

Gold rush: Investors play it safe

By Claes Bell • Bankrate.com



Highlights

Gold serves as a commodity as well as a hedge against inflation. A decade of upheaval has contributed to a rise in the price of gold. Higher interest rates could put the brakes on the current gold rush.

You know an investment is hot when people are going on the radio and asking you to melt down your jewelry so they can get in on the action.

Gold has been on a bull run over the last decade. In May 2001, the [price of gold](#) averaged \$272.36 per ounce. On May 18, 2011, it closed at \$1,496.50 per ounce, an increase of nearly 450 percent.

But what's behind those gains is a more complex question, says Tom Winmill, portfolio manager for Midas Funds in Indianapolis. That's because gold performs two distinctly different functions. It's a commodity and a hedge against inflation, and its importance in both roles has grown significantly in the last 10 years.

Gold, the commodity

Gold is a consumer good and is used in the production of other goods. Consumer jewelry, electronics, medical devices and other products consume about 10 percent of the world's gold every year, Winmill says.

Nowhere is that more evident than with jewelry. Cameron Brandt, director of research at Emerging Portfolio Fund Research in Boston, says part of the rise in gold can be attributed to increased demand for gold jewelry in the developing world.

As developing countries, particularly India, have matured economically, demand for gold jewelry there has increased substantially. The World Gold Council released a report earlier this year that found gold jewelry demand in the Indian market reached a record 746 metric tons in 2010, an increase of 69 percent over 2009's recession-eroded levels.

Gold also plays a major role in electronics. Most electronic devices contain a small amount of gold, and as electronic devices have become more popular, gold use has increased, Brandt says.

Gold, the inflation hedge

While gold's role as a commodity has had some influence over its price, its other role has accounted for most of gold's rise in value, Winmill says. Investing in gold is a hedge against inflation and a safe harbor for investors worried about political and economic instability.

In normal times, investors worldwide turn to currencies, particularly the U.S. dollar, as a safe haven. Lately, "U.S. fiscal and monetary policy is seen as being very detrimental to the value of the dollar," Brandt says.

Add to that a decade of global political and economic upheaval, and you have a recipe for skyrocketing gold, he says.

"This is a particularly uncertain period. There's been a somewhat unusual convergence of variables in a fairly short period of time - the outbreak of political unrest in North Africa and the Middle East, the eurozone's ongoing struggle to get on top of its debt crisis, the natural disasters in Japan, the looming end to QE2 in the U.S.," Brandt says.

"There's a lot for people to be nervous about, which historically has sent them toward gold," he says.

Winmill says the buzz surrounding gold also has added to its allure.

"There's been a lot of discussion of gold, a lot of additional investment in gold. We're seeing a lot of retail interest in gold in terms of the ETF (exchange-traded funds)," Winmill says.

Investing in gold today

Despite the recent run-up in value, investing in gold is far from a sure thing for individual investors. While it can provide value to a portfolio as an asset that moves independently of the stock market, returns on gold have lagged behind inflation, Winmill says. For one thing, gold has high carrying costs.

"Unless you simply take delivery and keep it in your house, there's going to be storage cost, safekeeping. Some people insure it," Winmill says.

Investing in gold also may come with an opportunity cost, Winmill says. After all, if your money is locked up in gold, it can't be growing in stocks, bonds or other investments with above-inflation returns.

Despite its historically low returns over the past two centuries, prices have risen almost 18 percent per year during the last decade. The question is: When will they fall back to earth?

Brandt says that depends in part on the actions of the U.S. government.

If the economy begins showing signs of a more robust recovery, and the Fed stops injecting liquidity into the banking system through quantitative easing, gold could lose some of its value as a hedge against inflation and be dropped by some investors, Brandt says. Higher interest rates, which have weighed historically on gold prices, also could put the brakes on the current gold rush, he says.

A prolonged period of relative global peace and stability and an improvement in government balance sheets also could erode gold's value as a hedge against disaster.

A soft landing for gold?

But even if gold prices turn in the near future, Winmill predicts a softer landing for gold than in its last great bull market in the late '70s. The end of that run in January 1980 saw the price of gold drop from a high of \$2,305 down to \$1,692 (adjusted for inflation) in a single week, a decline of almost 27 percent.

Winmill says the recent buildup in gold prices has been more gradual than in the 1970s. While there eventually may be a speculative blowup in prices that could lead to a sudden fall, that has yet to happen on the same scale as the earlier period.

"It's a very, very liquid market, and it takes a little bit more than a few retail investors to move the price," Winmill says.