

Five Reasons to Avoid the Gold Rush (Updated)

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Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.

- Warren Buffett



The reasons why one should sell the cat, pawn the mother-in-law, and use the proceeds to buy gold are well known: the Fed is printing money faster than you can read this, which will result in inflation; the government is borrowing like a drunken monkey, so the dollar will be devalued; this will debase all currencies, so the only thing that will save you is the shiny metal.

However, here are some arguments why one should think twice before jumping in bed with the gold bugs, or at least remain sober while determining gold's weight in the portfolio:

1. For investors (not speculators) it is very hard to own gold, because they cannot attach a logical value to it. Unlike stocks or bonds, gold has no cash flow and has a negative cost of carry – it costs you money to securely store the physical asset. It is only worth what people perceive it to be worth right now. The argument I commonly hear is, “What about all those Enrons, Lehmans, Citigroups, etc. that either went or got near bankruptcy? What were the values of those?” If the lesson learned is not to own stocks but to own gold, it is the wrong lesson. The lesson should be: own companies you can analyze (the aforementioned companies were unanalyzable) and diversify – don't put your all net worth into one stock.
2. The gold ETF SPDR Gold Shares (GLD) is the seventh largest holder of physical gold in the world. If its holders decide to sell (or are forced to sell; think of hedge fund liquidations), who will they sell it to? This is extremely important, as the presence of GLD changes the dynamics of the gold price, both to the upside and downside. If gold keeps climbing, the ease of buying GLD will drive gold prices higher than in GLD's absence. In the event of a significant sell-off, there are not enough natural buyers of physical gold. It is a bit like a roach motel – easy to get in, hard to get out.



3. In the past, gold had a monopoly on the inflation and fear trade. Not anymore. Now you have competition from Treasury Inflation Protected Securities (TIPS), currency ETFs, short-term US Treasury ETFs, government guaranteed/insured FDIC checking accounts, etc. TIPS suffer from the flaw of the CPI being measured and reported by the US government, which has an inherent bias to understate inflation; returns of commodity ETFs are skewed by price differentials between financial derivatives and the spot prices of underlying commodities; returns of leveraged ETFs diverge significantly over the intermediate and long run from the underlying index; FDIC reserves are being depleted with the every-Friday-night bank bailout (but believe me, the US government will not let the FDIC go bankrupt, even if it means it has to raise taxes and impose draconian fees on the banking sector).

The bottom line is this: none of those investment vehicles are perfect inflation hedges. Many have significant flaws; but despite their flaws they attract money away from gold, thus undermining gold's monopoly on the fear/inflation/currency debasement trade. (I've discussed this point in greater detail in my book).

4. If, because of points 2 or 3 above, gold fails to perform as expected, the perception of what gold is worth may change dramatically.
5. **Inflation is a possible but not a guaranteed outcome of what is taking place in the economy today.** Deflation or a muddle-through economy with very low nominal growth are possible and probable outcomes. We are seeing signs that point away from inflation: the money supply declined at a 12% annualized rate over the past four weeks, according to David Rosenberg of Gluskin Sheff. Though gold bugs argue that gold will perform well in either an inflationary or deflationary scenario, history doesn't support that conclusion. Gold has done well in inflationary environments but not during deflation or low nominal economic growth. In the 1970s, when inflation in the US was raging, gold performed better than any other asset class (though remember, at the time gold had no competition in the inflation trade). However, one had to know exactly when to get on and off the gold bus. If gold was bought after considerable appreciation, that investment/speculation resulted in losses. Gold has more than doubled in price since 2005, but has it already priced in future inflation? I have no idea; you cannot value it.

Though gold bugs make it sound as such, gold is not the only and not the best alternative if the worst fears come to pass. The best way to deal with the risks of dollar devaluation and high inflation – with a much lower cost of being wrong – is to own stocks of companies that have pricing power in their products. When inflation hits, they will be able to raise prices and thus maintain their profitability. Also, companies that



generate a large portion of their sales from outside the US will benefit from the declining dollar.

Gold bugs look at gold as a currency, but it is not one and unlikely to be one in our lifetime. There is not enough of it around, so even if world governments were to adopt a fractional system (currency in circulation as a multiple of gold reserves), they will never go for it, because central banks and governments will never give up their monetary tools – inflation is a very addictive tool to fight growing monetary obligations.

There is a wild card in the price of gold, though: If China decides to switch partially from owning US Treasuries to owning gold, the price of gold will skyrocket.

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