Going for Gold… Again

By Vineer Bhansali | August 31st, 2024

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In March of 2023, about eighteen months ago, I wrote a piece in this forum titled “GITA: Gold Is The Alternative” (see here), suggesting that investors should look at gold as an investment for various reasons listed in that piece. At the time, the price of gold was around $1,979 per ounce. As of today, the price of gold is $2,775 per ounce, which is 40% higher than March 2023.

By any means, the yellow metal has defied skeptics and continued to shine. For reference, over the same period the S&P 500 is up over 50% on a total return basis (inclusive of dividends, etc.), and bitcoin is up almost 160% (Source: Bloomberg). All the monetary and fiscal stimulus has certainly raised asset values. It has been a good run for investors despite global geopolitical turmoil and uncertainty. Now, as we sit on the eve of one of the most uncertain and polarized elections in memory, curious minds want to know — can gold’s tear can continue?

It is my belief that it can. The reasoning is quite simple and was discussed in a paper written with my colleagues and published last May looking at the three “faces” of gold* (see here). Simply put, gold has held its value over thousands of years because of its malleability in taking three qualitative attributes from time to time:

> “(1) Gold can act primarily like a real asset is some regimes, protecting against inflation (“real” regime), (2) Gold can act like a commodity in some regimes (the “commodity” regime), (3) Gold can act as a stable currency in some regimes (the “stable currency” regime).”

Of course, it is impossible to know much in advance when gold will switch into a different character, just as it is impossible for a slowly boiling frog to know in real-time when the water is getting hot enough to cook it. Our analysis, we believe, demonstrates that somewhere around the Global Financial Crisis in 2008-2010, gold started to switch determinedly into a stable currency character (was it all the money printing maybe?). What's important is that gold's regimes, once entered, are quite persistent, and until a crisis or other inflection point occurs, such as the Volcker inflation flight, or the credit crunch of 2008, the prior regime will continue, and indeed get stronger. We believe we are in the middle of such an accelerating increase in gold prices because we are in a regime that is still unfolding.

I don't like having to say that gold is a good "investment"; after all, the gurus of investing, including Warren Buffett have pooh-poohed gold: "Gold has two major shortcomings, being neither useful nor procreative", and "buying gold is going long on fear", or "it won't do anything, except look at you". Counterpoint to this from more ancient times, are gold bug sayings like "gold is the money of kings", "gold is a treasure, and he who possesses it does all he wishes to in this world (Columbus)", "the desire for gold is the most universal and deeply rooted commercial instinct of the human race (Loeb)". But gold is a great hedge when regime shifts are afoot.

Given the interest from central banks in accumulating gold over the last few months, we can probably say that gold is still widely considered around the world as a store of value, and when kingdoms and governments print money, gold tends to perform as an anchor. Regardless of who is running the government in a few weeks, we know one thing for sure: more money *will* be printed, and the debt load and servicing costs of the US government will be larger in a couple of years than they are now. And geopolitical uncertainty is also likely to increase.

> "Two questions emerge for investors who think gold might be a good investment, or a hedge. First, how does one access exposure to gold, and second, how much is a reasonable allocation?"

Again, we don't purport to know much about private gold investing, such as buying gold bricks and storing them in our basement, or coins of various sorts, so will limit ourselves to relatively liquid instruments (by the way did you know that according to the US geological survey all the gold ever mined in the history of mankind would fit in a 75 by 75 by 75 feet box and would weigh about 250,000 tons, see here).

First, the simplest way for retail investors to buy gold is via the GLD ETF, which as of this writing has a market value of about $75 Billion. Two ETFs, GDX ($15 Billion) and GDXJ ($6 Billion), own gold mining companies, with GDX owning major gold miners and GDJX owning "junior" miners. Then there are futures on gold that trade on the COMEX, with specific delivery procedures for those who have the will and ability to buy gold futures, and thus gold exposure on margin (details on delivery here). Of course, options, which can create more leverage and more risk, can also be traded on these ETFs as well as on the futures contracts. As with every investment, it is important to know that leverage can cut both ways — and can create large gains as well as catastrophic losses, and gold, a fickle friend, will punish those who don't manage their risk well!

Finally, what is a reasonable asset allocation to gold in the environment that we are in? If our research is correct and we are in the regime where gold will become a stable or "anchor" currency, then a 3%-5% allocation to gold in a balanced portfolio which consists of roughly 50%-60% in equities and 35%-45% in bonds would be in the zone of being "optimal" from very simple risk-return calculations. That does not sound very large, and indeed it does not compare to the over 10% allocation that an optimizer would have chosen in the inflationary period of the 1970s and 1980s. but it is large enough to make a difference.

My business is to expect the unexpected and position for it. In other words, always be on the lookout for the "tail", which usually accompanies a regime shift.

> "As an investor managing tail risks I thus have to be cognizant of regime shifts before they become consensus opinion. During regime shifts what has worked in the past might not continue to work. Yes, the textbooks and even the Oracles of Investing can be proven wrong under regime shifts."

It is every investor looking out for their own portfolio. In such an environment it may not be a bad idea to allocate a little bit to the metal that is the currency of no country, but is still the most liquid currency of everyone.

“Like the three-faced Greek goddess Hecate, or the Hindu triad (“Trimurti”) of Brahma, Vishnu, and Shiva, gold’s three regime “faces” provide insights into the performance of an asset that has been around for centuries in investment portfolios”; from “Mining Gold for Regimes: The Case for Holding Gold in a Strategic Asset Allocation,” May 30, 2024 by Colin Suvak, Matthew Johnson, Vineer Bhansali, Linda Chang, Jeremie Holdom.

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