Perspectives on Investing in Gold

Executive Summary

More than at any time in recent investment history, gold has taken center stage in the conversation about how to potentially grow assets and protect the value of personal savings. With many raising concerns about the state of the economy, government financial stability and currency valuations, promoters of gold are trying to create a sense of urgency about the need to include holdings of the commodity in individual portfolios.

Undoubtedly, many investors have been attracted to gold due to its recent dramatic run up in value. The price hike experienced in recent years is beyond the normal level of performance that gold has generated historically.

While gold holds a reputation as a store of value regardless of circumstances, a closer look reveals that many of the assumptions made about the expectations for gold may be flawed. These include:

1. Its limitations as a long-term investment. Gold does not easily fit into any of the typical categories that one would associate with typical investments. Perhaps of greatest concern is that speculative trading often seems to be the driving force behind price movements in gold.

2. Unlike items such as oil, steel or corn, gold is not a consumable commodity. Its price is not, for the most part, driven by traditional supply/demand factors that affect typical commodities.

3. Despite its reputation, the record of gold as an inflation hedge is spotty at best. Most investors can probably find better alternatives to help deal with the impact of the potential of a dramatic rise in living costs.

Important disclosures provided on page 5.
A Perspective on the New Gold Rush

Gold has been making headlines in the investment world. With the nominal price of gold reaching record levels, many investors who have not been part of the rally are wondering whether they are missing out by not including the metal (or proxies for it) as part of their portfolio.

Gold has a long generated a high degree of interest. While the metal has enjoyed periods of wild popularity and dramatic price increases, comparable to what we’ve seen in the current market, there are more significant questions about what proper expectations should be for gold within an individual’s portfolio. Although it carries a certain cachet as a holding with “intrinsic value,” a closer look at the historical record indicates that gold, as an investment, may not have the luster to match its reputation.

Before shifting money into gold, investors should be sure to gain a proper perspective on the role it can be expected to play as a long-term investment and whether it even has a place in a typical individual’s portfolio.

The “anecdotal” case for gold

The desire to own gold has been ingrained in many investors throughout life. Fairy tales dating back centuries have centered on the appeal of gold as a valuable commodity (i.e., King Midas). The quest to uncover gold has been the stuff of legend going back centuries. In America, gold rush days in California and the Klondike have been greatly romanticized.

From an economic perspective, many view gold as a primary store of value. For years, U.S. currency was tied to the gold standard, though that link was completely severed in the 1970s. The argument is raised from time-to-time that gold is the only trusted source of value, particularly if the economy or the nation’s currency should fall on hard times.

Yet for all of the anecdotal attraction of gold, the more pertinent question is whether it can live up to the investment expectations many have placed on it.

Gold’s disappointing track record as an investment

What is clear from looking at the historical record is that the recent run up in gold prices is not representative of typical performance for this commodity, though not unprecedented.

Over the past 85 years, including the Great Depression, a devastating world war, rampant inflation and a challenging fiscal environment, gold has delivered long-term returns that, while outpacing inflation, greatly underperform other asset classes.

Over the last few years, the environment has turned much more favorable for gold, with its current performance greatly diverging from standard, long-term return levels. This resumes a trend that has occurred in other decades. In the 1970s, a period of high inflation, gold performed extremely well. As inflation moderated in the 1980s and 1990s, returns for gold were far more muted. This trend continued into the first half of the 2000s. Gold prices on the New York Commodity Exchange (COMEX) have doubled from November 2008 to late 2010, as the price topped $1,400/ounce. Recent price action, along with constant advertising featuring celebrity spokespeople, has raised interest in gold to a fever pitch. Given the combination of soaring prices and heavy marketing, it is not surprising that many investors are considering moving some of their own money into gold.

Source: Factset; data as of 12/31/2010
Inflation: represented by Consumer Price Index (CPI)
Three important myths about gold

Before making a leap into the gold marketplace, it makes sense to understand that some of the assumptions that are often made about gold are not supported by the facts. Here are three important myths that should be considered when assessing options related to gold.

Gold Myth #1 – Gold is a viable long-term investment

Valid, long-term investments tend to fall into one of the following four categories:

- Securities (such as common stock) in companies with growing earnings (leading to the potential for increasing dividends over time)
- Investments that pay a defined rate of income, such as a government or corporate bond
- Securities linked to consumable commodities such as an oil futures contract
- Interests in real estate assets that have growing net operating earnings.

Gold does not fall into any of these specific categories, raising the question of whether it should be defined as an asset for investment purposes. Gold does not generate earnings or a regular stream of income. Unlike the forces that impact most long-term investments, traders speculating on short-term price movements drive the bulk of the market activity in gold. This is not a strategy that tends to work in favor of serious investors seeking to achieve key financial objectives.

Gold Myth #2 – Gold is a traditional commodity

There is an important distinction between gold and other types of commodities such as oil, steel or corn. Gold is not primarily a consumable commodity. While a portion of the inventory of the world’s gold is used for jewelry, dentistry and high tech purposes, most of the gold that exists is merely stored. Today approximately 30% of gold is held in private hands, more than all of the world’s central banks combined. This is unprecedented, and reflects a surge in demand from markets such as China and India. Yet only a small portion of the total supply of gold is traded on the markets.

From a trading perspective, rather than acting as a typical commodity, gold is considered to be a potentially hedge against future inflation or as protection against the possibility of a significant collapse in major currencies. In times of economic distress, gold tends to draw more attention. This has been the case in particular since the financial crisis of 2008 and the recession that followed.

Gold Myth #3 – Gold is a superior hedge against inflation

There is a belief by many that gold can hold its value during times of significant inflation. Over limited periods of time, this may be true, but there is a cost associated with holding investments in gold that can detract from its long-term value as a potential inflation hedge.

To own gold outright, there is a cost of storing the metal. During the holding period, it generates no income and will only provide long-term value if the investor is able to sell it for a profit (adjusted for inflation) at a later date. If gold is purchased through other instruments, such as Exchange-Traded Funds (ETFs), the management firm will charge expenses related to storage and transaction costs, reducing the potential return. The lack of income generation results in the investor having to rely on the capital appreciation potential of gold to earn a positive, after-inflation return. Given that the price of gold is driven primarily by short-term trading trends, it means that investors are putting their money to work in an asset that is primarily a speculative trading vehicle. This seems inconsistent with sound long-term investment strategies.
There are other options for potentially hedging inflation that utilize more viable investment choices. For example, Treasury Inflation Protected Securities (TIPS) can generate an ongoing stream of income that is linked to changes in the rate of inflation. These securities have no costs associated with storage that detract from the ultimate return of an investment in gold bullion. Likewise, commercial real estate has historically appreciated in value consistent with long-term inflation trends, and may still generate a current stream of income.

**Voting on future expectations**

One of the primary selling points for gold is centered on the idea of protecting an individual’s financial position in the event of severe economic distress or even collapse. The case that some are making for gold today is that it is a potential safeguard if other investments should lose their value, either through a stock market decline, numerous bank failures, currency devaluation or a government default on its debts.

All of these scenarios must be considered, by historical standards, to be well outside typical behavior of the financial markets and developed economies.

From an investment perspective, individuals must determine if their desire to own gold is to prepare for a severe economic or financial crisis. Without that type of event, history indicates that gold is unlikely to generate long-term returns that can compete with other types of financial instruments.

It should be noted that even during the peak of the 2008 financial crisis, gold prices on the COMEX dropped from $1,003 on March 18 to $704 on November 13. This 30% decline in value occurred during an unprecedented crisis that nearly brought the global financial market to its knees. It demonstrates the general unpredictability about gold prices in the short term, and the risks inherent in relying on gold as a means to achieving important investment objectives.
Conclusion

The bottom line for many investors is this – the best case that can be made for gold to be included in a portfolio is if a sound case can be made for the potential collapse of the economy, the banking system, the dollar, or the federal government. Our view, which appears to be shared by the vast majority of professional economists and market strategists, is that it is unlikely that any of these events will occur. In addition, if any of the scenarios mentioned were to occur, there is no guarantee that gold prices would remain high and could even lose value.

It is our belief that investors are best advised to consider the long-term perspective and not be overly influenced by recent events and trends in the market and economy. Factors such as individual financial goals, current and future income requirements and attitudes on risk are also critical to the investment decision-making process. We are firm in our opinion that the nation’s economic future remains strong and that a well-diversified portfolio designed to suit the needs of each individual investor is the best solution in today’s market.

IMPORTANT DISCLOSURES

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