

Gold Rush

**By: Alexander Hock, Consultant
March 2010**

It is difficult today to open a newspaper or turn on the television without seeing an article, opinion, or advertisement about gold. You may be asking yourself, Why all the recent attention? In this short piece, we examine the history of the yellow metal, what may be driving current prices, and how investors can access the commodity to diversify their portfolios.

History of Gold

Gold has been seen as a store of value since the dawn of civilization, due almost solely to its scarcity. A recent National Geographic article postulated that only about 161,000 tons of gold have been mined throughout human history. For some perspective, that is barely enough gold to fill two Olympic-size swimming pools. Even more surprising is that half of that total has been mined just within the last 50 years!

In addition to its physical traits, financial markets and world economies have also played a key role in the history and popularity of gold. In 1944, the Bretton Woods Agreement set the price of one ounce of gold at \$35 USD. This price remained virtually unchanged until 1971 when the United States went off the gold standard. Most major world countries followed the U.S. example in the early 1970s and adopted a floating exchange rate, and thus gold fell out of favor, taking a back seat to world currencies, equities and bonds.

Following its decoupling from the USD, the price of gold climbed throughout the 1970s, culminating in a January 1980 intra-day price high of \$850 per ounce (or about \$2,176 per ounce after adjusting for inflation). Similar to the current run-up in gold prices, the economic crisis of the late '70s, coupled with inflation concerns, resulted in a peak in gold prices that eventually fell back to \$300/ounce by late 1982.

Gold traded mostly sideways for the next 20 years (1982-2002), hitting a bottom of \$252/ounce in August of 1999. The terrorist attacks of 9/11 and the subsequent wars in Iraq and Afghanistan triggered renewed interest in the precious metal and it began its early stages of its current rise. As we've witnessed throughout history, global conflicts and civil unrest often result in a flight to gold as investors seek to preserve their wealth in times of uncertainty.

Current Drivers of Gold Prices

The price of gold has been on a historic run over the past few years peaking at an intra-day high on December 2, 2009 at \$1,227 per ounce. Although gold has since fallen about 11% from that high, the price of gold is still up nearly 300% over the past decade. This is in stark contrast to the performance of many other asset classes.

For example, the S&P 500 has declined nearly 20% over the same time period.



The increase in the price of gold over the past decade has been driven primarily by two factors: First, the financial crisis of the last several years, along with the overall poor performance of the broad global economy, has increased investor demand for investments traditionally viewed as “safe” or “secure”. Gold has been one of the few bright spots over the past several years creating a somewhat self-fulfilling prophecy.

Second, because of its traditional role as a preserver of wealth and value, gold is used by investors to hedge against future increases in inflation. The deficits that governments around the world have been running over the past decade, coupled with recent central bank efforts to inject liquidity into the monetary system, have contributed to a view by some that inflation is a growing threat. While the current global economic status is holding inflation down, the potential fear is that as the world recovers from the global recession, inflation will increase.

Ways to Invest in Gold

Investors have a variety of options they can employ to gain portfolio exposure to gold. The most straightforward option is through the physical purchase of gold bullion either in coin or bar form. However, this can be a fairly inefficient method of investing, as 1) gold dealers typically charge a commission of several percentage points over the spot price and 2) investors then must store and protect the bars. For example, homeowner’s insurance policies will typically require additional fees to insure gold in the home, while safety deposit boxes or private vaults carry their own fees.

Exchange-Traded Funds offer perhaps the most efficient method to gain exposure to gold. However, many Gold ETFs own both physical gold and gold mining companies and thus can often deviate from the performance of physical gold.

Investing directly in the equity of gold mining companies is another way for investors to gain indirect portfolio exposure to gold. Mining company stocks, however, are dependent upon both the price of gold and the underlying company performance. Mining companies make vast capital expenditures on exploration and extraction, and the company’s performance is ultimately determined by the relative success or failure of such projects and their subsequent effects on revenue and profits, irrespective of gold prices.

The futures market offers investors another method to gain portfolio exposure to gold. However, for the novice investor this can be an excessively risky and complicated proposal.

From a taxation perspective, it is important to note that the IRS classifies gold as a *collectible* rather than an *investment*. As a result of this distinction, gold is a fairly tax inefficient asset since a long-term realized capital gain on a gold investment is taxed at the collectibles rate of 28% rather than the preferential long-term investment gain rate of 15% typical of more traditional investments such as equities, bonds, and mutual funds.



DIMEO
SCHNEIDER
& ASSOCIATES, L.L.C.

Recommendation

The costs of purchasing and storing physical gold, the tracking error of Gold ETFs, and the inefficiencies and additional non-gold risks of mining company stocks can make it difficult for investors to have an appropriate allocation to gold within their portfolios. The typical DiMeo Schneider approach to asset allocation ensures that clients are exposed to a broad basket of commodities, including gold and other precious and industrial metals, by allocating a portion of their portfolio to a diversified commodity fund.

Please contact your DiMeo Schneider consultant if you would like further information.