Investing in Gold – as an Asset Class and Portfolio Diversification

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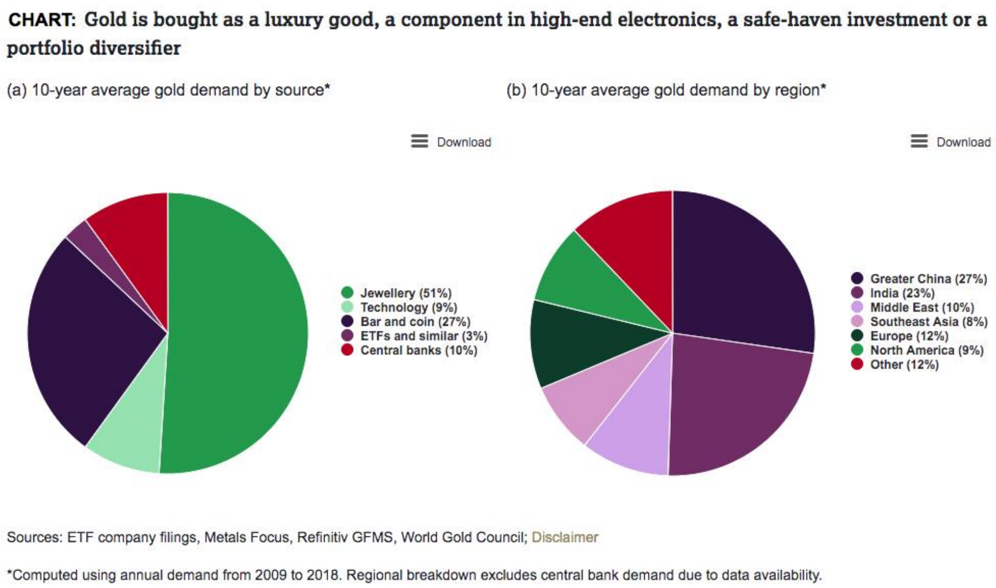
Gold is often mentioned as an essential part of one's portfolio. However, I would argue that investing in gold should depend on the strategy an investor has and whether such an asset will help him to reach his goals or not. We are going to discuss the most important factors related to investing in gold as an asset class and that should give you a good overview of the risks and rewards and how those might fit your investment strategy.

Interesting notes on gold

Gold is used mostly for jewellery and investment while the most demand comes from China, India and Asia 68%). So, that is important to watch over time as any changes definitely impact gold.



Demand for gold by sector and geography - Source: [Mining]

Also important is to note is that the gold price was fixed at $35 from 1944 till 1971 by the Bretton Woods agreement. Only in 1971, the Nixon shock, suspended the convertibility of the dollar into gold or other reserve assets. So, what we have now qua gold can actually only be measured since 1971.

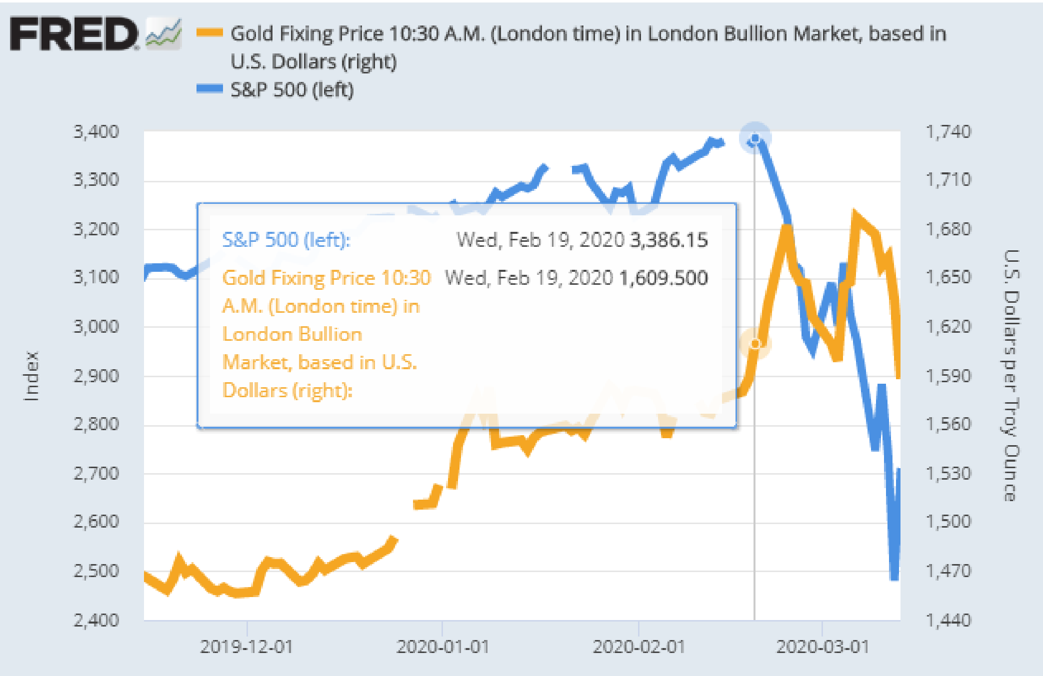
Let's talk investing now.

Gold Price – Can Gold go to $5,000?

Let's start the discussion about gold investing by discussing the price of gold. The price, not the value as with other investments, is key as gold doesn't pay dividends, if you have an ounce it will always be one ounce and therefore, it is all about the price and how it moves.

Gold is not a perfect hedge, and certainly not against stock market crashes

A common misconception is that gold is a perfect hedge and that it will protect you from whatever happens in the markets. Many were surprised to see gold prices (gold colour) fall alongside stocks (blue colour for S&P 500) since the coronavirus crash started.



Gold price and the S&P 500 – Source: Gold Price - FRED

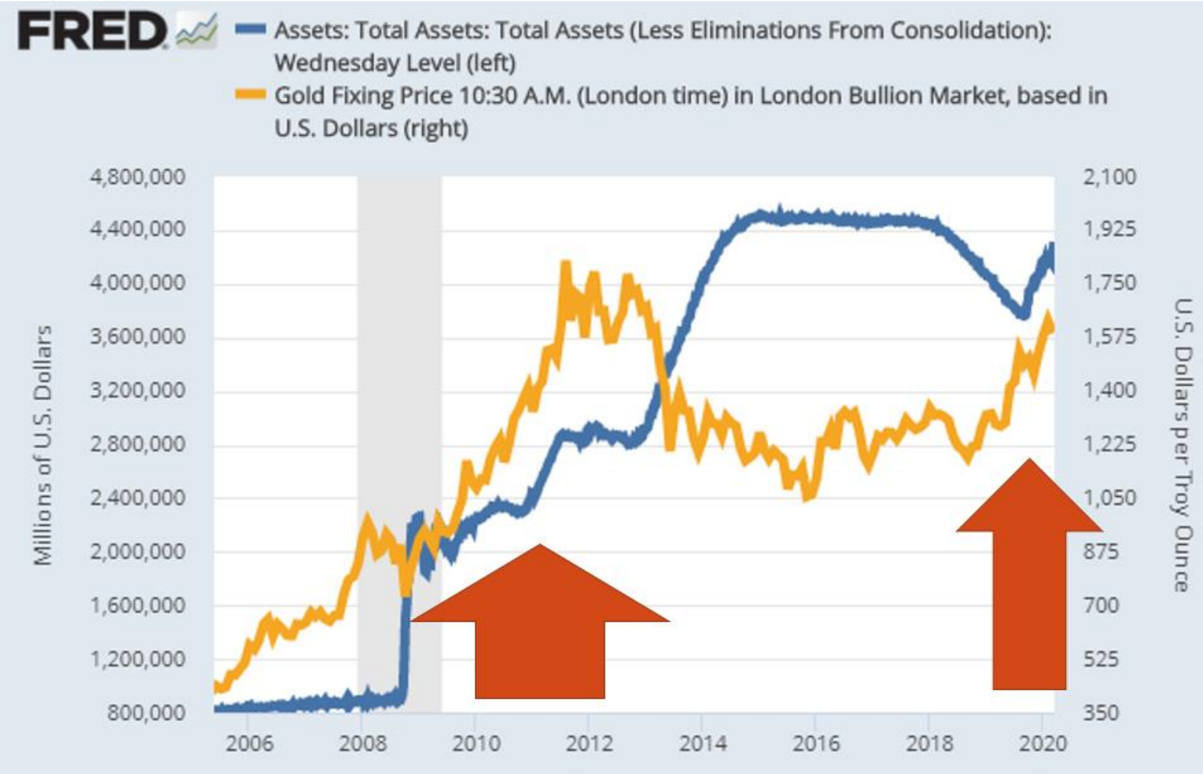
Unfortunately, gold isn't a hedge against market drops, gold is more of a hedge against loose monetary policy and inflation.

When it became clearer that the FED will not be able to maintain interest rates at 2.5%, because such rates were hurting the economy, gold started its jump from around $1,300 to $1,700 in 2019.

Gold price and interest rates – Source: [FRED]

If we take a long-term look, gold prices exploded during the inflation period in the 1970s, during the 2000s when it became clear that interest rates will remain lower than it was the case historically and after 2009 when central banks pushed rates to 0% and pumped trillions into the system.

As in 2019 the FED started lowering interest rates and in September further increasing the liquidity in the REPO market and therefore increasing its balance sheet again (blue line), gold prices exploded again.



Gold price and FED's balance sheet – Source: [FRED]

So, given gold is down due to liquidity issues and not because of fundamental issues, it might be a good time to look at it again. Something similar happened twice in 2008 where gold prices fell significantly for a short period of time despite the doom and gloom environment.

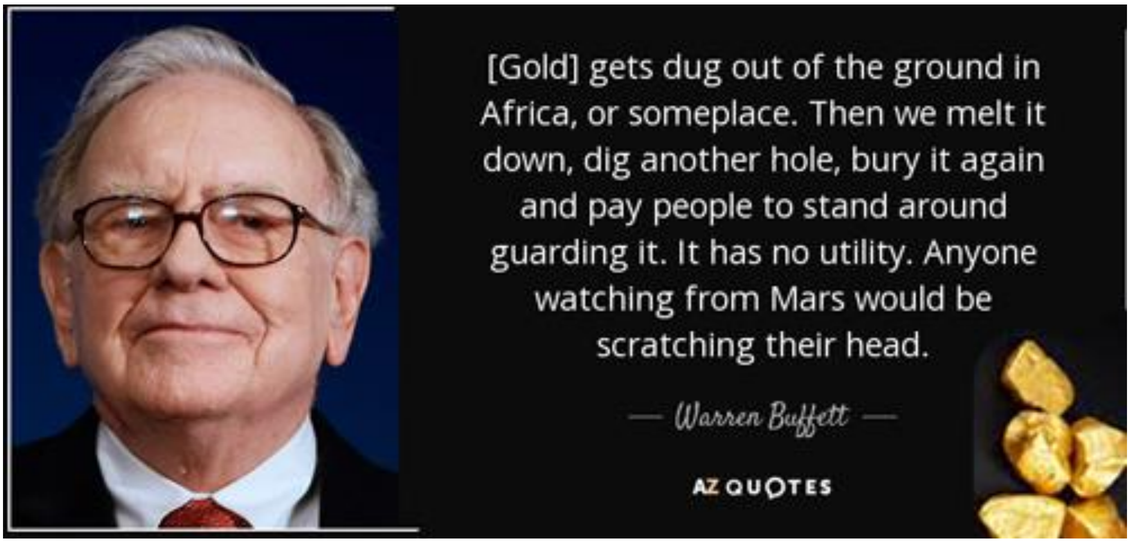
So, if the FED, EDB, BOJ, PBOC, BOC, BOE etc. all lower interest rates and print money, it is logical that gold, a relatively limited asset, goes up in price. Therefore, gold is a hedge against inflation, loose monetary and fiscal policy and I would not be surprised to see gold at $5,000 in the coming decade.

However, just because gold can and might go to $5,000, it doesn't mean it is the best possible investment out there. If central banks print more and more money, lower interest rates and governments increase their deficits; other asset classes might do much better than gold. Let's see how gold fits your portfolio as an investment. What kind of investment category can you put gold into?

Gold as an investment – no dividend but you can make one

We all know Buffett's view on gold. How it doesn't produce anything, there is no utility to it, no dividend, no growth and no earnings reinvesting and therefore no compounding. Plus, there is a cost to owning it. All components crucial for long-term investing as Buffett has explained in his [2019 letter to shareholders](#).

So, you have to see how gold, given it is a hedge against loose monetary policy but at the same time doesn't provide any utility to the investor, fits your portfolio.



Gold with a dividend

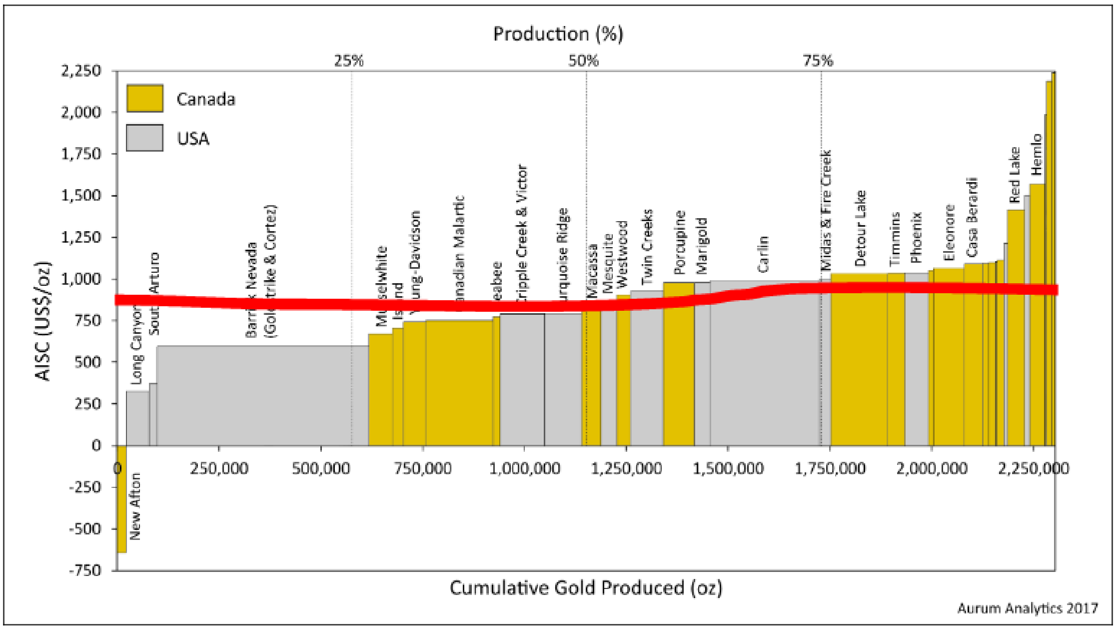
There is also a way how you can make gold have a yield for your portfolio. Gold can give you a yield if you rebalance on its volatility. Ray Dalio, who is a proponent of having gold in your portfolio, discusses how you can set a fixed exposure to gold and keep it fixed as a portfolio hedge.

Let's say you put 10% of your portfolio into gold. Then, when gold goes up from $1,300 to $1,700, you can rebalance and bring the balance down to 10% again. When gold goes down, you increase your position back to 10%. Given gold's natural volatility, you'll always have something to do and also get a yield. This is a strategy usually applied to all-weather portfolios.

A Value Investing Perspective on Gold

It is interesting that when is started my YouTube channel in 2017, I was discussing gold a lot. The thing is that I considered gold to be relatively cheap back then and thus gold to be a value investment with a margin of safety.

I considered gold as a low risk, relative high reward investment when gold was trading at $1,200 because it was close to its bottom price from a cost perspective. A look at the 2017 gold cost curve shows that most producers have an average all-in sustaining gold mining cost of around $900. When you add the debt, marketing costs and a return on capital on top of that, $1,200 or $1,100 provides you a demand and supply bottom.

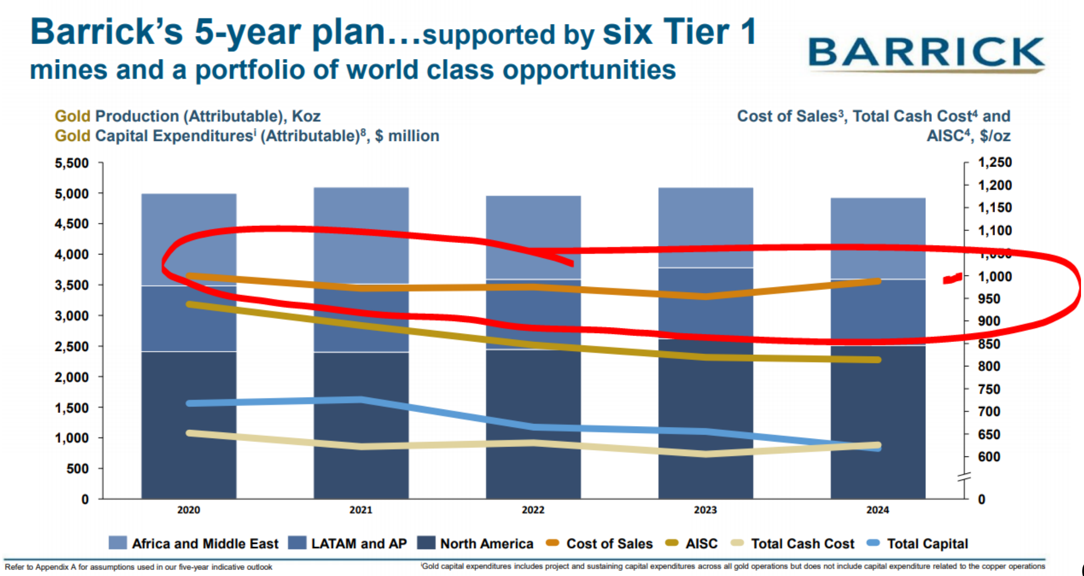


2017 Q3 USA and Canada gold production cost curve ranked by reported AISC

Gold price and cost curve – Source: [Aurum Analytics]()

So, the cost of mining gold provided a margin of safety which is what value investors look at. Further I looked at some gold miners that had also some business advantages or were mispriced and I [invested in those]().

Today in 2020, gold prices are much higher, but gold mining cost are still there. Barrick's gold cost of sales are expected to stay flat at $1,000.



Gold cost for Barrick Gold - Source: [Barrick Gold]()

The discrepancy between the price of gold and the actual cost of producing gold at current levels makes gold more of a speculation than a value investment at this point in time. Consequently, Barrick's estimated gold price for 2021 is still just $1,200. They must have learned the lessons from 2012 when all gold miners went on crazy investing sprees due to the exuberance related to gold.

Appendix A – Five Year Outlook BARRICK

Key assumptions	2020	2021 +
Gold Price ($/oz)	1,350	1,200
Copper Price (US$/lb)	2.75	2.75
Oil Price (WTI) ($/barrel)	65	65
AUD Exchange Rate (AUD:USD)	0.70	0.75
ARS Exchange Rate (USD:ARS)	65.00	75.00
CAD Exchange Rate (USD:CAD)	1.30	1.30
CLP Exchange Rate (USD:CLP)	725	680
EUR Exchange Rate (EUR:USD)	1.20	1.20

So, let's stick to discussing gold as a hedge, not as a value investment at this point in time. I am sure it will be a value investment in the future again, but not now.

Gold as a hedge and alternatives

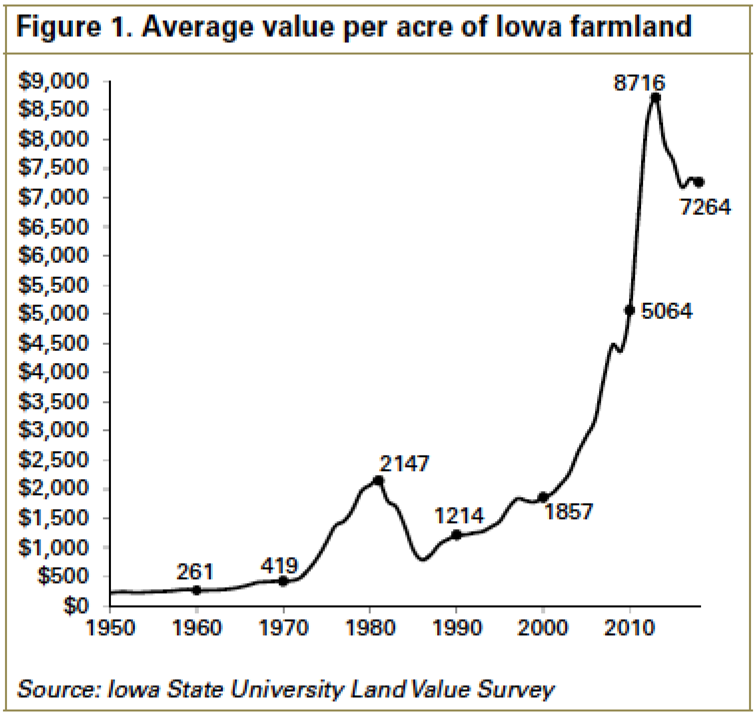
Now, many mention gold as a hedge against inflation, loose monetary policy etc. and they are probably right. However, my question is whether there are better options to hedge your portfolio against something that is inevitably coming given the loose monetary and fiscal policies ahead due to the coronavirus impact on the economy.

If central banks print money, government borrow more and increase their budget deficits one thing is sure, more money, thus less value for the money. Given governments have an inflation rate target of 2%, you can be sure that your money will lose 2% per year at least. In situations like the current one, even more.

Now, on the hedges, many are focused on gold, but an inflationary hedge could be defined as something in limited supply that can keep its real value fixed. Thus, there is not only gold there. For example, copper supply is also relatively fixed and the result over the past 20 years is similar to what happened to gold, albeit in different time periods.

Gold price (gold) vs. copper price (red) – Source: [FRED]

Another example is farmland, an asset that is definitely in fixed supply.



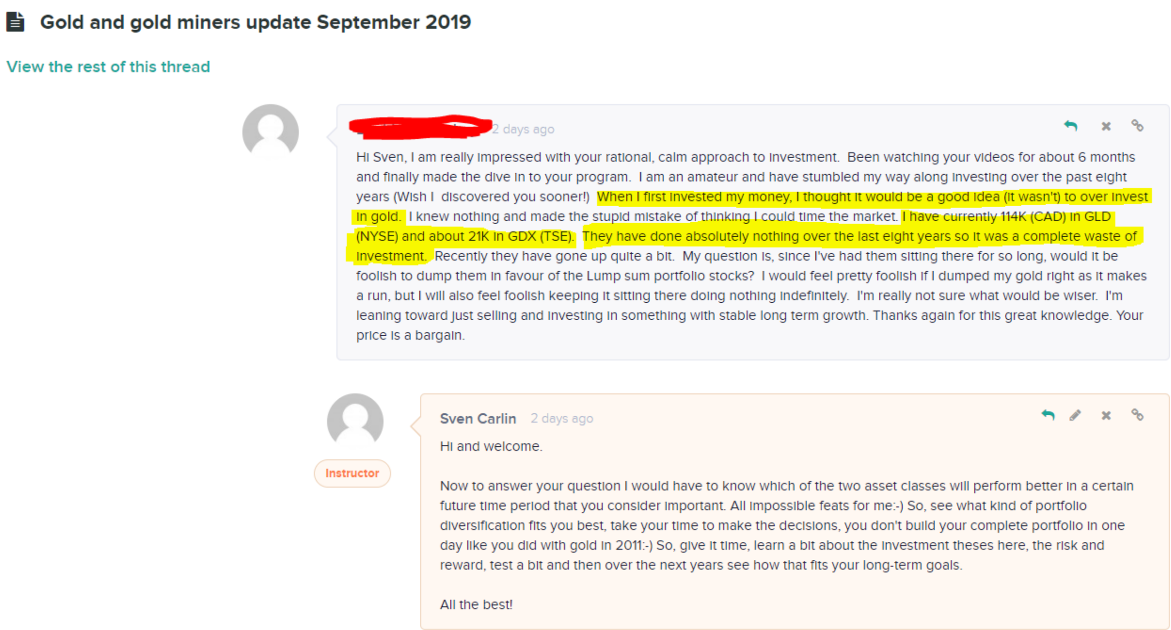
US Iowa farmland price – Source: [Iowa State University]

Not to mention real estate where today you can borrow at 1.5% fixed interest rate for 20 years (Germany). With inflation targeted at 2%, the banks today pay you to take their money. Another inflation hedge and asset class to discuss when it comes to investing.

So, when looking for a hedge against loose monetary policy and fiscal deficits, think of assets that have limited supply or, perhaps even better and what Buffett is doing, think of businesses that have pricing power.

Here are 3 business ideas with pricing power thanks to high margins: Mastercard (MA), Visa (V) and 3M (MMM). If there is inflation, or there is more money in the system, payment processors like Visa and Mastercard will have higher margins while 3M, thanks to its specific business qualities, can transfer higher costs to the customer.

So, my message is, see how gold fits you but don't become a gold bug, because this might be the consequence:



Gold and gold miners update September 2019

View the rest of this thread

[redacted] 2 days ago

Hi Sven, I am really impressed with your rational, calm approach to investment. Been watching your videos for about 6 months and finally made the dive in to your program. I am an amateur and have stumbled my way along investing over the past eight years (Wish I discovered you sooner!) When I first invested my money, I thought it would be a good idea (it wasn't) to over invest in gold. I knew nothing and made the stupid mistake of thinking I could time the market. I have currently 114K (CAD) in GLD (NYSE) and about 21K in GDX (TSE). They have done absolutely nothing over the last eight years so it was a complete waste of investment. Recently they have gone up quite a bit. My question is, since I've had them sitting there for so long, would it be foolish to dump them in favour of the Lump sum portfolio stocks? I would feel pretty foolish if I dumped my gold right as it makes a run, but I will also feel foolish keeping it sitting there doing nothing indefinitely. I'm really not sure what would be wiser. I'm leaning toward just selling and investing in something with stable long term growth. Thanks again for this great knowledge. Your price is a bargain.

Instructor

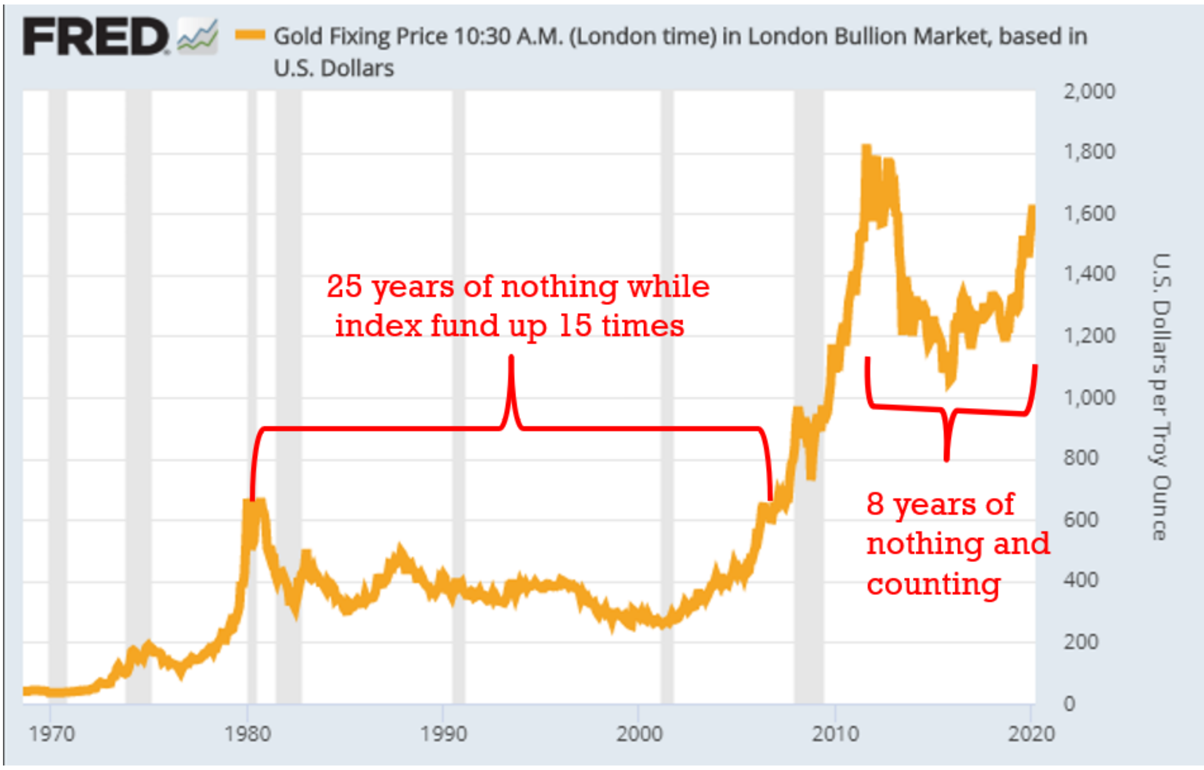
Sven Carlin 2 days ago

Hi and welcome.

Now to answer your question I would have to know which of the two asset classes will perform better in a certain future time period that you consider important. All impossible feats for me:-) So, see what kind of portfolio diversification fits you best, take your time to make the decisions, you don't build your complete portfolio in one day like you did with gold in 2011:-) So, give it time, learn a bit about the investment theses here, the risk and reward, test a bit and then over the next years see how that fits your long-term goals.

All the best!

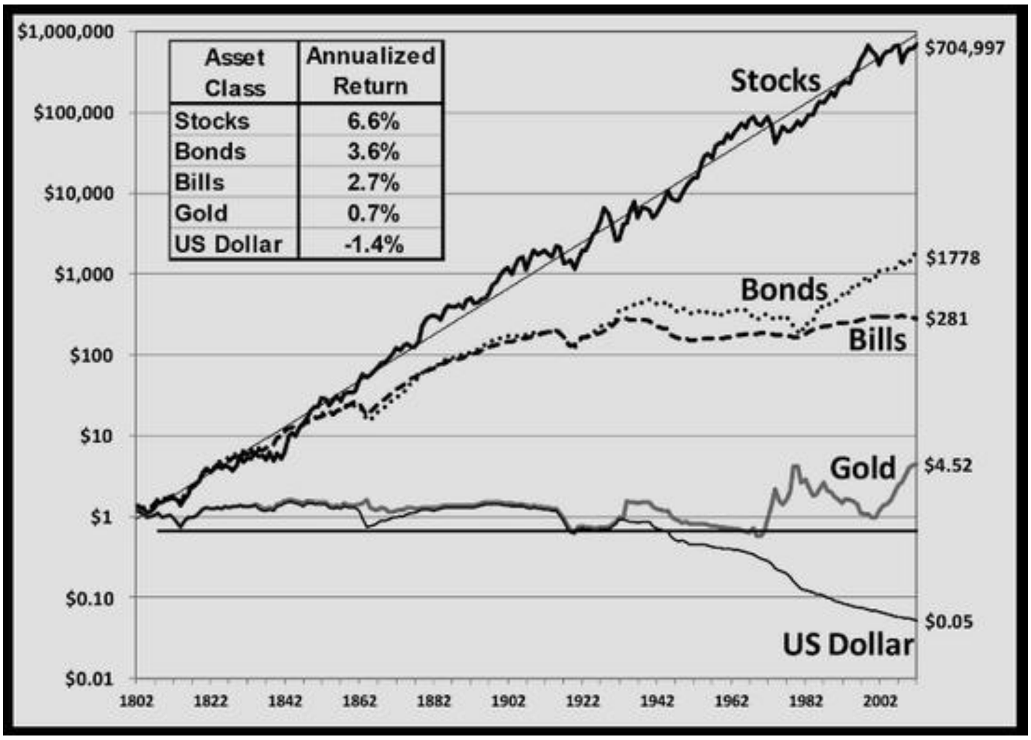
An investor on my Stock Market Research Platform commented how he invested in gold and for 8 years nothing happened, no dividend, no growth, no nothing. And, if we look at the long-term gold chart, things have been worse in the past😊.



The 25 years of negative returns, even longer if we adjust for inflation, and the current 8 years explain perfectly what Buffett means when he trashes gold.

Also, if we look at long-term data from Jeremy Siegel's book [Stocks for the long-run](), gold doesn't offer a stellar return in the long-run because it doesn't produce anything and doesn't grow. But it does protect you from inflation, nothing else.

Real investing returns since 1802.



Gold as an asset class - conclusion

The key when it comes to investing in gold is to know exactly what to expect from it. I think that many see the 2002-2012 bull run and expect that it will happen again soon. It can happen tomorrow but it can also not happen in the next 15 years. Therefore, it is up to you to see how gold fits your portfolio.

The second strategy, one praised by Ray Dalio and his all-weather portfolio, is a strategy where you rebalance in relation to how much weight gold has in your portfolio. For those who wish to be diversified, it is not a bad strategy but you have to be disciplined and patient.

The third strategy could be to own gold miners as they have the gold, they get paid to dig it out, they pay a dividend and they can grow. However, gold miners are extremely complex, highly volatile and can go bankrupt, gold can’t. This will be a topic for another lesson.