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A CLOSER LOOK AT GOLD

Amid all the hype and euphoria, some history is worth remembering.

Presented by Gary Mastrodonato, CEA

America's got gold fever. Internet headlines inform you that gold settled at another record close today. Nightly news segments show you footage of excited sellers and beaming commodities traders. Radio commercials remind you that gold has outperformed stocks in the last decade. How should you respond to all this?

There's no doubt that in recent history, the performance of gold is startling. Across the 2000s, gold gained 278.52% on the COMEX while the S&P 500 lost 24.10%. In 2010, the S&P 500 advanced 12.78% and gold notched a 29.76% gain.^{1,2,3}

So given these numbers, why doesn't everyone put every dollar they have into gold?

Recent price returns don't tell the whole story. Investing big in gold may seem like a no-brainer - until you take history and inflation into account. In 1980, gold prices were up around \$850 an ounce - adjusted for inflation, that's the equivalent of about \$2,300 an ounce today. Yet when 2008 ended, gold prices were at just \$870 an ounce. When 2003 started, gold futures were trading at \$343 per ounce.^{4,5,6}

Gold is often seen as a hedge against inflation - but from 1980-2002, annualized inflation averaged 3.55% and gold didn't exactly keep pace. So if you lengthen the window of historical performance, gold hasn't always trumped stocks.⁶

Remember, gold is a commodity. Since it tends to have little correlation with stocks and bonds, it can play a significant role in a diversification strategy. On the other hand, gold has no intrinsic value. It doesn't give you any cash flow. It doesn't pay you a dividend or earn interest. Gold is only worth what people are willing to pay for it.

Right now, people are willing to pay more than \$1,500 an ounce for gold. Three big factors have driven this gold rush - a consistent global demand, an assumption that the dollar will stay weak and a whole lot of speculation.

Bubbles can happen; bubbles have happened. Investors who bought gold at \$560 an ounce at the start of 1980 had to wait until 4Q 2010 to break even in inflation-adjusted terms. Those who bought gold at \$850 an ounce in 1980 won't effectively break even until gold prices top \$2,300. Gold has performed astonishingly well in recent years - but past performance is no guarantee of future success.²



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As I noted in my book *The Only Guide You'll Ever Need for the Right Financial Plan*, gold has served as a store of value over the very long term, but it has still gone through very long periods where it lost value in real terms. For example, gold traded at \$850 per ounce in 1980, then traded at around \$900 per ounce at the end of 2009 — 29 years later. During this time, inflation averaged 3.55 percent per year. To further illustrate this point, at the beginning of 2003 gold was trading at \$343 per ounce. From the period of 1970-2002, inflation averaged 3.84 percent per year. For this reason, gold can't be a good inflation hedge except perhaps over an investment horizon far longer than that of the typical investor.

The academic community is split on whether a broadly diversified basket of commodities is a good inflation hedge. On the one hand, Dartmouth professor **Ken French** argues that commodities (and gold) aren't a good hedge of inflation. On the other hand, **Gary Gorton** and **K. Geert Rouwenhorst** argue that commodities can hedge inflation. My position is that a broad basket of commodities provide more inflation protection than gold. Commodities, as an input into production of goods, are a source of inflation, while gold isn't.

A positive note for gold is that it has low correlations with stocks and bonds, so it theoretically should act as a great diversifier. However, the same is true of commodities in general. **Kevin Grogan**, who co-authored *Right Financial Plan* with me, examined the impacts of adding gold and adding commodities to a diversified portfolio.

Below are three portfolios*, and their returns 1970 through 2010:

	Annualized Return	Standard Deviation	Sharpe Ratio

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