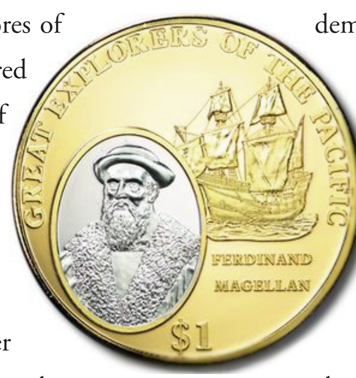
Worth its Weight: Six Reasons to Buy Gold Today

"He who has the gold makes the rules."

by Axel Merk, Merk Investments

Imagine the surprise of the world's first circumnavigator, Ferdinand Magellan, when upon arriving on the sandy shores of the present-day Philippines in March 1521 after the first-ever Pacific crossing, he was offered a gold bar and some spices by the native king. Gold – it was a store and show of wealth, even there, even then – in uncharted, uncivilized territory, halfway around the world, half a millennium ago.

Perhaps Magellan shouldn't have been so surprised. Gold had been "money" for more than 2000 years prior to his time. The first gold coins were struck in about 700 B.C. in modern day Greece. Throughout recorded history, other assets like weapons, spices, art, metals and even food have had their day as leading stores of wealth, but gold has endured as the supreme evidence of wealth across all cultures and time.



Little has changed today. Gold competes with other assets – stocks, bonds, real estate, and paper currency among others as stores of wealth. But in today's changing and ever more volatile world, the value of these other assets may fluctuate more than ever. What's more – paradoxically – in response to volatility, the policies of governments and central banks, in an effort to dampen economic downturns and prop up asset prices, may in fact make gold more valuable relative to these other assets. In our opinion, the real purchasing power of gold, over the long term, may rise.

Like most assets, price is determined by demand and supply. Going forward demand for gold may continue to rise, while supply will remain constrained as it has since the beginning of time. With this backdrop, let's explore some specific reasons investors may consider buying gold at today's prices.

Reason 1: Hedge Against Inflation

There was a time, until World War I, when gold was money and money was gold, or at least backed by real, physical gold. Then the need to repay war debts induced the involved countries to "print" money. Countries became partially disengaged from the gold standard then, and more disengaged with the onset of the Great Depression and World War II. But printing money on a massive scale happened only during these crises.

Today, it seems that the "crisis" is nearly perpetual, and the virtual printing presses run all the time. Virtual? Yes, you don't even have to print the money any more; it can simply be created with the stroke of a keyboard. And it's become so easy that trillions in new paper "fiat" currency will be created – all to chase the same amount of goods and services. It may be worth keeping in mind that there is no upper limit to the amount of dollars that can be created, and to the extent that gold (or anything else for that matter) is priced in dollars, there is no upper limit to what the price of gold can be. One estimate calls for $15 trillion to be printed in the next three years worldwide. We are getting ever further away from the gold standard.

Of course, that brings the potential for uncontrollable inflation. That is, unless these central banks can "mop up" the liquidity, withdrawing the cash from the economy. But in doing so, central banks will slow their economies – a politically unpalatable scenario. Add to that the crushing public debt loads, which induce countries to inflate their way out of debt, that is, to allow their currencies to depreciate and pay with cheaper money later, and we have a powerful mixture for future inflation. And what happens when there is inflation – or when people anticipate inflation? The price of gold may go up.

Comparatively, the next five reasons are relatively simple:

Reason 2: Store of Wealth

Aside from governments and central banks, ordinary citizens of developing nations see gold as the present and future storehouse of wealth. Moreover, they are buying it in increasing quantities as questions loom about their own currencies, and now the currencies of others like the Euro and U.S. dollar.

About 50 percent of world gold consumption is for jewelry, while 40 percent is for investments and 10 percent is for industry. India alone buys some 25 percent of all gold produced each year. That figure is increasing: in 2010 alone the amount of gold bought by Indian citizens increased 69 percent from 2009, and Indian households today control some 11 percent of the total global gold stock. Although demand in India dropped off somewhat in 2011 due to new import taxes, demand is growing in China, Russia and other countries for many of the same reasons.

Reason 3: Central Banks Fill Their Vaults

In part as an attempt to diversify their holdings and hedge against the inflationary effects of global money printing, central banks, for the first time since the mid 1960s, have become net buyers of gold. From 1965 through 2007, they were net sellers of gold. These banks, particularly in developing countries, want to fill their vaults with something other than paper currency and the ever-riskier bonds of sovereign nations.

Estimates call for central banks to buy some 10 percent of the new supply of gold each year. Countries like Russia and Mexico will actively buy bullion in the world market as well as directly from their domestic producers, keeping that new supply off of the world market.

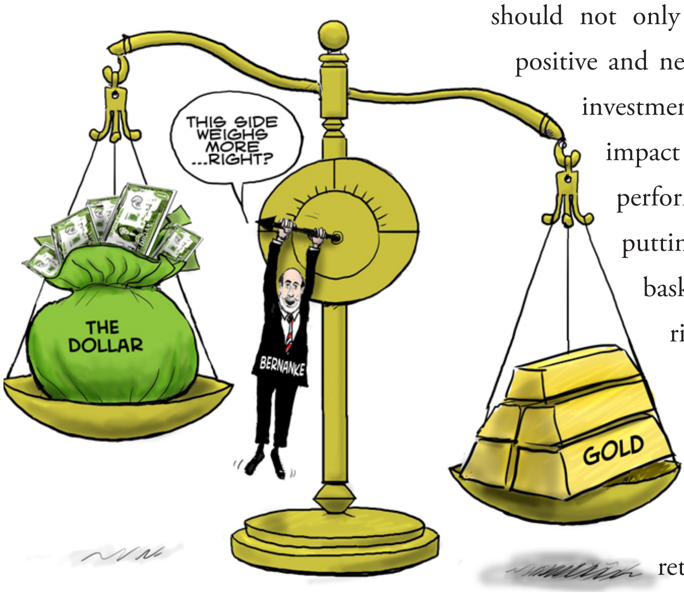
Reason 4: Protecting Your Purchasing Power

If you look at a long-term chart of the price of gold versus the price of oil, you'll notice that over time, and given some up and down volatility, gold and oil move pretty much in tandem. Put another way, an ounce of gold buys about 14 barrels of oil, plus or minus – would do so today, and has done so for over 50 years. In the early 1960s, gold was $35 an ounce, and Saudi oil could be had for less than $3 a barrel.

If you, like most of us, need to purchase energy, college education, or health care over time – items that can't be artificially deflated in price by, say, offshoring to China, investing in gold may allow your purchasing power to keep up with the price of these key goods and services. More people are figuring that out – which only adds to the demand for gold.

Reason 5: They Ain't Making More of It

Gold is a commodity. The biggest bugaboo in commodity investing is that demand eventually begets supply. That is, when the price of corn or soybeans or copper rises, what happens? Farmers plant more corn and soybeans, and miners mine more copper, and more copper is recycled – you get the idea. The supply adjustment may take a year or two to unfold, but for most commodities, more supply is around the corner when demand increases. As the saying goes: 'the cure for high prices is high



prices', in part because those higher prices attract greater supply from the market.

For gold, not so much. Even with the increased worldwide demand for gold as a store of value and an inflation hedge, production has remained relatively flat. Production did double from the 1970s to about 2000 to exceed 80 million ounces per year, but then fell back well below the 80 million mark in the mid 2000s. Only recently in 2011, did production slightly exceed the 2001 peak. Supply growth continues at a 5 percent rate in our assessment – modest in light of some of the demand figures already discussed.

Reason 6: It Pays to Cover the Field

An allocation to gold provides potential portfolio diversification benefits. The more asset classes you invest in, the less chance all of your holdings will fluctuate in tandem.

When considering any investment, you should not only consider the potential positive and negative scenarios for that investment over time, but also the impact on your overall portfolio performance. It is about not putting all of your eggs in one basket, as well as picking the right baskets.

It goes without saying that an investment with a positive expected return is preferred over one with a negative return. With gold, the outlook appears favorable for a number of reasons as outlined above. Equally important should be how the investment works with the rest of your portfolio; the way the expected return of this asset moves relative to your existing portfolio. This relationship is called correlation. Adding assets whose price movements have a low correlation, or a negative correlation, to your existing assets may help improve your overall portfolio's performance.

Think back to before the recent financial crisis had taken hold: it was great if you held assets that moved lockstep with one another on the way up. But, when the market capitulated in 2008, all those assets likely fell together as well, causing some investors to lose a great deal of value in their portfolios. The gold price has historically exhibited a low correlation with other asset classes. This fact makes gold a good source of diversification for a portfolio, and gold may help you protect yourself against downside risks. In 2008, when the S&P 500 lost 37% of its value, gold was up nearly 6%.

Holding a variety of assets, including gold, the price movements of which are uncorrelated with one another, may smooth out your portfolio returns over time and

help protect against catastrophic losses.

The final word: even though the price of gold, in the past ten years, has "woken up"

to these trends, and has quadrupled since the late 1990s, factors suggesting a strong future are there. No asset should comprise the majority of your portfolio, but it may be hard to argue against owning at least some of the precious metal going forward.

Turns out, Magellan's Pacific Island friends knew what they were doing.

About the Author:

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