The use of gold as a potential hedge against extreme market outcomes has long been a key tenet of First Eagle’s investment philosophy. In this interview with the World Gold Council, Thomas Kertsos, co-portfolio manager of the First Eagle Gold Fund, discusses how gold and gold-related investments can serve as an additional source of portfolio resilience and provides his thoughts on the factors driving gold’s performance. The views expressed in this interview are as of August 31, 2019. The interview was published on the Goldhub blog of the World Gold Council’s Goldhub website the week of September 16, 2019.

**World Gold Council:** What is the investment philosophy of First Eagle? And what sets you apart from other asset managers?

**Thomas Kertsos:** First Eagle Investment Management focuses on generating real returns for its clients through the business cycle while trying to avoid permanent impairment of capital. One thing that sets us apart is the amount of attention we pay to the potential downside risk of our investment decisions. We view risk not as volatility but as the permanent impairment of capital in real terms. We seek to create resilient portfolios by focusing on companies around the world with strong balance sheets, persistent competitive advantages, sustainable earnings and conservative management. And we commit capital to these companies only when we see a meaningful “margin of safety” in price; that is,
the difference between our estimate of the intrinsic value of the security and its market price. Value investing principles are deeply ingrained in our investment philosophy. We have a long investment horizon and try to make decisions based on the next decade rather than the next year. We understand that, due to the way compounding works, avoiding losses during certain periods of time may be as critical for long-term performance as generating returns during other periods. We have sometimes lagged in runaway bull markets when we believed security prices and business fundamentals were misaligned. While the positioning of our diversified funds\(^1\) may have resulted in short-term underperformance, it has generally protected clients’ assets against the full force of a number of pronounced market selloffs. For example, our Global Fund held no Japanese stocks when the Japanese stock market bubble burst in the early 1990s;\(^2\) it had very limited exposure to telecoms and technology when dot-com stocks crashed in 2000 and to financials, as the 2008 global financial crisis took hold.

Our focus on resilience means that our portfolio composition differs from many of our competitors’. While equities predominate in our diversified funds, we typically hold relatively high levels of cash and cash equivalents as a residual of our disciplined, bottom-up approach; if we cannot find undervalued securities that fit our investment criteria, our position in cash and cash equivalents may grow to 15% or 20%. This position is not strategic; it represents deferred purchasing power that we can deploy countercyclically when security prices become more favorable for us. In addition to equities, cash and cash equivalents, we hold between 5% and 15% of our diversified funds strategically in gold and gold-related securities. These act as a potential hedge against the many known-unknowns and unknown-unknowns in the market, adding greater resilience to our portfolios.

**WGC:** Can you tell us about the First Eagle Gold Fund?

**Kertsos:** In addition to our diversified portfolios, we also manage a gold fund.\(^3\) Here too, we focus on providing downside resilience and avoiding permanent impairment of capital. The Gold Fund is highly concentrated on a small number of securities and, due to our long-term investment horizon, our portfolio turnover rate has been as low as 9.3%.\(^4\) The structure of the portfolio does not resemble any index. To the extent that we cannot find undervalued gold-related equities, we tend to own a significant amount of gold bullion—17.9% as of June 30, 2019. Unlike the diversified funds, the Gold Fund holds very little cash and does so solely for working capital purposes. Apart from a few exceptions, we generally avoid owning pre-production miners, which don’t have self-funded balance sheets. Instead, in an effort to reinforce resilience, we try to own long-duration and, in our view, higher-quality gold-related stocks. We don’t give the benefit of the doubt to any gold stock because of a speculative expectation of a higher gold price. Rather, we aim to provide solid, risk-adjusted, real returns through the cycle, and our Gold Fund has exhibited resilience, even during periods of distress in the gold sector.

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1. In this interview, the term “diversified funds” refers to the First Eagle Global Fund, the First Eagle Overseas Fund and the First Eagle U.S. Value Fund.
2. Prior to January 1, 2000, the strategy was managed by its senior adviser while he served as the portfolio manager at a firm different from First Eagle Investment Management, LLC.
3. First Eagle Gold Fund is co-managed by Matthew McLennan, who also serves as head of the Global Value Team, and Thomas Kertsos. In addition, Max Belmont is the research analyst for the Gold Fund.
**WGC:** How does gold fit into First Eagle’s overall strategy?

**Kertsos:** We have a distinctive philosophy around gold. We believe gold has unique risk/reward characteristics that enable it to help preserve real value over the long term. We use gold as a potential hedge and do not speculate on its price over the next six to 12 months. We believe it is not possible to forecast the price of gold or, for that matter, the price of other investment assets. This, in fact, is why we have a potential hedge, and why we believe investors should consider using the Gold Fund as a potential hedge rather than as a speculative vehicle.

In addition to our $1.12 billion ⁵ Gold Fund, we also hold approximately $9 billion ⁶ in gold and gold-related investments as a potential hedge in our diversified funds. We leverage our research for the Gold Fund to actively manage the exposure to gold for the overall First Eagle organization. As one of the largest long-only, active shareholders in the gold sector, we spend significant time and resources meeting with and evaluating gold companies, and examining the broader trends affecting gold companies and the gold bullion market.

**WGC:** What do you think makes gold stand out from other assets?

**Kertsos:** Gold’s unique risk/reward characteristics mean it has the potential to preserve its value in real terms under both inflationary and deflationary conditions. Several assets—commodities, for example—may provide a potential hedge against inflation, while others—such as cash and bonds—may provide a potential hedge against deflation. But what happened to commodities during the deflationary shock of 2008? And what happened to cash following central banks’ countercyclical fiscal and monetary policies in the aftermath of the 2008 crisis? Gold is different because, despite potential short-term volatility, it has historically done well in real terms under the greatest variety of macroeconomic dislocations.

An additional quality that we like in gold is that it is a long-duration potential hedge. Gold doesn’t rot or rust or tarnish, and it is virtually indestructible. Unlike futures or options, gold does not have to be rolled forward or properly timed in order to serve as a potential hedge. Moreover, gold ownership doesn’t entail counterparty risk. It is a liquid asset, with an exceptionally long track record to support the above-mentioned qualities.

Over time, gold has also provided uncorrelated returns to the stock market. The long-term correlation of gold to stocks is practically zero, which means that gold adds true diversification to an equity position. Historically, the price of gold has moved countercyclically to the stock market, and the more stocks have dropped, the more, on average, the gold price has generally risen. So gold can provide value, especially to a long-only equity portfolio. By adding diversification and potential resilience, it can help investors maximize overall returns on a risk-adjusted basis through the cycle.

Historically, one of the biggest drawbacks of owning gold has been its lack of yield. In our view, this is less important now. With yields from sovereign bonds currently at extremely low levels (and negative in Europe and Japan) despite a record amount of sovereign debt and potential sovereign risks around the world, the opportunity cost of owning gold is minimal. Furthermore, although gold does not provide a yield, it has delivered a return over time because growth in the stock of gold from 1900 to 2017 has been less than 2% annualized, ⁷ whereas growth in the supply of man-made money—and thus nominal demand for gold—has been much higher.

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₅, ₆. As of June 30, 2019.


Diversification does not guarantee investment returns and does not eliminate the risk of loss.
Overall, therefore, we believe gold’s underlying long-term price stability, versatility, resilience, countercyclical relationship to stocks and duration make it the most compelling form of potential hedge.

**WGC:** Do you consider gold a strategic asset, a tactical asset, or both?

**Kertsos:** Gold is a strategic asset for us. We believe it is impossible to time the market in a consistently profitable way by buying and selling gold tactically. Moreover, uncertainty and complexity are increasing around the world, as many potentially disruptive issues, from monetary and financial developments to political and geopolitical tensions, remain unresolved. We take the humble view that, as it is impossible to predict such events, we cannot know in advance when we will need to own a potential hedge on a tactical basis. This means we have a strategic need for a long-duration potential hedge that can perform satisfactorily under the greatest variety of events disruptive to the financial marketplace. Gold fits that position for us.

It is also important, however, to consider the appropriate capital allocation to gold. In the diversified funds, we believe a level significantly higher than 15% is more of a directional bet on the gold price than a potential hedge, and a level significantly below 5% is probably too small to be material if it is needed for potential hedging purposes. By the same logic, we believe investors should consider gold as a strategic allocation within their overall portfolios rather than a tactical play.

**WGC:** What role do physical gold, gold-backed ETFs and gold mining stocks play in the Gold Fund and in your broad investment strategy?

**Kertsos:** Our gold exposure in the Gold Fund consists of investments in gold bullion, gold royalty companies and gold mining companies. We sometimes own small positions in silver bullion and silver stocks, too. In terms of gold bullion, we directly own the physical asset in an allocated account. One of the advantages of doing so is that gold bullion does not have any counterparty risk. We prefer ownership of the underlying asset to financial price participation in the kind of gold-proxy financial vehicle that some ETFs may represent.

We recognize that gold bullion has different liquidity and risk characteristics from gold stocks, but at the right price, we are interested in owning both. We build our overall gold exposure from the bottom up, and we actively manage the relationship between gold bullion and gold mining companies. If we can find undervalued gold mining companies at any given spot gold price, we will own gold mining companies; if we cannot find cheap enough equities, we tend to keep our clients’ capital in gold bullion until we have an opportunity to buy undervalued mining companies.

In effect, gold equities have to compete with gold bullion to be included in the Gold Fund and our diversified funds. While valuation is critical in allocating capital to specific companies, it isn’t the only component of our process. Beyond valuation, we look at three other key attributes in the precious metals mining companies that we invest in:

- **Resilience.** We try to look at all the factors that can go wrong in a company—financial, political, technical, operational and capital-allocation risks. We also look in detail at the company’s balance sheet and cost structure to determine how low the gold price must go before it may create problems for the company.
• **Optionality.** We look at the potential rewards of investing in precious metals companies and try to own those that, in our opinion, offer growth, either in production per share or gold reserves per share. We also look for management teams that operate effectively, make conservative capital-allocation decisions and have a good record of exploration success.

• **Duration.** We seek long-duration holdings—companies that have long mine-lives, solid balance sheets, management team depth and good ESG and sustainability practices.

We believe that these types of companies, if bought at the right price, have the potential to create value for shareholders over the long term and ultimately grow their free cash flow per share, despite possible short-term volatility in the price of gold.

**WGC:** Which factors/drivers do you use to understand gold’s performance?

**Kertsos:** We believe that the most important driver of the gold price is the direction of real interest rates. Real rates represent the opportunity cost of owning gold; when they move higher, the gold price (despite some lead/lag effects) will usually move lower—and vice versa. While there can be short-term deviations in this inverse correlation, we believe it is the most important statistical relationship determining the price of gold in the medium to long term. Gold’s relationship to the US dollar and the general level of equities (e.g., the S&P 500 Index) is far more mixed, but we do look at those relationships closely as well.

We have seen several main factors drive the price of gold since September 2015, including:

• **Communication from the Federal Reserve regarding interest rate policy.** Hawkish comments from the central bank have driven the price of gold lower, while dovish comments have driven it higher. The Fed’s 2019 U-turn on cutting rates pushed the gold price to a six-year high.

• **Political events and geopolitical developments.** We have seen significant volatility in the gold price since 2016 resulting from political events such as the Brexit vote and the US elections. Geopolitical discord has also created significant volatility in the gold price. Tensions arising from North Korea raised the price of gold in the summer of 2017, for example, and the price fell as those tensions eased. Geopolitical developments in the Persian Gulf have affected the price of gold as well.

• **Trade negotiations.** These discussions, primarily between the US and China, have had a significant impact on expectations for economic growth and the gold price.

**WGC:** How do you incorporate insights from consumer demand or central bank demand into your decision process, as these tend to have less frequent data updates?

**Kertsos:** Both consumer and central bank demand trends can be useful from a broad perspective, though we are cautious not to read too much into these numbers.

The gold market is a $9.1 trillion market, with significant aggregate global daily trading volume. There are many players involved, including central banks. While we find it very encouraging that central banks—particularly those in emerging markets—have become net buyers of gold since 2009, it is worrisome that many developed market central banks have remained inactive. That said, only limited conclusions can be

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derived from central bank gold data in the short term, given that it is rarely current. China, for example, has at times reported no changes in its gold holdings for five-plus years before suddenly indicating a dramatic increase.

One important recent development is the decision by the European Central Bank and the region’s other central banks to let the Central Bank Gold Agreement expire in September 2019. This agreement was signed in 1999 to stabilize the gold market by coordinating central bank gold sales. Such sales prompted a steep correction in the gold price in 1999. However remote the possibility that European central banks will become net sellers once again, such a scenario must be considered from a risk management perspective, especially if there is an economic downturn or a banking crisis in Europe.

We also follow consumer trends closely and find it interesting to see a dichotomy in this market similar to the one we see in central banks, namely that consumers in Asia exhibit much more appetite for gold than those in the West. It is also interesting to see how contrarian these markets can be; consumers in China and India, in particular, have been buying gold on price declines. This doesn’t happen always, but it does seem that gold is moving from weaker hands to stronger ones that have higher conviction in the value of owning gold—a trend supportive of the price.

WGC: What developments are you watching most closely over the next six to 12 months in terms of their impact on gold’s performance?

Kertsos: We don’t forecast the price of gold; we approach the gold market as we do every other asset class, with the humility to recognize that it is part of a complex non-linear system that is hard to predict. But within our risk management process, we do try to understand the dynamics of the gold market. We believe that the key development to monitor currently is the possibility of a US or worldwide recession, as this would likely have a significant impact on the price of gold.

Although recessions historically have been favorable for the gold price in the medium to long term, they have often led to short-term price corrections. We saw this in both 2000 with the bursting of the dot-com bubble and in 2008 with the bursting of the real estate bubble. In 2008, for example, the gold price rallied at the start of the recession and reached $1,002.95/oz in March 2008, only to decline to $712.30/oz in November of that year, following the bankruptcy of Lehman Brothers. After all the countercyclical monetary and fiscal policies used to battle the financial crisis, gold rallied to $1,900.22/oz in September 2011. Maintaining resilient gold exposure during inflection points is critical to reaping the benefits of the price appreciation that may follow.

While we saw a lot of volatility in asset prices in 2000 and 2008, the epicenter of the 2000 asset bubble was in stocks, whereas in 2008 it was in real estate. Today, in our view the most egregious example of asset price overvaluation is in the bond market, where there are bonds trading at negative short- and long-term yields. This is highly unusual by any historical standard. And the most extreme example of this is in Europe, followed by Japan. The share prices of many European financials have also been very weak. We are keeping a close eye on financial, monetary and political developments in Europe.

Another area that needs to be monitored very carefully is communication from the Fed, whether hawkish or dovish. In June, there was a simultaneous increase in the prices of almost all assets—gold, stocks, commodities and bonds—which suggests to us that asset prices were responding primarily to the Fed’s easing rhetoric. In the past few years, we have seen the Fed change its stance on monetary policy in light of changing economic circumstances in the US and around the world. The most characteristic example was in April 2013, when the central bank signaled that it was nearing a decision to start winding down its bond purchases and end the third round of quantitative easing (announced in September 2012). This news, coupled with the simultaneous rumor that Cyprus was about to sell its approximately 10 metric tons of gold reserves, caused the price of gold to drop sharply from $1,561.45/oz to $1,347.95/oz in roughly two days. Such events can have a powerful impact on the price of gold and can be exacerbated further by speculative positions in the futures market, which have risen substantially since June 2019.

Although renewed hawkishness at the Fed currently seems unlikely, it must be taken into consideration from a risk management perspective, as such a change could have a significant negative impact on the price of gold.

Though the recent move in the gold price has been encouraging, we continue to diligently execute our investment management process, and we participate in this move with caution. We do recognize that gold fundamentals have been improving steadily as global sovereign debt continues to rise and signs of an economic slowdown mount, but the gold price can be quite unpredictable in the short term. While it might be demoralizing to see the price of gold decline from current levels, such a pullback could present an excellent opportunity to buy more gold at a reasonable price.

Maintaining resilient gold exposure during inflection points is critical to reaping the benefits of the price appreciation that may follow.

WGC: What developments may change this perspective (on the upside or downside)?

Kertsos: Historically, gold has not done well in periods of strong economic growth. Strong growth is exactly what has driven gold lower since 2011 and during the 1980s and 1990s, while pushing assets such as stocks and real estate significantly higher. However, it is important to distinguish between liquidity-driven increases in asset prices, as we experienced in June 2009, and increases that are due to real economic growth, which can raise the prices of assets with more leverage to an economic upturn at the expense of less economically sensitive asset classes, such as gold. With the US economic expansion appearing to have reached a late phase, we assign less probability to the latter scenario.

Given increasingly high sovereign debt levels, an increasingly complex political and geopolitical backdrop, and the continuing rise in the price of some risk-on assets, it makes sense to be cautious about projecting the relatively good economic conditions of the last few years too far into the future. Despite possible short-term volatility in the gold price, we see this as an important time to maintain a strategic position in gold as a potential hedge.

10. Source: Bloomberg.
Thomas Kertsos

Thomas Kertsos is portfolio manager of the First Eagle Gold Fund and a senior research analyst on the Global Value team covering precious metals and marine transportation. Prior to joining First Eagle in May 2014, Thomas spent six years as an associate analyst covering precious metals and mining in the global research group of Fidelity Management & Research. Thomas earned a BSc in economics and finance from Athens University of Economics and Business and an MSc in accounting and finance from the London School of Economics and Political Science.

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