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Gold Stays In Spotlight

But advisors wrestle with issues surrounding the metal.

By Alan Lavine

Come rain or shine, many believe gold should be part of an investment portfolio—particularly today. The huge U.S. and European government deficits, weak currencies and concerns about future inflation are driving gold prices higher.

As of midyear 2010 alone, gold bullion prices were up 10% and precious metals mutual funds gained 12%. Over the past five years, gold has grown at a 19% annual rate, while precious metals funds have risen 22% annually, according to the World Gold Council, New York, and Morningstar Inc., Chicago.

Is investing in gold a sure thing? No. Some analysts point out that U.S. inflation is at a 44-year low, interest rates are at record lows and unemployment is high. In late June, Atlanta Federal Reserve Bank President Dennis Lockhart cautioned that deflation is a risk. With no inflation, gold may not perform as well as expected.

Nevertheless, the greatest driver of gold prices this year is higher investment demand in the United States and Europe, according to Gold Demand Trends, a publication of the World Gold Council. James DiGeorgia, a gold bull and the publisher of the online report Gold and Energy Advisor (www.goldandenergyadvisor.com), expects the metal to end the year at $1,400 an ounce, and believes it could eventually trade at more than $2,500 an ounce.

"Investors are learning that the major currencies in the world have major risk to the downside," he says. "Gold is seen as a safe haven and inflation hedge due to huge worldwide government deficits. There is a finite supply of gold, and demand is very high. Central banks are diversifying their reserves into gold, and this trend should continue."

DiGeorgia reports that many financial advisors are buying legal tender gold coins such as American Eagles and want to diversify away from gold bullion and mining stocks.

Legal tender coins are liquid, don't need to be assayed and can be sold in much smaller amounts than 100-ounce gold bars. Gold stocks and precious metals mutual funds, meanwhile, don't act the same way as the price of the actual metal. They are more volatile and are a paper asset tied to the value of a company. For example, when the financial markets collapsed in 2008, gold stocks plunged with the rest of the stock market. By contrast, the metal itself acted as a hedge against paper losses.

DiGeorgia has concerns about GLD, the exchange-traded fund that invests in gold bullion (and which is sponsored by World Gold Trust Services LLC, a wholly owned subsidiary of the World Gold Council). In a major gold market sell-off, liquidity in GLD could dry up, and investors may find it hard to sell at the price they desire. This happened to bond exchange-traded funds in 2009 and to equity ETFs during the May 6, 2010 "flash crash."

Although coins sell at a premium to bullion, DiGeorgia adds, advisors can save $500 on the wholesale cost and $900 on the retail cost by buying gold coins in rolls of 20.

Many advisors buy and hold coins for long-term hedges. Others who want to avoid large losses in the volatile investment can use trend analysis based on changes in interest rates and price charting. Technical trends can help advisors get out of the market and avoid large losses.

Precious metals mutual fund managers report that mining companies, meanwhile, are cash rich and earnings are growing at double-digit rates. The reason: It costs about $500 per ounce for major producers to pull ore out of the ground. Every 1% increase in the price of gold typically results in a 3% increase in the price of mining stocks because of the operating leverage.

Rachel Benepe, manager of the First Eagle Gold Fund, sticks with the largest mining companies, those with long-life mines. She seeks proven reserves and operations in regions where mining is widely accepted and where the political environment is stable. For diversification, she keeps about 25% in gold bullion.

"Large-cap producers like Newmont Mining and AngloGold are all generating tremendous cash flows and have good business plans," Benepe says. "Their costs are contained and the price of the product is going up."

The fund's largest holdings, on average, are growing earnings at 14%. "Gold is currently playing the role of substitute currency," she says. "We see the fiat currency system facing a number of challenges. The status of the U.S. dollar as the world's reserve currency is suspect. The euro is facing its most critical challenge in its ten-year history. The yen also lacks appeal."

Benepe adds that the above-ground supply of gold is limited and the quality of newly mined ore isn't as good as it used to be. She does not forecast the price of gold, but instead "evaluates the cost on a spot basis versus alternatives." She will increase the fund's holdings in gold bullion to up to 25% if she sees that bullion is cheaper to own than mining stocks.

Although the valuations of platinum mining companies declined last quarter, Thomas Winmill, manager of the Midas Fund, believes that both platinum and silver will outperform gold over the next several months. The reason: The industrial use of both metals will rise with Asian buying and an improving U.S. economy.

The Midas Fund invests in gold, silver and platinum mines, as well as other natural resources and commodities such as iron, aluminum, copper, uranium, titanium, coal, oil, natural gas and forest products. At this writing, the bulk of the fund was invested in gold, silver and platinum mining companies. The fund's five largest holdings, which make up 25% of the portfolio, include Newmont Mining, Barrick Gold, Centerra Gold, Northgate Minerals and Aquarius Platinum. The fund had about 16% of its assets in other natural resources companies.

Other money managers say we are experiencing a gold bubble because of the fears about government deficits and inflation. When the bubble bursts, investors could experience massive losses in bullion and mining stocks.

Bob Wiedemer, managing partner of the Foresight Group, an advisory firm in Washington, D.C., sees gold as a long-term bubble that could last another ten years before bursting. "I remain very bullish on gold long term," he says. "It will reach $5,000. But short term, I am concerned about a pullback in commodities prices due to a popping of the Chinese government stimulus and real estate bubbles. A 30% pullback in commodities could take gold with it—down 10% or more."

He recommends that advisors avoid jumping in and out of gold given its extreme volatility. They should instead sell to capture some profits or use put options to hedge their positions.

Paul Pomfret, managing partner with PDP Capital, a Palm Beach, Fla.- based fund of hedge funds, does not like gold, particularly GLD. He says he can get better diversification by adjusting his positions in market neutral, long-short and arbitrage hedge funds.

"The recent crisis in Greece, coupled with coming out of the recession, drove people to buy gold out of fear—not fundamentals," says Pomfret, a former analyst at Goldman Sachs. "Although gold keeps rising, the demand from end users, such as jewelry stores and consumers, has not increased. Gold's substantial increase was related to gold investing being easier with the exchange-trade funds. But when the economy starts to pick up one day, there is a potential to see gold unwind as quickly as it went up."

"Will gold maintain its purchasing power value if inflation erodes the purchasing power of the dollar or the euro?" asks Martin Feldstein, Harvard University economics professor. "And will gold hold its value in euros or yen if the dollar continues to decline?"

In a recent article posted on the Web site of the National Bureau of Economic Research (www.nbr.com), Feldstein answers no. The dollar price of gold does not increase with the U.S. price level, he says. Plus, the value of gold does not increase in dollars to offset the fall in the value of the dollar relative to the euro or the yen.

For example, the price of an ounce of gold in 1980 was $400. Over the next ten years, inflation was up 60%, but gold remained $400 at the end of the volatile decade.

Consumer prices were twice as high as they were in 1980 by the end of 2000. But the price of gold was about $300 at year-end 2000. And even though the price of gold hit $800 an ounce in 2008, it did not keep pace with the rise in consumer prices since 1980.

Gold, Feldstein adds, didn't do much better as a currency hedge. For example, a dollar was worth 200 yen in 1980. Twenty-five years later, the exchange rate had strengthened to 110 yen per dollar. Since gold was $400 an ounce in both years, holding gold did nothing to offset the fall in the value of the dollar.

"There are better ways than gold to hedge inflation risk and exchange-rate risk," Feldstein says. "TIPS [Treasury Inflation Protection Securities] or their equivalent from other governments, provide safe inflation hedges, and explicit currency futures can offset exchange-rate risk."

On the plus side, Feldstein says that gold can sometimes be a good investment. Since 2005, the value of gold has tripled. And gold is a liquid asset that provides diversification in a portfolio of stocks, bonds and real estate.