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Time To Go For Gold?

Intelligent Investing

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Martin Fridson, Contributor

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Gold is up 27% this year, but still 25% below its late-2012 peak. In short, the price is right for taking a modest position as a safety net.

When market pundits are asked by television interviewers whether the time is right to buy stocks, they do not first have to defend the proposition that equities are a legitimate investment category. It is a different story when the subject is gold. Before offering a Buy or Sell opinion, pundits usually have to fend off objections to the asset itself: “Gold represents no productive activity.” “It has value only because people believe it does.”

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Fisher Investments’
Jim Grant has an answer for that last point. He facetiously remarks that gold is now a high-yielding asset, at 0% in a world of negative interest rates on many countries’ sovereign debt. The other two objections are irrelevant. What matters is not philosophical questions, but whether owning gold today advances some worthwhile financial objective.

If that objective is hedging against routine inflation, gold is not the solution. The table below shows that gold rose by a mere 7% during a quarter-century in which the Consumer Price Index more than doubled. While CPI was rising at a compound annual growth rate (CAGR) of 3.34%, gold appreciated at a paltry 0.30% a year.

**Gold ($/ounce) and Inflation (%)**

<table>
<thead>
<tr>
<th>Date</th>
<th>Gold</th>
<th>CPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/29/06</td>
<td>636.70</td>
<td>203.10</td>
</tr>
<tr>
<td>12/31/80</td>
<td>589.75</td>
<td>86.40</td>
</tr>
<tr>
<td>CAGR</td>
<td>0.30%</td>
<td>3.34%</td>
</tr>
<tr>
<td>Change</td>
<td>+7.16%</td>
<td>+107.96%</td>
</tr>
</tbody>
</table>

*Based on Gold Spot Price and Consumer Price Index.*

*Sources: Bloomberg, Federal Reserve Bank of St. Louis*

Gold may prove more effective as a hedge if inflation gives way to hyperinflation. Economists generally define that term as an inflation rate exceeding 50% per month. This is not an imminent prospect, no matter how
Certainly, there was no hyperinflation to account for gold’s 53% surge between 2009 and 2012. In fact, no universal agreement exists concerning the cause. Perhaps the most plausible explanation is that demand for gold increased in emerging economies, which were enjoying exceptional prosperity at the time. A return to those conditions would probably require a pickup in China’s economic growth and, by extension, greater demand for industrial materials exported by those emerging market countries.

The 2009-2012 episode was not the only time gold rallied without the catalyst of hyperinflation. The price more than doubled in 1979 and nearly tripled between 1972 and 1974. Those spikes coincided with oil shocks that severely disrupted the global economy. Currently, oil prices are languishing, but the risk of some other kind of shock is not insignificant. Terrorism and the rising populist tide in Western democracies are two possible triggers of future crises.
Even for investors who are primarily interested in income, it would not be inappropriate to allocate 2% of assets to this non-income-generating commodity.

It is essential, however, to avoid letting ideology interfere with a clear-eyed assessment of gold’s investment merits. Admittedly, returning to the gold standard, as Ted Cruz proposed during his unsuccessful presidential campaign, dangles the appealing prospect of keeping the dollar’s purchasing power constant for a very long time. According to Duke University finance professor Campbell Harvey, an ounce of gold bought 350 loaves of bread in 562 B.C., during Babylonian King Nebuchadnezzar’s reign. That comes to $3.14 a loaf at the current gold price, approximately what Harvey pays at Whole Foods.