The Fighting Irish of the Investment World

SYNOPSIS

- Gold is a lot like Notre Dame's football team - either you love them or you hate them, and there's no in between.
- Although gold has proven to be a terrible investment over the long run, a small allocation can bring diversification to a portfolio.
- There are several ways to invest/own gold, and the easiest and cheapest is through a handful of Exchange Traded Funds (ETFs).

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GOLD'S ON A TEAR

Gold has enjoyed its best start to a year in three decades, climbing more than 20 percent, and its dramatic climb higher is even more evident in the chart below:

Source: Yahoo! Finance

This performance marks a huge turnaround for gold, which fell over 41% from 2012 through the end of last year (next page).

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Source: Yahoo! Finance

Add these two charts together and you get a very volatile asset that has decimated even the most experienced traders in the world. I've lost count of the number of hedge funds in New York that were on the wrong side of gold over the past four years and are no longer in business.

Trying to time the ups and downs of the gold market is one of the more creative ways to commit financial suicide, and if the professionals can't seem to get it right, then it's best to just assume that it's not worth even trying.

However, *owning* an asset is quite different than *trading* one, so let's address three pertinent questions regarding *owning* gold:

1. Should an investor own gold?
2. If so, how much gold should an investor own?
3. For an investor who does want to own gold, what's the best vehicle to own gold?

THE FIGHTING IRISH

Notre Dame football is unique in that sports fans in this country either love them or hate them. Rarely do you come across someone who is indifferent on the Fighting Irish.

The same applies to gold in the investment world, and gold commentary is typically divided into two camps. The first is "gold bugs" that own and practically worship it, and the second is "gold haters" who think it is a terrible investment and practically consider it offensive to own.

Take Warren Buffet for example. He gave a speech at Harvard back in 1988, where he famously slammed gold by saying: "It gets dug out of the ground in Africa, or some place. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

On the flip side, gold bugs can argue that when things get really, really bad in an economy, gold has been the savior for thousands of years. It acts as a "store of value" and a form of universal currency across the world.

In the spirit of full disclosure, I tend to agree with Mr. Buffett because (1) gold produces no cash flow or earnings, (2) it cannot reinvest back into itself in order to grow over time, and (3) gold pays no dividends. Add all this up and gold has no real way of

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growing value, which prohibits investors from realizing the powers of compounding returns over time.

However, when it comes to portfolio management, it's best to view gold through agnostic eyes and see if there is any direct or ancillary benefit to owning the metal.

Within this context, it is indisputable that gold does offer benefit as a portfolio diversifier because it exhibits no directional relationship to stocks and just a little to bonds. Meaning, the direction of the price of gold has shown no dependence to the movement of stocks over time.

Gold's lack of "correlation" to these major asset classes can reduce volatility in an investor's asset allocation and provide needed strength to a portfolio during times of financial stress.

Simply put, although I consider gold to be a shiny "pet rock" and a poor long-term investment vehicle, it still warrants consideration in a portfolio as a diversification tool.

THE RIGHT WAY

The answer to the second question is to keep the amount to 5 percent or less of total investible assets. For example, if an investor has $500,000 in assets, excluding a primary residence, then the maximum amount of gold this investor should own is $25,000 ($500,000 x 0.05 = $25,000).

The third question is slightly more complicated due to the variety of options available to investors. The three most popular ways to own gold are via (1) bars/coins, (2) the stocks of companies who mine gold, and (3) Exchange Traded Funds (ETFs).

Owning physical gold may sound like the easiest of the three, but there are "storage costs" associated with gold. It's often way too risky to dig a hole in your backyard, so gold is best kept in a safety deposit box or somewhere else equally secure.

Gold also needs to be insured against theft or damage, and annual insurance premiums add up over time. Overall, owning gold coins or bars is a suitable option as long as an investor cares for it properly.

Several investors believe that owning the stocks of companies that mine gold are a great way to get exposure to gold without having to pay for the storage costs. However, owning a company stock exposes an investor to "company risk," which is not ideal when using an asset as a hedge.

For example, if a gold miner incurred a massive amount of debt to expand operations to the point where the company could no longer support the interest payments, an investor is now at risk of losing his money if the company files for bankruptcy. Hedges are supposed to reduce risk in a portfolio, not add new and unnecessary risk.

The third option is my preferred method for owning gold. An Exchange Traded Fund (ETF) is a marketable security that tracks an index or a basket of stocks, bonds, and/or commodities. In this case, the fund owns bars of gold in a vault and then issues shares that represent a percentage ownership of the gold in that vault. These shares are then traded in the same manner as any other company stock.

Buying and ETF is identical to buying shares of stock on an exchange, and several gold ETFs are now available to investors. The most popular choice is the SPDR Gold Shares ETF (ticker: GLD), which has been around since 2004. This ETF tracks gold by storing bars in a vault in London.

The downside to ETFs is that they charge fees to investors for owning them. The fee for GLD is currently 0.40%, which is admittedly high for an ETF. For those who balk at such a high fee, there are other ETFs to consider.

The other sizeable gold ETF is the iShares Gold Trust (ticker: IAU) and differs from GLD in two ways. First, the expense ratio is much smaller at 0.25 percent

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($25 annually for every $10,000 invested), which is 37% cheaper than GLD. Second, IAU diversifies where its gold is stored by keeping it spread out across London, New York, and Toronto.

Other gold ETFs exist that offer unique and often quirky features. For example, the Merk Gold Trust (ticker: OUNZ) is the first gold ETF that allows investors to take physical delivery of gold when they sell their shares.

Meaning, an investor has the option to request her share of gold that's stored in the vault upon selling the ETF if she so desires. The company managing the ETF will even overnight her gold via UPS once the paperwork is complete!

***NOTE**: Since an ETF share represents a claim to a portion of the gold sitting in a vault, even if the company managing the ETF were to blow up or go under, investors would still get their money back. The value of gold will be divided up and returned to shareholders of the ETF, so there is no company risk associated with an ETF.*

Of these options, I recommend owning IAU first, because of the low expense ratio, and then GLD second. I do not like OUNZ because redeeming gold from them is quite expensive, unless an investor was requesting 40 ounces or more, and taking physical delivery of gold just brings an investor back to the issues explained above.

The bottom line is that a 5 percent allocation to either IAU or GLD is a good way to provide diversification to a portfolio, but none of these products should ever be traded.

Sincerely,

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