Gold ETF More than a Flash in the Pan

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Introduction

An exchange-traded fund backed by physical gold finally made its long-awaited debut on the New York Stock Exchange on November 18th. The gold ETF (symbol: GLD) was widely expected to attract a great deal of interest, because until now it has been inconvenient for most investors to own gold bullion. The fact that the launch of the gold ETF happened to coincide almost precisely with a plunge in the value of the dollar – and a corresponding rise in the price of gold – to multi-year highs has further heightened interest in the new security. In just two weeks of trading, GLD has already attracted over $1.5 billion in assets.

Now that ownership of gold bullion has been facilitated by the launch of a gold ETF, investors are faced with the decision of whether it is a good idea to purchase it. After all, the price of gold has already risen over 65% in the past three years and is trading at its highest levels since 1988. Before dismissing GLD on the assumption that the rally has already occurred, investors would be wise to consider gold's history as an asset class and the reasons to own gold in the current environment.

Gold's Performance as an Asset Class

The investment establishment generally refuses to recognize gold as an asset class or a worthy investment choice, despite the diversification benefits resulting from gold's lack of correlation with stocks or bonds. Skepticism about gold is largely due to the fact that physical gold does not generate a yield like most other investments. Unlike stocks, bonds or REITs, there is no internal compounding with gold.

Another difficulty with gold as an asset class is the inconsistency of its performance record. Gold experienced a phenomenal bull market in the 1970s as the yellow metal rose from a price of $35 an ounce in 1971 to $700 an ounce in 1980, producing an *annualized* return of 38% over this period. This parabolic rise was driven by the confluence of several factors, all of which fueled demand for gold:

1. Nixon's abandonment of the gold standard, which allowed gold to rise above the artificially low price of $35, which had been fixed by the U.S. government since 1933.

2. The inflation of the 1970s, in which over the course of the decade the U.S. government increased the money supply by 150% and the CPI increased over 100%.

3. Geopolitical turmoil, particularly the OPEC oil embargo in 1973-1974 and the Iranian hostage crisis in 1979-1980.

4. The bear market in stocks and bonds, which eroded confidence in paper assets and created demand for hard assets.

As a result of this "perfect storm" driving the price of gold in the 1970s, by 1980 gold had become highly overvalued, which set the commodity up for two decades of poor returns. From 1980 through 2000, gold produced an annual return of –4.4%. This long period of poor performance steadily eroded support for gold as a viable asset class (even though gold's annualized return over the entire period of 1971 to the present is a respectable 7.4%, versus 11.3% for the S&P 500 and 8.3% for intermediate-term government bonds).

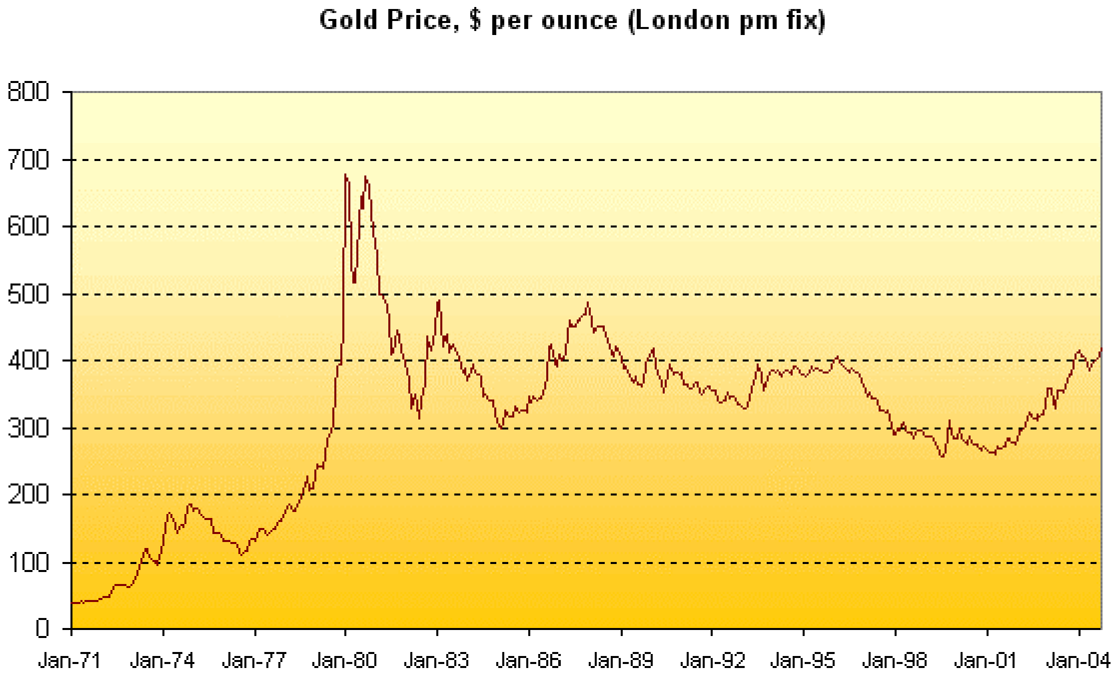
Those inclined to dismiss gold as a worthwhile investment are missing a key insight to be gained from the history of gold's performance presented above. There are periods when gold performs extremely well and periods when it does not.
The question investors should be contemplating today is whether an investment in gold is timely or not given the current environment. To analyze this question, one must consider the monetary dynamics that drive the valuation of gold.

Gold as a Hard Currency

Gold can properly be thought of as a hard currency, whose supply is relatively static and therefore not subject to government manipulation through monetary and fiscal policy. Consequently, the price of gold is ultimately a function of inflation in whatever paper currency its value is being measured. As governments inflate their currencies, it is reflected in the price of gold, which is why gold has historically been used as a barometer of inflation.

Gold is denominated in U.S. dollars in the global markets, but its price can be measured in any currency. For example, over the past three years, gold has risen over 60% in U.S. dollar terms but less than 10% against the Euro. As can be seen in the chart below, much of the weakness in the dollar since the beginning of 2002 has been simply a correction of the sharp run-up in the dollar from 1997 through 2000 that resulted from a surging U.S. economy and a series of currency crises abroad that created a capital flight to the U.S.

The following chart shows how gold has mirrored – in reverse – the movement of the dollar over this period. The price of gold measured in dollars became excessively depressed in 2000-2001, as the dollar peaked. Only in the past year has gold moved back above the $400 level, which was its approximate average price from the mid-eighties to the mid-nineties. Viewed from this perspective, today's gold price of $450 certainly does not appear overly elevated, especially in light of the monetary inflation that has occurred over the past 20 years.



Gold's Outlook Tied to the Dollar

To a great extent, the outlook for gold (in dollar terms) is linked to the outlook for the U.S. dollar. Unfortunately, the prognosis for the dollar remains bleak. The key problems facing the dollar are all variations on the same theme. As a result of our debt binge in both the government and private sectors, we have flooded the world with dollars, and the degree of external financing of our debts is unsustainable (as Mr. Greenspan has finally come to recognize). The details are as follows:

1. **Record Current Account Deficits.** Driven by a ballooning trade deficit, the current account deficit has grown to a level of $600 billion per year. At 6% of GDP, the current account deficit has never been higher. To fund this deficit, foreigners must mop up dollars at a rate of $1.6 billion a day.

2. **Record Budget Deficits.** Unfortunately, our demands on foreign savings are not limited to funding the current account deficit. Our federal budget deficit is increasingly funded from abroad as well. Over the past few years, as the U.S. savings rate has declined essentially to zero, approximately three-quarters of our federal budget deficit has been financed by foreigners.

3. **Record Foreign Ownership of U.S. Assets.** As a result of these trends, the net indebtedness of the U.S. vis-à-vis the rest of the world is at record levels. The U.S. is a net debtor to the rest of the world to the tune of over $3 trillion.

How High Can Gold Go?

There are persuasive analytical models that have compared the growth of the money supply to the growth in the supply of gold over the past 33 years (since the U.S. went off the gold standard) and have concluded that the current fair value of gold is in the $700 range.

Ultimately, how high gold can go depends on how much the U.S. debases its currency. Economic history is full of examples of nations devaluing their currencies to stimulate spending and reduce the burden of their debts. Unfortunately, this is exactly the course the U.S. now seems to be following.

The U.S. government and Federal Reserve can be expected to continue to pursue inflationary policies, which should further drive up the price of gold. Fiscal conservatism has been absent from this Republican administration, and the Fed has painted itself into a corner. The Fed should be raising rates more aggressively to defend the dollar, but it knows that the economy can't handle a significant rise in interest rates, due to the mountain of debt it has helped to create.

Gold Bullion versus Gold Stocks

Investors have traditionally gotten exposure to precious metals through gold stock or mutual funds that own gold stocks. The primary argument for owning gold stocks rather than the metal itself (via the gold ETF) is two-fold. First, gold stocks typically outperform bullion by a substantial margin when gold is rising because of the operating leverage inherent in gold companies. Second, gold stock investments held longer than a year are subject to the 15% long-term capital gains rate, whereas physical gold is considered to be a "collectible" by the IRS and is taxed at a long-term capital gains rate of 28%. The counter argument for gold bullion is that it is about a third as volatile as gold stocks and is less correlated with the broader stock market. In addition, GLD's expense ratio of 0.40% compares favorably with the typical gold mutual fund, whose expense ratio is in the 1.5% range. Of course, investors do not need to choose one or the other; they can hold the gold ETF alongside their gold stock investments.

Conclusion

The gold ETF is a welcome addition to the investment landscape. It represents a major innovation in facilitating the ownership of bullion, and opens up a new asset class for investors building diversified portfolios with low-cost ETFs. Given the formidable problems facing the U.S. dollar, gold could still be in the early stages of a multi-year bull market. Moreover, given its lack of correlation to stocks and bonds, a modest allocation to gold can be expected to improve the risk-adjusted returns of a diversified investment portfolio in the years ahead.

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