AIER | Research Reports

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH www.aier.org Vol. LXXVII, No. 15, September 6, 2010

Investing in Gold

If you want to invest in gold, there are a variety of ways to do so. Here we sort out the pros and cons of each.

by Kerry A. Lynch, Senior Fellow

The price of gold has quadrupled since 2002. This increase, along with the disappointing performance of many other investments, has helped fuel enormous investor interest.

The primary reason to invest in gold is not to *make* money, however, but to *have* money, in any and all circumstances. It has a long and impressive history as a safe haven during economic disasters.

The other reason to invest in gold is that adding it to a diversified, periodically rebalanced portfolio tends to reduce the volatility of the portfolio's returns, without reducing the overall rate of return. Gold has value as portfolio insurance because it behaves differently than most assets: The correlation between the price of gold and the prices of stocks, bonds, and other investments has historically been very low.

If you decide to invest in gold, your next decision is what type of gold investment to make. Investors have three choices: physical gold, the stocks of gold mining companies, and exchange-traded funds (ETFs).

The pros and cons of these different gold investments are summarized in the table on the next page. In the rest of this article, we focus on the two purest gold plays: physical gold and gold-bullion ETFs. We leave aside gold mining stocks (and ETFs backed by such stocks) because these are, first and foremost, stocks. They are only secondarily a gold investment, and their value is influenced by many factors besides the price of gold.

Physical Gold. The best way to invest in physical gold is to buy gold coins. But there are three types of coins, and only one is suitable for investment purposes.

Bullion coins are coins whose value is determined almost solely by their gold content. Their price is equal to the value of their gold content plus a small premium, typically 5 to 8 percent. These coins are the most popular, most liquid, most portable, and most convenient way to invest in physical gold.

The most popular are the U.S. Eagle, the Canadian Maple Leaf, the Austrian Philharmonic, and the South African Krugerrand. In addition to the standard one troy ounce coin, they are also manufactured in smaller denominations of one-half, one-quarter, and one-tenth ounce. Because it costs roughly the same to manufacture a small coin as a large coin, the smaller the coin, the larger the premium per ounce.

Numismatic coins are those whose value is based not only their gold content but on their age, rarity, design, finish, and popularity as "collectibles." Fluctuations in their price may be only loosely tied to the gold price, and the resale market is limited. If you are willing to invest the time to learn about rare coins, this can be a rewarding market. But it's a market best left to serious collectors, not investors.

The third kind of gold coin is the *commemorative coin*, which is a hybrid of bullion and numismatic coins. The initial price of these coins may be far above the value of their gold content. But the resale value may be much lower, little more than the bullion value. For this reason, these coins are best avoided by gold investors.

Gold bars are another option. But they are larger (typically 10 ounces or more) and therefore more expensive, less convenient, and less liquid than coins. There are fewer dealers and, because bars are easier to counterfeit, when you resell them you may be required to provide proof of gold content, including assaying (a chemical test to determine purity).

Inside this report In a few weeks we begin a 10-part series on Modern Portfolio Theory by Professor Donald R. Chambers of Lafayette College. On page 4 of this issue we preview the series, highlighting the bottom line for real-world investors. To wit: diversification allows you to reduce risk without reducing returns. The series will show you why.

Also The recovery remains anemic but there's no evidence yet of a double-dip. See enclosed report on Business-Cycle Conditions.

Investing in Gold: Several Considerations

	Gold Bullion Coins	Gold Bullion Bars	Gold Mining Stocks	Exchange-Traded Funds Invested in:	
				Gold Mining Stocks	Gold Bullion
Liquidity	Very high if gold is viewed as a form of money. Low for converting to cash. Also depends on type of coin (U.S. Eagles and other widely traded coins are best) and access to active dealers.	Lower for bars than for coins. Bar market is smaller, bars are harder to authenticate, and dealers may require proof of gold content.	Very high for converting to cash (relative to holding physical gold). Low relative to other common stocks. These are small-cap stocks, which are less liquid than large-cap stocks.	Very high for converting to cash (relative to holding physical gold). Low relative to other (larger capitalization) common stocks	Very high for converting to cash.
Pricing	May be highly variable among dealers. Price equals value of gold content plus small premium.	May be highly variable among dealers. Price equals value of gold plus small premium.	Shares traded in highly transparent market. Bid/ask spreads far higher among small versus large mining stocks	Shares traded in highly transparent market. Shares trade in reasonably tight range versus underling index.	Shares traded in highly transparent market. Shares trade in very tight range versus gold price.
Exposure to Gold Price ("tracking error")	Very high exposure (low tracking error).	Very high exposure (low tracking error).	Low relative to alternative means of holding gold. Difficult to "diversify away" company-specific and industry risk.	Low relative to alternative means of holding gold. Company-specific risk "diversified away" relative to holding individual stocks, though industry risk remains.	Very high exposure (low tracking error).
Accessibility	Immediately accessible if kept on hand, though security is a concern.	Immediately accessible if kept on hand, though security is a concern.	Shares held by third party (broker).	Shares held by third party (broker).	Shares held by third party (broker).
Investment-Related Costs	Storage costs (safe deposit accounts). High transaction costs possible (markups, delivery, insurance).	Storage costs (safe deposit, gold bullion bank accounts). High transaction costs possible.	Trading commissions for common stocks will apply.	Trading commissions for ETFs will apply. Explicit mutual fund expenses incurred (expense ratio). Trading costs incurred to track index.	Trading commissions for ETFs will apply. Ongoing fund expenses (expense ratio), paid via periodic gold sales that result in taxable share liquidations.
Taxation	IRS treats gold coins as "collectibles," subject to 28% tax on realized capital gains. Owner is responsible for reporting taxable gains.	IRS treats gold bars as "collectibles," subject to 28% tax on realized capital gains. Owner is responsible for reporting taxable gains.	Dividends: Qualified dividend income, currently taxed at maximum of 15%. Realized gains: Long-term, maximum tax rate 15%; short-term taxed as ordinary income.	Qualified dividend income, currently taxed at maximum of 15%. Realized gains: Long-term, maximum tax rate 15%; short-term taxed as ordinary income.	IRS treats bullion-based ETFs as "collectibles," subject to 28% tax on realized capital gains.
Other considerations	The best way to hold physical gold.	Thinner market relative to coins, as bars are larger, less portable, more costly, and less popular.	Income generated through dividends.	Income generated through dividends.	Cannot redeem ETF shares for gold. Shares are backed by gold and held in trust, but auditing process has drawn criticism. Best viewed as paper investment that tracks gold price, not as direct ownership of gold.

Where To Buy. As the price of gold has risen, the number of gold dealers has soared. Experts advise dealing only with businesses that have been around for at least five years, and preferably 10 or more. Choose firms that are members of the Better Business Bureau (BBB). You can check out BBB ratings, complaint histories, and company profiles, for both member and non-member firms, at www.bbb.org.

To find local coin dealers, you can search by state, city or zip code at www.coininfo.com. To find dealers who belong to the Industry Council for Tangible Assets, a trade association, go to www.ictaonline.org. Note, however, that ICTA doesn't regulate or rate members.

Regardless of where you buy, the Internet makes it easy to comparison shop. Be sure to compare coins of similar size and gold content, and to ask about fees for delivery and insurance.

Gold-Bullion ETFs. Gold-bullion exchange-traded funds (ETFs) are sold through stock exchanges, and shares in them can be bought and sold like common stocks or mutual-fund shares. They track the price of gold very closely, and they are inexpensive to trade and more convenient to own than coins.

Although they have been around for less than a decade, they have transformed the gold market. They have also attracted a huge inflow of money from institutional investors, who previously avoided gold and other commodities. The various gold ETFs reportedly now hold over 1,800 tonnes of gold. That makes them the sixth largest institutional owner of gold, behind only the official holdings of the United States, Germany, the IMF, France, and Italy.

Three ETFs hold physical gold and trade on major U.S. exchanges. The SPDR Gold Shares ETF (GLD) was the first one that traded in the U.S., and it's also the largest. The others are the iShares Comex Gold Trust (IAU) and ETF Securities' Physical Swiss Gold Shares (SGOL).

ETFs involve trade-offs. They are paper securities that track the price of gold, and that's very different from direct ownership of physical gold. These instruments offer indirect ownership of gold held in storage by third-party custodians and subcustodians. Though these accounts are audited, this introduces an additional source of risk because, as with all fund structures, investors forego direct ownership and transparency. ETFs are relatively new, and their auditing process has drawn criticism from some quarters.

This doesn't mean that gold investors should avoid gold-bullion ETFs. For individual investors, ETFs have brought gold trading from the shadows into the daylight of highly liquid central exchanges that trade in real time. The market thus far appears to have cast a vote of confidence in the ETF arbitrage mechanism; the prices of both IAU and GLD (the two oldest ETFs) have tracked the gold price very closely.

One drawback of both physical gold and gold-bullion ETFs is that they do not produce any income. Gold mining stocks and ETFs backed by them, in contrast, pay dividends. This is an additional consideration for anyone investing in gold.

AIER's website has more articles on gold (in the password-protected Archive section). Another good source of why and how to invest in gold is *The ABCs of Gold Investing* by Michael J. Kosares (Addicus Books, 2004, $14.95).

For information on the historical rates of return of various sample investment portfolios that include gold, contact American Investment Services (AIS) at www.americaninvestment.com or 413-528-1216. AIS is wholly owned by AIER, is the only investment advisory endorsed by AIER, and its recommendations are based on AIER's research.

ASK THE EXPERT
Planning on the Go

Should you redo your will and other legal documents if you move to another state or have homes in more than one state?

Regardless of whether you have connections to one state or more than one, it is important to keep all of your estate planning documents up to date and current. These include your will, a durable power of attorney, a health care proxy, and sometimes one or more trusts. They should be reviewed by an attorney whenever there are changes in your financial circumstances, family circumstances (including buying and selling property, as often happens when people move), or when there are changes in the law. (Many attorneys will advise their clients about the latter.)

Although it is a good idea to have your estate planning documents reviewed by an attorney if you move, the documents will still be effective in the new state. This is because the Full Faith and Credit Clause of the Constitution requires that documents done in accordance with the laws of one state be recognized by the other states.

As a practical matter, it may be a good idea to have durable powers of attorney and health care proxies done in compliance with the laws of each state where you spend significant time. Wills and trusts need not be done in such a duplicate fashion, but should be reviewed to ensure that they are designed to best comply with the laws of each state.

—Steven J.J. Weisman is a lawyer and author. His website is www.stevelaw.net.

To submit questions for future columns, email asktheexpert@aier.org. For guidance on specific situations, consult your lawyer or financial advisor.

Investing in Uncertain Times

Announcing a 10-part series on Modern Portfolio Theory (MPT).

by Donald R. Chambers

Later this month we begin a series on Modern Portfolio Theory by Professor Donald R. Chambers of Lafayette College. Here we preview the series by excerpting key points from his recent talk during AIER's summer session (available on video at www.aier.org). The bottom line for real-world investors: "Diversification allows you to reduce risk without reducing returns." What kind of diversification? The series will answer this and other questions you may have.

1. Without taking risks, there has been no after-tax return on your investment, when you take account of taxes and inflation, over the past 90 or so years.

2. If you buy and hold stocks (meaning take risks), your return would hypothetically be something like 1,000-fold over the last 90 or so years.

3. But in sub-periods of the last 90 years, as in 2008, you might experience a 50 percent drop in the value of your stocks. As another example, in 2008 Japan's Nikkei stock average was still down 80 percent from its peak 20 years earlier.

4. Modern Portfolio Theory began in 1950 in the work of Harry Markowitz. It uses unrealistic or farfetched assumptions to gain insights into real-world investment strategies. It led to something that has come to be known as the "efficient market theory," which in a nutshell says that all available knowledge about a stock is already incorporated in the current price of the stock.

5. MPT yields the following simplified way of looking at your investment options: All of your financial assets or investments should be placed in one of two portfolios, either "risk-free" or "the market portfolio." By risk-free assets, we mean cash or very short-term bonds, neither of which carries a risk of default. By the market portfolio, we mean all risky assets, but in a word, and roughly speaking, stocks.

6. But MPT does not tell us the proportions of your portfolio that should go into each of the two asset categories. This is a matter of personal preference regarding risk.

7. That said, the "age rule" can serve as a starting point. Put your age, expressed as a percentage, into risk-free assets (e.g., short-term bonds), and the balance into the market portfolio (e.g., stocks). A 40-year-old would thus hold 40 percent of her financial assets in short-term bonds, and 60 percent in diversified stocks.

8. The most amazing insight from MPT is this: Diversification allows you to reduce risk without reducing returns. This is what Markowitz discovered in the 1950s.

9. By implication, your goal should not be to minimize risk (because if you did this by putting all your eggs in the risk-free basket, over time your real after-tax returns would be zero). Instead, your goal should be to minimize risk per unit of return.

10. A good example of a risk-free investment is short-term CDs, using different maturities to protect against low rates of return. Another is TIPS, or Treasury Inflation-Protected Securities. Here we are protected not only against default (because we assume that the U.S. will never default on its issues) but also against inflation.

11. What, then, is the market portfolio? The answer: All risky investments. In theory, the way to think about how to diversify to gain the highest returns for any given level of risk is, in a phrase, "Buy everything." More precisely, "Buy a piece of all the risky investments in the world." How much of each risky investment? Buy each asset-class in proportion to how much of it there is in the world, relative to other risky assets. Now we are talking not only about stocks and corporate or municipal bonds, but also gold, real estate, and art.

12. How could we approximate this in practice? By buying indexed funds, such as a Vanguard index fund that invests in every U.S. and every foreign stock.

13. None of this tells you what proportion of your portfolio should be in risk-free assets, and what in the market portfolio. But the age rule is a good place to start.

14. MPT thus suggests that you can maximize your investment returns, given the amount of risk (or volatility) you are willing to take on. This is the idea to be developed and evaluated in the full 10-part series. Stay tuned!

Author **Donald R. Chambers** is the Walter E. Hanson/KPMG Professor of Finance at Lafayette College in Easton, Pennsylvania.

AIER | gold corner

Price of gold, September 2, 2010, London PM fix.

Research Reports (ISSN 0034–5407) (USPS 311–190) is published twice a month (except for combined issues in January and August) at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts and additional offices. Sustaining memberships $59 per year. POSTMASTER: Send address changes to *Research Reports*, American Institute for Economic Research, Great Barrington, Massachusetts 01230.

AIER | Business-Cycle Conditions, September 2010

Sputtering Along

Amid signs that economic activity remains weak, our statistical indicators continue to signal recovery.

by Polina Vlasenko, Research Fellow

There is no evidence yet of a double-dip recession in our statistical indicators of business-cycle conditions. But the pace of the recovery remains anemic. Some economists, such as Paul Krugman (writing in *The New York Times*, August 27), say it no longer matters whether we call it a U-shaped or a W-shaped ("double-dip") recovery. Either way, the economy seems mired in a slow-growth track with few signs of anything improving soon—and certainly not the unemployment rate of 9-plus percent.

The recovery clearly faces challenges. One of them is the financial position of consumers. Plummeting stock prices and falling real estate values reduced the wealth of many households. High unemployment threatens the incomes of many others. And income must be stretched to service the high debts accumulated during the boom years.

By the end of 2007 (when the recession began), total home mortgage debt in the household sector had increased to a record 99 percent of disposable income. Consumer debt (credit card balances, auto loans, and the like) amounted to another 24 percent of income. Since then, increasing numbers of families have found it difficult to service their debts, and delinquency rates have

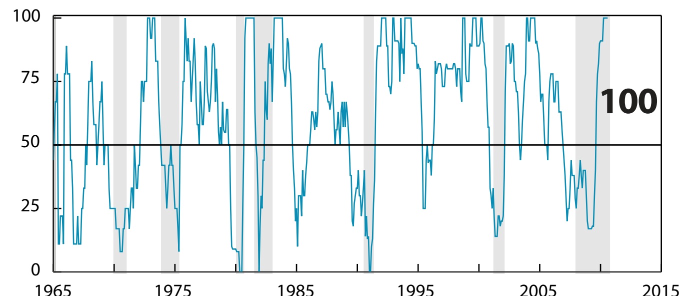
Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Apr.	*May*	*Jun.*	*Jul.*	***Primary Leading Indicators***	*Jun.*	*Jul.*	*Aug.*
-	+	+	-	M1 money supply	+	+	+
+	+	+	+	Yield curve index	+	+	+
+	-	-	+	Manufacturers' supply prices	+	+	+
-	-	+		New orders, consumer goods	+?	+?	+?
-	+	+		New orders, core capital goods	+	+	+
-	-	+	-	New housing permits	?	?	?
-[r]	-			Ratio of sales to inventories	+	+	+
-	-	-	+	Vendor performance	+	+?	+?
+	-	-	-	Index of common stock prices	+?	+?	+?
+	+	-	+	Average workweek, mfg.	+	+	+
-	-	-	+	Initial claims, unemplmt. insurance*	+	+	+
-	+[r]	+		Change in consumer debt	+?	+?	+?
				Percentage expanding cyclically	*100*	*100*	*100*
				Primary Roughly Coincident Indicators			
+	+	-	-	Nonag. employment	+?	+?	+?
+	+	-[r]	+	Index of industrial production	+	+	+
+	+	+		Pers. income less transfer payments	?	+?	+?
+	-			Manufacturing and trade sales	+	+	+
+	-	-	-	Civilian emplmt. to population ratio	+?	+?	?
+	+	+		Gross domestic product	+	+	+
				Percentage expanding cyclically	*100*	*100*	*100*
				Primary Lagging Indicators			
-	-	-	+	Avg. duration of unemployment*	-	-	-
+	+			Manufacturing & trade inventories	+?	+?	+?
+	-	+		Commercial & industrial loans	-?	-?	?
-	-	-		Ratio of cons. debt to income	-	-	-
-	-	+		Chg. in labor cost/output, mfg.	-?	-?	-?
+	+	-	+	Short-term interest rates	?	?	?
				Percentage expanding cyclically	*20*	*20*	*25*

nc No change. [r] Revised. * Inverted. Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

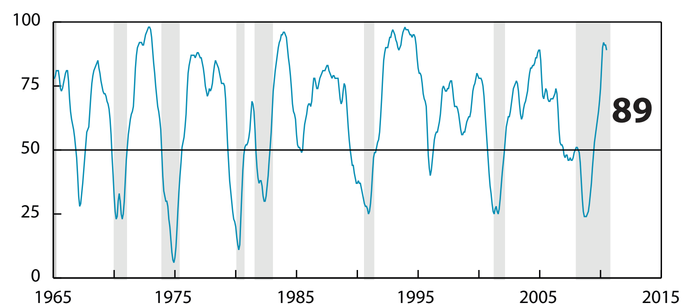
AIER Leaders Expanding and Cyclical Score Charts

Percentage of AIER Leaders Expanding



The percentage of leaders expanding is based on the analysis of 12 statistical series that move reliably in advance of general business activity. The cyclical score is based on a separate, purely mathematical analysis. For each measure, a score above 50 indicates an expansion is likely.

Cyclical Score of AIER Leaders

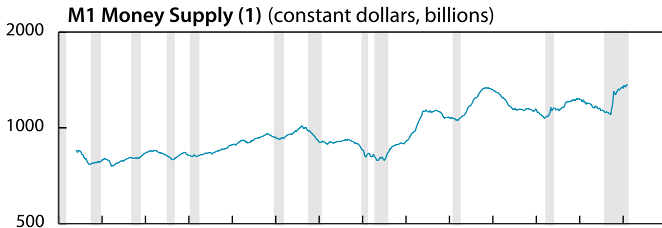


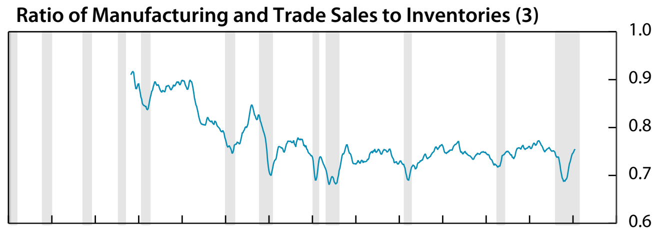
been rising. All this makes it difficult for households to increase spending and sustain recovery.

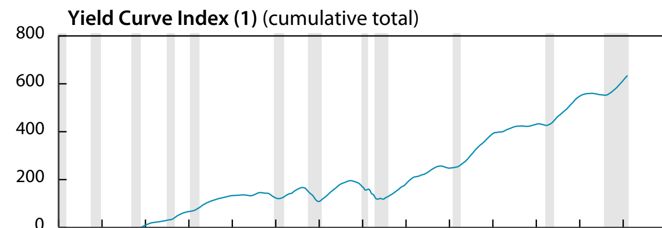
Rather than spending, consumers have been saving by paying down their debts. Outstanding consumer debt has been falling for almost two years, the longest downturn in postwar history. (The chart below for the *3-month percent change in consumer debt*, a leading indicator, shows that debt has been decreasing since October 2008).

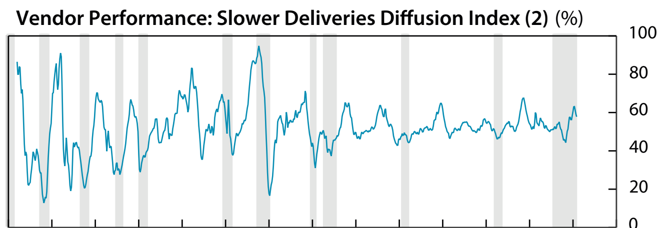
Consumer debt is falling both because banks are more careful about lending and because consumers are less eager to borrow. The financial crisis forced banks to tighten their lending standards. At the same time, consumers are no longer applying for as many new loans as they used to. According to the *Quarterly Report on Household Debt and Credit*, issued last month by the Federal Reserve Bank of New York, the number of credit-

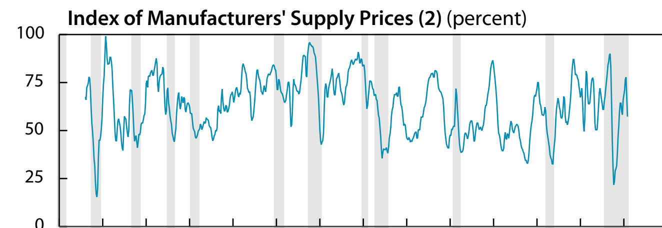
Primary Leading Indicators

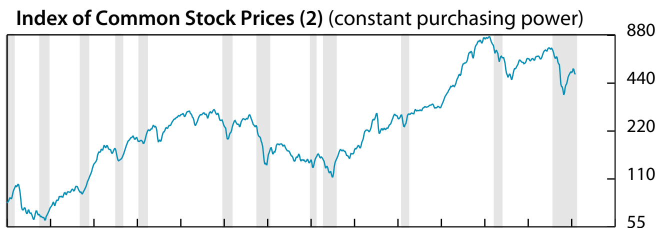


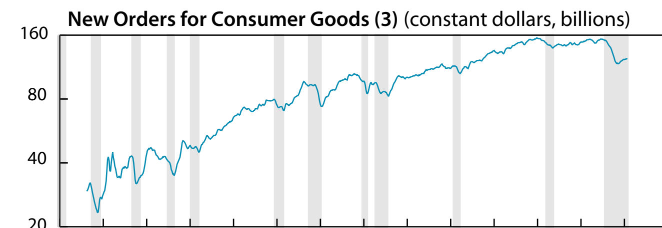


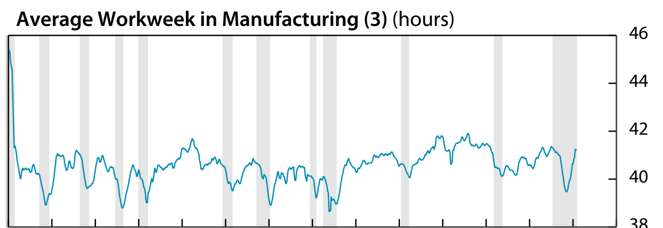


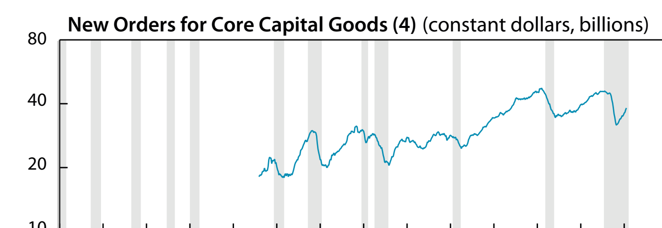


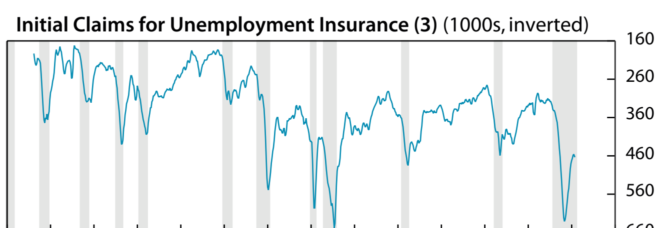


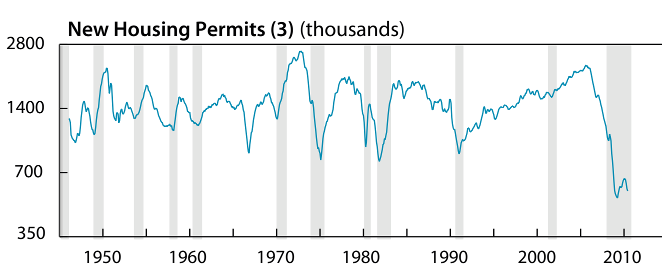


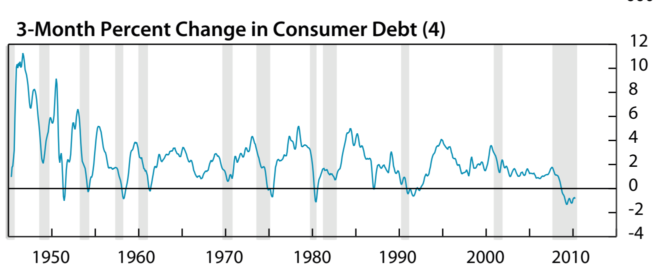












report inquiries related to applications for new credit—a measure of consumer credit demand—has been falling since early 2008.

Increasing the saving rate and reducing debt is a prudent course of action for households seeking to repair their financial position. But it has painful implications for the current economy. The expansion of consumer credit and mortgage debt has been a driving force behind recent business-cycle expansions, especially the 2001-2007 expansion. Neither is likely to be the engine of this recovery.

Reducing debt is a prudent course of action for households seeking to repair their financial position. But it has painful implications for the current economy.

With the home buyer tax credit now expired, the sales of both new and existing homes plummeted in July. The Commerce Department reported that sales of new single-family homes fell to the lowest rate since the data began to be collected in 1963. Sales of existing single-family homes, reported by the National Association of Realtors (NAR), decreased to the lowest level since 1995.

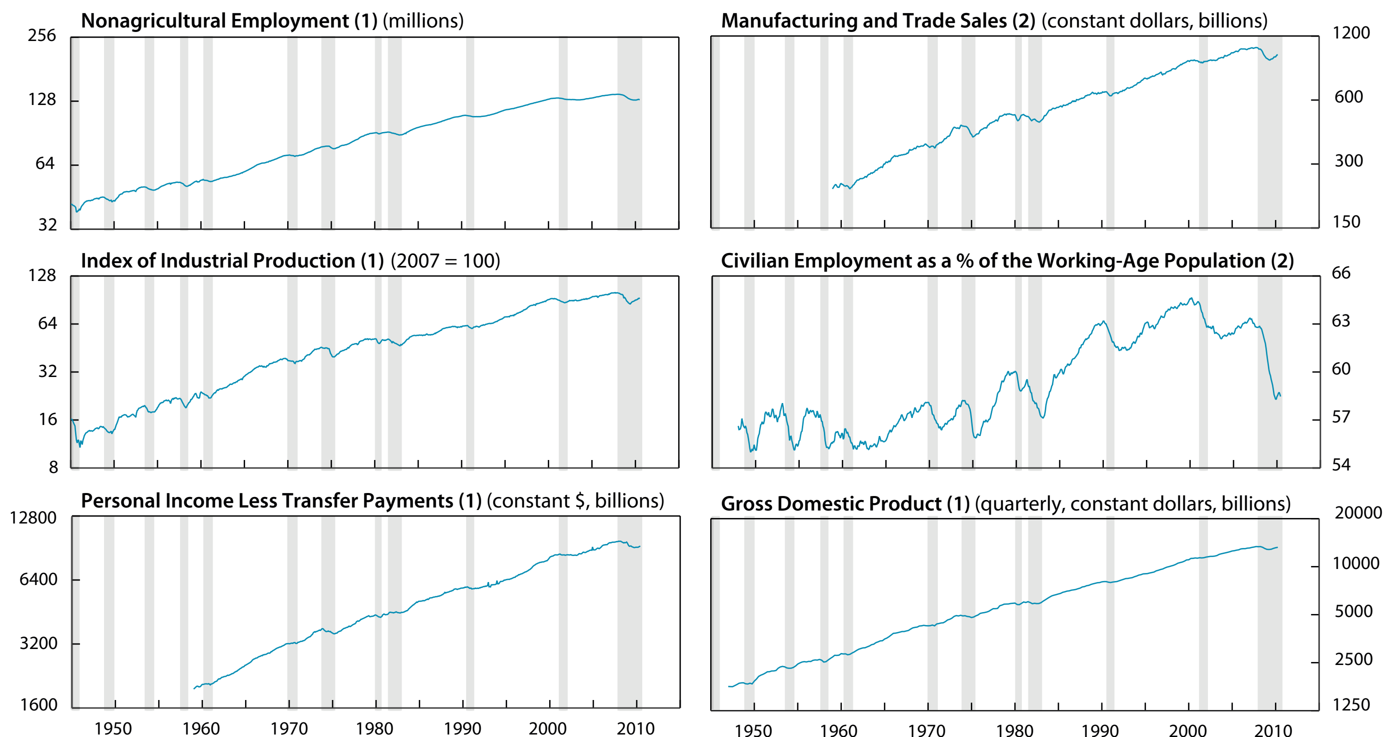
Historically-low mortgage rates have not been sufficient to induce people to buy houses. Even when demand does rebound, it will take many months to work through the extensive inventory of homes for sale. According to the NAR, the inventory of existing homes reached a 12.5-month supply in July, about twice the level during normal times.

Despite the recent weakness in the data, AIER's primary leading indicators still signal recovery, with 100 percent of the leaders (11 out of 11 for which a trend is apparent) appraised as expanding. The cyclical score of the leaders, which is based on a separate, purely mathematical analysis, remains high but decreased slightly, from 94 last month to 89 this month. A value above 50 for both of these measures indicates that an expansion is more likely than a contraction.

These numbers will drop if the recent weakness in the monthly data persists. With no clear source of growth, the economy seems to be sputtering. Government stimulus measures can only do so much, and they seem to have run their course. The economy will have to find some other driver of sustained growth.

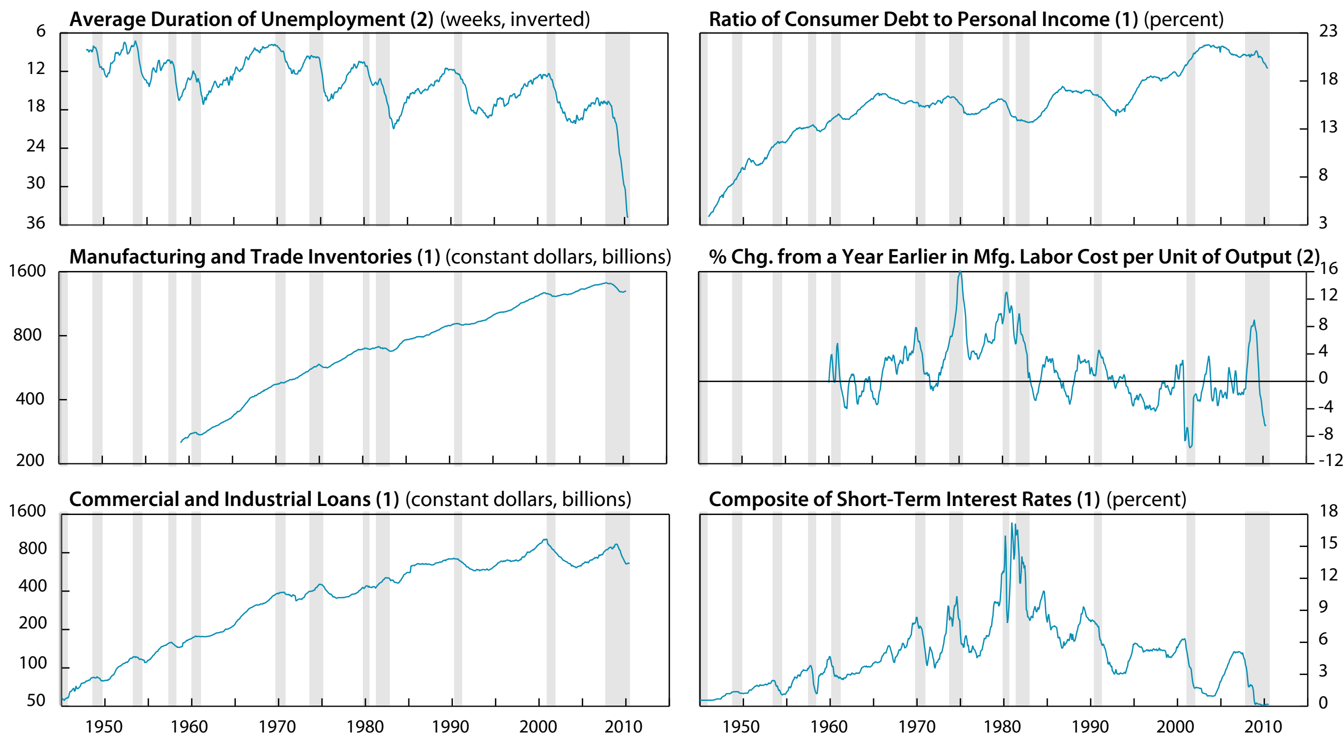
One possible candidate is manufacturing, which has shown more strength in recent months than other sectors. The *average workweek in manufacturing*, a leader, and the *index of industrial production*, a coincider,

Primary Roughly Coincident Indicators



Notes: 1) Shaded areas indicate recessions as dated by the National Bureau of Economic Research. 2) The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data.

Primary Lagging Indicators



increased for all but one month in 2010. Capacity utilization among all industries (the fraction of the existing productive facilities and equipment that are in use) has increased consistently this year and reached 74.8 percent in July, up 5 points from a year ago.

The increases in output and employment have been fairly widespread in the industrial sector. Among 312 industries surveyed by the Fed, 67 percent reported that their output was higher in June than it was six months earlier. This is down from the peak of 72 percent in April, but still quite high. A separate survey shows that manufacturing employment has increased in 63 percent of industries. But the increase has been modest, with only 180,000 jobs added since January.

The primary lagging indicators improved this month. Their eventual expansion would confirm that the recovery is underway.

More generally, the recent data continue to paint a bleak employment picture. *Initial claims for state unemployment insurance* increased in April, May, and June, rising above 450,000 claims per week. This is a worrying sign of a new wave of people losing their jobs. At this level of initial claims, the unemployment rate is unlikely to fall.

Nonagricultural employment decreased in the past two months. Some of this reflects the loss of temporary census jobs. Excluding these and other government jobs, the private sector has added 630,000 jobs so far this year, with most of the gains occurring in March and April.

A related measure, the *ratio of civilian employment to population*, decreased precipitously in the recession. At the lowest point in December 2009, only 58.2 percent of adult U.S. population was employed, well below the range of 61-65 percent seen during the prior 20 years. Although the ratio has rebounded a bit from that low, it has decreased for the past three months. This prompted us to downgrade the series' cyclical status from probably expanding to indeterminate.

With this change, the percentage of primary roughly coincident indicators expanding remains at 100, but now only five out of six series have a discernible trend. The coinciders suggest that the economy is likely expanding.

The primary lagging indicators improved somewhat this month—an encouraging development, because these series, by definition, are usually the last to turn, and their eventual expansion would confirm that a recovery is underway.

Data for five of the six laggers increased this month. The increase in *commercial and industrial loans* was substantial enough to warrant upgrading the series from probably contracting to indeterminate. This brings the percentage of laggers expanding to 25 (one out of four indicators for which trend is apparent), up from 20 last month.

If the recovery proceeds in the usual fashion, more of the laggers will start increasing in coming months. If they fail to do so, it would indicate that obstacles on the way to expansion are not being removed, thus calling the viability of the recovery into question.