Taking a second look at gold's inflation-hedging properties

The precious metal's reputation for portfolio protection isn't borne out by history, according to research.

For many investors, gold earns its place in portfolio by acting as a hedge against the wealth-eroding effects of inflation. But a look at the historical evidence suggests that's far from the case.
In a column published on the *Wall Street Journal*, columnist Mark Hulbert noted how over the past half-century, the ratio between gold prices and the U.S. consumer price index has vacillated from a low of 1.0 to a high of 8.4.

“If gold were a good and consistent hedge, the ratio of its price to the consumer-price index would have been relatively steady over the years,” he said.

Hulbert cited research by Duke University’s Campbell Harvey and Claude Erb, a former commodities portfolio manager at TCW Group, which found that gold’s purchasing power has only been preserved over very long historical periods on the order of at least 100 years. Over shorter windows, its inflation-adjusted price fluctuates to a similar extent as other assets.

Gold’s current lofty valuations – the gold-to-CPI ratio now sits at 6.5, compared to its 50-year average of 3.6 – further weaken its potential as a buffer against inflation, according to Harvey.

Since August 1971, Hulbert said, the precious metal has seen its price grow fifty-fold, equivalent to an 8.2% annualized return. In contrast, the S&P 500 generated an annualized return of 11.2% over the same period, assuming dividends were reinvested.

A large chunk of gold’s returns over the last 50 years, he added, can be attributed to a decision by former U.S. President Richard Nixon to end the convertibility of U.S. dollars into gold at the fixed price of US$35 an ounce. In the decade following that August 15, 1971 announcement, gold posted a huge return.

“Take away that decade, and gold has lagged behind even intermediate-term Treasury notes,” Hulbert said. He noted that gold has risen at a 3.6% annualized rate over the past 40 years, in contrast to 12.2% for the S&P 500 and 8.2% for Treasurys.
Some investors may appreciate gold as a diversifier, since its correlations with equities or bonds has often been low or even negative. A small allocation to gold, on the order of 5%, could have improved the risk-adjusted performance of a stock-bond portfolio, Hulbert said.

However, he warned, *gold's correlation with stocks has varied widely in the past*, with some occasions in which it had a positive performance correlation with equities. In one recent example, stocks of gold mining shares declined by 39% during the stock decline in February and March last year, while the S&P 500 dropped by 34%.

“It is always possible that gold will be a more consistent inflation hedge in coming years,” Hulbert said. “It’s just that you will have to look elsewhere than history to find support for such a possibility.”

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