NATIONAL CENTER FOR POLICY ANALYSIS

Gold Revisited

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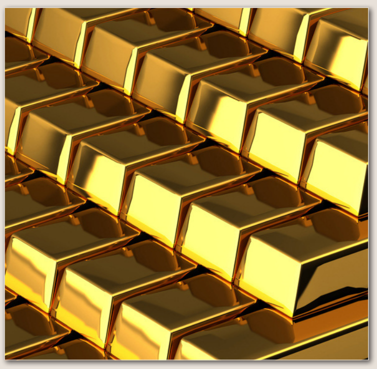
Gold is a useful hedge against inflation and uncertainty, but investing in it speculatively is not always a good strategy. In 2011, the price of gold climbed to historic heights; but since then, it has fallen significantly, though not to pre-Great Recession levels.



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Why Do People Care About Gold? For thousands of years, gold has been used as a means of exchange and a store of value. In 1900, the Gold Standard Act guaranteed the convertibility of the U.S. dollar into gold. In 1933, the United States banned private ownership of gold, a prohibition that was not lifted until 1974. Since 1971, the United States has had a pure fiat money system. Today, central banks around the world still hold 18 percent of all the gold ever mined, though no currency is tied to it.

Some policymakers have advocated that the United States return to a gold standard as a way to prevent governments from debasing the currency (that is, inflating). However, many economists, such as Milton Friedman, have warned that such an inflexible regime would deepen recessions by constraining the amount banks are able to lend. This is disputed by some, most notably those in the "Austrian School," such as F. A. Hayek, who argued lending *should* be restricted to the amount people save.

Considering gold purely as an investment, comparable to other commodities on the market, what are its advantages and disadvantages?

Gold Prices since 2011. The price of gold peaked in 2011 at $1,813.50 an ounce, only to rapidly decline throughout 2013, and steadily decrease afterward. [See the figure.] By the end of 2015, its price had fallen to $1,060.00, a mere 58.4 percent of its previous value. If an investor bought gold in 2011, the five-year effective rate of return would be -5.5 percent — a heavy loss. While gold seems to be experiencing a slight rebound in 2016, as a long-term investment these are far from encouraging numbers.

Buying and holding gold is typically a way of dealing with uncertainty. If the value of the dollar is called into question, the price of gold rises. When the economy begins to recover, it falls. Gold is seen as "safe," a store of value that can ride out inflation and easily be sold off. It is an easy defense against economic woes. But the economy has continued to recover since 2011, albeit more slowly than usual. Fears have diminished, Quantitative Easing (QE) has slowed, the Federal Reserve has begun raising interest rates, price inflation has not been as great as many expected, and the shadow of financial collapse does not appear to loom as much as it did.

Gold has "bubbles" like any other commodity, with sharp and unexpected declines. The data for the last 35 years show that, even with its recent drops, the price of gold is up compared to pre-recession levels.

However, if we consider the last five years alone, gold has done rather poorly. Suppose an individual made a $100 per month contribution to an investment account from January 2014 to December 2015, for a cumulative total of $2,400; losses would have been as follows [see the table]:

- A stock index fund (FUSEX) would have lost a mere $15, for an annual rate of return of -0.61 percent.
- Gold in the form of shares (exchange-traded funds) sold on the NYSE (GLD) would have lost $168, for an annual rate of return of -7.0 percent.
- A gold mining fund (MIDSX) would have lost the most, $761, for an annual rate of return of -38.5 percent.

While clearly none of these investments have done well, gold did worse than the typical stock index fund, which essentially broke even.

Effective Annual Returns on Gold Compared to Other Investments (2014 and 2015)

Investment Strategy	Rate of Return
Stock Index Fund (FUSEX)	-0.61%
Gold ETFs (GLD)	-7.0%
Gold Mining Stocks Fund (MIDSX)	-38.5%

Note: Assumes a $100 a month contribution into a tax-deferred 401(k)-type account for a total principal contribution of $2,400. Not adjusted for inflation.

Sources: Yahoo! Finance: FUSEX, GLD, MIDSX and author's calculations.

Conclusion. Whether gold is a good investment now depends on what the future holds, not the past. With Federal Reserve Chair Janet Yellen acting cautiously about raising interest rates, and predicting slow economic growth, the economy seems to be on rather weak foundations. When the United Kingdom voted to exit the European Union (Brexit), the future of the global economy became more uncertain and investors have turned to gold as a safe store of value until the dust settles.

This may very well be a "buy low" moment for gold, or gold may continue to follow the trends of the past five years. The moral of the story, though, is that gold should not be treated as an investment that will always outperform other investments, as many people are inclined to assume.

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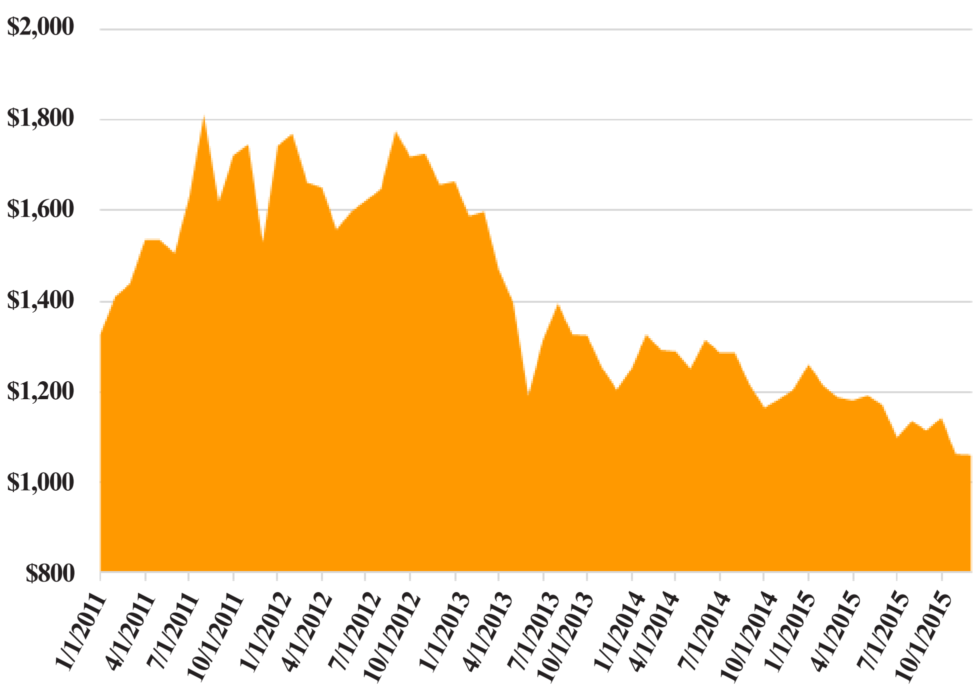
Gold Price, Per Troy Ounce (2011-2015)



Source: World Gold Council.