reasons why.

Inflation has been steady to low, and hence gold as a store of value or purchasing power was not required by most investors. Its industrial and commercial value tends to be fixed by a somewhat static demand, and its monetary value as an instrument for transactions is nonconsequential. Overall, with the low levels of inflation the past number of years, gold is just not a vehicle to reckon with.

Central banks have had a definite bias to reduce their gold holdings. It seems that the only central banks that may buy gold are those in the developing economies—perhaps for the prestige that gold once afforded a country, or in response to concerns that the home currency may not be always stable. Whatever the case, gold has had only limited use for most financial organizations and economies today.

The Case for Inflation

Annual money supply growth has often approached double-digits in the past two decades, especially in times of crisis. Yet this rapid increase in money supply by most Western central banks has not produced inflation as measured by the Consumer's Price Index (CPI) or commodity indexes. Why? Some would point to the rise in financial assets as the answer. Rather than spending on goods and services, investors have put the excess cash into financial assets. In turn, the rise in financial assets has had an increasing influence on economic growth, otherwise termed the wealth effect. In essence, easy monetary conditions has produced inflation, but in financial assets, not consumer products and services. If there is ever a sense that financial assets will no longer deliver attractive investment returns, then we could find that the money leaving financial markets could finally be spent on products and services producing inflation (that is, a latent danger of heavy consumer demand at some point).

The rise in financial asset inflation has been often noted by officials such as Alan Greenspan, Chairman of the U.S. Federal Reserve, but for the most part it is often ignored by most monetary officials, or the rise in asset values has been explained to have occurred due to excellent economic fundamentals. However, when one looks at equity valuation measures of very large blue-chip organizations, one can see that virtually all traditional overvaluation benchmarks have been broken. Financial asset inflation is just not a factor in economic decision making, and has not been perceived by many to have apocalyptic overtones.

Low Inflation Leads to Currency Stability

As consumer inflation and increases in producer prices have remained low, it is difficult to shun assets such as U.S. bonds that pay an attractive yield, and where the underlying currency is very stable. The U.S. dollar has taken on a "rock-hard" reputation which rivals the traditional view of gold, and U.S. assets also provide an attractive return. Gold on the other hand really provides no return unless one loans or leases gold, or engages in the futures market. What gold needs in order to attain renewed appeal, is to no longer have a rival "currency" or "store of value" to compete against it. Now with the advent of the euro, we can anticipate two strong currencies. However, what is needed to topple these two major currencies is a return of inflation which no longer preserves their purchasing power, and thereby maintains the attractive return of their underlying investments. In fact, the world as a group has been so negative toward gold and has for the most part sold its holdings beyond reason, that we can expect very buoyant demand for gold once the tables turn. To date, gold has had only appeal to the struggling economies of Asia, where the strength of the underlying currencies has always been questionable.

The Gold Standard Did Have Benefits

The old gold standard restricted the ability of participating central banks to print money at will. Any increase in currency supply had to be tied to the increase in gold reserves. The advantage of this system was that inflation could or should not be induced. Unfortunately however, in terms of economic thought that developed this century, the gold standard also prevented the central bank and the government from stimulating the economy (when it was depressed) through aggressive monetary policy. By tinkering with the monetary variables, it was believed that one should be able to achieve better economic results than if one's economy was strictly tied to gold, tightening when the economy was strong, and loosening when the economy was weak. This approach was not always practically possible under a gold standard, without the borrowing and lending of gold reserves. Of course, tinkering with economic variables does now incorporate a more human element of subjectivity, so one would witness more instability at various times.

Greenspan has been noted to like the idea of the return to the gold standard. Its return, of course, is now a major fantasy, but it could certainly curtail the rise in asset inflation which I believe has been largely induced by aggressive monetary policy. The rapid rise in asset inflation whether it be in a country (e.g. 1980s Japan) or globally (the 1920s) tends to end badly. It cannot be unwound as gradually as it occurred without some major pain. The issue becomes whether one believes things are different this time, and hence asset inflation is not a threat yet, or whether the fact that many small and midcap indexes are not as inflated as the popular indexes, so that in aggregate we do not have a problem with asset inflation (hence we should not tar the entire equity market with the same brush of "inflated"). One concern that

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also always haunts many economists, is that if investors suddenly come to the realization that financial assets will no longer rise as they have in the past, or that asset values will even possibly decline, that they may begin to liquidate their financial assets which were a form of saving, and begin to spend, driving up inflation dramatically. Hence all the inflation that central bankers were expecting all these years that never came (because the inflation occurred in financial assets and was in a sense stored up as future spending) could suddenly be unleashed in a big flurry all at once. Such a big burst of inflation will be very hard to control, and gold would explode upwards.

Whatever the case, gold's day should come, as there is always an up and down for any investment. Its day will likely be tied to the time when currencies are no longer perceived as stable, which has certainly not been the case since the early 1980s. It is interesting to note that the U.S. currency has grown in popularity and acceptance in direct reverse correlation to gold since that time. In the future, if the U.S. economic environment takes a turn for the worst or inflation reemerges with a vengeance, and the euro cannot fill the U.S. dollar's shoes as a world currency of choice, then gold will once again shine. Until then however, the gold price appears to be atagnant to slightly down. Jewelry demand and mine shutdowns have helped to support the price, while central bank sales has depressed it.

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Stochastic Modeling for Segregated Fund/Variable Annuity Products

by Craig Fowler

The Canadian Institute of Actuaries (CIA), The Actuarial Foundation and the Society of Actuaries is sponsoring a symposium on stochastic modeling for segregated fund/variable annuity investment guarantees, September 13-14, 1999, at the Toronto Airport Hilton Hotel. The goal of the symposium will be to advance education and research in the area of stochastic modeling of investment returns in respect of the maturity and mortality guarantees offered on segregated fund and variable annuity products. While this conference is not intended to produce a 'silver bullet' with respect to reserving and capital for these products, it is hoped that this symposium helps move the profession towards a more consistent methodology in terms of model properties and assumptions.

Working groups in both Canada and the United States were commissioned by the CIA and American Academy of Actuaries to study the investment guarantees offered on the segregated fund and variable annuity products offered in their respective countries. Because of the similarities of the guarantees, there have been discussions between the two working groups. Last fall, the CIA working group published a research paper on "Financial Consider-ations of Segregated Fund Investment Guarantees." The paper stopped short of attempting to specify a stochastic approach given the wide array of stochastic models. The working group advocated the completion of more intensive research activity aimed at building professional consensus on one or more stochastic approaches to modeling these features that can be widely used for risk management and valuation, and will produce consistent results for similar circumstances.

A subcommittee with representatives from the CIA, the Actuarial Foundation and the SOA has recently been formed. This subcommittee is interested in work that has been done throughout the industry in the area of stochastic modeling and would like to have different models that are currently in use presented at the symposium. Also, this subcommittee has recently issued a call for papers asking for work to be submitted on the following three main topics: the distribution of long-term market returns, investment returns for individual funds and policyholder behavior/product features.

Cash Prizes To Be Awarded for Research Efforts

The response to the call for papers has been extremely positive and several industry experts on the subject have come forward to share their research and help advance this field within the profession. In recognition of the importance of this research effort, the Investment Section Council has approved the provision of up to three prizes of $2,000 (Can) each for the authors of the best papers at the symposium.

The program for the symposium is being mailed this month. Please contact Charles Hill at *chill@ymg.ca* for more information.

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Editor's Note: The symposium is an opportunity for actuaries to integrate the traditional work of actuarial modeling and long-term risk management with the financial engineering used in short-term derivative trading. We urge all actuaries practicing in this field to attend this symposium to share their knowledge and experience.