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HULBERT ON INVESTING

Weighing the Prospects for Gold Prices

Some experts argue that the precious metal is still overvalued.

By MARK HULBERT

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A Newmont Mining gold-mine operation in Nevada's Carlin Trend area. *Reuters*

The gold bugs are stirring.

A 10% gain by the yellow metal this year is rekindling hope among long-suffering bulls that the major bear market that began nearly three years ago finally might be over.

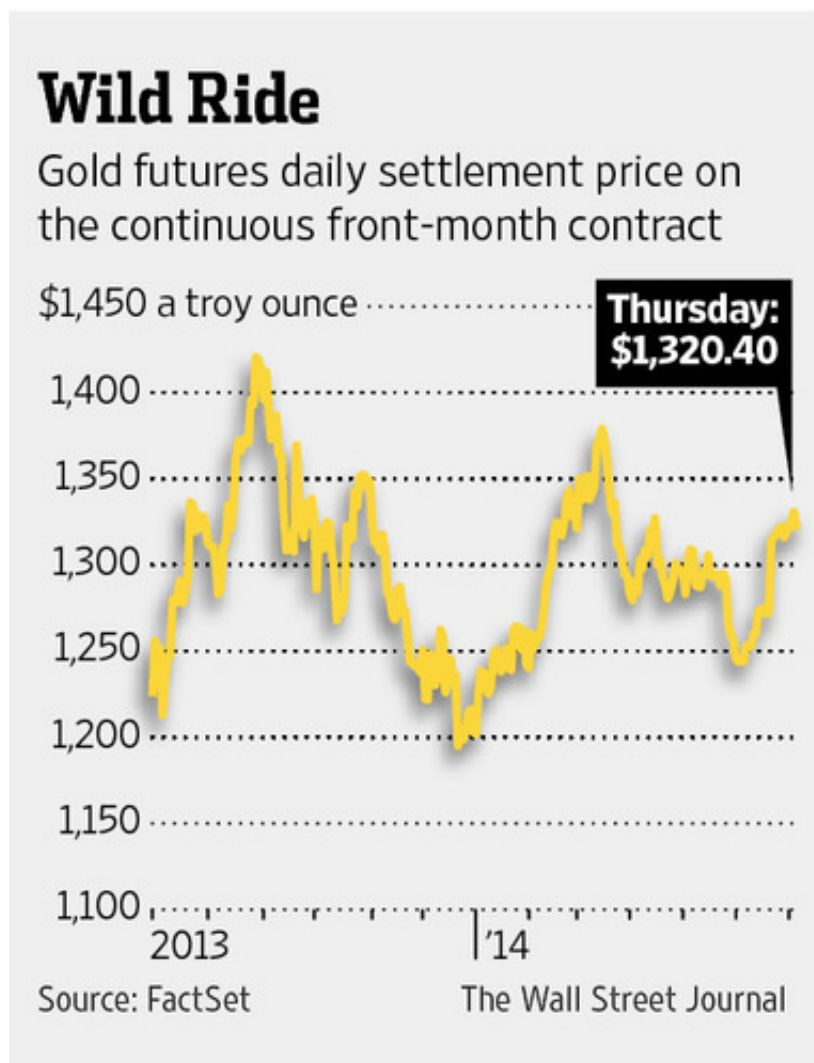
They argue that gold will continue to rise because investors will be seeking a hedge against rising inflation, currency fluctuations and geopolitical uncertainty.

Yet according to Duke University finance professor Campbell Harvey—one of academia's leading experts on gold prices—the odds are poor that the metal will return any time soon to its all-time high in August 2011. That month, the spot Comex gold contract reached an intraday high of \$1,929.20, more than \$600 above Thursday's settle price of \$1,320.40.

He puts gold's fair value today at a little higher than \$800.

A valuation model Mr. Harvey proposed in a National Bureau of Economic Research study 18 months ago, when gold was nearly \$1,700 an ounce, correctly foresaw that the metal was overvalued.

That model is based on the tendency for gold to decline whenever the ratio of its price to the consumer-price index rises well above its average level of about 3.4, and to rise when it is significantly below that average. With the CPI now at 237.1, this ratio stands at 5.6.



To be sure, Mr. Harvey acknowledges, gold is perfectly capable of taking a long time to return to its fair value—and by no means will the path it takes be a straight line. So a near-term rally isn't out of the question.

There is a shorter-term factor that nevertheless leads him to doubt gold can mount even a short-term rally that is very significant: rising Treasury yields, which go up as bond prices fall.

Over the past decade, Mr. Harvey points out, gold's price has been quick to respond to changes in Treasury yields—rising as yields fall, and vice versa. If you believe that yields will on average be higher in coming months than where they are today, as he does, then "gold will most likely decline" over the shorter term.

Shouldn't inflation be taken into account in predicting gold's performance? After all, gold is widely considered to be one of the best inflation hedges.

But gold's track record as an inflation hedge depends greatly on your time horizon, according to Claude Erb, Mr. Harvey's co-author on the National Bureau of Economic Research study and a former commodities and fixed-income manager at mutual-fund firm TCW Group.

Over the short term, he says, gold is a very unreliable inflation hedge. It is only over the long term that it can be a decent hedge—and he emphasizes that this long term must be measured over many decades at a minimum.

Based on the markets' recent behavior, Mr. Erb is confident that if inflation and Treasury yields were both to rise over the next couple of years, the most likely outcome still would be a lower gold price.

What steps should you take in your portfolio if you think inflation is about to heat up? Mr. Erb acknowledges that there isn't a great short-term inflation hedge. But he says that intermediate-term government bond funds should largely hold their own when inflation and interest rates rise, since they can reinvest in higher-yielding issues as their older bonds mature, thereby absorbing the losses of principal caused by those higher yields.

Mr. Erb points to the surprising resilience from 1966 through 1981 of intermediate-term U.S. government bonds—those with five-year maturities. This 16-year period is often considered the worst environment in recent history for bond investors, since intermediate Treasury yields nearly tripled. Nevertheless, according to Ibbotson Associates data, these bonds produced a 5.8% annualized return over the period.

The most popular intermediate-term bond fund, among those advisers monitored by the Hulbert Financial Digest who have beaten the S&P 500 over the past 15 years, is the [Vanguard Intermediate-Term Investment-Grade Fund](#), which charges annual fees of 0.20%, or \$20 per \$10,000 invested.

The fund's current yield is 2.6%, and its average effective duration of the bonds it owns is 5.2 years. ("Duration" is a measure of sensitivity to interest-rate fluctuations; a lower duration implies less sensitivity.)

If you nevertheless want to bet on gold, or simply want to follow the advice of many financial advisers to allocate a small amount of your portfolio—perhaps 5%—to gold for diversification purposes, shares of gold-mining companies are probably the cheapest way in, as the shares of such companies have significantly lagged behind bullion over the past 18 months.

Since the beginning of 2013, for example, the NYSE Arca Gold Miners Index has fallen 42%, nearly double bullion's 22% loss. Shares of smaller gold-mining companies have lagged behind even more.

Two exchange-traded funds that track such stocks are Market Vectors Gold Miners, with a 0.53% expense ratio, or \$53 per \$10,000 invested, and Market Vectors Junior Gold Miners, with expenses of 0.57%. In the first half of 2014, these funds gained 25% and 36%, respectively.

If you prefer the shares of individual gold-mining companies, Freeport-McMoRan Copper & Gold is currently the one most recommended by the Hulbert Financial Digest-monitored advisers who have beaten the S&P 500 over the past 15 years. Also popular are Agnico Eagle Mines, Barrick Gold, AngloGold Ashanti and Newmont Mining.

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