Gold – Store of Value or Barbarous Relic?

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Gold's recent surge to all-time highs is generating renewed interest amongst investors and has rekindled the age-old debate about whether it ought to be part of diversified investment portfolios.

We consider the issues for and against gold and determine that, under certain scenarios, it does have characteristics that enhance the resilience of portfolios.

The Case for Gold

Gold is a Store of value

For over 4,000 years gold has been regarded as a form of money across many different cultures and civilisations. Whether or not there is a theoretical basis to this scarcely matters. It is deeply ingrained in the human psyche that gold is valuable and that it acts as a safe haven, or store of value, in times of trouble. Gold's recent performance highlights that this age-old appeal persists.

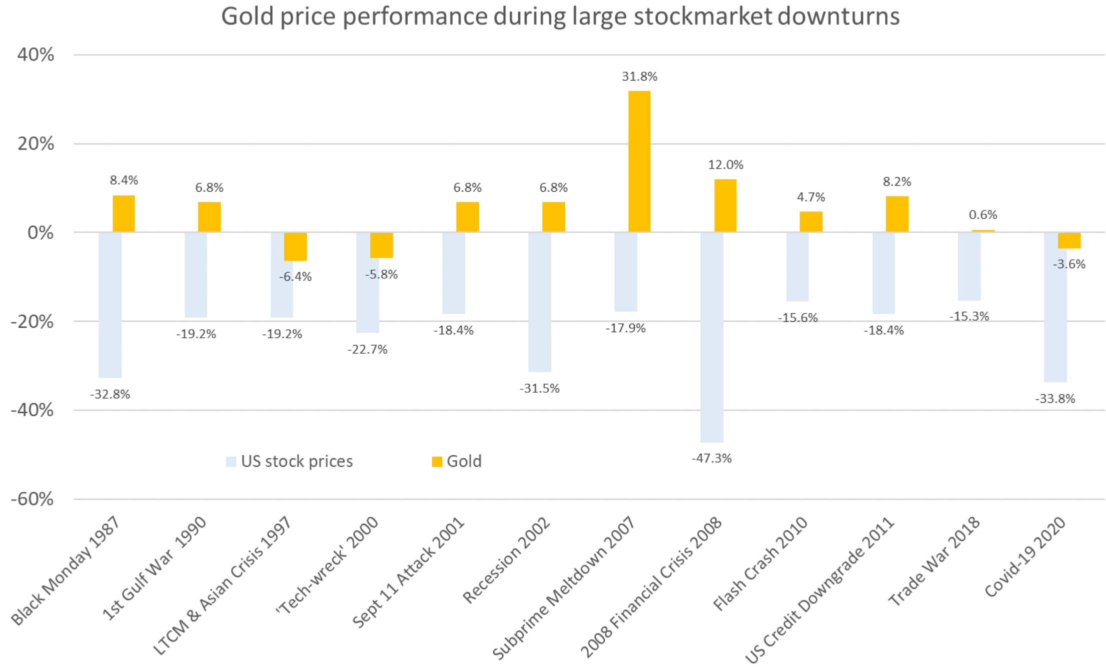
Gold is an Inflation Hedge

Unlike currencies, gold's supply is limited to its annual production of around 1.5% of total existing gold stocks. The amount of gold in circulation is therefore relatively stable. This is in stark contrast to other commodities, and also to fiat currencies, where supply has been growing rapidly.

Gold has performed well since President Nixon suspended the gold standard in 1971, appreciating by about 8% p.a. Governments in most developed countries, including New Zealand, are now running huge deficits. This debt will either be paid back eventually through higher taxes, or governments may take the easier route of letting inflation get away to erode the real value of the debt. Gold, which has appreciated by 16% pa when inflation has exceeded 5% since 1971, is a logical beneficiary.

Gold can Hedge Tail Risk

Historically gold has also performed well in equity market declines, outperforming in every 15%-plus market decline since 1987. Even more impressively though, it can do more than just outperform, it usually appreciates during these episodes. This means gold can provide some of the defensive characteristics that fixed income has traditionally provided in investment portfolios.



Source: Bloomberg, State St Global Advisors

Gold is a Diversifier

Historically gold has been essentially uncorrelated to both equities and bonds. This makes it a powerful portfolio diversifier and thus a means to improve risk adjusted returns. Assets that are not just uncorrelated to the two pillars of investment portfolios, but which are negatively correlated to equities in crises, are particularly valuable.

The Case against Gold

Gold has no intrinsic value

This is essentially the 'barbarous relic' argument – gold has no value because it has no utility. Its use in jewellery is hardly essential to a functioning economy, and any value as an investment is based on nothing more concrete than superstition and emotion. The counter to that is 4,000 years of history. There may be no logical basis for turning to gold in times of trouble, but there is ample evidence that people do just that.

Gold has no yield

This is undeniable. Gold clearly has no yield, but nor do some sovereign and even corporate bonds in the current environment.

Conclusion

The second argument to the contrary, the absence of yield, is a compelling argument against owning gold when rates are at ‘normal’ levels, but it is largely irrelevant in the context of prevailing market yields.

If we could be confident that gold will generate returns equal to, or better than fixed income over the medium to longer term, then this, in conjunction with its diversification benefits, would mean that gold would merit a significant place in diversified institutional portfolios. Its lack of intrinsic value though means we simply cannot have a high degree of confidence about future return prospects, especially given its currently elevated price.

However, gold’s potential to hedge against environments in which bonds and equities may struggle, primarily those associated with higher inflation, argues for a role in diversified portfolios. Money printing and huge fiscal deficits all suggest heightened inflation risk going forward and these risks are not priced into bond or equity markets. Portfolios containing gold are likely to perform better in this scenario than those without.

Whilst we believe the arguments in favour of gold are strong, we are wary of buying at current prices. If, as we suspect is likely, the speculative component of the current gold renaissance leads to a material retracement, this will represent an attractive longer-term buying opportunity.