



Why We Own Gold—and Why You Should Still Think About Adding it to Client Portfolios

By Jeff Waters, CFP®

I know what you're thinking. Gold? Now? If I own it already for my clients, I'm happy I do and might be thinking of lightening up the position. If I don't already own it, I might be kicking myself, but I'm not going to be suckered into buying at what must be near the top.

It's a perfectly rational line of thought. But let me suggest why you might still want to add some gold to your portfolio and maybe why you should not be so quick to sell what you have.

Why do investors own gold, and is their rationale sound? Back in the 1980s and 1990s when I worked in institutional equity sales on Wall Street, we had an analyst who followed gold and gold-

mining stocks. This was the period when gold had come off its bubble highs of the early '80s and the price of the metal and the equities was moribund. Those interested in gold were often referred to as "gold bugs," and I would derisively characterize them as "the canned goods and crossbows crowd." The underlying assumption was that gold was a fringe asset for non-mainstream investors. Of course, it didn't help that the performance was so poor for so long.

More Than a Flight to Safety

Even today, it is not uncommon to read or hear a comment in the media that a move up in the price of gold was due to a "flight to safety." Of course, there have

to be more fundamental reasons for the price to move than that. A very common view is that gold is an inflation hedge. However, in August 2010, *The Wall Street Journal* carried a story on gold and quoted an Ibbotson and Associates study that it had commissioned as saying that gold's correlation with inflation going back to 1978—which includes a period with an inflation spike—was a mere 0.08. In other words, there was virtually no correlation, positive or negative.

Another common view is that gold is a hedge against the dollar. Upon closer examination, this thesis appears to be much closer to the truth. The same article quotes negative correlations between gold and the dollar of between -0.45 and -0.65, depending on the time period studied. That is a pretty strong negative correlation and indicates that a hedging characteristic exists.

But the current thinking on gold takes this idea one step further. Gold itself is now seen as a *de facto* currency. It is not just the dollar that people are questioning, it is the soundness of paper money itself, now often referred to as "fiat currency." In other words, paper money only has value because the government issuing it says it does, and we go along by agreeing to use it. In the current environment in which many of the world's developed economies are pursuing fiscal policies that appear to many experts to be unsound, so-called fiat currencies are increasingly being called into question.

That leaves gold as an alternative. Gold is a medium of exchange that has had intrinsic value for centuries. The United States Constitution declares that "no State shall ... make any Thing but gold and silver Coin a Tender in Payment of Debts." The traditional term "debasement of the currency" referred



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to a reduction in the metal content of coins going back to Ancient Rome. This view, which was until recently considered by many to be the philosophy of a fringe element, has become much more mainstream. Some market observers believe that many central banks are accumulating gold, and they say there may even be a move by China to back its currency fully or partially with gold and, ultimately, to make it the world's reserve currency, with concomitant negative implications for the dollar.

Small Core Position

With all this said, on a practical level what does this mean for advisors? I am not actually advocating a specifically bullish case for gold. I acknowledge that gold has had a very large move over several years. I am advocating that holding a small core position in gold is

a very sensible course of action for a mainstream portfolio.

First, gold is a less-correlated asset. I use that characterization, as opposed to “negatively correlated,” because the correlation varies over time. But it is certainly less correlated than other traditional equity assets. Data show that it is negatively correlated to the dollar, and so in that sense, it’s a tool to hedge the dollar alongside international equities and fixed income.

Second, and maybe at least as important, gold is a security blanket for your clients. During the market meltdown, gold performed well. Many of my clients commented favorably on their gold allocation and seemed to take great comfort from it, even though the position in most cases wasn’t large. If we do have another difficult market and gold continues to perform well, you will be

glad to have that position and to point out to your clients that they own gold. The impact on their psyches will go beyond the impact on their portfolios. **NA**

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Holding Gold: Practical Tips

Gold is treated as a collectible for tax purposes and thus is taxed at a 28-percent rate.

A gold ETF, which for most investors is the most practical vehicle to hold gold, is best held in a tax-deferred account.

The formula for AGGRESSIVE AUM goals! ETFs + Covered Calls = Client Acquisition

Offer your clients unique portfolio OPTIONS.

Notes:

ETFs:

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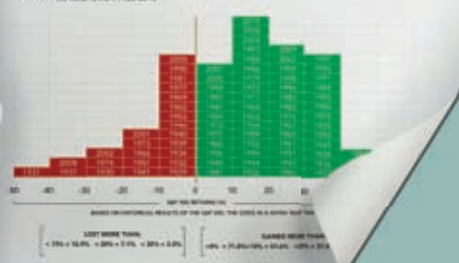
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