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The arguments for and against investing in gold

By Larry Swedroe

(MoneyWatch) Since 2002, gold has experienced a meteoric rise, increasing from about $280 an ounce to about $1,600. A recent Gallup poll found that roughly 30 percent of respondents considered gold to be the best long-term investment, making the metal a more popular investment than real estate, stocks, and bonds.

Duke University professor Campbell Harvey and co-author Claude Erb have examined a number of "popular stories" to better understand the role of gold in asset allocation. Among the justifications for owning gold they covered where inflation hedging, currency hedging, disaster protection, and demand from emerging market countries. They also examined the role of supply and demand and found what could be considered an anomaly -- the new supply of gold that comes onto the market each year hasn't substantially increased over the past decade even though the price of gold has risen fivefold.

The following is a summary of their findings:

Gold as an inflation hedge

Despite the widely held belief that gold is an inflation hedge, gold has historically been a poor hedge against higher prices in the short or intermediate run. For example, the price of gold hit $850 per ounce on January 21, 1980. By March 19, 2002, gold had fallen to $293 per ounce. Note that the inflation rate for the period 1980-2001 was 3.9 percent per year. So the loss in real purchasing power was about 85 percent.

Still, gold has been a good hedge of inflation in the very long run (such as a century, clearly much longer than the horizon of most investors). Importantly, the authors also found that there was no correlation between unexpected inflation and the price of gold. Unexpected inflation is important because even nominal bonds hedge expected inflation.

Harvey and Erb went on to observe:

> If gold is just a 'good' inflation hedge and not a perfect inflation hedge then deviations between the real price of gold and the expected, average, real price of gold should be corrected over time. Investing when the real price of gold is high, expensive, should act as a drag on future real returns and investing when the real price of gold is low, inexpensive, should enhance prospective real returns.

They go on to note:

> In January 1975, the month-end price of the nearby gold futures contract was $175 an ounce. The month-end January 1975 index value of the U.S. CPI index was 52.3. The

> ratio of the price of gold relative to the CPI index was 3.35. Since the inception of gold futures trading this real price ratio has averaged about 3.2, reached a low value of 1.46 in March of 2001 and a high value of 8.73 in January 1980. Using this measure, the month-end March 2012 real price of gold was recently 7.3. Since the start of gold futures trading the only other time the real price of gold has been roughly as high as it is today was in 1980.

And you already saw what happened then. If the real price ratio of gold mean reverts over the coming decade to its historical average of about 3.2, the real returns would be abysmal.

Gold as a currency hedge

The change in the real price of gold seems to be largely independent of the change in currency values. Since the real price of gold seems to move in unison across currency perspectives, it is unlikely that currency movements help in explaining why the real price of gold fluctuates. Is gold a currency hedge? The answer appears to be no.

Gold provides safety when markets drop

If this is true, gold should be stable when other asset markets falter. However, we see gold fell in nearly one-sixth of months when stock prices fell. If gold was a true safe haven, then we would expect very few, if any, such observations.

Bottom line: Gold may not be a reliable safe haven asset during periods of financial market stress.

Momentum investors drive demand for gold

Both production and supply of scrap gold are insensitive to the price of gold. The increased demand for gold has been a result of the impact of momentum-based investors. The result has been that today a single exchange traded fund (SPDR Gold Trust, GLD) holds more gold than the official reserves of China.

Momentum is a well-known factor in returns. However, it's a short-term phenomenon. In the long term, prices/valuations originally driven by momentum-fueled bubbles tend to revert to the mean. Things that can't go on forever eventually stop. And it's important to remember that momentum works both on the upside as well as the downside.

Gold is under-owned

The authors note that there has been an increase in gold demand by the central banks of developing countries, and that has likely been an important driver of the increase in the real price of gold. A rising level of gold investment by emerging market central banks in an illiquid gold market could lead to a rising real price of gold. A rising real price of gold could act as a signal to momentum based investors to allocate capital to gold. As long as some central banks are insensitive to the price they pay for gold, the possible move into gold could drive the real price of gold much higher.

In summary, the authors concluded:

- The real price of gold is very high compared to historical standards
- There's little evidence that gold has been an effective hedge against unexpected inflation whether measured in the short- or long-term
- Gold isn't a currency hedge
- There's no proof that gold is a good investment when real returns on other assets are low
- If key emerging market countries owned gold on levels like more developed markets, the price of gold would likely rise

Investors tend to search for or interpret information to confirm their own views and ignore information that contradicts those views. Erb and Harvey present enough evidence to support either side of the debate about whether you should consider including an allocation to gold in your portfolio. At least now you can make a more informed decision.

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