

Extended Commentary

BLACKROCK GLOBAL FUNDS (BGF)
BGF World Gold Fund

Fund Manager: Evy Hambro

Market & Portfolio Performance

The BGF World Gold Fund declined -4.9% over the third quarter; the FTSE Gold Mines Index, its benchmark was literally flat, returning 0.0%. Over the same period, gold bullion appreciated by 7.1% finishing the quarter at \$1,618/oz.

Despite a strong start to the quarter for both bullion and the gold producers, a crisis in confidence erupted in August with the downgrade of US debt by S&P from AAA to AA+. Chairman Bernanke's announcement regarding the implementation of 'Operation Twist' coupled with further rating agency downgrades in Europe did little to ease negative investment sentiment. Fears over weak global growth and a lack of political impetus to finding a resolution to the Eurozone debt crisis, sparked an indiscriminate liquidation across most asset classes.

The ongoing market uncertainty helped gold deliver positive returns over the quarter as investors continued to seek out its safe haven status. Over the period gold outperformed other precious and base metals returning 7.1% versus falls of -13.1%, -12.3% and -25.7% in silver, platinum and copper prices respectively (Source: Datastream). Yet it was not immune to the market turbulence, posting its worst three day performance for 30 years, as it fell back to close to \$1,600/oz in September. In this bearish environment investors flocked to the US dollar in the face of a second credit risk event.

The growing theme of gold purchases by emerging market central banks continued through the third quarter. A report from the IMF indicated that central banks in Thailand, South Korea and Russia have all recently increased their gold holdings. Typically buyers of gold have been those countries that are either: the drivers of global growth eg China and India; or those that receive foreign currency in exchange for natural resources eg Saudi Arabia, Russia and Mexico. These rapidly developing economies have large balances of foreign exchange reserves typically in dollars, euro and yen on their balance sheets; increasing their gold holdings allows them to diversify their currency risk during a period where currency markets have been volatile and uncertain.

GFMS released some telling data in their demand trends publication for the second quarter. ETF inflows have been comparatively modest compared to the surge in interest this time last year, but that has been more than compensated for by strong jewellery and physical investment demand, largely from Asia. Jewellery demand was, for example, up 12% from this time last year, surprising to the upside given that it is typically price sensitive. The central bank buying trend continues to be a constructive and powerful one: over the first half, the official sector purchased a net 192 tonnes. Gold continues to be highly sought after in this uncertain climate, in which even US sovereign debt can no longer be considered 'risk free' and in which paper currencies cannot be counted on to hold value.

As global economic issues dominated the market, investors continued their rotation out of risk assets. The most recent outlook from the IMF cast a shadow over the global economy as they downgraded their world growth forecast. As result, those commodities that are more closely aligned with industrial production weakened over the period.

Our underweight to Newmont, the North American large cap gold producer (currently 11.7% of the benchmark) detracted from performance over the quarter. The company outperformed its peers following an announcement that it would link its dividend to the gold price.

This impacted some of the Fund's South African non-gold holdings such as Impala, the platinum producer and African Rainbow Minerals, the diversified miner. The market also punished those companies with any financing requirements, such as European Goldfields, despite successfully achieving key permits for the development of their assets in Greece. These holdings detracted from performance over the period.

The portfolio's holding in Fresnillo contributed positively to performance over the period. Due to concerns over production and corporate governance, the portfolio's underweight to Zijin also contributed to performance over the quarter. Following a substantial investment by a new shareholder, the valuation of the portfolio's holding in a private Russian gold producer was revised upwards.

Contact us

+44 (0)20 7743 3000

www.blackrockinternational.com

Transactions & Portfolio Activity

Over the quarter we evolved the focus of the portfolio to be more closely aligned with the higher quality, mid-tier producers in the portfolio, reducing our exposure to those companies that may be required to raise capital in order to develop new/existing projects and those with limited cashflow.

We added to our holding in the large cap gold producer Barrick and increased our weighting to gold royalty companies. Gold royalty companies should enable the Fund to benefit from a strong gold price, while providing some level of protection from the risk (and implied volatility) of operating a mine.

We took profits in some of the silver names held in the portfolio, such as Penoles, who have delivered good performance over the course of the year. We also sold out of Primero Mining. The company agreed a merger with Northgate, but we were uneasy about the scope within the agreement for an external party to take control of Northgate in the course of the transaction and as a result gain access to the company's young Davidson project. Our scepticism was well founded: AuRico Gold subsequently bid for Northgate and Primero's share price fell.

Market Outlook

Investment demand has been the most important driver of the bull market to date and the key factors that have been driving that demand – concerns about financial markets, Eurozone debt, the health of the US economy and inflation – are likely to persist for the foreseeable future. As the official sector continues to seek diversification of its currency positions, we have seen purchases of gold from a number of emerging market central banks, which appear likely to continue.

Gold equities have underperformed gold bullion year to date as a result of the intense pressure applied on the equity market by macroeconomic concerns. Gold equity valuations are as a result in historically low

ranges but recent earnings reporting has confirmed that margins have been able to expand on the back of gold's rise and cashflows are at record levels. Gold equities bucked the trend of a falling market in August and performed strongly but there is still plenty of scope for a re-rating.

The key threat to the gold market is an increase in real (adjusted for inflation) interest rates. When real interest rates begin to rise, so does opportunity cost of holding gold. At the moment, we believe the interest rate and exchange rate environments remain bullish for gold, this is supported by the recent announcement from the Fed that it intends to keep rates low for the foreseeable future. Since the recent sell off, gold bullion appears to have stabilised above \$1,600/oz, which suggests the market may have established a new floor for the precious metal.

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Contact us

+44 (0)20 7743 3000

www.blackrockinterantional.com