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Gold's disappointing history

Gold has turned out to be the most disappointing mainstream investment in the past 50 years as it continues to underperform the targets of its promoters.

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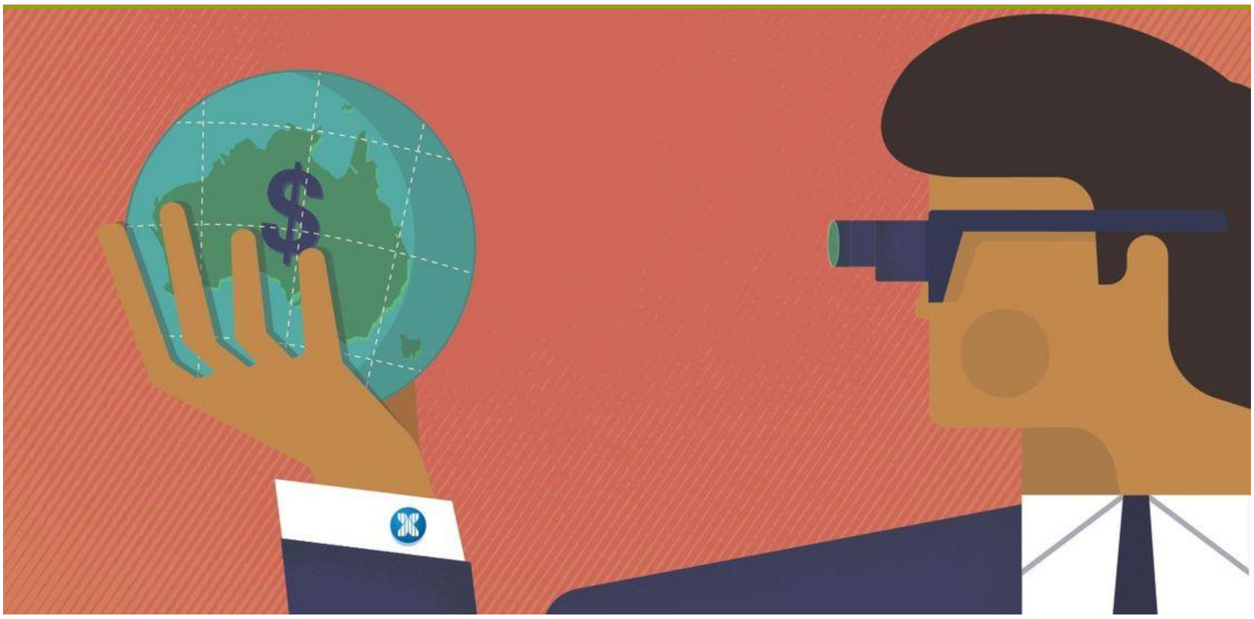

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Rising inflation? Buy gold! Falling inflation and lower interest rates? Buy gold! Strong growth? Buy gold! Economic crisis? Buy gold! There is scarcely an economic or market circumstance in which gold does not benefit, in the eyes of its admirers.

With so many reasons being proffered in favour of having a stake in the precious metal, its performance as an investment medium is surprisingly lacklustre. Of course, the most fervent gold protagonists, undaunted by history, will add "so far".

Once the nexus between gold and the US dollar was broken under the Nixon administration, great things were expected for the precious metal.

Within a decade of having shed its shackles, the gold price had exceeded US$600/oz. Annualised gains of 30% favoured those with some outrageously bullish views about how high bullion prices might rise.

The Aden sisters - Mary Anne and Pamela - famously helped build the gold bandwagon in the early 1980s tipping a rise to $4,000/oz by 1986. In those days, their celebrity was by no means confined to peripheral investment newsletters. Their forecasts featured prominently in a 1982 'New York' magazine article.

Inflation caused by a surge in unfunded government spending was the driver of the rapid ascent in bullion prices anticipated by the Adens. Senior mining executives, generally with a conservative political bent, readily embraced warnings of government profligacy, mollified by its impact on their own financial prospects.

Of course, the Aden sisters were off by a long way. They had fallen victim to the great curse of forecasters, namely, putting too much emphasis on their most recent experience in framing thoughts about the future.

The same issue of ‘New York' featuring the Aden sisters showed how far the forecaster's curse extends beyond financial markets. The lead feature entitled "Is Sex Dead?" drew on perceived signs of a recent lull in enthusiasm for recreational sex.

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A renewed eagerness for sex and dramatically changed expectations of inflation both confounded early 1980s forecasters. The Aden sisters' forecast did not foresee central banks so ruthlessly breaking the back of a global inflation problem. The stunned gold price changed little for nearly 20 years.

Prices did rise dramatically between 2002 and 2011 but even a top gold price approaching $1,900/oz meant performance could be characterised as disappointing, given earlier hopes.

The near 600% rise in the first decade of the 2000s paralleled the 570% price rise through the latter 1970s. The first rise came with a massive diversion of wealth from advanced economies to Middle East oil exporters. The second came with another massive wealth migration, this time to China.

The latter shift in financial resources has now seemingly given way to another prolonged period of relatively static prices consistent with gold needing something far bigger than marginal interest rate or exchange rate changes to propel it higher.

Hope does persist. The Aden sisters' current website highlights one reason for gold's disappointing show. The supply of physical gold has been swamped by limitless amounts of gold traded in paper form, according to the analysis posted on the site. Without the paper-based gold market, the upside in the price of physical gold would be enormous - possibly as high as $60,000-80,000/oz, if only money supply was backed by gold.

More mainstream proponents of gold have scaled back their ambitions considerably. This past week, one commentator cautioned investors against impatience over their wait for higher prices, now in its sixth year, because the gold price is set to convincingly break $1300/oz and could even go as high as $2,000/oz, provided the US dollar weakens, inflation pressures rise and official debt keeps growing.

Today's forecasts, still highly conditional, are extraordinarily modest by the standard of what investors had once been encouraged to expect.

Rather than strong capital appreciation under any known economic outcome, gold's low correlation with major asset classes has assumed a higher profile among those, such as the World Gold Council, arguing the case for gold as an investment medium.

The absence of a strong statistical connection between gold returns and returns on other financial assets translates into a cogent analytical case for having some gold exposure in every well constructed investment portfolio.

The advocates of using gold's low correlation attributes might also be guilty of having gilded the lily about its potential to fulfil that role.

Over the two decades after 1982, while there was no change in the gold price, the S&P 500 rose by 975%. Since June 2013, the gold price has not changed while the S&P 500 has risen over 80%.

Referring to low correlations is an analytically artful way of papering over meagre returns while everything else is going up rapidly. Historically low correlations with other assets, and the accompanying sacrifice of alpha, has depended in part - as it will in the future - on lengthy periods of disappointingly weak prices.

The correlation between the US dollar gold price and the S&P 500 share-price index might have averaged near zero but has been highly cyclical. Fifty seven percent of the time rolling 36-month correlations, for example, have exceeded 0.6 or have been less than -0.6. Prolonged periods of high positive or negative correlations with mainstream investments, not zero, typify the relationship.

Gold's risk-return characteristics have been superior to those of industrial metals and a plethora of other potential investments. It can still fulfil a money-making trading or investment role. Depending on an individual's risk tolerance and financial objectives, a prominent portfolio role for gold, or gold linked securities, might make sense.

Disappointment, which is not necessarily the same as poor performance, is measured relative to expectations. No asset has been more disappointing. The reality for gold is far more nuanced than the portrayal of huge returns predicated on impossibly demanding circumstances.

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