Swedroe: Don’t Be Distracted By Gold’s Glitter

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Perhaps fueled by the election of Donald Trump, once again we are hearing and reading stories about investors flocking to gold as both a safe haven and an inflation hedge. I’ve also noted an increase in the number of commercials promoting gold as a way to protect the value of your investments.

With that in mind, I thought it would be a good idea to return to my trusty videotape. I dug into my files to find the following forecasts, as well as some of the academic evidence on gold as an investment vehicle.

Pro-Gold Voices

In mid-July 2012, with gold trading at about $1,577, Merrill Lynch added its voice to the many that were predicting gold would reach $2,000 an ounce by the end of that year. Francisco Blanch, head of global commodities research at the investment bank, said: “We think that $2,000 an ounce is sort of the right number.”

At about the same time, in an interview with ETF.com, money manager Peter Schiff, who has attracted much media attention with his doomsday forecasts, offered up this prediction: “I’m looking for another leg up … it’s going a lot higher. It’s hard to tell where the next move is going to take it. But it’s going thousands of dollars higher than it is now.” When asked how high, he responded: “I think a minimum of $5,000. But it could go a lot higher than that.”

These kinds of predictions almost certainly helped drive investor interest in gold. In fact, a 2011 Gallup poll found that 34% of Americans thought gold was the best long-term investment, far more than those who chose real estate, stocks or bonds.

Of course, given investors’ tendency to buy high and sell low, after its poor performance since 2011, the 2016 Gallup poll found that gold was the favorite investment for just 17% of investors, now well behind the 35% figure for real estate and the 22% figure for stocks.

The question I’ll try to address today is: Do individuals choose to invest in gold for the right reasons? Well, one reason for investor interest in gold is the belief that it is a great hedge for inflation. Another is that it provides a hedge against currency risk. And a third is that gold can act as a haven of safety in bad times. Are these valid reasons?

The Evidence
In their June 2012 study, “The Golden Dilemma,” Claude Erb and Campbell Harvey examined these issues. In terms of being a currency hedge, they found the change in the real price of gold seems to be largely independent of the change in currency values. In other words, gold is not a good hedge of currency risk.

As for gold serving as a safe haven, meaning that it is stable during bear markets in stocks, Erb and Harvey found gold wasn’t quite the excellent hedge some might think. It turns out 17% of monthly stock returns fall into the category where gold is dropping at the same time stocks post negative returns. If gold acts as a true safe haven, then we would expect very few, if any, such observations. Still, 83% of the time on the right side isn’t a bad record.

In terms of gold’s value as an inflation hedge, the following example should help provide an answer. On Jan. 21, 1980, the price of gold reached a then-record high of $850. On March 19, 2002, gold was trading at $293, well below where it was 20 years earlier. Note that the inflation rate for the period 1980 through 2001 was 3.9%. Thus, gold’s loss in real purchasing power was about 85%. How can gold be an inflation hedge when, over the course of 22 years, it loses 85% in real terms?

As additional evidence of gold’s inflation hedging abilities, Goldman Sach’s “2013 Outlook” contained the following finding: During the post-World War II era, in 60% of episodes when inflation surprised to the upside, gold underperformed inflation. That said, gold has been a good hedge of inflation over the very long run (such as a century). Unfortunately, that’s a much longer investment horizon than that of most investors.

Thus, in two of the three cases, with the exception of the safe-haven hypothesis, there is not sufficient evidence to support investing in gold.

**A Research Update**

In August 2015, Erb and Harvey updated their 2012 study. They began by examining the argument that gold is an inflation hedge, or what they call a “golden constant.”

The authors explained: “One way to think about the golden constant perspective is as a collection of statements that assert that: 1) over a very long period of time, the purchasing power of gold remains largely the same; 2) in the long run, inflation is a fundamental driver of the price of gold; 3) deviations in the price of gold relative to inflation will be corrected; and 4) in the long run, the real return from owning gold is zero.”

Their study covered the period beginning in January 1975. The authors found that, over the period, the average real price of gold is 3.46 times the U.S. Consumer Price Index (CPI). I updated the data through January 2017. Doing so put the CPI level at 241.7. Multiplying gold’s average real price by the current CPI (3.46 x 241.7) delivers a price of approximately $836. This represents what the nominal price of gold should be today—if we assume the real price of gold is constant.

Of course, over time, prices have strayed far from the golden constant. And, as Erb and Harvey noted, the golden constant isn’t a fact, just a hypothesis. But if your reason for buying gold is that it is an inflation hedge, your expectation should be that gold will revert to its golden constant over time. Despite haven fallen from a peak of almost $1,900 in September 2011, with the price of gold at about $1,209 as I write this, it’s still about 45% above the golden constant of $836.

Returning to the 2015 update of Erb and Harvey’s paper, they asked: If the golden constant provides a guide to the value of gold, what typically happens when the price of gold is above or below its golden constant value? They found that the high real price of gold has been about 8.73 and the low real price of gold has been about 1.47.

Thus, while there is a tendency to revert to the golden constant, the price of gold can vary greatly from the golden constant and stay well above or below it for a long time. And as the authors observe, there is no way of
knowing if the “future high and low real prices of gold may be more or less extreme than in the past.” As of March 2017, those are still the highest and lowest values. In addition, the current real price of gold is about 5.00, roughly 45% above its historical average of 3.46.

Erb and Harvey added the following: “The high and low real prices of gold highlight that even if there is on average a golden constant the real price of gold has strayed, and probably will stray, far from this possible central tendency. It is also possible that the future will be unlike the past.” They warn that if the “real price of gold falls, the golden constant level is not a floor—a protective line in the sand that the real price of gold will not cross.”

With this caveat, they went on to examine the outlook for gold returns given where the price is relative to the golden constant.

**Expected Returns To Gold**

Erb and Harvey examined what happened to the return on gold when prices were above or below the golden constant. As you might expect to see, the authors found that “below-average real gold prices have been followed by above average 10-year real gold returns” and “above-average real gold prices have been followed by below-average 10-year real gold returns.” The real price of gold is currently above its historical average, suggesting that, over the next 10 years, real gold returns seem more likely to be below their average.

Erb and Harvey also looked at the downside risk of owning gold. To do so, they asked: How low might the price of gold go if the previous low real price of gold is revisited? Given the value of the U.S. CPI for June 2015 (237.8) and the previous low real price of gold, they found a possible low price for gold of about $350 an ounce. This, of course, does not mean the price of gold would immediately decline to $350 an ounce. Rather, it's simply a suggestion that, given the volatile history of real gold prices, the real price of gold once fell to 1.47 and it could fall to that level again.

The authors also examined what would happen if gold went back to its previous highest real price. If that occurred, it means the price of gold would again have reached about $2,080.

Erb and Harvey then looked at what would happen to real and nominal returns on gold if we assumed inflation of 2% per year over the next 10 years. Why 2%? It was roughly the difference between the yield on 10-year Treasuries and 10-year Treasury inflation-protected securities, as well as similar to the consensus forecast of economists gathered by the Federal Reserve Bank of Philadelphia.

**Assuming 2% Inflation Per Year**

Starting with the golden constant price of gold calculated using the June 2015 CPI level, they found that the golden constant value of gold would increase from $825 an ounce to $1,006 an ounce, and the “overshoot” price would rise from $350 an ounce to $427 an ounce.

If, over a 10-year investment horizon, the price of gold fell from $1,096 an ounce (gold’s nominal price in mid-2015) to $1,006 an ounce, it would experience a nominal return of -0.9% per year and a real return of -2.8% per year. Given that today’s price is $1,209 per ounce (an increase of 10% from gold’s price of $1,096 at the time Erb and Harvey did their original analysis), and inflation has increased by a much smaller amount, the return over the next 10 years would look even more dismal.

Erb and Harvey calculated that if the price of gold dropped from $1,096 an ounce to its 10-year “overshoot level,” the nominal and real returns would be -9.0% per year and -10.8% per year, respectively. Again, given today’s higher price of $1,209, the next 10 years would look even more dismal.
Erb and Harvey concluded that, even though there is little relation between the nominal price of gold and inflation when measured over 10-year periods, the evidence suggests gold does hold its value over the very long run.

For example, in a prior paper, they presented historical evidence that the wage of a Roman centurion (in gold) was approximately the same as the pay earned by a U.S. Army captain today. They also showed that the price of bread (again in gold) thousands of years ago was about the same as we would pay today at an upscale bakery.

**Summary**

The conclusion we can draw is that, while gold might protect against inflation in the very long run, 10 years—or even 20 years—is not the long run. Erb and Harvey note: “In the shorter run, gold is a volatile investment that is capable and likely to overshoot or undershoot any notion of fair value.”

I would add to that another insight that becomes important in the long term. While the laws of economics can be defied in the short term, history demonstrates that investors ignore them at their peril. For instance, a basic economic principle is that, over the long term, prices tend to move toward the marginal cost of production.

In their “2013 Outlook,” Goldman Sachs observed that more than 80% of gold production costs less than $1,000 an ounce—or about 20% below the current price.

Here’s another data point. In June 2016, Pavel Grachev, chief executive of Polyus Gold, the largest gold producer in Russia and the world’s lowest-cost gold producer, told CNBC: “Our so-called total cash cost is about $400 per ounce.” He then added: “However, we keep reducing our costs.”

Another important point to consider is that, unlike with other commodities, all the gold that’s ever been mined is basically available for sale today.

The recent revolution in energy production created by new fracking technology provides another reminder of how technology can change the whole supply/demand curve. As Dimensional Fund Advisors’ Weston Wellington pointed out: “It’s also conceivable that a significant real price increase would encourage development of electrochemical extraction of the estimated 8 million tons of gold contained in the world’s oceans, dwarfing the existing gold supply.” That’s a lot of supply that could potentially hit the market.

The bottom line is that, while my crystal ball always remains cloudy, based on the fundamentals and the historical evidence, there doesn’t really seem to be a case that gold is likely to provide strong investment returns, even though it has already fallen about 36% from its peak nominal value (and even more in real terms). Forewarned is forearmed.

If you have been considering an investment in gold—perhaps you see the sharp drop from its 2011 high as a buying opportunity—hopefully the information in this article will enable you to make a more informed decision.

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