

November 25, 2008

ALL THAT GLITTERS

No. 17

While the world's financial markets are plummeting, the merchants of doom are warming up their pitches. A doom and gloom favorite in any chaotic time ... gold.

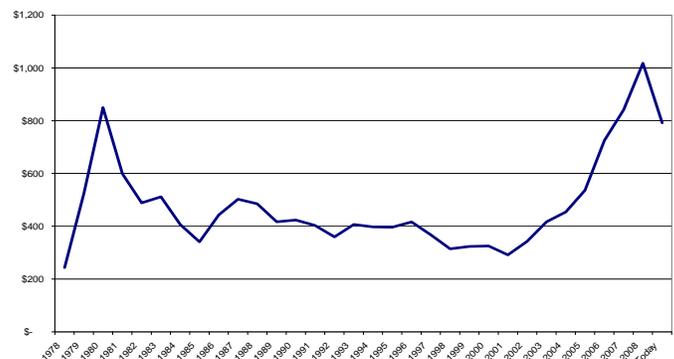
For thousands of years, gold has been used in jewelry and coins. In both cases, gold's malleability and its high resistance to corrosion have been critical. Its use as a coin helped lead to the gold standard as a basis for currency values until 1971. Gold has a reputation for serving as a currency of last resort in a crisis, for being an investment that heads higher when others are headed lower and for hedging against inflation.

Gold's history as a basis for coins and currency value may explain why some believe gold could be useful in social chaos. But transaction costs for converting gold into goods make this unconvincing. On a recent afternoon, the Colfax Coin Exchange in Lakewood, Colorado was selling one ounce Gold Eagle coins for \$905. They were buying one ounce Gold Eagle coins for \$810. The \$95 difference, 10.5%, is the transaction cost for holding gold. Imagine how inefficient it would be to buy 100 cans of beans with a portion of your Eagle coin if paper dollars no longer worked. Imagine as well the cost of caring for your stash of gold. Better to just buy beans and bottled water than gold.

How much simpler to buy gold in the form of an exchange-traded fund. Barclay's iShares offers a gold ETF with the ticker IAU. (AU is the chemical symbol for gold). It charges 40 basis points, 4/10ths of one percent, per year to keep the 65 tons of gold it needs in a well-protected vault to back the ETF shares. Still, the brokerage statement showing your IAU holdings probably wouldn't buy many beans if society fell apart.

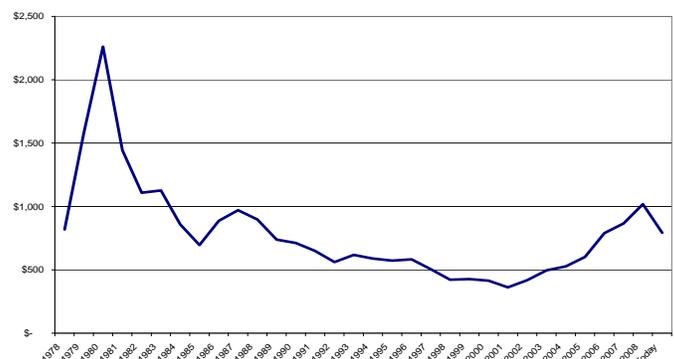
Despite the performance of equity markets this year and worries about financial chaos, gold has not been the shining investment exception that its fans might have hoped. Instead of zigging while stocks zagged, gold tracked higher while stocks were in a bull market and dropped substantially since the spring despite the financial panic. There are times when gold hedges other holdings, but they are hard to predict.

Gold Annual High Price



Gold built its reputation as an inflation hedge during hyperinflationary periods in certain countries and during the last bout of high inflation in the U.S. in the 1970s. But when you adjust its price history for inflation, gold doesn't look like much of an inflation hedge.

Inflation-adjusted Annual Gold High



In the end, you need to ask yourself whether the merchants of doom are peddling real gold – or just glitter.