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How to Hold Gold

Throughout history gold has served as a store of value that has survived the rise and fall of civilizations and monetary systems. It has no official monetary role today but large amounts remain in the vaults of central banks that hold it as a store of value, as a means of investment diversification, and as protection from economic or political crises. Individuals invest in gold for the same reasons. In this bulletin we describe the various ways of owning and investing in gold.

The history of fiat currencies is that they eventually become worthless. Their decrease in value has usually been accompanied by increasingly severe restrictions on personal economic freedom culminating in seizures of assets and *de jure* and *de facto* defaults on promises by desperate governments.

Currencies originated as coins of a fixed weight and fineness. However, today all are fiat currencies. Because a limited amount of gold exists in the world and paper money can be created without limit, gold is the ultimate protection against the debasement of currencies.

That the current experiment with fiat currency has continued for many decades, that price inflation has abated from the peaks of the 1970s and 1980s, or that the benefits of economic freedom are increasingly understood and accepted around the world, are not, in our view, sufficient reasons to ignore the lessons of history, one of which is that gold has held its value down through the ages.

Paper is paper, *gold is money*. As a financial asset, gold is unique because it is "no one else's liability." This is the situation with anything tangible that one might own, but unlike, say, antiques, fine art, jewelry or other "collectibles," the spread between the bid and asked prices for gold is narrow. That is, the price that a person can sell gold for at a given moment in time is usually close to the price that he can buy gold for at that moment. Moreover, gold does not rust or decay, and a relatively large amount of value can be stored in a relatively small space. This means that holding it costs little.

Finally, the value of gold is less dependent on economic and political conditions than any other tangible asset and much less so than are stocks, bonds, and other paper investments.

Bullion and Coins

The most fundamental reason to hold gold, therefore, is to obtain protection for a portion of one's wealth against the possibility of serious economic, monetary, and political disruptions that lead to a breakdown of payment and credit mechanisms based on fiat currency. Gold in one's physical possession cannot default or otherwise have its value destroyed by the stroke of a pen.

Bullion bars of approximately 400 troy ounces are what most mines produce, what central banks hold, and what are traded at the daily London gold "fixings," which set the price of gold for the rest of the world.

But gold ingots are not the best way for individuals to hold gold, because they must be assayed whenever they change hands. The expense of an assay cannot be justified for smaller bars, and the 400 oz. bars, even if one could afford them, are unsuited for an individual's purposes.

Gold coins do not require an assay—their weight, size, and issuer, rather than an assay, can be used to identify them as genuine. Recently minted one-ounce coins, such as the American Eagle, Canadian Maple Leaf, South African Krugerrand, or Chinese Panda trade at relatively small premiums or discounts from the bullion price. This is not the situation with fractional-ounce coins from the same mints, which trade at large premiums and should be avoided. The coin with the greatest worldwide reputation and the most convenient size is probably the British Sovereign, which weighs a little under one-quarter ounce. Among coins that once circulated as currency, such as the Sovereign, only "common date" coins should be purchased.

Coin dealers should be approached with caution. They are salesmen, after all, and will steer you toward the fractional-ounce coins or numismatic coins, which are collectibles whose value is highly subjective. Both kinds have large markups. The market for numismatic coins is complex and is best left to experienced coin collectors rather than investors. Dealings should be "cash and carry." No payment should be made until the coins are in your possession, and coins should never be consigned to a

Table 1: Correlation of Returns on Selected Assets, January 1978-November 2004

	*MSCI EAFE**	*S&P/BARRA 500 Growth*	*S&P/ BARRA 500 Value*	*DJ Wilshire Real Estate Securities*	*Fama/ French Small Value*	*U.S. Inter-Term Govt. Bond*	*Gold*
MSCI EAFE Index*	1.00						
S&P/BARRA 500 Growth Index	0.51	1.00					
S&P/BARRA 500 Value Index	0.54	0.86	1.00				
DJ Wilshire Real Estate Securities	0.34	0.49	0.62	1.00			
Fama/French Small Value Index	0.46	0.68	0.80	0.70	1.00		
U.S. Inter-Term Govt. Bond Index	0.12	0.15	0.17	0.19	0.05	1.00	
Gold	**0.22**	**0.00**	**0.02**	**0.09**	**0.03**	**0.02**	**1.00**

* Morgan Stanley Capital International equity index; European, Australian, Far East.

dealer for resale.

Obviously, gold coins should be kept in a safe place, such as a safe deposit box. If you keep them in your home be aware that in the event of your death, their disposition may become "finders keepers" rather than distribution according to the terms of your will. Of course, gold coins may also be given to your heirs while you are still alive.

The advantages of gold coins must be weighed against some disadvantages. Safe storage entails ongoing expenses, unless you already have a safe deposit box. Gold coins provide no offsetting income. And while we believe that gold would prove to be a well-recognized form of money in the event of the collapse of fiat currencies, in the present environment gold coins are not readily exchangeable for goods and services.

The reason to hold gold directly is not to make money but to *have* some money in any and all circumstances. Nevertheless, gold can serve an important function in an investment portfolio, in addition to its role in preserving wealth.

Gold as an Investment

The price of gold tends to fluctuate very differently from the prices of other financial assets. The rate of return on gold has a very low correlation* to the returns on stocks and bonds (see table above).

Because of this, gold can potentially reduce the overall volatility in a diversified investment portfolio, without significantly reducing the portfolio's overall rate of return.

Between January 1968 and December 2003, the price of gold increased from $35 per oz. to more than $400 per oz., for an annualized return of 7.1 percent. During the same period, Treasury bills provided exactly the same 7.1 percent return.† Gold was far riskier, however. The standard deviation of the annual returns, a measure of volatility, for the bullion price was *nearly eight times* that on Treasury bills.

With the same return as Treasury bills, but vastly larger volatility, gold would seem to be an unattractive addition to an investment portfolio. However, we recently examined the results of a hypothetical, passively managed portfolio composed of large-cap stocks, large-cap value stocks, and small-cap value stocks, in equal amounts rebalanced annually for the same 36-year period cited above, from 1968 to 2003. We considered two additional portfolios: one with the same mix of equities but with 10 percent gold bullion, and another with 10 percent in six-month Treasury bills. The addition of 10 percent gold reduced the total portfolio return by 0.07 percent, but reduced the standard deviation by 2.31 percentage points. The addition of 10 percent Treasury bills reduced the total return by 0.49 percent but reduced the standard deviation by only 1.82 percentage points.

Thus, even though gold, in absolute terms, is far more volatile than Treasury bills, it has the potential to reduce the magnitude of the swings in the value of an investment portfolio.

Detractors claim that gold is "just another commodity." Indeed, gold itself provides no stream of income. Bonds and stocks, on the other hand, are capital assets that represent a stake in economic growth. Investors who hold a diversified portfolio of stocks or bonds thus can expect to benefit from future economic growth.

In the final analysis, gold is a viable form of portfolio insurance with a long track record. For most investors, devoting a small portion of a portfolio to gold-related assets is prudent.

Other than bullion, two ways to hold gold for investment purposes are to buy quality gold-mining stocks and/ or the recently introduced gold-based exchange-traded funds (ETFs).

"Gold In The Ground"

Not all mining companies are alike. Some gold pro-

* The correlation coefficient measures the way in which the returns of two assets move in relation to each other. It equals +1 if the returns move in perfect tandem, –1 if the are perfectly inversely related, and zero if they are independent.

† Of course, the interest on Treasury bills may have been taxable, whereas the gain on the bullion holdings would not be taxable in the absence of any sales (and then at capital gains rates). The IRS considers all gold coins to be "collectibles," like art or stamps. Thus, when you sell coins, any long-term capital gain is subject to income tax at rates up to 28 percent, versus a maximum rate of 15 percent for other assets. It is the owner's responsibility to track and report such realized gains.

ducers are involved in speculative or "junior" gold mines, and others may produce gold as a by-product of silver, platinum, or base-metal mining. (The prices of these metals are largely determined by economic conditions, because their uses are mainly industrial rather than as a store of value). Accordingly, those wanting to hold stock in gold-mining companies should invest only in companies that are actually producing and have reserves sufficient to support production for a prolonged period. The company should not have excessively high debt or production costs. It should be large enough that its shares are highly liquid and its operations are diverse enough to protect it from political or other risks to company assets. Above all, the company should pay a dividend so that investors can gain some current income from this portion of their portfolios.

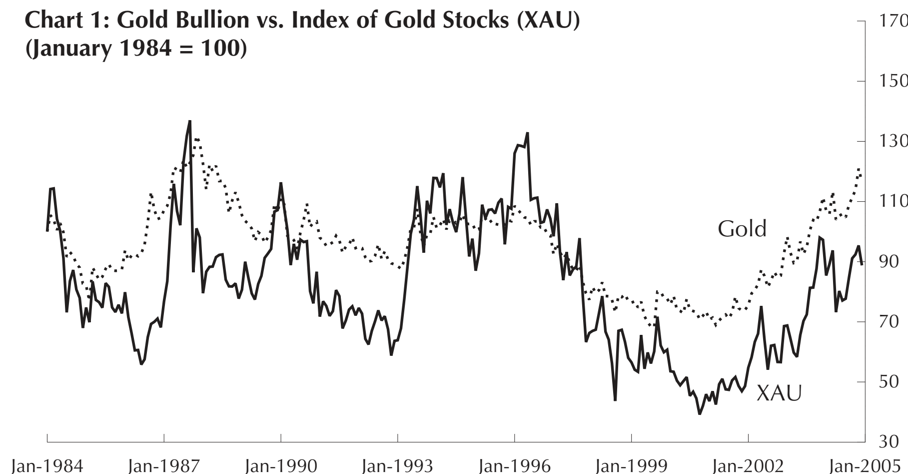


Chart 1: Gold Bullion vs. Index of Gold Stocks (XAU) (January 1984 = 100)

Gold-mining company shares are common stocks and therefore receive preferential tax treatment relative to bullion coins. These shares represent gold in the ground, and investors have a claim to those assets in the event of bankruptcy. Ultimately this is merely a legal claim represented by a stock certificate, and for those who favor the gold-as-money argument and cherish the security of "holding gold in your hand," shares in gold-mine companies may be inadequate.

A significant disadvantage of gold-mine stocks is that the investor must assume company-specific risk over and above the risk inherent in the gold price. Company-specific risks (mine disruptions, environmental liabilities, etc.) can be reduced but not completely "diversified away."

The accompanying chart demonstrates the volatility in the price of gold-mining shares, as represented by the Philadelphia Stock Exchange's Gold and Silver Sector Index (PHLX: XAU) This is a weighted index of 12 companies in the gold and silver mining industry. We emphasize that this is a price index alone, and does not include the returns attributable to dividends. If dividends were included, this would increase the returns and reduce the volatility of the share index relative to bullion. Also, little can be said that is conclusive regarding the *total return* over this period; it is apparent that the beginning and end dates one chooses can dramatically alter the picture to favor either index.

"Gold In The Vault"

An exchange-traded fund (ETF) is like an index mutual fund, in that it enables you to invest in an underlying asset (typically a basket of stocks or other securities) with one purchase. Unlike a mutual fund, ETF shares trade on a stock exchange, where they can be bought and sold throughout the day. The price of an ETF share changes throughout the day, in contrast to mutual funds, which are priced and traded only at the end of the day. Unlike closed-end mutual funds, ETFs rarely stray from the market value of their underlying assets.

Gold ETFs are invested in gold bullion and thus they track almost perfectly the price of gold bullion. (Since the first gold ETF was introduced in the United States in November 2004, its share price has remained within +0.31 to -0.16 percent of the value of the fund's underlying gold holdings.) In this regard they are an excellent proxy for gold as a pure asset class.

Their advantage over holding gold directly is that you can easily buy or sell your ETF shares, and you do not have to pay for storage. Their advantage over gold-mining stocks is that you avoid the company-specific risk of mining companies.

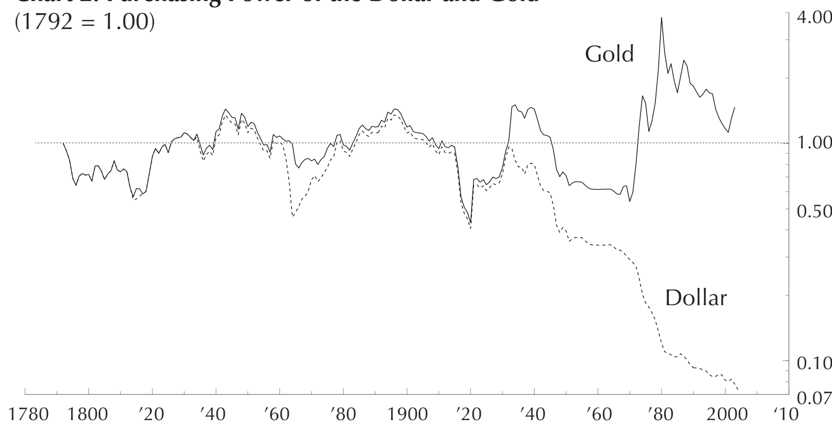
The drawback is that ETFs are ultimately nothing more than paper. Although a share of a gold ETF technically represents a claim on actual gold bullion that is held in trust in a vault, it is not likely that the investor will ever be able to trade his paper for bullion. A gold ETF share is not "gold in hand." That is both its strength and its weakness: the shares are easily traded but less secure than gold in one's physical possession.

Gold ETFs are a major innovation. They provide investors access to a highly liquid asset that provides direct exposure to the gold price and has been successfully trading in other countries for several years without problems.

There are two gold ETFs available in the United States. The streetTRACKS Gold Shares ETF (NYSE: GLD) has been available since November 2004. Sponsored by a wholly owned subsidiary of the World Gold Council, the gold mining industry's foremost trade group, a share of GLD is worth a tenth of a troy ounce of gold. The bullion collateral for GLD is held in London. A competing product, Barclay's Global Investors iShare Comex Gold Trust (AMEX: IAU) became available in January 2005. (AIER provides the names of these funds solely as a matter of information. The Institute does not provide individual investment advice, nor do we receive any forms of renumeration from these funds or any brokers.)

The two available ETFs each have an expense ratio of

Chart 2: Purchasing Power of the Dollar and Gold
(1792 = 1.00)



0.40 percent. Because the gold they hold earns no income, this fee must be paid by selling gold from the funds. Over time, this will create a drag on the price of gold ETFs because each fund will sell gold reserves to pay operating costs. If the price of gold is flat, the net asset value of each share will decline. For example, if the price of gold held steady at $400 per ounce, and an ETF share initially sold for $40 (i.e., one tenth of an ounce), after five years, the share would be worth $39.21.

ETF shareholders are treated, for income tax purposes, as if they directly owned the gold held in trust for them. Thus, capital gains on ETF shares are taxed at maximum rate of 28 percent, rather than the 15 percent rate applied to most other capital gains. Also, unlike other ETFs and mutual funds, gold ETFs are created as “grantor trusts” and therefore no 1099 is issued. When you sell shares, a letter stating the dollar amount of the proceeds is issued to you, but the IRS does not get a copy, and it is your responsibility to report any gains.

Gold Over the Long Term

The price of gold has increased in recent years from a 2001 low of $250 to a December 2004 high of $450. Although it has since drifted downward to about $420, the rapid increase since 2001 continues to fuel new interest in its investment potential. However, to repeat, history suggests that the main reason to own gold directly is not to *make* money but to *have* money in any and all circumstances.

Gold’s tendency to hold its value over the long term is evident in Chart 2, which shows the purchasing power of gold and the dollar since 1792 (for both series, 1792 = 1.00). After the United States abandoned the domestic gold standard in 1934, the purchasing power of the dollar began a long and virtually uninterrupted descent that has continued to this day. The purchasing power of gold decreased from 1934 until 1971, a period when its official price was fixed at $35 per ounce. However, when the U.S. Government abandoned all efforts to maintain a fixed price in 1971, the purchasing power of gold skyrocketed. This upward trend reached an extraordinary and brief peak in 1980. After that, the price of gold, in real terms, moved erratically downward until 2001.

For purposes of this discussion, the more significant point is that even in 2001, when gold was $250 an ounce, its purchasing power was close to what it was in 1792. Since 2001, the purchasing power of gold has increased further and is now in the upper part of the range recorded throughout U.S. history.

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