Step up allocation for gold to beat inflation

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OVER THE last fortnight, some old fears have resurfaced — investors world over have got concerned about Europe once again on the back of default worries around Ireland, Portugal and Spain. The second round of quantitative easing in the US has confirmed that all is not well there yet, and China has raised the reserve ratio due to inflation hitting 25-month highs.

Though the growth in India has tended to be driven by domestic demand, the free flow of capital across the globe and the dependence that India has on foreign capital flows means that India is very likely to be affected by what happens in the rest of the world, both good and bad.

While building a pure fixed income portfolio has tended to be the most commonly used strategy in times of uncertainty, this strategy tends to be inadequate in an environment of high inflation. There is every likelihood that high inflation in India will continue, some of it exported by the developed world due to an increase in money supply and low interest rates, another part of it from China due to significant wage increases and lastly from higher food prices due to supply issues around an extended monsoon and higher support prices for agricultural products.

While fixed income will continue to have an important role in a portfolio due to its perceived stability, portfolios will need to be made more inflation proof through the use of precious metals. Precious metals have been used in India for jewellery and on social occasions, but will now have to play an important role in investment portfolios as well. We will restrict ourselves to discussing silver and gold as options to build your precious metals portfolios. With both gold and silver at highs, it is critical that the portfolio be built over a period of time, rather than all in one shot. While classically investors have been advised to hold 10 per cent to 15 per cent in precious metals, it may be time to move to a tactically higher allocation of 15 per cent to 20 per cent due to the heightened global uncertainties and inflation concerns.

How does one build a precious metals portfolio?

- Physical purchases — Both gold and silver have traditionally been bought in the form of jewellery and utensils. Concerns around purity, lack of transparency in pricing with markups varying depending on where you buy from, storage and wealth tax implications mean that physical holdings, though important, should make up only a part of the portfolio.
- Exchange Traded Funds (ETFs) — ETFs allow investors to buy and sell gold units on a stock exchange. The units appear in your demat account just like your shares. Unfortunately, silver ETFs are currently unavailable in India and will need to be purchased overseas through the LRS (Liberalised Remittance Scheme) of RBI that permits residents to invest overseas.
- Mining Funds — Currently there are a few international funds available in India that invest in gold and silver mining companies globally. Since there are very few companies in India that are in the gold mining space, you could take advantage of international funds with long track records to build this exposure. However, do keep in mind that since these funds invest in stocks of mining companies, there is every likelihood of them reacting to short term stock market trends instead of precious metal prices.
- Structured notes — Wealthier investors could take advantage of structures where returns vary based on the performance of gold or silver as the underlying asset. However, remember that whilst some of these products have capital protection structures, they carry other risks like issuer risk. Keep in mind that your returns on precious metals will be affected by the movement of the currency as well and this could work for or against you over different time frames.

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