Even with price drop, gold mutual funds are still a good bet

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Published: September 16, 2011

The price of gold is up 30 percent in just the past six months. That return looks all the more enticing at a time when investor fears are growing in the stock market, and there's little to be made from U.S. Treasurys or money-market funds.

But gold's run goes back even further. In October 2007, an ounce sold for about $740. Just a year later, the price rose above $1,000 for the first time. And in early September, an ounce traded above $1,900. Gold has edged downward, closing at $1,778.50 on Thursday.

By comparison, since hitting a record high in October 2007, the Standard & Poor's 500 stock index is down 25 percent.

Investors have voted with their wallets. Gold's swift rise has made it popular with those seeking big returns, as well as presumed safety from turbulent financial markets. Still, as an investor, one must always be aware of any shiny object that may cloud your judgment.

Leo Larkin, a senior metals and mining analyst at Standard & Poor's, says investors have poured too much money into gold. He believes the price of an ounce could fall back to $1,450 to $1,550 in coming months.

That doesn't change the fact that the price of gold remains high, and there are a number of factors that support the idea that it will stay there. Among them is the mounting fear of another recession.

Volatility shouldn't deter you from looking at the long-term outlook, said Joe Foster, gold strategist for Van Eck Securities' actively managed gold funds.

When to buy

The big question now is when to jump in. As demonstrated in recent weeks, gold prices react very quickly to economic news.

“The pendulum swings one way on fearfulness and back the other way on complacency,” said Tom Winmill, portfolio manager of the $105 million Midas Fund, which owns gold and stocks in gold miners.

Also affecting gold prices are purchases by the world's central bankers. This amount more than quadrupled this April through June, compared with a year ago, according to the World Gold Council. That continued source of demand bodes well for sustaining gold's value.

But looking at the purchase from a personal level, gold provides a hedge against inflation, and it's a reliable store of wealth since investors don't have to worry about credit risk.

It also adds diversification to a portfolio because its price doesn't move in tandem with the stock and bond markets.

“It all makes the argument for establishment of a gold position as a core holding (in your portfolio),” Winmill said.

How to buy

It's not very practical for most of us to go out and buy actual gold bullion. It's costly and has to be stored somewhere safe.

While a 1-troy ounce American Eagle gold coin may cost as much as $1,900, investors can get into a mutual fund or exchange traded fund (ETF) for a fraction of that.

But fund investment strategies vary, and they all don't invest directly in gold. Instead some invest in the stocks of exploration and mining companies; so their performance doesn't track the rise in gold prices as closely.

Of the funds that actually buy gold, the most popular offering is SPDR Gold Shares (GLD), which last month for a time was the largest ETF in the world with assets of $76.7 billion. Its shares are backed by gold bullion, which is purchased and held in vaults in London under the watchful eye of HSBC Bank USA.

The gold ETF's total return year-to-date is 28.7 percent, compared with a 5.5 percent decline of the S&P 500 ETF (SPY).

Another option is iShares Gold Trust (IAU), which also is backed by gold bullion. Of the two, Abraham Bailin, a commodity ETF analyst for Morningstar Inc., favors IAU because of its lower expense ratio — 0.25 percent versus 0.40 percent for the GLD — and it's a much smaller fund at $9.9 billion in assets.

IAU has returned 29.2 percent so far this year.

Some of the exchange-traded funds that invest in gold mining companies rather than the bullion itself include: Market Vectors Gold Miners (GDX), which invests in large gold mining companies and is up 4.8 percent this year; and Market Vectors Junior Gold Miners (GDXJ), an ETF that invests in smaller mining operators. It is down 8.1 percent.

These funds — because they invest in the stock of mining companies — are pressured by rising energy, labor and operational costs. That weighs down any boost they might get from improved profitability due to higher prices.