Is Gold a Good Hedge?

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CAMBRIDGE – As I walked through the airport in Dubai recently, I was struck by the large number of travelers who were buying gold coins. They were not reacting to Dubai's financial trouble, but rather were joining the eager rush to own gold before its price rises even further. Such behavior has pushed the price of gold from $400 an ounce in 2005 to more than $1100 an ounce in December 2009.

Individual buying of gold goes far beyond the airport shops and other places where gold coins are sold. In addition to buying coins minted by several governments, individuals are buying kilogram gold bars, exchange-traded funds that represent claims on physical gold, gold futures, and shares in gold-mining companies that provide a leveraged position on the future price of gold.

And gold buyers include not just individuals, but also sophisticated institutions and sovereign wealth funds. Recently, the government of India purchased 200 tons of gold from the International Monetary Fund.

Many gold buyers want a hedge against the risk of inflation or possible declines in the value of the dollar or other currencies. Both are serious potential risks that are worthy of precautionary hedges. Although inflation is now low in the United States, Europe, and Japan, households and institutional investors have reason to worry that the low interest rates and the extensive creation of bank reserves could lead to inflation when economic recovery takes hold. And the declining value of the dollar – down more than 10% against the euro in the past 12 months – is a legitimate cause of concern for non-US investors who now hold dollars.

But is gold a good hedge against these two risks? Will gold maintain its purchasing power value if inflation erodes the purchasing power of the dollar or the euro? And will gold hold its value in euros or yen if the dollar continues to decline?

The short answer is no on all counts. The dollar price of gold does not increase with the US price level. And the value of gold does not increase in dollars to offset the fall in the value of the dollar relative to the euro or the yen.

Consider first the potential of gold as an inflation hedge. The price of an ounce of gold in 1980 was $400. Ten years later, the US consumer price index (CPI) was up more than 60%, but the price of gold was still $400, having risen to $700 and then fallen back during the intervening years. And by the year 2000, when the US consumer price index was more than twice its level in 1980, the price of gold had fallen to about $300 an ounce. Even when gold jumped to $800 an ounce in 2008, it had failed to keep up with the rise in consumer prices since 1980.

So gold is a poor inflation hedge. Moreover, the US government provides a very good inflation hedge in the form of Treasury Inflation Protected Securities (TIPS). A 10-year inflation-protected bond will not only provide interest and principal that keep up with the CPI, but also now pays a real interest rate that is now slightly more than 1%. And, if the price level should fall, a newly issued TIPS bond will return the original nominal purchase price, thus providing a hedge against deflation. Of course, investors who don't want to tie up their funds in low-yielding government bonds can buy explicit inflation hedges as an overlay to their other investments.

Gold is also a poor hedge against currency fluctuations. A dollar was worth 200 yen in 1980. Twenty-five years later, the exchange rate had strengthened to 110 yen per dollar. Since gold was $400 an ounce in both years, holding gold did nothing to offset the fall in the value of the dollar. A Japanese investor who held dollar equities or real estate could instead have offset the exchange rate loss by buying yen futures. The same is true for the euro-based investor who would not have gained by holding gold but could have offset the dollar decline by buying euro futures.

In short, there are better ways than gold to hedge inflation risk and exchange-rate risk. TIPS, or their equivalent

from other governments, provide safe inflation hedges, and explicit currency futures can offset exchange-rate risks.

Nevertheless, although gold is not an appropriate hedge against inflation risk or exchange-rate risk, it may be a very good investment. After all, the dollar value of gold has nearly tripled since 2005. And gold is a liquid asset that provides diversification in a portfolio of stocks, bonds, and real estate.

But gold is also a high-risk and highly volatile investment. Unlike common stock, bonds, and real estate, the value of gold does not reflect underlying earnings. Gold is a purely speculative investment. Over the next few years, it may fall to $500 an ounce or rise to $2,000 an ounce. There is no way to know which it will be. Caveat emptor .

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