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The skinny on gold

Research suggests it should represent only a modest portfolio allocation

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As fears of inflation and escalating government debt mount, gold is being highlighted as an asset that can hedge these risks. To assess the portfolio role of gold, my firm, Tacita Capital Inc. of Toronto, analyzed its long-term returns and volatility (in Canadian dollars), its correlation to inflation and surveyed the current product environment.

A meaningful analysis of gold starts in August 1971 when U.S. President Richard Nixon closed the U.S. gold window and ended the last vestiges of the gold standard that once backed currencies. From then to October 2009, gold had an annualized compound return of 8.9%, behind the 9.9% and 10% returns of the S&P/TSX composite index and S&P 500 composite index, respectively. On the important reward-to-variability metric measured by the Sharpe ratio, gold also ranked third.

The return from gold, however, was episodic. Prices skyrocketed from August 1971 to September 1980, generating a 37.1% annualized return that massively surpassed stocks. The climb was far from straight up. Gold had an annualized standard deviation of 42%, almost twice that of stocks. Investors needed strong stomachs to stay invested.

From the September 1980 peak, gold suffered a massive and prolonged drawdown of 51.3% over a 227-month period, finally hitting bottom in August 1999. This decline is almost seven times longer than the 34-month drawdown experienced by stocks in the Great Depression. Gold didn't fully recover its value until November 2007, a grinding 27-year round trip.

In retrospect, gold had bloomed into an asset bubble in the 1970s, followed by the inevitable painful collapse. Inflation was not the sole catalyst. The correlation of annual inflation and gold returns from 1972 through 1980 was only 0.32. Fear of many items — the Cold War, Middle East instability, weak economic growth as well as hyper-inflation — was likely the cause. When fear subsided, gold prices plummeted.

Gold prices have been rising over the past decade, far outpacing stocks. It is not inflation, but the decline in the U.S. dollar that has been the catalyst. Fear of an outright US$ collapse because of the chronic trade and fiscal deficits of the U.S. have now been compounded by worries over extraordinarily expansive monetary policy and sovereign debt defaults.

Gold has acted as a store of value through several millennia and it is this “safe haven” role that attracts so many investors. However, it is a more speculative asset class than bonds and stocks, whose returns in the form of interest, dividends and the re-investment of capital occur regardless of market sentiment. Gold is an inert metal whose value is based solely on the price other parties will pay for it. Hence, its heightened volatility. Worse, if you get the timing wrong, there is no income stream to recoup lost principal. Gold’s last drawdown is illustrative. Portfolio allocations, therefore, need to be modest, acting solely as an insurance policy against prolonged economic malaise.

Advisors can access gold through a variety of vehicles. For example, Sprott Gold Bullion Fund was recently launched by **Sprott Asset Management Inc.** of Toronto. Central GoldTrust, administered by **Central Gold Managers Inc.** of Ancaster Ont., is a closed-end trust that invests exclusively in gold bullion and trades on the Toronto Stock Exchange. Advisors should check to see if it is trading at a premium to net asset value before buying. Claymore Gold Bullion Fund managed by Toronto-based **Claymore Investments Inc.** is a closed-end fund that just converted to an exchange-traded fund. It hedges the C$ to avoid currency risk since gold is priced in US$.

In the U.S., there are two major gold bullion ETFs: iShares COMEX Gold Trust, sponsored by BlackRock Asset Management International Inc., and SPDR Gold Trust marketed by State Street Global Advisors LLC. **IE**

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