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Three Ways to Value Gold. Three Conclusions.

Gold is selling at a huge discount. Or it's really pricey. It all depends on how you look at it.

Only over the extremely long term does gold do the job. *PHOTO: AKOS STILLER/BLOOMBERG NEWS*

By **MARK HULBERT**

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Where is the price of gold headed? Well, consider this: One closely followed statistical model concludes that bullion is 46% overvalued, while another says that gold is 35% *under*valued.

Which is closer to the truth? It's impossible to say.

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Gold poses more difficulty than almost any other financial asset when it comes to determining fair value. The reason that there can be such a divergence of forecasts, according to Campbell Harvey, a finance professor at Duke University's Fuqua School of Business: "Gold is poorly understood. There are many forces driving the price of gold, and the importance of those forces changes through time.... This is very hard to model."

Prof. Harvey says that when it comes to valuing a company, "we can look at the fundamentals, the sales, the margins, new investments, debt and dividends, and build a bottom-up valuation." Or when looking at a country, he says, "we can do a similar exercise looking at GDP growth, indebtedness, consumer behavior, and get a sense of the value of sovereign debt or stock markets."

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But for gold, Prof. Harvey says, “there is not much to work with.”

Analysts often disagree as well on valuations of particular stocks or industries, he adds. “But the range of disagreement is [relatively] small. With gold, reasonable people can have sharply different views of the value.”

To see how sharply those views differ, consider three different ways to value gold: as an inflation hedge, as a hedge against political uncertainty and as a way to get portfolio diversification.

First, gold’s relationship to inflation has been anything but stable since the early 1970s, when it became legal for U.S. citizens to invest in gold. The ratio of gold’s U.S. dollar price to the consumer-price index has been as low as 1.5 and as high as 8.7, according to Claude Erb, a former commodities manager at mutual-fund firm TCW Group. (See chart.)

Only over the very long term—many decades, if not longer—does gold do a creditable job as an inflation hedge, according to a study of gold over the past 2,000 years by Mr. Erb and Prof. Harvey. Over any period of relevance to individual investors, relating gold’s price to inflation proves profoundly unhelpful.

If an investor nevertheless should insist on basing gold-trading decisions on inflation, he or she currently should be out of gold, according to Mr. Erb. That’s because bullion currently is 46% higher than its inflation-based fair value of $860, according to his and Prof. Harvey’s research.

Next, consider geopolitical uncertainty. This also makes at least some intuitive sense. But until recently it couldn’t be confirmed statistically, because no one had come up with a way to quantify uncertainty. Then three economics and finance professors—Scott Baker of Northwestern University, Nick Bloom of Stanford University and Steven Davis of the University of Chicago—created a series of Economic Policy Uncertainty, or EPU, indexes. And sure enough, according to Prof. Harvey, gold shows a modest historical correlation with the global version of the EPU.

That modest correlation translates into a bullish forecast for gold currently, since the global EPU index is at an all-time high, while gold is trading 35% below its record high of $1,925 an ounce. But don’t forget that gold’s inflation-based valuation model is painting a very bearish picture.

A different argument for investing in gold comes from financial planners. They argue that owning gold promotes portfolio diversification, on the grounds that it zigs when other assets zag, and vice versa. But Mr. Erb cautions against overconfidence on this score as well. He says that, on those occasions over the past three decades in which the financial markets suffered their worst returns, gold was more or less evenly divided between rising and falling.

If you want to invest in gold, exchange-traded funds are probably the least expensive way to do so. To invest in the physical metal itself, the largest ETF is SPDR Gold Trust (GLD), with $33.9 billion in assets under management and an expense ratio of 0.40% (or $40 per $10,000 invested). To invest in gold mining companies, the largest ETF is VanEck Vectors Gold Miners ETF (GDX), with $11.5 billion in assets and a 0.52% expense ratio.

If you're looking for the least expensive way to hedge against inflation, however, you might want to look elsewhere altogether. Treasury inflation-protected securities, or TIPS, guarantee a return over inflation. A low-cost ETF that invests in TIPS is Schwab U.S. TIPS ETF (SCHP), with an expense ratio of just 0.07%.

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