THE WALL STREET JOURNAL.
WSJ.com

UPSIDE | April 19, 2013, 5:43 p.m. ET

The Great Gold Divide: Which Side Are You On?

By BRETT ARENDS

This past week's turmoil in the gold market knocked the precious metal down to its cheapest price in two years.

Yet when adjusted for inflation, it remains far above the average price levels it has seen since 1975, when it became freely tradable for U.S. investors.

There is a case for holding a modest amount of gold in a broader portfolio, but mainly as a diversifier, some investors say. Gold is hard to value, but it tends to behave differently than stocks and bonds in certain situations, such as inflation or financial distress.

Few investments, if any, produce the strong reactions that gold does.

The Wall Street Journal

Some investors love it. They think it is the only "real" money, a haven in crisis and a protection against runaway inflation. Others hate it. They think it is a "barbarous relic," as John Maynard Keynes described the gold standard, and a superstition rather than an investment.

The full range of opinion was on display this past week. Prices tumbled 9% on Monday, the biggest one-day slump in 30 years, although they firmed up slightly later in the week.

Some gold skeptics argued that the falling price was proof the economy was getting better and irrational fears were abating.

Gold proponents, often known as "gold bugs," took the opposite line. They argued the falling price was proof things were getting worse. They blamed the decline on China's slowing economy, possible bullion sales by distressed European governments or rising fears of a deflationary slump.

Investors try to buy assets when they are cheap in relation to their intrinsic value. The trouble with gold is that no one can agree on what that value should be.

Gold can't be measured in the same way as other financial assets, analysts point out. Unlike stocks and bonds, gold generates no income.

Many analysts have attempted to value gold in other ways, such as by assuming a constant ratio between the gold price and consumer prices, personal incomes, the amount of U.S. dollars in circulation or the value of the world's financial assets. A recent study by Campbell Harvey, a finance professor at Duke University's Fuqua School of Business, and Claude Erb, a former investment manager, found these led to an array of values.

Valuations based on price and income suggested the value could be as low as about $800 an ounce. Some estimates based on the money supply, by contrast, approached $8,000 to $10,000. Charles de Vaulx, chief investment officer at International Value Advisers, an investment firm in New York with $17 billion under management, says that there is no way to value gold precisely.

Josh Strauss, a partner at Pekin Singer Strauss Asset Management in Chicago, which has $1 billion under management, recommends holding plenty of bullion. He has 17% of his Appleseed Fund, a mutual fund, invested in bullion and was buying more this week.

Gold prices will soon resume their upward march because of the actions of the world's central bankers, Mr. Strauss says, adding that central banks in developed economies continue to print more money to combat sluggish growth. Japan's government is the latest to join the world-wide rush to print money, he notes.

Mr. Strauss also expects emerging-market countries such as China to buy more gold for their reserves, further boosting demand. Currently, China has less than 2% of its foreign currency reserves in gold bullion, compared with more than 70% for the U.S. and Germany, according to the World Gold Council, a trade group.

There is limited data about how gold has performed as an investment in the modern era, because for so long the gold market was either heavily regulated or fixed by governments. Yet some studies have found that gold has often performed well at times when stocks and bonds have done badly.

That has been the case at times of high inflation, such as in the 1970s, and in some cases at times of financial distress. If gold performs differently than other assets, then including some gold in a portfolio of stocks and bonds should lower volatility, analysts say.

Mr. de Vaulx of International Value Advisers holds almost 5% of his firm's flagship IVA Worldwide Fund in gold bullion as insurance against the risk of poor investment performance from other financial assets. Most stocks and bonds, he says, are currently expensive.

Cautious investors who want to allocate a small percentage of their portfolio to bullion have a number of choices. The simplest way to own gold is through an exchange-traded fund such as the SPDR Gold Trust, which has annual expenses of 0.4%, or $40 per $10,000 invested. Keep in mind, though, that capital gains on such funds face tax rates of up to 28% under rules for so-called collectibles.

An alternative, some investors say, is to purchase shares in a closed-end mutual fund that owns bullion. Gains on such funds are taxed more lightly, under standard capital-gains rates. This past week several such funds also saw their shares fall below the intrinsic value of their bullion holdings, a rare event.

The Central GoldTrust charges annual fees of 0.36%, or $36 per $10,000 invested. The Central Fund of Canada, which charges 0.31%, or $31 per $10,000, is the oldest such bullion fund and holds gold and silver.

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A version of this article appeared April 20, 2013, on page B7 in the U.S. edition of The Wall Street Journal, with the headline: The Great Gold Divide: Which Side Are You On?.