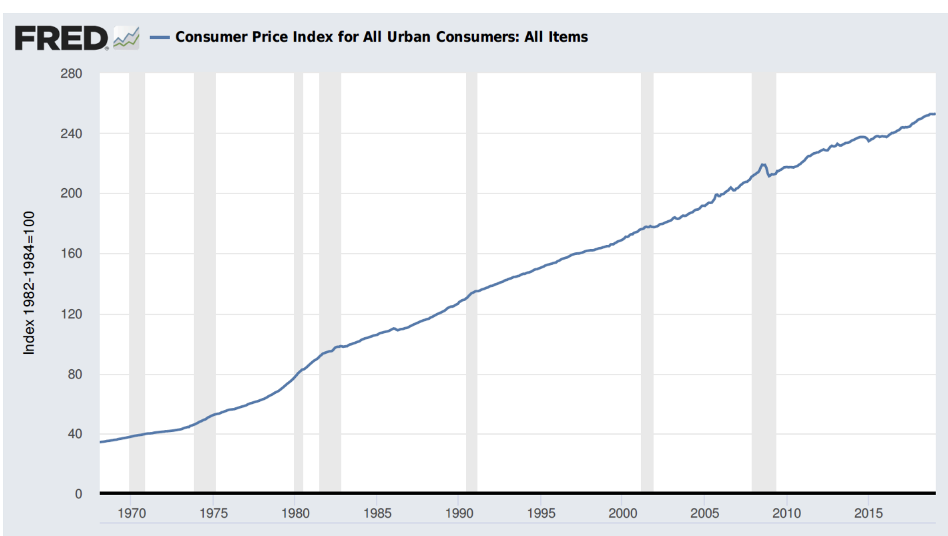
Geek-Out Wednesday Topic: Gold

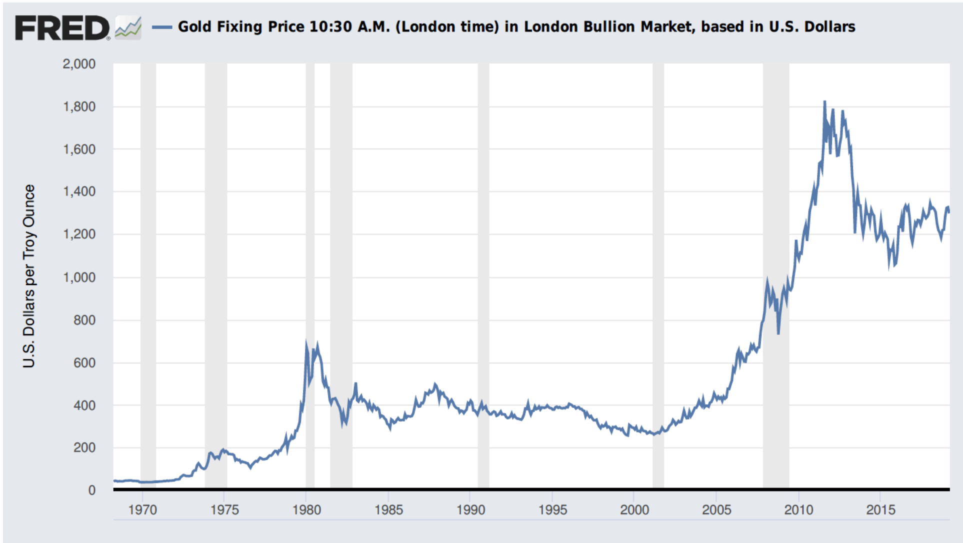
Gold is perhaps one of the world's oldest currencies and yet it remains relevant within today's modern-day investment construct. First a bit of history. Gold was first used as a precious metal as far back as 3600 B.C. by the ancient Egyptians. As early as 800 B.C., gold was used in the minting of coins as the scarce metal became a tool to transfer wealth in commerce. Later on in history, Gold was one of the key drivers of the European expansion into the new world as Sovereigns send first explorers and eventually soldiers out in search of the commodity.

Modern Uses of Gold in Investments

As a Hedge Against Uncertainty. Many investors flock to the metal when geopolitical uncertainty arises. The reason is because the value of traditional currencies are tied to the success of a country or government while the value of gold remains independent. Similarly, investment vehicles like stocks or bonds are tied to the success of a company making the investments exposed to not only systemic (market) risk but also company risk. If an economy hits a rough patch its currency would weaken. A weaker economy would also impact corporate performance and would likely weaken stocks and bonds. Gold would have a better chance of maintaining its value in that environment which is why it is often referred to as the "crisis commodity".

As a Hedge Against Inflation. A traditional currency's real value diminishes in an inflationary environment. This means that as the prices of goods go up, a unit of currency will get the consumer less of that good. Just think about how much candy you could have bought with 25 cents a few decades ago. Gold tends to inflate in value during times of high inflation so while a fixed unit of currency will fetch less goods in an inflationary environment, a fixed unit of gold will be more likely to continue to fetch the same amount of goods. The relationship is easy to see by observing the following two charts. As the Consumer Price Index has grown since the late 1960's so has the value of gold.

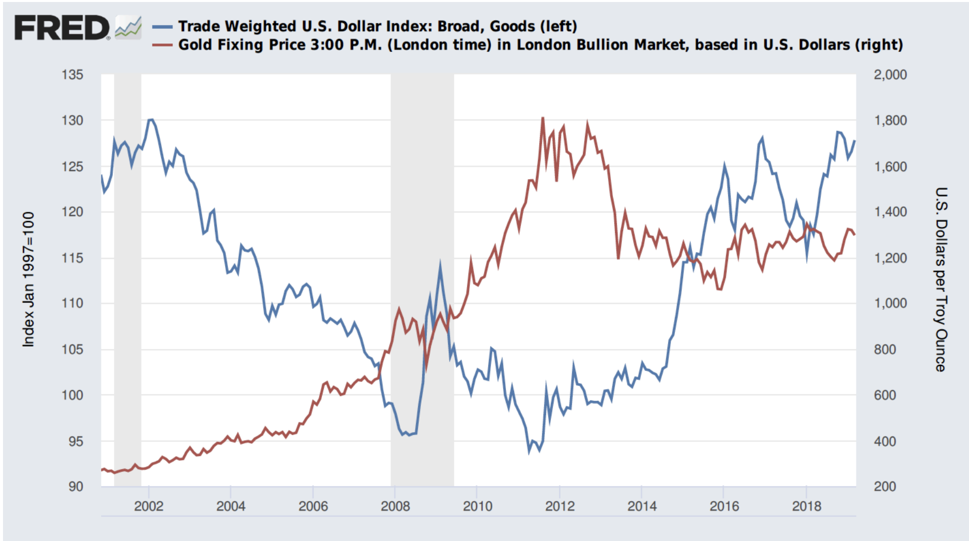




Many investors prefer to include gold in their portfolios to provide stability during unstable times and to add diversity. While its popularity as a hedge has diminished somewhat with the advent of derivative hedging products like the VIX Index instruments and inverse ETF's, it is still the go to commodity when the going gets rough.

Factors that affect the price of Gold

Value of the US Dollar. The US Dollar used to be directly tied to the price of gold until the gold standard was dropped in 1971 at which time the US Dollar became a fiat currency. Until the decoupling, the price of gold and the US Dollar were correlated, which means as the value of gold went up, so did the value of the dollar and vice versa. Since the standard was dropped, the dollar and gold are inversely correlated with the value of gold decreasing when the dollar strengthens, and vice versa. The inverse correlation is due to the fact that gold is traded in US Dollars and when the dollar loses value versus other currencies gold becomes cheaper increasing demand, thus pushing gold prices higher. Additionally, the US Dollar is considered the world's safest and most stable currency, so when the dollar weakens investors will seek the next best thing, which some believe to be gold. This further accentuates the inverse relationship. This inverse relationship can be seen quite clearly in the following graph which depicts the trade weighted dollar along with the price of gold. The trade weighted dollar index shows the value of the Us Dollar relative to other currencies. You can see that as one goes up, the other goes down, and vice versa.



Supply and Demand. Gold cannot be manufactured therefore the supply is always limited by the amount that can be mined along with the refined amount that exists. Demand for gold comes from four principal areas and is broken down as follows:

- Jewelry – 636 tons
- Technology – 84 tons
- Investment – 393 tons
- Central Banks – 167 tons

With a fixed amount of supply, increases in demand by any of these areas would serve to increase the price of gold. For example, gold is used in manufacturing technology components so when the economies of the world are expanding, demand for gold will increase as an industrial commodity. Similarly consumers demand more jewelry as wealth is created. This can be seen as Far East economies have enjoyed a boom creating significant new wealth and demand for gold jewelry.

How to Invest In Gold

Investors can gain exposure to gold in several ways and is usually based on the size and objective of the investment.

ETF's and Mutual Funds. Perhaps the simplest way for an investor to invest in gold is through an investment vehicle such as an ETF of Mutual Fund. Investors can purchase these vehicles in controlled amounts and usually have lower management fees. Investors should note the distinction between funds that entitle the investor to actual gold bullion and those which are derivatives.

Gold Bullion. The actual gold itself! Investors can purchase gold bullion but it is atypical as it is difficult to trade in smaller denominations and has high storage costs. It therefore is not a practical investment for most investors.

Gold Coins. While gold coins have intrinsic value based on the price of gold, the coins themselves may actually increase or decrease in value based on the rarity of the coin. This makes an investment less of a pure play. Similar to bullion, coins are expensive to store and insure and are not easily traded. Coins are therefore more valuable to collectors rather than investors.

Futures and Options. Investors can trade gold on futures and options exchanges in which contracts entitle owners to fixed amounts of the commodity. Future and options typically have low margin requirements and can be traded with relatively low commissions. Futures and options tend to be volatile and are usually not suitable for average retail traders who tend to favor ETF's and Mutual Funds.

Gold Mining Companies. Gold mining companies are highly correlated to the price of gold and can offer investors exposure to the commodity. Some ETF's and Mutual Funds invest in gold mining companies along with the commodities to give investors exposure. A downside to investing in mining companies is the company risk. Company performance can affect the company's stock price despite the price in gold, so investing in a mining company is not a pure play investment.

In Conclusion

Gold as an investment vehicle offers investors an interesting hedge to inflation and risk due to its increasing value along with inflation, its inverse correlation to the dollar, and its inverse correlation to risk. Though there are many modern alternatives to the commodity for investors who seek diversification, gold is still a popular choice by many. The simplest way to gain exposure to gold is through the use of ETF's and Mutual funds.

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DISCLOSURE