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No gold trader should ignore these odds

Commentary: Fundamentals don't explain gold's fluctuations

By Mark Hulbert, MarketWatch

CHAPEL HILL, N.C. (MarketWatch) — Gold traders should never forget that fundamentals are of import primarily for the long-term investor—and nearly irrelevant for the short-term trader.

To be sure, this is hardly an earth-shattering insight, and it applies to all markets, not just gold .

But, like everyone else when markets get overheated, gold traders in recent years became all too prone to overlook it. They were too quick to declare that short-term movements were entirely justified by the (CNS:GCQ3) fundamentals — so long as the direction was up.

GCQ3 **1,403.50**, +6.30, +0.45%

They were thus caught by surprise when gold fell several hundred dollars in just a few days' time. Since the drop could not be justified in terms of any change in fundamentals, they cried foul. But short-term gyrations — neither up nor down — can never be justified in those terms.

So those crying foul are only half right in contending that, when gold futures fell by more than $140 on April 15 of this year, fundamentals at the close of that day's session were not appreciably different than they were at the end of the previous session. But the same was true, say, three weeks later — on May 8, to be exact — when gold rose $25 in a single session.

Consider a fascinating recent study published by the National Bureau of Economic Research in Cambridge, Mass. Entitled "The Golden Dilemma," its authors are Claude Erb, a former commodities portfolio manager for Trust Company of the West, and Campbell Harvey, a finance professor at Duke University. They studied all the fundamental justifications for a gold bull market of which they were aware, looking for any that justified gold's historical short-term fluctuations.

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They came up empty: Regardless of how gold's fundamental value was defined, they found that gold's price fluctuated wildly relative to that definition.

Consider, for example, the commonly held belief that gold is an inflation hedge. That's tantamount to believing that gold's price remains more or less constant in inflation-adjusted terms, of course.

But that is manifestly untrue: Gold's real price fluctuates wildly, regardless of the currency in which gold's price is being expressed. For example, a ratio of gold's dollar price to the U.S. Consumer Price Index has risen as high as nearly nine-to-one over the last three decades and as low as less than two-to-one.

Note carefully that we can't wriggle out from underneath this conclusion by arguing that the CPI under-reports inflation's true magnitude. For example, Erb told me in an interview there has been just a big a fluctuation in gold's real price over the years when using alternate inflation measures like the one that has been advanced on John Williams' Shadow Government Statistics website.

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The same conclusion emerged when the researchers focused on other fundamental justifications for a long-term gold bull market, such as currency debasement, the threat of hyperinflation, money supply growth, and so on.

If not fundamentals, then what should traders turn to for insight into gold's short-term movements? The traditional answer, of course, is technical analysis.

Unfortunately, the track record of the short-term gold timers tracked by the Hulbert Financial Digest provides little reason for hope that technical analysis is the answer. Consider their track records, as summarized in the accompanying table.

	Last 5 years	Last 10 years	Last 15 years
% of gold timers making more money than buying-and-holding	8%	0%	0%
% of gold timers with a higher monthly Sharpe Ratio than buying-and-holding	15%	0%	0%
Average annualized gain of all monitored gold timers	3.4%	5.4%	3.7%
Gold's annualized gain	11.0%	15.9%	10.9%
Average monthly Sharpe Ratio of all monitored gold timers	0.07	0.09	0.04
Gold's monthly Sharpe Ratio	0.17	0.23	0.16

The results are, to say the least, awful. The best overall record of success comes at the 5-year horizon, and even then only 15% of monitored gold timers have beaten buying and holding gold on a risk-adjusted basis. And even that depressingly low percentage disappears when we focus on longer periods such as the last 10 or 15 years.

Furthermore, as you can see, the average gold timer produces a return that isn't even close to buying and holding.

The bottom line? Those who invest in gold are on the horns of a big dilemma.

If they decide not to trade, and simply buy and hold gold for the long term, then they must face squarely the daunting prospect of having to live through plunges as big and scary as that seen earlier this year.

And if they decide nevertheless to try their hand at trading, they must instead face squarely the historical odds that suggest they most likely will fail.

We would all rather not be faced with a dilemma both of whose horns are so unsatisfying. But wishing does not make it so.