Golden opportunity for gold?

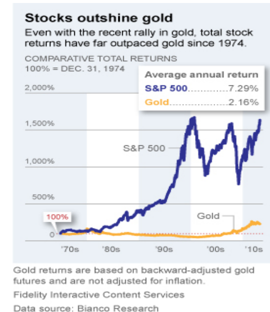
BY DAREN FONDA, FIDELITY INTERACTIVE CONTENT SERVICES — 05/01/13

Gold prices have tumbled in the past few months and some pros think it may be time to buy. Here's why.

In Wall Street's animal kingdom, the bears are squashing the gold bugs. Prices for the precious metal have tumbled 12% this year, including a 9% plunge on April 15 alone. Even with a recent rebound, gold has lost about 22% of its value since peaking in 2011 at $1,890 an ounce.

Yet some advisers say it may be a good time to buy — if not a golden opportunity, then at least a better one than a few months ago.

"I still view gold as a very good long-term hedge against inflation," says George Kiraly, an adviser with LodeStar Advisory Group in Short Hills, N.J. The slide in gold, he says, has presented a "decent opportunity" for investors who wanted to own gold but were leery of its lofty price.



Gold returns are based on backward-adjusted gold futures and are not adjusted for inflation.
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Data source: Bianco Research

Investing in gold isn't like buying stocks or bonds. The price is volatile, influenced by many economic factors, including inflation expectations and forecasts for the dollar. (Gold prices tend to rise when the dollar weakens.) If you're going to invest, it's helpful to understand the pros and cons of the precious metal and how it could work in your portfolio.

A timeless currency

Throughout history, gold has been viewed as a durable currency that can withstand wars, political turmoil and financial crises. Gold has some industrial uses, but most of the demand today comes from the jewelry market and investors buying and selling the metal, according to the World Gold Council. Central banks are also major players in the market, holding 19% of above-ground supplies.

The big reason to buy gold now, proponents argue, is that it should hold its value better than currencies that aren't backed by hard assets, such as the dollar or Japanese yen. The Federal Reserve, along with central banks in Europe and Japan, have bought so much debt — and pumped so much cash into their economies — that they'll eventually have to inflate their way out of debt by devaluing their currencies, according to this line of thinking.

As a hard asset whose supply barely increases each year, gold would hold its value if this scenario comes to pass, the bulls argue. "Investors continue to distrust government policies that are debasing their currencies," says Douglas Groh, co-manager of the Tocqueville Gold Fund (TGLDX). Indeed, foreign central banks, particularly in the developing world, have been buying gold to diversify their reserve assets away from the dollar and euro, Groh says, adding more than 500 tons of gold to their reserves last year alone. Another potential benefit for individual investors: Prices aren't closely tied to other financial assets. Historically, gold has moved in the opposite direction of stocks, according to a 2011 report by Oxford Economics. Gold also has scant connection to real estate prices and would beat all other assets, including stocks, in a high-inflation scenario, potentially helping diversify a portfolio, the research firm noted in its report.

The pitfalls of gold

While gold may offer long-term benefits, it has major drawbacks too. Prices soared to $850 an ounce in 1980 after inflation spiked in the late 1970s but plunged afterward and took decades to recover.

Despite jumping almost four-fold since 2003, gold still languishes below its 1980 peak when adjusted for inflation, according to data from Bianco Research. "Timing is everything with gold, despite what you might hear," says money manager Groh. Indeed, gold had its own lost decade in the 1990s, when the price declined an average 10% a year, according to Oxford Economics. And long-term gold returns still trail stocks going back to 1974, when gold futures first started trading (see chart above). "Gold is like many Hollywood starlets; its only real talent is that it is pretty," says Jim Heitman, an adviser with Compass Financial Planning in southern California who generally doesn't recommend gold for his clients.

There's also an opportunity cost to investing in gold. Unlike stocks and bonds, gold doesn't pay a dividend or interest, so buying it means giving up money you could put in those income-producing investments. Moreover, there are vastly different opinions about what gold is really worth. Companies can be valued by their sales and profits, but gold is a commodity with limited industrial use and demand based largely on investor sentiment and the global jewelry market. You won't find a price/earnings ratio for gold and you can't calculate its income stream like a bond, making it tough to figure the "intrinsic value" of gold.

One way to estimate the price is to view it in relation to the growth of the money supply, says Groh. Since 1985, the U.S. money supply has grown about 5.5% a year, rising from around $2.4 trillion to more than $10 trillion. Gold traded around $320 an ounce in 1985 and would be worth $1,350 today, he calculates, based on a similar growth rate. For mining companies, the current cost of supply is also around $1,300 or $1,350, he says, suggesting that gold prices have a "floor" around that level.

Whether prices rise from here is another matter.

While gold has been moving higher again, the decline that started in 2011 may resume due to changing dynamics affecting the metal, says Groh. For example, global economic growth forecasts have come down recently, easing fears of a pickup in inflation.

The dollar has strengthened. And investors seem to be shifting into stocks, away from traditionally defensive assets like gold, based on money flowing into and out of mutual funds and ETFs.

Five gold investments
If you're concerned about inflation or want gold as a kind of insurance policy against a market crash, there are several ways to invest. You can buy bars or coins and store them in a safe. Or you can invest in the stocks of gold miners, gold-backed ETFs or mutual funds that focus on gold. How much to buy depends on your tolerance for risk, time horizon and other investments in your portfolio, and you should consider investing gradually, given the volatility of gold prices and the potential for a plunge.

The adviser Kiraly, for one, recommends putting 5% to 10% of a long-term portfolio in gold. He uses the **SPDR Gold Shares Trust** (**GLD)** for his clients. The fund is the largest and most liquid gold-backed ETF on the market with $51 billion in assets. It offers fractional shares of physical gold held in a London vault and costs 0.40% in annual expenses, or $4 on a $1,000 investment, according to ETF sponsor State Street Global Advisors.

The downside: Gold held through the ETF is treated as a "collectible" by the IRS. That means a long-term investment gain in the ETF is taxed at 28%, above long-term capital gains rates of 15% to 20%.

If you're willing to take a bit more risk in exchange for a dividend, Kiraly suggests the **Market Vectors Gold Miners ETF** (GDX), which tracks an index of 29 miners and recently yielded 1.6%. Capital gains are taxed at standard long-term rates. And it offers good exposure to North American and "global gold mining leaders," he says. Its annual expense ratio is 0.52%, or $5.20 for every $1,000 invested.

The downside: The ETF is about twice as volatile as the MSCI World Index, according to Morningstar. Kiraly recommends investing gradually to lower your risk of losing money right before a price drop.

Among closed-end funds, **Central GoldTrust** (GTU) holds 98% of its assets in gold bullion. The fund recently traded at a slight discount to the net value of its underlying assets, an unusual situation since it historically trades at a premium, according to Cecilia Gondor, chief investment officer for Thomas J. Herzfeld Advisors, a closed-end fund investment firm in Miami. The fund's annual expense ratio is 0.36% and it can be traded like a stock.

The downside: Closed-end funds can be more volatile than traditional stocks. The fund's share price may fluctuate above or below its net asset value. The fund is structured as a trust based in Canada and may be classified by the IRS as a "passive foreign investment company," making your taxes more complex.

Some mutual funds also focus on gold, holding a mix of stocks and physical gold. The **Tocqueville Gold Fund** (TGLDX) is the top-ranked fund in the space, according to Morningstar, beating 99% of peers over the past five years with an average annual return of -0.4% compared to loss of 6.9% for precious metal stock funds. Its annual expense ratio is 1.28%.

The fund holds about 9% in physical gold and 85% in mining companies, focusing on small- and mid-size businesses such as Canadian miners Franco-Nevada (FNV) and Osisko Mining (OSKFF). Mining stocks have lost around a third of their value over the last year, but they now look much cheaper relative to the price of gold, says Groh, trading 30% below their five-year average. Many companies are also focusing on cost control and boosting cash flows, he says, and hardly any new gold supply is likely to hit the market in the second half of the decade.

The downside: The fund would be hit hard by another downturn in gold. It's about twice as volatile than the MSCI World Index, according to Morningstar.

A more conservative way to go is with a fund that holds gold as part of a broader investment mix. One top "multi-asset" fund, according to Morningstar, is **First Eagle Global** (FESGX). The fund holds 8% in gold-related investments, alongside foreign stocks, bonds and other investments. Its 5.3% annualized return over the last five years beat 82% of funds in its category and it has "turned in fine results through economic and market cycles," according to a recent report by Morningstar analyst Bridget Hughes.

The downside: About one-fifth of fund assets are in cash, which can help preserve capital — one of the managers' goals — but has held back returns lately. The fund's 1.89% expense ratio is relatively high, $18.90 a year on a $1,000 investment, and it costs $75 to buy shares on Fidelity.com.

Daren Fonda is Senior Writer and Investing Columnist with Fidelity Interactive Content Services, a provider of objective investing content on Fidelity.com. He does not own any of the securities mentioned in this article.

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