First Ascent Asset Management

THE GLITTER OF GOLD

Should Gold Be a Part of Your Portfolio?

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Gold is beautiful to look at and has a rich history, but does it belong in your investment portfolio? The information below will help you answer that question.

A Quick History

Gold has been valued throughout most of recorded history. It was used to display wealth, power, and status over 5,000 years ago in Egypt. Other ancient civilizations treasured it as well due to it rarity, aesthetic qualities, durability, and malleability.

The Lydians are believed to be the first culture to use gold as money, producing the first gold coins somewhere between 600 and 700 BC. It has played a role in global monetary systems ever since.

In the 1870s European countries adopted a gold standard that guaranteed they could redeem their paper currencies for an equivalent amount of gold. The US adopted the Gold Standard Act of 1900 establishing gold as the only metal that could be used in redeeming its currency.

The US abandoned the last vestiges of its gold standard in the 1970s. US currency is now backed by the "full faith and credit of the US government," not by gold reserves. Today all the world's currencies are "fiat currencies," which means they are not backed by gold reserves.

Gold Today

Although gold is no longer used to back up any of the world's currencies, it is still highly valued. In part, this is due to its rarity. It is estimated that all the gold that has ever been mined (approximately 197,580 tonnes) would fit into a cube about 69 feet on each side. On average, the supply of above-ground gold increases only about 1.5% annually through mining activity.

Gold has three main uses. Estimates vary, but about 47% of all gold is used in jewelry, 39% is held by central banks and private investors in the form of coins or bullion, and the remaining 14% is used for industrial or technology purposes.

The price of gold is driven by supply and demand. As we have seen, the supply of gold does not change much year-to-year. Changes in demand can be dramatic and may be driven by any or all of the three areas mentioned above—jewelry, investment, or industrial/technology.

What Role Should Gold Play in an Investment Portfolio?

Investors have mixed feelings about gold as an investment. Some see it as a safe haven that can play an important role in preserving wealth during times of economic trouble and global strife.

Others see it as one of many commodities that can play a role in a well-diversified portfolio.

Still others have no interest in gold as an investment because of its relatively poor long-term performance history and high volatility.

All these views have some merit. Let's examine each one.

Gold as a Safe Haven

Many articles written about gold as an investment refer to the precious metal as a “safe haven.” A safe haven investment is not the same as a “safe asset.”

Treasury securities, for example, are considered a safe asset. That is because they are backed by the US government and their prices are relatively stable compared to other asset classes.

Gold is different. It is considered a safe haven because people believe that it will hold its value and even, perhaps, increase in value during difficult times.

Difficult times is a catch-all term. It can include bear markets, periods of heightened uncertainty because of world events, concerns about a weakening dollar, the prospect of increased inflation, and even worries about the collapse of the global financial system.

Any occurrence or concern that raises investor anxiety can create increased demand for gold, as investors abandon traditional financial assets for the perceived safety of gold. This increased demand can drive the price of gold higher, thus reinforcing gold’s reputation as a safe haven.

The perception of gold as an enduring safe haven is driven, in part, by history and, in part, by the nature of gold itself. The Pharaohs of Egypt were amassing golden treasures all the way back to 3,100 B.C., while stocks and bonds did not come along until well over 4,000 years later.

The first paper stock certificates were issued by the Dutch East India Company in 1602. The first true government bonds were issued by the Bank of England in 1693. So, stocks and bonds are relative newcomers as vehicles for wealth retention.

Stocks and bonds have an ephemeral quality not shared by gold. They are intangible interests that can, and sometimes do, lose all their value. One-third of all companies in the Fortune 500 in 1970 no longer existed in 1983. On average, 3% of all corporate bonds default each year.

Gold is tangible and never goes out of business. It never misses a dividend or defaults on an interest payment. It doesn’t even corrode. If you put a gold bar in your safe at home, it will be there, unchanged, thousands of years later—long after both you and your home are long gone.

And gold has held its value well over time. In ancient Rome an ounce of gold bought a toga and a pair of sandals. Today an ounce of gold pays for a nice Italian suit and a pair of Gucci loafers.

It is easy to understand why gold is considered a safe haven by many investors.

Is Gold a Good Investment?

Gold has been around a long time and is perceived as a safe haven, but is it a good investment? As a stand-alone investment, gold’s long-term track record is not particularly good.

Research published in The Economic Journal in 2015 by Robert Barro and Sanjay Misra found that from 1836 through 2011 gold earned an average annual inflation-adjusted return of 1.1%. By contrast, Barro and Misra estimated long-term returns over the same period to be 1% for Treasury Bills, 2.9% for long-term bonds, and 7.4% for stocks.

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Research by Joshua Kennon of Kennon-Green & Co. looked at the amounts you would have received if you went back nearly 200 years and invested $10,000 in gold, bonds, and stocks. The results are expressed in inflation adjusted dollars and assume reinvestment of all dividends, interest, and other gains. Gold does not fare well over this long time period.

Real Returns on $10,000 Investment

196 Years

Asset Class	Return
Stocks	$5,600,000,000
Bonds	$8,000,000
Gold	$26,000

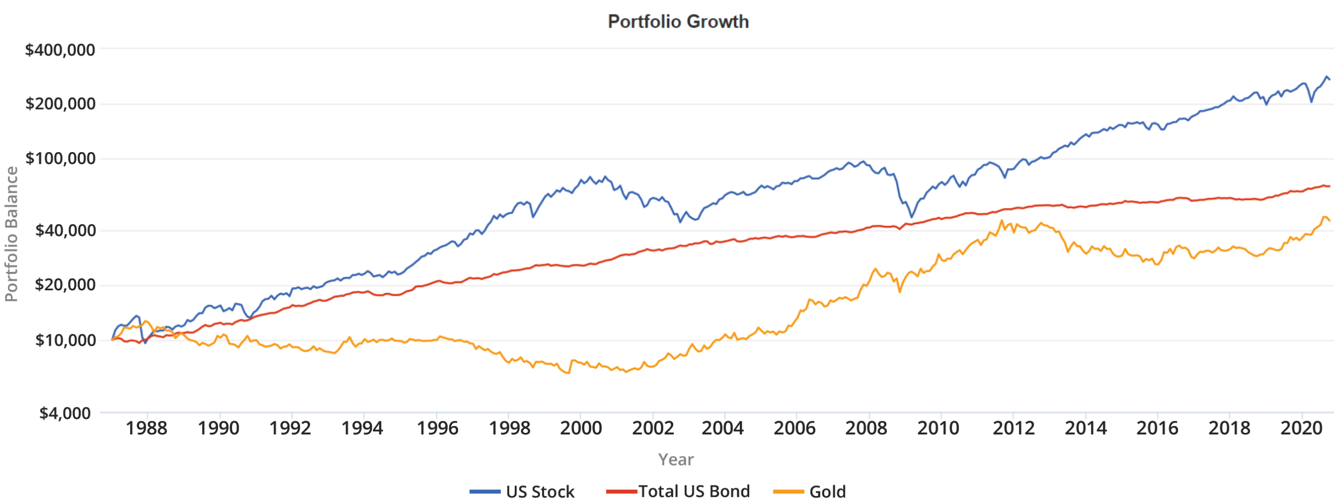
Source: Keenon-Green & Co.

We looked at a more recent time period, and also found that gold lagged both stocks and bonds. Our research shows that between January 1987 and December 2020, gold returned 4.57%, while US bonds returned 5.91% and US stocks returned 10.64%.

Real Returns on $10,000 Investment

1987- 2020

Portfolio	Initial Balance	Final Balance	CAGR	Stdev	Best Year	Worst Year	Max. Drawdown	Sharpe Ratio	Sortino Ratio
US Stock	$10,000	$311,048	10.64%	15.42%	35.79%	-37.04%	-50.89%	0.54	0.77
Total US Bond	$10,000	$70,475	5.91%	3.8%	18.18%	-2.66%	-5.86%	0.74	1.2
Gold	$10,000	$45,629	4.57%	15.12%	30.45%	-28.33%	-48.26%	0.17	0.26



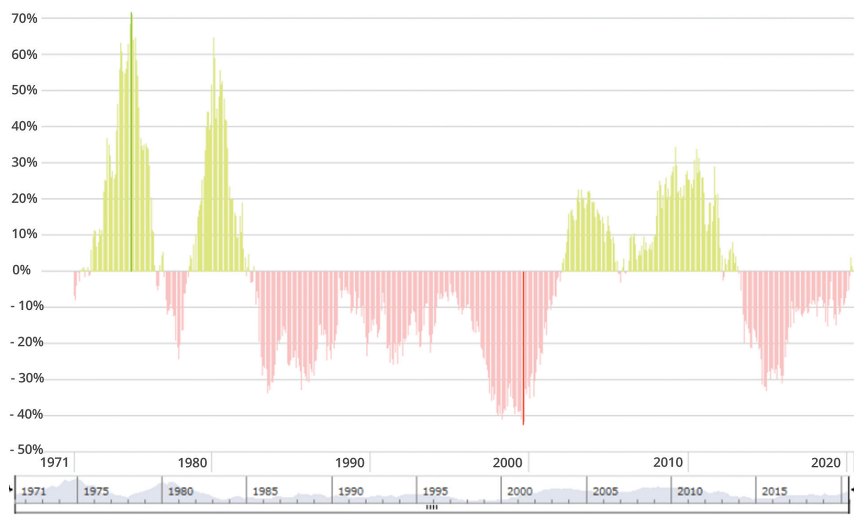
Source: Portfolio Visualizer asset allocation back-test. Logarithmic scale. Date range January 1987 – December 2020. Past Performance is no guarantee of future results.

Note that during this period, the volatility of these asset classes, as measured by standard deviation, was 15.12% for gold, 3.80% for US bonds, and 15.42% for US stocks. Gold returned less than US bonds, but was about as volatile as US stocks, which had far higher returns.

Research by Morningstar shows that in the last 50 years there have been considerable periods when gold has underperformed stocks as represented by the S&P 500. The graphic below shows the relative outperformance of gold and the stock market over rolling 3-year periods since 1971. Gold does have periods of strong performance, but they are not consistent.

Rolling 36-Month Returns Relative to S&P 500

1971-2020



Source: Morningstar. Data as of June 30, 2020

Gold's Performance in Down Markets

However, research published by Morningstar in July 2020 shows that over the last almost 50 years, gold has excelled during bear markets and periods of unusually high market volatility.

The graphic below shows that gold has performed very well during down markets and has usually generated positive returns even during periods of deep losses in the stock market.

Performance in Market Drawdowns

1973-2020

	Jan 1973– Dec 1974	Sep 1987– Nov 1987	Jul 1990– Oct 1990	2008	Mar 2000– Oct 2002	Q4 2018	Feb 19, 2020– Mar 23, 2020
LBMA Gold Price PM USD	69.58	8.62	7.75	4.32	7.92	7.73	-4.05
S&P GSCI Gold TR	n/a	8.75	6.16	3.91	8.67	7.24	-2.02
S&P GSCI Precious Metal TR	47.74	3.82	1.33	0.48	10.52	7.05	-4.31
US Fund Equity Precious Metals	31.89	-12.56	-9.45	-19.54	45.44	4.68	-30.73
S&P 500 TR USD	-20.81	-29.58	-14.11	-37.00	-32.82	-13.52	-33.47

Source: Morningstar. Data as of June 30, 2020

Gold did not show positive performance during the corona virus-induced bear market early in 2020, but it performed far better than stocks, and its price quickly rebounded and reached an all-time high of over $2,000 per once by August 2020.

Gold as a Hedge Against Inflation

Gold has a solid performance record during down markets over the last 50 years, but, overall, its record during that period as a hedge against inflation is weak.

Research done by Morningstar shows that gold did serve as a hedge against inflation when inflation reached historically high levels in the 1970s. However, during the milder inflationary periods from 1980-1984 and 1988-1991 it showed negative returns and underperformed large cap stocks by a wide margin. Gold's role as a reliable inflation hedge is questionable.

Mixed Record as an Inflation Hedge

Annualized Returns

	1973–79	1980–84	1988–91
LBMA Gold Price PM USD	31.77	-10.06	-7.58
S&P GSCI Gold TR	n/a	-11.45	-7.12
S&P GSCI Precious Metal TR	28.59	-15.50	-7.60
US Fund Equity Precious Metals	25.79	7.79	-5.32
US BLS CPI All Urban NSA 1982–84	9.26	6.54	4.55

Source: Morningstar. Data as of June 30, 2020

How Does Gold Impact Risk-Adjusted Returns?

Gold can have a positive impact on the overall performance of a portfolio. This derives from the fact that gold has a very low correlation with stocks, real estate, and other more traditional asset classes. In fact, gold tends to become less correlated with major asset classes during periods of market turbulence. But it's record of improving portfolio performance characteristics is very time-period sensitive.

The graphic below shows the performance, standard deviations, and Sharpe Ratios of a standard 60%/40% stock/bond portfolio over various time periods during the last 15 years. It also shows the same information for the 60%/40% portfolio with various amounts of gold added in place of equity. This is a period of relatively favorable performance for gold.

This snapshot makes a convincing case for adding gold to a portfolio. The portfolios with heavier weightings of gold had lower volatility and higher Sharpe Ratios. Over the 3-year and 15-year time periods, the gold-heavy portfolios had better performance too.

Impact of Adding Gold to a Portfolio

15 Yr. Total Returns

Gold Weighting (%)	YTD	3 yr	5 yr	10 yr	15 yr	Std Dev	Sharpe Ratio
0	1.02	8.91	8.26	9.84	7.46	8.18	0.76
2%	1.42	8.95	8.23	9.66	7.50	7.93	0.79
5%	2.01	9.00	8.17	9.38	7.55	7.60	0.83
10%	3.00	9.09	8.07	8.90	7.63	7.17	0.88
15%	3.99	9.17	7.97	8.42	7.70	6.90	0.93
20%	4.98	9.25	7.87	7.92	7.75	6.81	0.95

Source: Morningstar. Data as of June 30, 2020

But the Morningstar research shows that changing the time period analyzed can make a noticeable difference in the results. The graphic below compares the balanced 60%/40% portfolio and a portfolio that substitutes a 15% gold allocation to the equity weighting over five different 10-year periods. The results are interesting.

In all time periods studied, gold reduces the volatility of the portfolio as measured by standard deviation. But gold improved the returns of the portfolios in only two of the five time periods. It improved the Sharpe Ratios of the portfolios only in those two time periods. So, gold consistently reduced volatility, but often not enough to improve risk-adjusted returns.

Impact of Adding Gold to a Portfolio

Decade by Decade

	1970–79			1980–89			1990–99			2000–09			2010–19		
	Tot Ret (%)	Std Dev	Sharpe Ratio	Tot Ret (%)	Std Dev	Sharpe Ratio	Tot Ret (%)	Std Dev	Sharpe Ratio	Tot Ret (%)	Std Dev	Sharpe Ratio	Tot Ret (%)	Std Dev	Sharpe Ratio
Balanced Portfolio (no gold)	6.68	11.17	0.06	15.44	11.60	0.51	13.96	8.92	0.96	2.72	8.75	0.03	9.54	7.14	1.23
15% gold	11.50	9.52	0.51	12.58	10.06	0.32	10.86	7.04	0.80	4.95	7.11	0.31	8.14	6.12	1.22

Source: Morningstar Direct. Data as of June 30, 2020. Balanced portfolio includes 60% stocks and 40% bonds; 15% gold portfolio substitutes gold for part of the equity weighting. Both portfolio assume annual rebalancing. All total returns are annualized. Yellow highlights indicate periods with better results.

How To Invest in Gold

If you want to add gold to your investment portfolio, there are three basic ways to do so.

You can own physical gold. This takes the form of either gold bullion or gold coins. If you own physical gold, you must consider issues like storage, transportation, and insurance. These will add cost to your investment, but you control what you own. If the entire financial system collapses (it has never done so), you still have possession of your gold. Unlike some other investments, however, physical gold pays no dividends, interest, or other passive income.

Instead, you can choose to own what is sometimes referred to as “paper gold.” Paper gold takes the form of financial instruments such as futures, options, or exchange traded funds. These instruments can be traded electronically, making them cheaper to maintain and more efficient to sell than physical gold. However, you are more exposed to financial system risks.

Alternatively, you can invest in stocks of companies that mine gold. These shares fluctuate in value with the price of gold, but tend to be somewhat more volatile than physical gold itself. These stocks may pay dividends, but, like paper gold, have exposure to financial system risk.

Is Gold Right for You?

As a stand-alone investment, gold has a poor track record relative to alternatives such as stocks or bonds, both on an absolute and a risk-adjusted basis. But in the event of a serious meltdown in the global financial system, gold may play a role as a vehicle for the preservation of wealth.

Adding gold to a portfolio can play a role in reducing volatility and protecting against loss of value in down markets. The extent of these benefits will vary over different time periods. Gold’s record as a hedge against inflation is more questionable and time-period dependent.

Gold is not right for every investor. But, if you have a reasonable understanding of its performance characteristics, adding a modest amount of gold to a portfolio may provide risk reduction and even return benefits during some time periods.