

Market Analysis, Research & Education

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Asset Class Update: Gold

Investors Find Sparkle in Gold's Unique Traits

KEY TAKEAWAYS

- The global financial and economic crisis and the corresponding government policy reactions helped push up the prices for gold bullion and gold-mining stocks in early 2009.
- As a universally accepted store of value and monetary safe haven, gold has benefited from concerns about the stability of the financial system and expectations that government actions may weaken currencies and ignite future inflation.
- Gold's unique set of performance drivers cause it to have low correlations with other assets, and therefore maintaining a small allocation in gold can offer diversification benefits to a portfolio.

Gold bullion and gold-mining stock prices have rebounded this year, resuming a multi-year ascent that began earlier in the decade after a temporary correction in the fourth quarter of 2008.¹ The strong appreciation of gold investments throughout the bulk of this decade puts a spotlight on the unique characteristics and performance drivers of this precious metal, which have been quite different from other asset classes. Investors seeking to diversify their portfolios with assets that don't move in lockstep with core investments, such as stocks and bonds, might give some consideration to how a small allocation to gold could influence their portfolio's performance.

Spotlight on market fundamentals

Unique performance drivers

Gold is perceived by many people as a safe haven investment and store of financial wealth. It is an imperishable asset that has retained its purchasing power for centuries—hence why it remains the largest component of foreign exchange reserves in central banks around the world. While the value of financial assets, such as stocks, bonds and paper currencies, has fluctuated or even deteriorated over time, gold has held up as one of the most enduring and widely accepted reservoirs of monetary wealth. For this reason, gold has tended to rally during periods of elevated financial turmoil or inflation, as investors often view it as an effective hedge against the loss of purchasing power by paper currencies.

Global financial crisis boosts demand

These traits help explain why gold has performed so well of late. As the current global economic and financial crisis has evolved during the past six months, demand for gold has surged. Many investors have grown concerned about the solvency of large U.S. financial institutions and the stability of the global credit markets in general. Throughout Q1 2009, the nominal price of gold remained elevated and at times

neared its 2008 all-time high (\$1011 per ounce). Gold bullion rallied 5% during the quarter, while the broader U.S. equity market fell 11%.² With recent economic data pointing to perhaps the longest and most severe economic recession since the 1930s, investors turned to gold as an asset that historically has provided some wealth protection during such turbulent times.

Rising inflation expectations in focus

In response to the financial and economic crisis, global policymakers have taken unprecedented actions. Central banks in most countries have aggressively cut interest rates, while the U.S. Federal Reserve and others have pursued extraordinary quantitative easing measures. Further, many governments have enacted large economic stimulus programs and offered massive guarantees of both bank deposits and of the financial institutions that hold them. While thus far there is little price inflation in the global economy, some investors are concerned that the flood of liquidity will eventually lead to higher inflation. In addition, with many governments facing huge current or expected fiscal deficits, there may be a temptation in the future to allow higher inflation to make servicing debt less costly. If these inflationary concerns

come to fruition, they could effectively reduce the value of paper currencies. Historically, gold prices have tended to move inversely to the value of the U.S. dollar, but it may be more accurate to portray gold as a hard-asset hedge against the perceived decline in value of paper currencies relative to hard assets. Gold held up well in Q1 2009, despite the stability of the U.S. dollar. This suggests that some investors fear generally higher global inflation as a potential by-product of worldwide government policy actions, which they believe could lead to currency debasement and higher inflation down the road.

Investing in gold

Portfolio protection

Why invest in gold? Gold is considered its own investment category by some people who believe its characteristics as a currency and trusted source of wealth can help provide protection (in some ways, like an insurance policy) against extreme events, such as a global financial crisis, a geopolitical catastrophe or outbreak of rapid inflation. For others, given its uneven performance history and amorphous market drivers, gold is viewed as a niche asset at best.

Diversification opportunities

Given its atypical characteristics, the performance of gold has had little or no correlation to other asset classes, such as stocks and bonds (see Exhibit 1, below). As a result, making an allocation to gold may be an effective way to achieve diversification benefits. So far this decade, a position in gold would have provided a boost to a diversified portfolio, as gold bullion prices soared 216%, while U.S. stocks

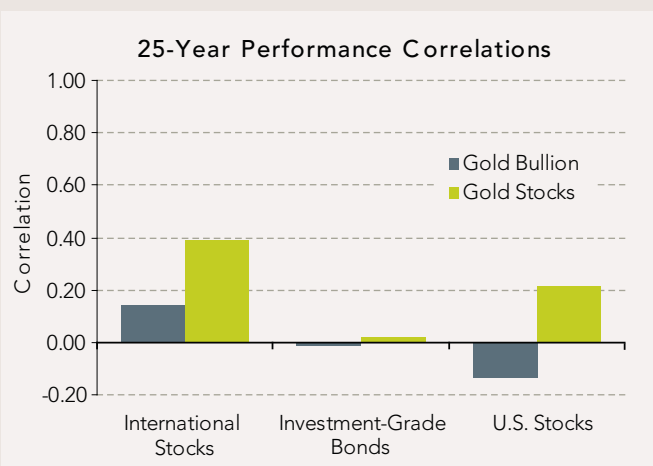
and bonds returned -36% and 75%, respectively.ⁱⁱⁱ However, gold has a history of being an extremely volatile asset class. For example, throughout the gold bullion bull market this decade, gold-related stocks have had five corrections of at least 25%, with a near 70% decline during the most recent drawdown.^{iv} As a result, maintaining only a small allocation to gold might be a reasonable approach.

Some potential investors might be fearful of buying gold now, given its recent rally. At the end of March, the price of gold (\$928 oz.) was still within range of its nominal all-time high of \$1011 oz. reached in 2008. However, on an inflation-adjusted basis, gold stood well below its peak reached in 1980 (\$2321 per oz.)—see Exhibit 1, below. [Editor's note: Potential investors also should note that there have been periods, such as the 20-year period ending May 2002, when gold prices were relatively flat.]

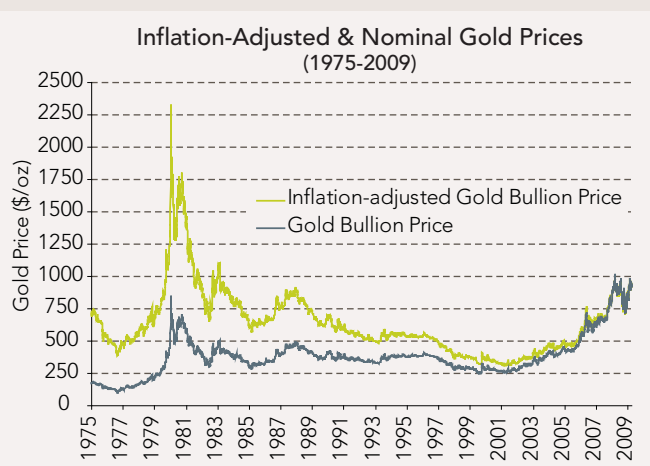
Investment implications

Given its unique properties—imperfect correlations with other asset classes, historical pattern of being a good hedge against inflation, and historical volatility—a small investment in gold may be an effective portfolio diversifier and provide some protection against potential events that may drive down the value of other financial securities. While there are never any guarantees, in the context of today's market climate owning gold as an investment may be an effective hedge against continued financial system instability or the possibility that massive government spending could lead to future inflation. ■

EXHIBIT 1: Gold is imperfectly correlated with other assets (below, left), and the price of gold remains well below its peak on an inflation-adjusted basis (below, right).



Correlations use monthly returns. Gold bullion - London gold bullion PM fix price; Gold stocks - Lipper Gold Fund Index; U.S. Stocks - S&P 500 Index; Investment-Grade Bonds - BC Aggregate Bond Index; International Stocks - MSCI ACWI ex US Index. Source: FMRCo (MARE) as of 3/31/09.



Gold price inflation-adjusted to 2009 dollars using the Consumer Price Index. Gold prices represented by London Gold Bullion, PM Fix Price (US\$/Troy oz). Source: Haver Analytics, FMRCo (MARE) as of 3/31/2009.

How to invest in gold

One can invest in gold by purchasing the stocks of gold-mining companies, either directly or through a mutual fund or exchange-traded fund (ETF) specializing in the sector. It is also possible to obtain indirect exposure to gold prices by owning an ETF that closely tracks the price of gold bullion. Some mutual funds also have the ability to directly purchase gold bullion.

Gold stocks historically have been more sensitive to an increase or decrease in gold prices, and thus have delivered a higher magnitude of performance, both in up and down markets. As such, an investor may achieve a higher rate of return by owning the stocks of gold-mining companies (vs. gold bullion) if the price of gold rallies, but also may experience bigger losses if the gold price declines.

Investing in a professionally managed gold fund or ETF helps investors avoid some of the barriers—such as taking physical possession, storing and insuring a direct investment—that historically may have prevented them from directly owning gold bullion.

Whichever investment vehicle one chooses, it's important to recognize that gold prices can move significantly in a short period of time, and therefore building an allocation slowly (such as through the strategy of dollar-cost-averaging) may be an effective way to minimize risk.

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All indices are unmanaged and performance of the indices includes reinvestment of dividends and interest income, unless otherwise noted, and are not illustrative of any particular investment and, an investment cannot be made in any index.

The Barclays Capital Aggregate Bond Index is an unmanaged market-value-weighted performance benchmark for investment-grade, fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities with maturities of at least one year.

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Lipper Gold Fund Index - The purpose of the Lipper Analytical Services, Inc. Fund Indices is to provide measurements of the central tendency of similar investments. The indices may be used to describe the returns that an investor could reasonably have expected to achieve in the past. Year-end total net asset values are used to determine the components of the indices. The top 10 funds comprise these equally-weighted indices. A gold-oriented fund is defined as a fund that has at least 65% of its equity portfolio in shares of gold mines, gold-oriented mining finance houses, gold coins, or bullion.

The S&P Global BMI Gold Index provides investors with a broadly representative benchmark for global gold portfolios. The index consists of securities classified under the GICS[®] Gold subindustry which includes producers of gold and related products.

[i] All references to gold bullion and gold-mining stocks statistics are represented by the following: Bullion – London gold bullion PM fix price; Gold-mining stocks – Lipper Gold Fund Index. Source: Lipper, Haver Analytics, FMRCo (MARE) as of 3/31/09.

[ii] Stock performance represented by S&P 500 Index. Source: FMRCo (MARE) as of 3/31/09.

[iii] Performance figures from 12/31/99 through 3/31/09. Performance represented by: Stocks – S&P 500 Index; Bonds – Barclays Capital Aggregate Bond Index. Source: FMRCo (MARE) as of 3/31/09.

[iv] Gold-mining stock performance represented by S&P Global BMI Gold Index from Jan 1, 2002 to March 31, 2009. Source: FMRCo (MARE) as of 3/31/09.

Diversification does not ensure a profit or guarantee against a loss.