All That Glitters

COMMENTARY
September 2021

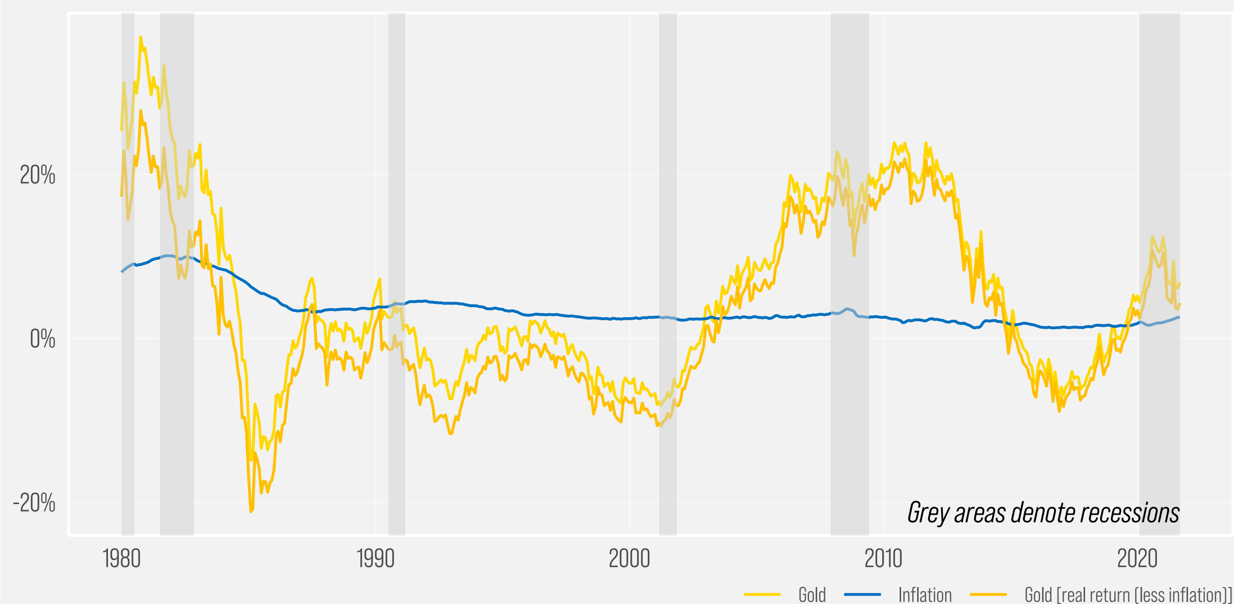
Financial and social media can leave investors with an overpowering feeling that there's something missing in their portfolios. Our approach seeks in many ways to counter those pressures. And there actually are many oft-championed exposures that we purposely leave out of our portfolios. While the motivations of this approach are many, the primary rationale is that, for the average investor, most such exposures are not a necessary component of a generally appropriate allocation. See, promoters often focus solely on potential performance of their favored ideas. But such a narrow focus on potential gain—or even protection from loss—ignores the context of each individual's financial situation and the fact that the intended flavor of such exposures might already exist within the portfolio. We find the better approach to be one that provides a breadth of broadly applicable investments, encourages clients to be candid about their financial situations and evaluates additional portfolio exposures as the scenario demands.

A Precious Example

A fine example of an often promoted "must-have" exposure in a portfolio, especially in times such as these, is gold. Champions of the precious metal often focus on two potential benefits of gold's presence in a portfolio: protection against inflation and safety in times of market/macroeconomic stress. But gold can be seen as unreliable by both measures over its more recent history. In Figure 1, we show the trailing 5-year return in the U.S. dollar price of gold along with inflation over that same time frame. The "real" return in the price of gold is gold's price change minus inflation. A negative real return for gold means that its price failed to keep up with inflation over the previous 5-year period. In that sense, at least over 5-year time frames, gold has proved an unreliable protector against inflation.

Figure 1: Rolling 5-Year Gold Returns and Inflation

Gold has seen long stretches during which its price has not kept up with inflation. And the price of gold has been anything but stable over the past half-century



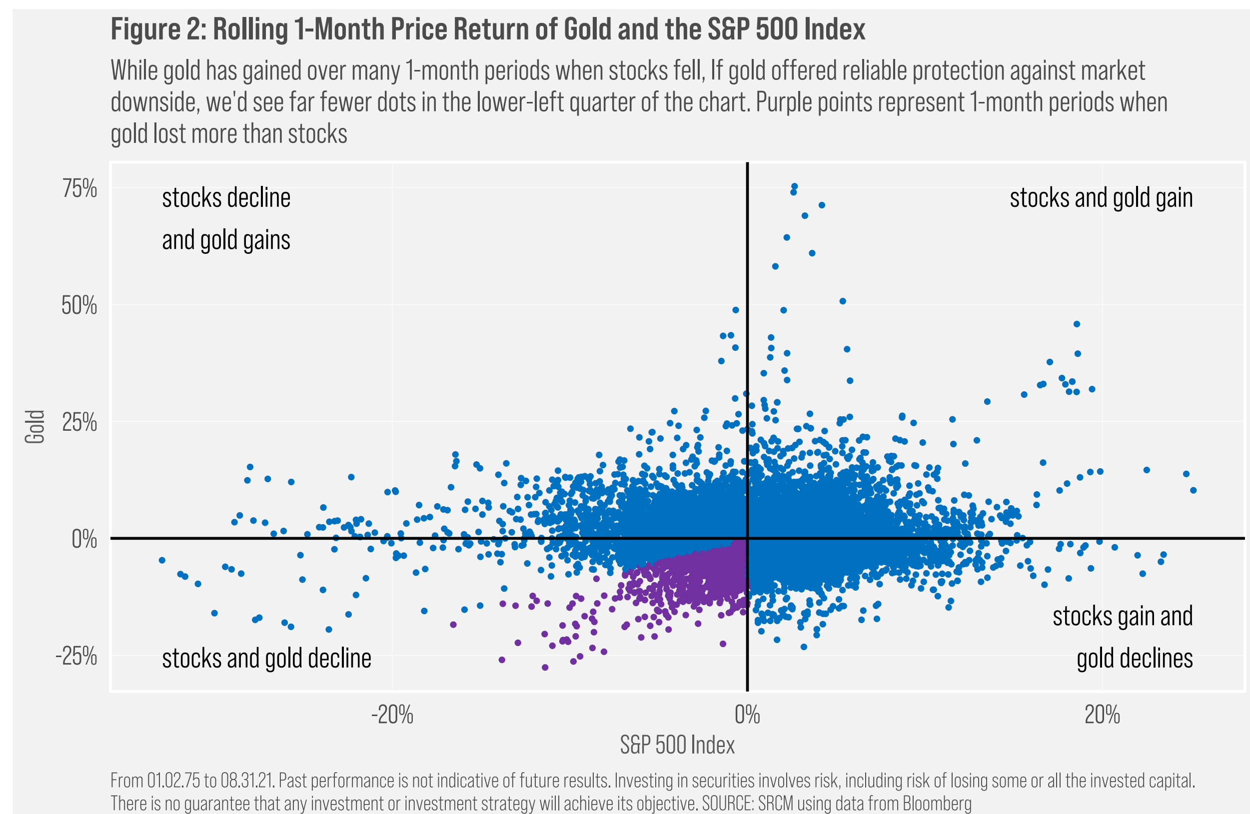
From 01.02.75 to 08.31.21. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Inflation is mesured using cumulative annualized change in price level as measured by the U.S. Consumer Price Index (CPI). CPI is a measure of prices paid by consumers for a market basket of consumer goods and services. SOURCE: SRCM using data from Bloomberg

Stability in Times of Stress?

And it doesn't help the comparison that the price of gold has been pretty volatile over the past 50 years. Speaking of volatility, what about serving as a sea of calm during times of stress? Well, gold seems not to be so super good at that, either. If we assume that the U.S. equity market is a good indicator of "stress" and if gold is meant to provide protection during periods of stress, then one might imagine that if stocks fall, gold should gain, or at least fall less. That happens sometimes, but not always. And so we'd question gold's reliability as a stress-protector. Supporting that conclusion is Figure 2, in which we show monthly returns for stocks (using the S&P 500 Index) and gold. While the top left shows all the occasions when stocks fell, but gold gained—when gold could have been seen to have provided protection against the market's decline—the bottom left corner shows the many times when stocks and gold both fell. Even more, there are more than a few rolling monthly periods, highlighted in purple, when gold fell more than stocks.

Figure 2: Rolling 1-Month Price Return of Gold and the S&P 500 Index

While gold has gained over many 1-month periods when stocks fell, If gold offered reliable protection against market downside, we'd see far fewer dots in the lower-left quarter of the chart. Purple points represent 1-month periods when gold lost more than stocks



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Looking over longer periods, there have been 18 drawdowns (decline from a prior peak) of 10% or more in the price of the S&P 500 Index since the beginning of 1975. On eight of those occasions, gold saw a loss through the drawdown period as well. And on three of those occasions, gold dropped more than stocks by the time stocks had bottomed. Compared to the full drawdown period (from a peak through the drawdown back to breakeven, or a zero return for stocks), gold turned in a loss on seven of the 18 drawdowns.

And let's be clear, if you are buying physical gold because you think mass hysteria is upon us, just imagine how difficult it might prove to be to actually use that gold in any commercial manner when chaos rules the streets. There's a reason, too, why we framed this analysis from 1975 onward: it was illegal for U.S. citizens to own gold coin, gold bullion or gold certificates from May 1, 1933[1] to December 31, 1974[2]. Imagine that you had, with fine foresight, amassed gold

[1] https://www.presidency.ucsb.edu/documents/executive-order-6102-requiring-gold-coin-gold-bullion-and-gold-certificates-be-delivered

[2] https://www.govtrack.us/congress/bills/93/s2665

prior to or during the early stages of the Great Depression, only to see your ownership of that gold no longer legal and to learn that you were required to deliver that gold to the Federal Reserve in return for fixed-price compensation. We'd guess many readers might cringe at the notion that such actions might be necessary again in the future. But we've seen some of the more emphatic promoters of gold investment envisioning future scenarios not too dissimilar to those of the Great Depression, so the potential for such actions in the future is surely worth some manner of estimation.

Past performance is no guarantee, but it's instructive, nonetheless. Owing to its relatively short history of availability for investment in modern times, gold's investment characteristics may well change through time. Perhaps it does eventually establish a more defensible record of protection from inflation and market duress. We just don't find the evidence so defensible yet.

What's it you want?

Looked at another way, the data in Figure 2 show that the performance of gold has been different than that of the market during past drawdowns, meaning there are potential diversification benefits to a portfolio from the inclusion of gold. But that can be said of a host of other exposures, too. And that understanding leads us to the finer point we'd like to establish with this commentary.

Our goal is not to state that it's either good or bad to own gold. This discussion is not meant only to be solely about gold, actually. Take your pick of any "alternative" investment—any investment for that matter—and you'll find it easy with some work to collate reasons for and against owning it in a portfolio, based on its realized merits. Note the qualifiers in that statement, though: "with some work" and "realized merits". The analytics we've offered for gold in this piece are shorthand at best. But they highlight what we find to be a rather common error with investing: mistaking a perceived characteristic of an investment for an actual characteristic.

We think the consideration of "why" one wants to own a particular exposure within a portfolio always should take center stage, with the consequent decision being one that focuses on what might be the most efficient and effective means to incorporate that exposure into the portfolio. That in mind, we continue to believe that, for most folks, a proper investment foundation is one that seeks to use a mix of stocks and bonds in order to target a level of expected return in a way that leaves the investor comfortable with near- and medium-term realized risk. Your advisor, of course, is always happy to discuss ways we might seek to augment that core with exposures finer tuned to individual financial scenarios and future expectations.

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