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5 Reasons Not to Buy Gold

By MARK HULBERT

Conventional wisdom is that gold is an inflation hedge and a safe haven, but a new study finds otherwise.

Humphrey Neill, the father of contrarian analysis, famously wrote that "when everyone thinks alike, everyone is likely to be wrong."

That's a sobering thought when it comes to gold, since the belief in gold's investment virtues seems to be almost universal.

For this column I am taking Neill's advice to heart, with help from a new study published by the National Bureau of Economic Research in Cambridge, Mass. "**The Golden Dilemma**," by Claude Erb, a former commodities portfolio manager for Trust Company of the West, and Campbell Harvey, a finance professor at Duke University, calls the conventional wisdom into question.

I should stress that the study's authors are not predisposed against gold. For example, Erb told me, he frequently bought and held gold for the commodities portfolio he used to manage. Here's a summary of the study's findings:

Gold as inflation hedge

This is perhaps the most widely held belief about gold, and the one that the study's authors devote the most energy to analyzing. They found that gold does not live up to the widely held belief that gold's price in real terms remains more or less constant.

Over any of the time periods assumed by investors — from the short term to as long as 20 years — gold's real price has fluctuated wildly. Interestingly, Erb and Prof. Harvey told me in separate interviews that this finding holds regardless of how inflation is defined — whether it's based on government data, or the shadow statistics some think are more accurate, or monetary inflation as measured by money supply.

Gold as currency hedge

This is a close variant of the "gold as inflation hedge" argument. And it fares no better.

For example, the researchers found that the price of gold — both nominal and adjusted for inflation — in each of the three dozen countries studied tends to fluctuate more or less in unison. Currency fluctuations explain relatively little of the price change.

Gold as hedge against hyperinflation

This also is a close variant of the "gold as inflation hedge" argument. But it's worth discussing separately, since it's possible that even though gold does a disappointing job of hedging lower levels of inflation, it does a good job hedging against hyperinflation.

Unfortunately, the researchers find much to be desired on this front, too. Take what happened in Brazil between 1980 and 2000, for example, when — according to the International Monetary Fund — inflation averaged 250% *per year*. Over this two-decade period, according to the researchers' calculations, gold's price in inflation-adjusted terms dropped 70%.

What's more, this calculation relied on the official government statistics. If we make the reasonable assumption that those statistics understate the true extent of the inflation, the drop in gold's real price over this period would have been even greater.

Gold as a safe haven

Another widely held argument in favor of gold is that it hedges against the breakdown of geopolitical order. Thankfully, we don't have many opportunities to test this thesis, but the researchers find reason to question it.

For example, when the researchers focused on those occasions over the last three decades in which the financial markets suffered their worst returns, they found that gold's performance was more or less evenly divided between gains and losses.

Gold as hedge against low real interest rates

This is yet another widely held argument in gold's favor. And it certainly appears to be based solidly in the data. In the late 1990s in the U.S., for example, when real interest rates were high, gold's price was low. And in recent years, with real interest rates low, gold's price has been high.

Yet data from other countries paint a different picture. In the United Kingdom over the last three decades, for example, there is a very low correlation between gold's price and real interest rates — explaining only 9% of the change in the price of gold.

Conclusion

Are these arguments the final word on the subject? Of course not. The impulse behind contrarian analysis is not to close down debate but to pose hard questions. And, I think it's fair to say, many of us have not subjected our pro-gold arguments to rigorous historical scrutiny.

The researchers believe that there are other factors, beyond the standard ones that they investigate, that have a big impact on gold's price. It behooves investors to at least acknowledge that those other factors will greatly affect their returns over the short, intermediate and even longer terms.

One of the counterarguments that the gold bulls make is that gold's price has been manipulated and that, therefore, all analyses such as the researchers' are fundamentally flawed. One ancillary implication is that, because it is assumed that all such efforts at manipulation will ultimately fail, gold's virtues eventually manifest themselves over the very long term.

Interestingly, the researchers don't necessarily disagree. For example, they found that, over the very long term, gold does indeed appear to maintain its purchasing power. But, the researchers are quick to add, this tendency emerges in the data only when the holding period is measured over very long periods indeed — not years or decades, but over centuries.

So it's all well and good to buy the shiny metal because of its ability to hold its value over the very, very long term. But, the researchers find, you shouldn't use that argument to justify shorter-term expectations for gold, since it may be only your distant heirs several generations hence who will reap the rewards.

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