All That Glitters

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Happy New Year!

As several of our clients have asked lately if they should have gold in their portfolios, we have reminded them that our managed accounts have had a gold ETF (Exchange Traded Fund) in their account for over a year and a half purchased in the $800's and we have been taking profits and trimming these positions as the price has run up. We thought that this special issue of *The Navigator* might be helpful this time of year to put "cocktail party" chatter in perspective.

See if you can relate to this situation: the struggling U.S. economy experiences severe unemployment, and a falling dollar spooks investors. The stock market seems to be in a protracted tailspin, and the situation in Afghanistan is increasingly alarming. So you look for an alternative investment, and find... gold, which is generating impressive returns after a long dormant period. In fact, the precious metal has been testing all-time highs, and there are plenty of newsletters, touts and analysts that see a lot more legs to the rally.

As familiar as this sounds, it's actually a pretty good description of the latter months of 1979 and early 1980, when the price of gold rose from $400 an ounce in November 1979 to $850 by the middle of the next January. Investors who poured in expecting lots more of the same were sorely disappointed; by the end of March 1980, gold was back to selling at less than $500 an ounce, leaving investors who bought at the peak holding a stunning 40% loss for the quarter. Holding on didn't help; by the end of the stock market runup in early 2000, an ounce of gold was selling for under $300 an ounce on the spot markets.

Today, of course, you're hearing a similar refrain, as the shiny metal has tested all-time highs almost monthly, most recently leaping from a little over $1,150 an ounce in late July to its latest all-time high, just over $1,432.50 earlier this month. (The price has since fallen into the $1,380 range.) Is it time to jump on this bandwagon and ride the gains up to (according to some bullish newsletters) $2,000 an ounce or higher? Or is gold an overpriced investment ready to go bust?

One of the interesting problems with gold in your portfolio is how hard it is to get a handle on what its price SHOULD be. You can't compare its price to its earnings, like a stock, because when you put gold in your safe deposit box, there ARE no earnings. But there are ways to help decide whether the current price is being driven by fundamentals or yet another mania.

The first is to look at where the demand is coming from. Back in January, when gold was still riding the crest of investor disillusion with the global economy, the Commodity Online web site interviewed Miguel Perez-Santalla, vice president of marketing at the German precious metals producer Heraeus Precious Metals Management. Heraeus fabricates precious metals products for industrial use, but Perez-Santalla said that at such high prices (which have since gone higher), physical consumption of gold has fallen dramatically. "The gold investment market is the main demand driving the price up," he said in the interview. "Everything is being delivered on the Comex and to the London warehouses."

Loosely translated, that means that industrial users are waiting for the price to fall, and they will get their wish as soon as investors stop outbidding each other.

Another way of looking at the reasonableness of gold's prices is to look at the cost of extraction and refining--in other words, the cost per ounce of getting gold out of the ground and into the hands of jewelry makers, industry and investors. This information is not always easy to find, but an article on the MineWeb web site back in April 2007 estimated that gold mining companies were spending $401 an ounce in overall costs. More recently, in October of this year, an article suggested that today's extraction costs run between $500 and $600 an ounce--or a little less than half of what you would pay today on the spot market.

Loosely translated, that means that investors are buying at far higher prices than it costs to produce an ounce of gold. In fact, the disparity today at least challenges the record disparity back in early 1980.

Finally, you could look at supply and demand issues. If there is a worldwide shortage of gold, or much more is being used than is being produced, then this would justify a dramatically rising price. To get reasonable estimates of gold supply and demand fluctuations, you could go to the World Gold Council's web site, which notes that gold production over the past five years has been relatively stable: about 2,485 tons a year. In general, new mines are replacing the depleting production of current ones, so there has been little significant expansion in global output. It can take up to ten years to get a new mine started, which means that gold mining companies can't take instant advantage of today's higher prices.

However, the World Gold Council notes that as prices rise, the market begins to see more recycled or scrap gold--a category which includes people selling gold jewelry. Between 2004 and 2008, recycled gold contributed 28% to annual supply flows; a chart says that this amounts to another 1,016 tons a year. (The remaining supply flow comes from sales by central bankers, which may or may not continue in the future.)

Mine production and recycling together account for roughly 3,500 tons of gold coming into the marketplace each year. How does that compare to demand? According to the World Gold Council, jewelry demand--by far the largest market for gold--amounts to 2,436 tons a year. Industry uses another 493 tons--for a total of just under 3,000 tons between the two.

Loosely translated, that means that more gold is coming onto the market than industry and the jewelry manufacturers appear to need. There is no supply/demand imbalance, unless you count thousands of eager investors looking for more price runups or a hedge against inflation.

And is gold a reliable hedge against inflation? Since gold's peak in early 1980, the annual inflation rate dropped, but cumulative inflation increased--as gold was falling in value through the next two decades. According to InflationData.com, gold's 1980 peak spot price reached $2,250 if it were measured in today's inflation-adjusted dollars, and it dropped to an inflation-adjusted $370 two decades later. If gold had been an effective inflation hedge during that 20-year period, the price would have remained the same in inflation-adjusted terms.

The InflationData organization makes a good point: gold has been a lousy inflation hedge for long periods of time, but it does appear to be a pretty good "crisis hedge." That is, when people are frightened of events like the Soviet invasion of Afghanistan, as they were in 1979-1980, or when they are concerned about the global liquidity crisis and its economic hangover (as they have been for the past couple of years), gold takes off. When the panic subsides, so too does the price of the precious metal.

Of course, we can't predict whether the current fear of a double-dip recession or other nameless anxieties will continue to drive gold higher. But history suggests that as soon as people start feeling more secure about the world situation, gold will suddenly leave its investors holding significant losses.

The question we have to wrestle with is: if we invest in gold, are we investing, or speculating? If we're speculating, is the best time to do it at near-record high prices?

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