How secure is gold as a store of wealth for investors?

Gold is one of the best-performing assets of 2016, but its reputation may be overstated

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Gold has been one of the big winners of 2016, with gains of almost 20 per cent fuelling talk that a new multiyear bull market is under way. Should investors be increasing their exposure, or is the precious metal best left to gold bugs?

Although prices have slipped in recent weeks, gold has nevertheless been the second-best-performing precious metal this year, behind only silver. Gold’s 17 per cent gain in the first quarter was its biggest quarterly gain in 30 years, while gold demand soared 21 per cent – the second-fastest pace on record, according to a recent World Gold Council (WGC) report.

Inflows into gold exchange-traded funds (ETFs) hit their highest level since the first three months of 2009, with the WGC positing that this surge in demand was not merely driven by price momentum alone; rather, “latent demand among investors who have been looking for an opportunity to re-enter the market was a key factor”, with investors “initiating or rebuilding strategic, long-term holdings after the wash-out of positions since early 2013”.

The suggestion that the recent rally signifies the end of the bear market that saw gold tumble from $1,920 in 2011 to $1,050 last December is unsurprising, perhaps, given that the WGC is an industry-backed body. However, others are similarly enthusiastic.

Earlier this month, legendary investor Stanley Druckenmiller, who averaged annual returns of 30 per cent over the 1986-2010 period, advised investors to “get out of the stock market” and to buy gold, which he described as “our largest currency holding”.

Druckenmiller’s former partner, George Soros, has also been buying, as have hedge funds in general – net long positions by money managers recently hit their highest levels since 2011. JPMorgan too is bullish, recently telling clients “to position for a new and very long bull market for gold”.

**Negative interest rates**

Bulls point to a number of developments that buttress the case for gold, the key one being growing uncertainty regarding the effectiveness of global monetary policy.

Negative interest rates are now prevalent across Europe and Japan; globally, yields are negative in about 30 per cent of government bonds (another 35 per cent yield between 0 and 1 per cent). Institutional investors and central banks that might otherwise be reluctant to purchase non-yielding assets like gold are forced to reconsider when the alternative is a
loss-making bond investment, potentially driving a structural increase in demand for the precious metal.

Additionally, fears that central bankers are running out of ammunition – negative rates would have seemed unthinkable not so long ago – increase the safe-haven appeal of gold, which has long been viewed as offering shelter from potential market storms.

The idea that gold is in a bull market will jar with those who note that even a $1,300 gold price – a level briefly surpassed earlier this month before slipping back – remains some 35 per cent below 2011’s all-time high.

Gold has enjoyed many counter-trend rallies since 2011’s all-time high, all of which ultimately petered out. However, none of those rallies matched the recent advance – gold soared by 23 per cent between mid-December and early May, meeting the technical definition of a bull market. According to Charlie Morris, a former HSBC money manager who now runs the Atlas Pulse blog, 20 per cent rallies have “a good history of being the line on the sand”; over the last four decades, gains of that magnitude have marked the end of bear markets on all but one occasion.

**Fair value**

On the other hand, bear markets don’t tend to end when assets reach fair value; rather, they overshoot to the downside. Although valuing a non-yielding asset like gold is an inherently difficult exercise, many observers would argue that did not occur during the 2011-2015 bear market. For example, Prof Campbell Harvey and former commodities manager Claude Erb, co-authors of the 2015 study *The Golden Constant*, argued history suggested a fair value estimate of $825, well below last December’s $1,050 nadir.

Additionally, gold’s surge during the first quarter of 2016 was partly catalysed by expectations that the US Federal Reserve would not hike interest rates any time soon.

Gold has pulled back in recent weeks, however, following hawkish noises from several Fed governors. Futures data indicates the odds of a June rate increase have risen from just 4 per cent to 30 per cent in recent weeks, while the odds that rates will be hiked by July have risen from 30 per cent to above 50 per cent.

As always, both sides have their arguments; an honest observer would admit the trajectory of gold over the short – and intermediate – term is anyone’s guess.

What about gold’s appeal as a long-term investment? Does it deserve its reputation as a hedge against inflation, a safe haven in times of trouble?

The safe-haven thesis is overstated, according to Campbell Harvey and Claude Erb. They looked at the monthly returns of equities and gold over the 1975-2012 period and found that on almost half the occasions where stocks declined, gold also declined in value. The same point was made in a Barclays note last week: there is an assumption that gold does well when equities tumble but gold’s “historical record over the long run is far from perfect on this count”. 
**A store of wealth?**
Gold’s reputation as a classic store of wealth partly stems from research conducted in 1977 by Prof Roy Jastram. Using UK data that went all the way back to 1560 and US data that stretched back to 1800, Jastram showed gold did indeed hold its purchasing power over the centuries.

In Germany, too, gold held its purchasing power throughout the 20th century, when other assets were decimated by hyperinflation and political and economic collapse.

However, Jastram also showed that while gold was a good inflation hedge over a century or longer, it was a poor inflation hedge over shorter timespans.

“Patience is surely an important trait in investing”, to quote the aforementioned Barclays note, “however, this may be stretching it”.

Gold’s record in recent decades is telling in this regard. It has (just) beaten inflation over the last 40 years, even if equity and bond returns were much superior. Huge returns were seen in the 1970s, soaring from about $40 in 1971 to $850 in 1980. However, gold went on to lose 70 per cent of its value over the following 20 years, and did not surpass its 1980 peak until 2008 – a 28-year wait. Adjusted for inflation, gold has yet to reclaim 1980 levels.

**Asset allocation**
While the data indicates gold’s reputation as a safe haven and an inflation hedge is overstated, that doesn’t mean it has no place in investors’ portfolios.

Many investors will argue gold offers obvious diversification benefits. For example, Bridgewater’s Ray Dalio, one of the most successful hedge fund managers of all time, once said there is “no sensible reason” not to own gold, “other than you don’t know history and you don’t know the economics of it”.

Dalio’s famous All-Weather Fund is based on the idea that investors should prepare for all eventualities so that their portfolio can survive an event that might be catastrophic for any one portfolio component.

Nevertheless, although Dalio’s above-mentioned words are often cited by gold bugs, his All-Weather Fund is dominated by stocks and bonds, with gold accounting for an asset allocation of 7.5 per cent.

Barclays suggests a lower allocation again, “no more than low single digits in percentage terms” as a proportion of portfolios. “Calls to hold significantly more, no matter how honeyed the voices, should be strongly resisted.”