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Why To Buy And Why Not To Buy Gold ?

Jan. 29, 2015 4:22 AM ET
by: Builder

Summary

- Reasons for buying gold that have been debunked.
- Reasons for buying gold that may make sense today.
- Options to buy?

Gold has been in a bear market since September 2011. However, since the beginning of the year, it has had a nice run compared to the major indexes. Many investors must be wondering whether this is the 'Year of Gold' and whether this is a good time to buy some.

Before putting money into any commodity instrument, one must always question why one is investing in it, under what circumstances might its value go up and under what circumstances might its value come down. This article will critically examine historical reasons for buying gold that have been soundly discredited, reasons for buying that may still have some validity and options to consider for investing.

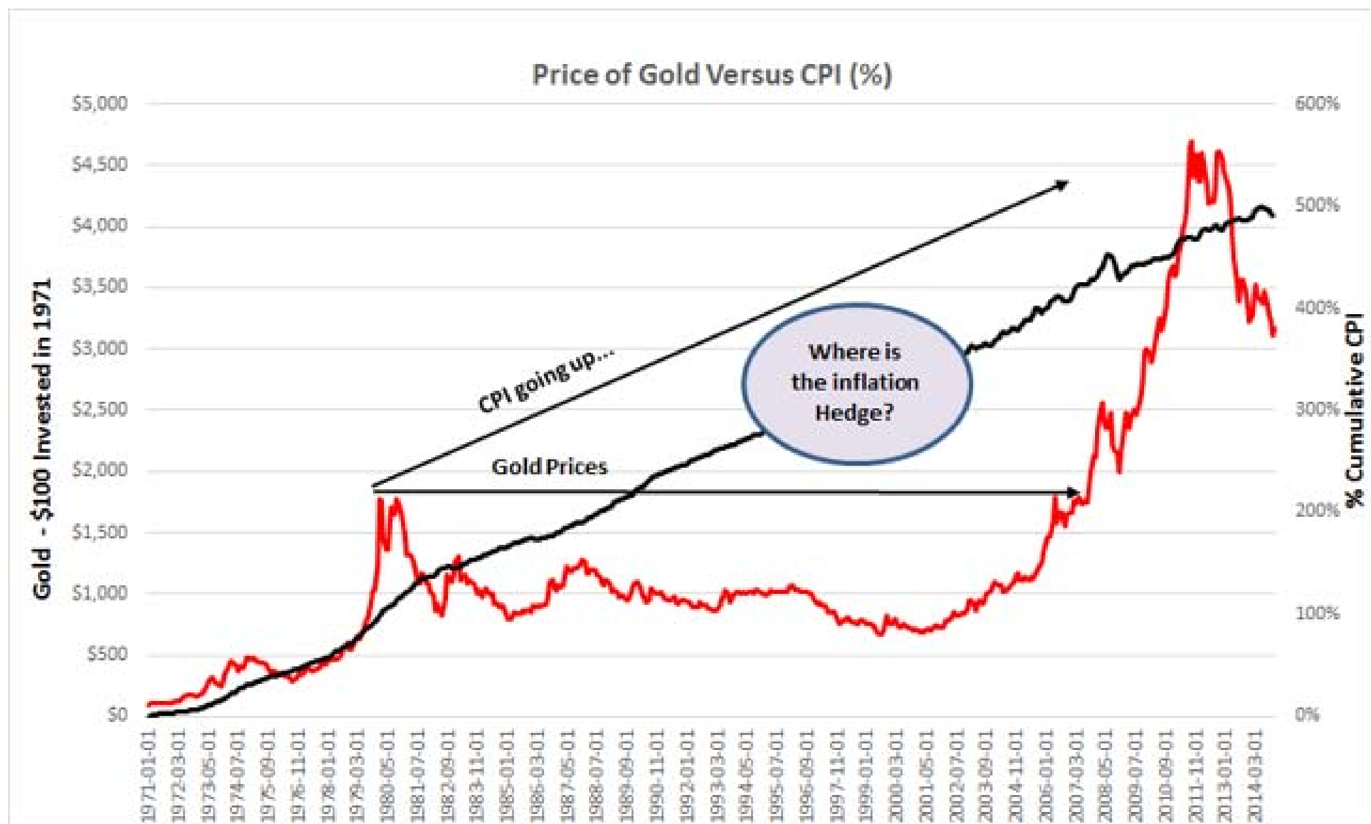
Reasons for buying gold that have been debunked

Gold as an Inflation Hedge

Gold had a massive bull run from 1971 to 1980, when it increased from $38 per Troy Ounce to a peak of $850 per Troy Ounce, an increase of more than 2000% over ten years. Around the same time, annual inflation was averaging 9% for almost half a decade until it peaked out in 1980. This lead most people to wrongly conclude that gold is an excellent long term inflation hedge.

I looked at data comparing the increase in price of gold to the increase in the cumulative CPI from January 1971 to December 2014. The spike in gold prices coincides with an increase in the CPI right until 1980 and then the relationship completely breaks down. From 1980 to 2006, the CPI almost tripled, but gold was still where it was in 1980.

(click to enlarge)



A more comprehensive study conducted recently by Jonathan A. Batten, Cetin Ciner and Brian M. Lucey from three different universities in 2014, concluded in no uncertain terms that 'there is no cointegration between gold and the consumer price index if the volatile period of the early 1980's is excluded from the data.'

Well known academicians and most finance professionals of good repute agree that it has been conclusively proven that gold is not a good inflation hedge, if anything it's a bad one and yet this notion persists. In general, the prices of both gold and CPI have gone up over time, and occasionally gold may very well catch up with the percentage increase in the CPI. However this does not mean that they are correlated or that gold can be treated as an inflation hedge. They are completely independent.

Gold as a Currency Hedge

Currency hedging with gold is another major idea that has been floated around mostly in the 2000's. It's a roundabout way to hedge inflation in the United States against inflation in other major developed economies. This hypothesis has

also conclusively been proven wrong. For gold to be a good currency hedge, there needs to be a clear relation between gold and these currencies. However, the standard deviations between gold and the global currencies are very high, and the coefficient of determination values are very small. In layman's terms, the statistical data simply does not support the case for using gold as a hedge. If you can digest some college level statistics, here is the paper.

In a separate study, Erb and Harvey looked at 23 different currencies including emerging market behemoths like India and China, and the results were largely identical. Their conclusion is pretty unambiguous - real gold prices rise and fall largely in tandem and gold is not a good currency hedge.

The Real Local Price of Gold, 1975-2012

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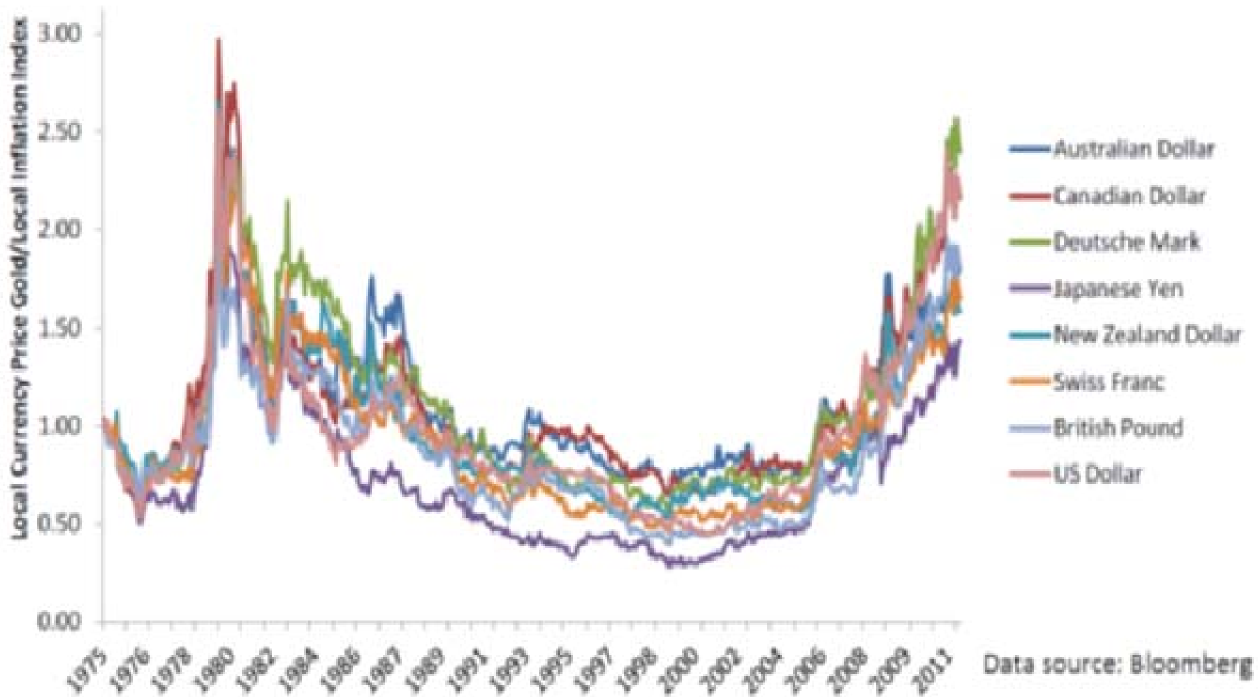
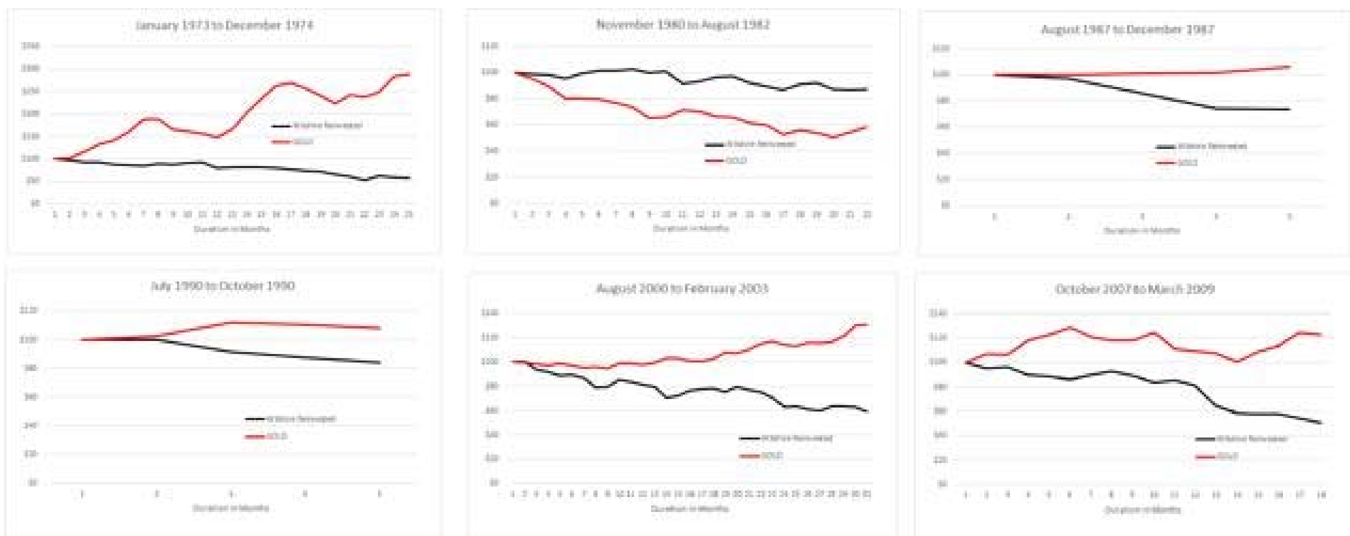


The chart has been extracted from 'The Golden Dilemma' by Claude B. Erb and Campbell R. Harvey from Duke University.

Gold for Protection During Bear Markets

There is actually some truth to this. I compared the performance of gold and the Wilshire 5000 dividend reinvested index, and results indicate that gold did indeed perform better during bear markets on all six occasions except once from November 1980 to August 1982. Results are presented in the Figure below.

(click to enlarge)



This chart is incredibly misleading because there are two major catches to this. These returns are from the absolute bull market highs to the bear market lows. I don't know of any person living or dead who has been able to identify market highs and market lows consistently in real time. Also, let's say if someone were able to identify the bull market high, isn't it better to short the market where the results are guaranteed rather than invest in gold?

Reasons that may have some merit

Emerging Market Consumers

The price of gold increased from around $260 in the late 1990's to almost $1300, which represents a 400% plus return and at its peak at $1920 represented a 600% increase. Everyone was taken by surprise when gold started showing signs of life after lying dormant for almost 20 years. The most rational and reasonable explanation that I have found for this increase is consumer demand from emerging market economies. The percentage of gold demand in emerging markets in 1999 was about 39% of the total and throughout the 2000's ramped up to between 50 - 60%. This thesis was presented by Amit Bhartia and Matt Seto in their white paper on gold prices.

They plotted the price of gold to the percentage of gold demand emanating from emerging Asia, and visually it makes a compelling case. Another point that they make that is even more compelling is that even though consumers in India and China are getting richer they do not have many investment avenues to put their hard earned money into, a notion they call 'financial repression'. Their article can be accessed here.

However, they have also cautioned that '***Our intent is not to make predictions about the price of gold, but to create awareness that emerging markets represent a significant factor in how gold is being, as well as will be, priced in the future.***'

One of the biggest flaws that I noticed in their analysis is that they completely ignored global demand numbers. Throughout the decade, the total world gold demand had not changed much since 1999. So, when the total demand is relatively stagnant over such a long time, how can demand from emerging countries account for such a run in prices? Their white paper does not address this issue nor does it offer any explanation.

India and China are growing, and the consumers there will buy more gold. They will buy gold not only for ornamental purposes, but also as an investment just because they don't have enough liquid avenues to put their savings into. I find this a rational and reasonable assumption. This may lead to an increase in gold prices.

Major Geopolitical and Military events

The dramatic spike and rise in gold prices between 1978 and 1980 was caused due to a combination of extreme geo-political events like the Russian invasion of Afghanistan and the Iran hostage crisis. The world was on the edge of war and gold spiked. Gold played its part perfectly as a hedge and a store of value against extreme political and economic uncertainty. The reasons for the spike in gold in1973 and 1974 were similar. Given below is an excerpt from 'The 1972-75 commodity boom' by Richard Cooper and Robert Lawrence for the Brookings institution. This was written in 1975 right in the middle of the decade.

The sharp increases in gold prices in the spring of 1973 and again in the spring of 1974 can be taken as a rough indicator of the prevailing uncertainty about the functioning of the international economic system in the face of substantial changes such as the adoption of floating exchange rates or a marked increase in oil prices. (It is also true, however, that South Africa, the major producer of new gold, reduced its sales substantially in 1974, pushing the price up; and there were periodic rumors that European nations would resume official purchases of gold at a high price.) Prices of art objects, antiques, real estate, wine, and other hedges against an uncertain value of money also rose sharply during this period. Thus, the continued climb of prices of nonferrous metals in early 1974, despite sharp declines in industrial demand, may reflect this same uncertainty with regard to the financial system.'

So, whenever financial uncertainty persists, gold generally spikes. So hedging with some gold in a portfolio can be considered a good idea. The downside is that most of these events are very short lived and gold prices typically collapse after the event subsides.

The world gold council recommends making an investment in gold partly due to what they like to call 'a tail risk hedge'. In one of their research reports, they mention events like Black Monday, the LTCM crisis, September 11th, the financial crisis of 2007-2008 and a few more as tail risk events and argue that on an average a portfolio with 2.5 - 9% allocated to gold would be less volatile.

Limited Supply of Gold?

People always love to talk about how the planet will eventually run out of mineral resources, and it's no different in the case of gold. As expected, this prediction of 'peak gold', a theory similar to 'peak oil' has been made several times in the past. Here are some of the more recent ones.

1. As recently as September 2014, the CEO of one of the world's biggest gold miners, Goldcorp (NYSE:GG) Chuck Jeannes said, "peak gold" will be reached in 2014 or in 2015. He said, "Whether it is this year or next year, I don't think we will ever see the gold production reach these levels again." He went on to add, "There are just not that many new mines being found and developed."
2. In 2009, the then CEO of Barrick Gold, Aaron Regent claimed that global production had peaked in 2000.
3. In 2012, the CEO of Natural Resource Holdings, Ltd, Roy Sebag claimed that gold production would peak between 2022-2025.

I am deeply skeptical about the peak gold theory. The same script has been played several times in history. Typically whenever gold prices have reached unprecedented highs, mining companies magically find more gold.

Another thing to take into consideration is that gold is a renewable resource. That makes it even more difficult to anticipate the impact of peak production. Every ounce of gold that has ever been mined is still available on this planet. So what does peak gold even mean?

However, I do find this notion of peak gold combined with tightening supply and increasing demand from emerging markets at least rational and reasonable. This can prove to be quite a potent momentum builder for gold prices in the near term.

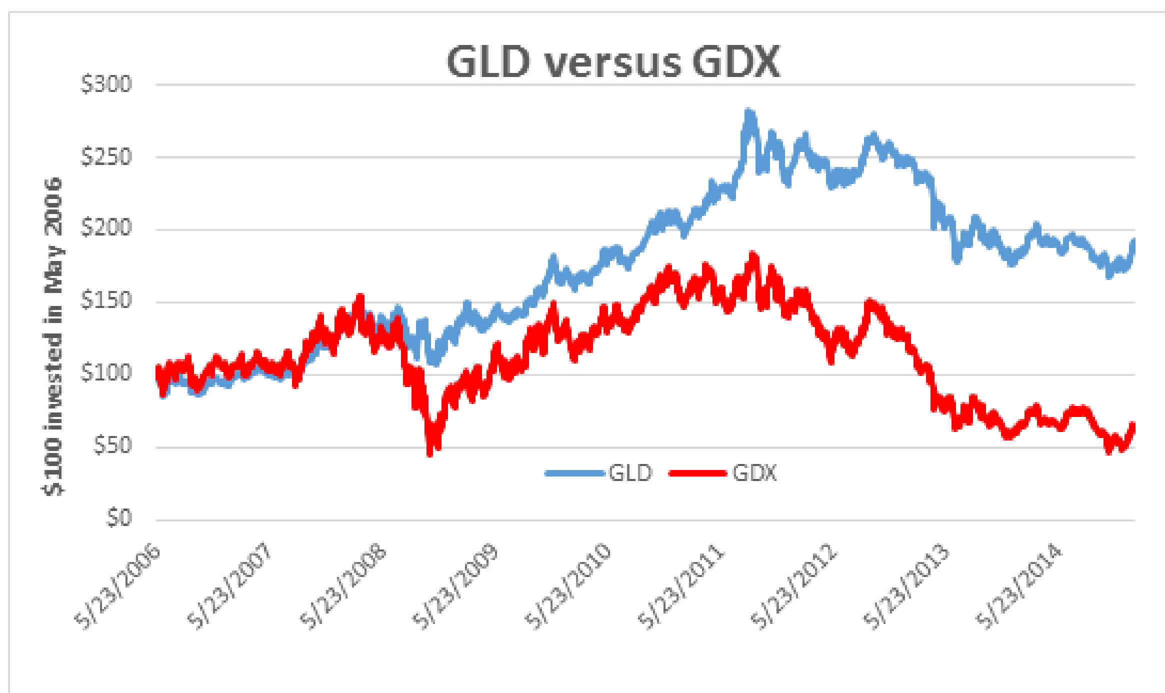
Options to Buy

Buying bullion or gold coins is impractical for most investors so I am not going to include that in this analysis. I am also skipping analyzing specific company stocks since they require detailed research into company financials and this article is not focused on that. Since we are looking to invest in gold as an asset class, I will use ETFs for my analysis. Please remember that this is a very basic 'starter' list and more research would be needed before considering any serious investments.

There are two predominant ETFs tracking the price of Gold Bullion - the SPDR Gold Trust (NYSEARCA:GLD) and the iShares Gold Trust (NYSEARCA:IAU). Both provide ample liquidity, with average volumes of above 2 - 4 million, although GLD is lot more liquid. ETFS Gold Trust (NYSEARCA:SGOL) is also an option, and it may be traded commission free at Charles Schwab, but it's relatively illiquid compared to the other two. The expense ratios for GLD, IAU and SGOL are 0.40%, 0.25% and 0.39% respectively. Also, all three have a short term and long term capital taxes that are typically higher than regular stocks.

You can also consider investing in Market Vectors Gold Miners ETF (NYSEARCA:GDX). This ETF tracks the NYSE Arca Gold Miners Index. But this instrument is a lot more volatile. If you are confident about the start of a gold bull market, this may be a good option to look into. Figure below shows the comparative performance of GLD and GDX.

SPDR Gold Trust versus Market Vectors Gold Miners ETF



Conclusion:

Since the advent of modern economics, gold has been soundly beaten by stocks over longer-time horizons. But, it has always sprung back to life whenever a major geopolitical or financial event occurs. In my view, this makes it a trading instrument or a hedging instrument rather than a long-term investment.

Research indicates that investment in gold as a hedge against inflation, as a hedge against currency movements and as protection against bear markets are all flawed ideas. It does not offer adequate protection against any of these.

Gold has now become accessible to individual investors in the form of ETFs. That makes it a lot easier to own and invest in it compared to any other time in modern economic history. If you are planning to invest in gold as a play on emerging market consumers, as a hedge against major geopolitical events or as a bet on limited worldwide supplies, it may work as a speculative bet. However, you have to be a 'market timer' rather than a long-term investor in order to be able to generate positive returns.

Further Research:

A lot more serious academic research needs to be done on the 'Peak Gold' theory and its ramifications on worldwide gold demand.

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