

## **Towneley Special Report: Gold**

Because gold and other precious metals tend to appreciate in value during times of economic uncertainty, including this asset class in an investment portfolio can be a prudent move. A modest position in gold provides diversification for a long-term portfolio, a hedge against inflation and a defense for a declining currency.

### ***What is the best method of investing in gold?***

As we have advised our clients over the years, the best method for an investor to directly invest in gold is to take physical possession of coins or bullion and to provide for its safekeeping. With the advent of exchange traded funds (ETFs) that purchase and store gold bullion, however, investors can now receive some of the same benefits via their portfolios as if they directly owned gold, with greater ease and without the security concerns.

Direct gold ETFs actually buy and hold gold bullion in vaults located in the U.S., London or Switzerland. These ETFs provide direct exposure to gold price fluctuations, so the price of these funds tends to move closely in line with the price of gold. Other gold ETFs either invest in gold futures or in the stock of companies that mine or process gold. Neither of these latter two types of ETFs tracks the price of gold as closely as do the ETFs that actually buy and hold gold bullion, so we prefer the direct gold ETFs.

While “gold” mutual funds exist, we prefer ETFs over mutual funds for gold exposure because they offer liquidity, intraday trading and a way to track the price of gold that is not easily captured through mutual funds. Also, due to their structure, mutual funds cannot purchase and store gold, and investments in gold futures or the gold-industry-related stocks typically held by “gold” mutual funds do not provide pure asset class exposure.

### ***Why gold?***

Gold and other precious metals tend to appreciate in value during times of economic uncertainty. A modest position in gold can provide a hedge against rising price inflation and currency declines while helping to diversify a long-term portfolio.

Treasury Inflation Protected Securities (TIPS) provide a hedge against moderate price inflation, but the inflation adjustment component of TIPS cannot adjust quickly to fast-rising price inflation. One of gold’s primary roles in a long-term portfolio is to hedge against fast-rising price inflation. Although inflation is currently low, we believe that there is an increasing risk of price inflation.

For U.S. dollar-based investors, gold also helps hedge against the impact of the declining U.S. dollar. As the value of the dollar relative to other currencies falls, investors seek the stability of gold and other precious metals, driving up their prices. In this respect, gold acts more like an insurance policy than an investment.

Unlike securities, gold has intrinsic value. Should the worst occur, and world currencies collapse, gold and other precious metals could themselves be used as currency. Barring a government confiscation of gold in ETFs, your portfolio will be partially protected in such an environment. Nevertheless, the ultimate protection is a small amount of gold coins in your possession.

At times, gold has also hedged domestic equity performance. Through most of the last four decades, the price of gold has moved inversely to that of the U.S. stock market, as represented by the S&P 500 Index, making gold an excellent hedge against market volatility during this period. During the last decade, the correlation between the daily spot price of gold and the S&P 500 was near zero. In the two worst years for the S&P 500 in the last decade, 2002 and 2008, the index lost 22% and 37%, respectively, while gold gained 24.7% and 5.4%, respectively.

Of course, gold doesn't always outperform equities. Indeed, over the very long term, a well-diversified global equity portfolio has outperformed gold by a wide margin. Gold doesn't always produce positive returns either, which is why we recommend a relatively small investment in gold: up to five percent of one's assets at cost. Our research and experience have convinced us that, for most investors, the benefits of such a relatively small position in gold may outweigh the potential risk that the gold in your portfolio does not perform as well as the balance of your portfolio.

***Why buy gold now?***

You've probably heard or read recently that the price of gold is at an all-time high. This is true in nominal terms. However, when historic gold prices are adjusted for inflation, gold is currently valued at only half its 1980 price of \$2,200 an ounce in today's dollars. We believe that the combination of the Federal Reserve's low interest rate policy, mounting budget deficit and increasingly burdensome government debt will provide a nexus for increased demand for gold.

***Why not buy other precious metals too?***

We feel that silver exposure is appropriate in addition to gold. Two other precious metals often purchased by investors, platinum and palladium (PGMs), are primarily industrial metals, so their prices are driven by growth in the industries in which they are used: automobiles, computers and chemicals, to name a few. Because of the cyclical nature of their price fluctuations, PGMs do not hedge currency fluctuations as well as gold and silver do. Silver is also used in industry, although not as extensively as are its white metal cousins.

***How much gold?***

We recommend a position not to exceed five percent of total portfolio assets at cost in precious metals, 80% of which is allocated to gold and 20% to silver.

***Why not rebalance?***

For gold and silver to truly hedge against a substantial collapse of the currency, rapidly rising price inflation or hyperinflation, the portion of the portfolio allocated to precious metals should not be actively rebalanced. This is particularly important when the risks of currency devaluation or rapid price inflation are high or increasing. In this case, investors would continue to rebalance the portion of their portfolios that is not allocated to precious metals. Should there be a clear indication that monetary policy and the government deficit and debt are under control, investors should consider rebalancing their gold/silver position. In a more extreme case, should a new global gold-based reserve currency be created and/or should the U.S. dollar be officially devalued against gold, investors should consider substantial changes to their gold/silver position.