THE MONEY MARATHON: IS GOLD A GOOD INVESTMENT? APRIL 2010

With dramatic increases in government spending, huge government deficits and an unprecedented increase in the expansion of the Federal Reserve's balance sheet(to protect the financial markets), and concerns about a decrease in the value on the dollar, there are many legitimate concerns about future inflation. Based on these concerns, many people wonder if they should invest in gold. What follows is some discussion on this question.

Back in the mid 70s, I purchased two one-ounce South African Krugerrands (the federal government allowed households to purchase gold in 1974 for the first time since the depression). To the best of my recollection, the cost of each was about $200 per ounce. I made one of them into a necklace that I gave to my mom for Christmas. The other is in our lock box. Shortly after giving this to my mom, gold increased to about $850 per ounce sometime in 1980. The value had increased so rapidly that my mom worried about wearing it because of fear she would lose it or it would be stolen. However, after hitting $850 an ounce in 1980, the price of gold went through an extended decline. If someone had purchased gold in the early 80's and held it until the turn of this century 20 years later, they would have seen their $800 per ounce investment drop to $250 per ounce in 20 years - an extremely poor investment. Beginning in 2000 the tables turned once more. An investor purchasing gold in 2000 and holding it for the entire decade would have seen his investment increase approximately 350% to over $1200 per ounce at its high. As you can see, timing made a great deal of difference. Before I give you my personal view I will give you both bull and bear cases for gold. First is the bull case.

According to The Street.com, some sophisticated investors including billionaire James Rodgers and David Tice believe gold will appreciate to $2500 per ounce. The author of "GoldMoney" predicts $8000 per ounce, and Mike Maloney predicts $15,000 an ounce. (Gold Prices Headed to $820 An Ounce?-Steel, Alix, 2-08-2010 The Street.com) These are a few of the very optimistic bulls. The argument for the bulls is that with massive government debt and easy, plentiful and low priced money from the Federal Reserve, sooner or later it will lead to much higher inflation and a lower value of the dollar. These factors should increase the value of commodities--especially gold, the supposed safe haven in a panic situation.

As a little bit of history, our dollar used to be backed and redeemable for gold. In 1933, President Roosevelt made it illegal for individuals to purchase gold, and in 1971 President Nixon took the dollar off the gold standard which meant foreign countries could no longer redeem dollars for gold at $35 per ounce. Inflation has varied widely over the last 50 years reaching the mid teens in the early 80s but the long term average of the last 80 plus years has averaged about 3% per year. Even at a 3% inflation rate, a dollar is worth half as much every 24 years. Consequently, if inflation continues at this historic average of 3%, a dollar today would be worth a quarter, 50 years from now- or even less if inflation is higher. If inflation averages 6% for the next 50 years, a dollar today will be worth about 6 cents 50 years from now. The summary of the bull case is that gold is a safe haven against a falling dollar, higher inflation and panic.

The bear case for gold has several different points. One point the bears make is that the global financial concerns in Greece, Spain and Portugal have been leading to a higher dollar as investors flee foreign investments for the safe haven of the US. A higher dollar from continued worldwide financial concerns can lead to lower commodity prices including gold. Secondly, the demand from China for gold could diminish if that country's growth or their government stimulus slows, which some people believe will happen. Finally, gold has historically been a hedge for inflationary expectations. Inflation is expected to be low for a while as a result of high unemployment, excess industrial capacity, low demand for borrowing, and higher savings rates. Based on all of these, some of the gold bears believe gold will decrease to $820 an ounce by 2014 and then further to $700.

Here are my thoughts regarding gold. Gold does have uses primarily in jewelry, but its uses are really rather limited. Most of its demand is from investors. Unlike commodities like oil that have a use for its demand, part of gold's demand has nothing to do with a use. I see this as a negative. Secondly, gold does not pay interest or dividends. I like investments that pay annual interest and dividends. As an example, approximately half of the long-term return from stocks comes from dividends. Finally, even with the run up in the price of gold in the last 10 years, the long-term performance of gold compared to stocks and real estate has not been that attractive. Since 1974 the S&P 500 has compounded at a 11.5% rate while gold has compounded at only 5.1%, just slightly above the inflation rate for that period of 4.2%.

Even with the concerns mentioned above, I think gold can be a good hedge in a diverse portfolio against inflation and panic - a safe haven. Therefore, I think it can be an acceptable part of a person's overall portfolio, preferably 5 % or less up to a maximum 10% of an entire portfolio. Since gold usually does not correlate much with stocks and bonds (i.e. it can move up when other standard investments are going down), I believe it is a reasonable diversification for an overall portfolio. It is possible to own stocks of gold producers, but it seems to me that most of those stocks are priced fairly high today. One of the best ways to own gold may be to own the exchange traded fund (ETF) SPDR Gold Shares (Symbol GLD). This trades at one tenth the price of an ounce of gold. I think this is much better than physically owning gold and having to worry about transportation and safekeeping.

The bottom line in owning gold may be to hope that it doesn't do well, which may mean a person's other more sizeable investments are doing well. However, if there is a panic, a person may be glad that he owns some.

Remember every investor's situation is unique and it is important to review your specific situation with a financial professional.

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