

Data! Data! Data!” he cried impatiently, “I cannot make bricks without clay!”

— The Adventures of Sherlock Holmes, The Adventure of the Copper Beeches - Sir Arthur Conan Doyle, 1892

All that Glitters is Not Gold

You can't spend 5 minutes listening to drive-time radio, or watch morning TV without being bombarded by ads screaming for you to “BUY GOLD NOW.” They titillate with predictions of astronomical returns based on gold's recent rise in value, and encourage individuals to hop on board lest they miss the buying opportunity of the century.

The saddest part is most investors are driven to make important investment decisions based on fads and hype when they do not have the data. Smart investing requires that you get the information you need and know the characteristics of your investment. This knowledge will lead you to two imperative elements for smart investing:

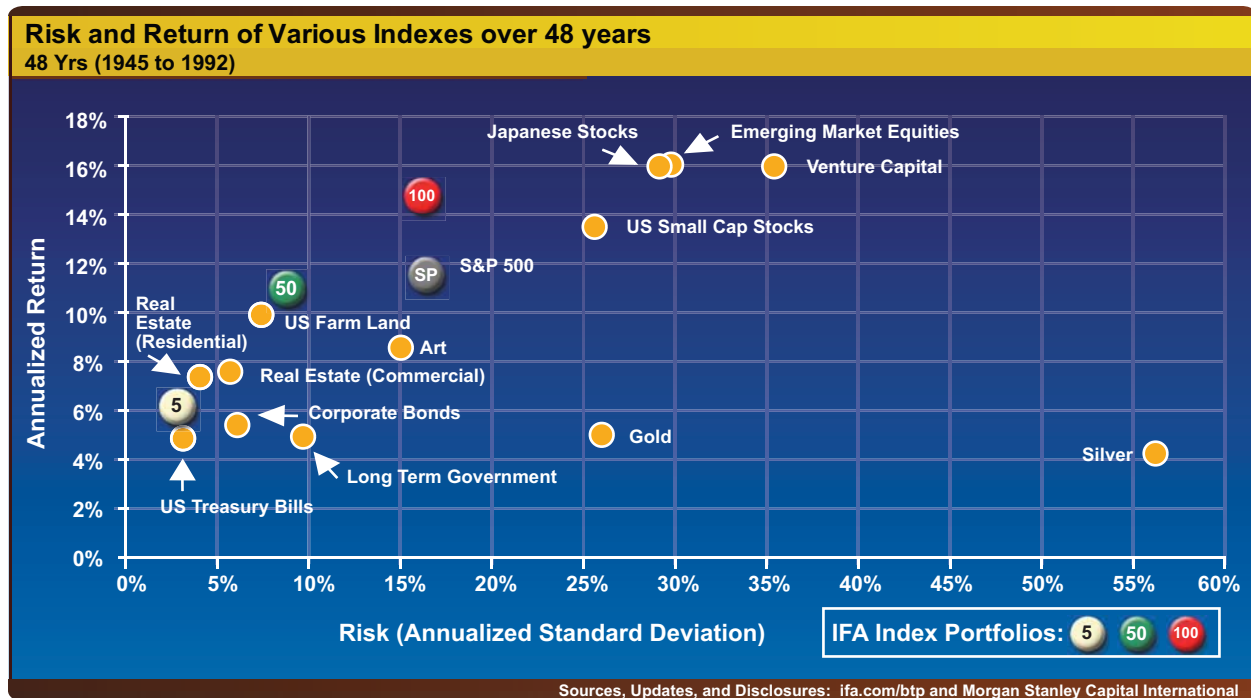
- 1. the expected return
and**
- 2. the uncertainty of that return--also known as risk.**

In order to make an informed decision about investments, you need high quality estimates of expected returns and the uncertainty of obtaining them. Investors must obtain statistics about investments, which is the science of collecting, organizing and interpreting data. This sort of information cannot be discerned from small samples of short-term price movements or from speculative hype about the near-term future of the economy.

Susan Dziubinski of Morningstar wrote, “Statisticians will tell you that you need 20 years of data – that’s right, two full decades – to draw statistically meaningful conclusions. Anything less, they say, and you have little to hang your hat on.”

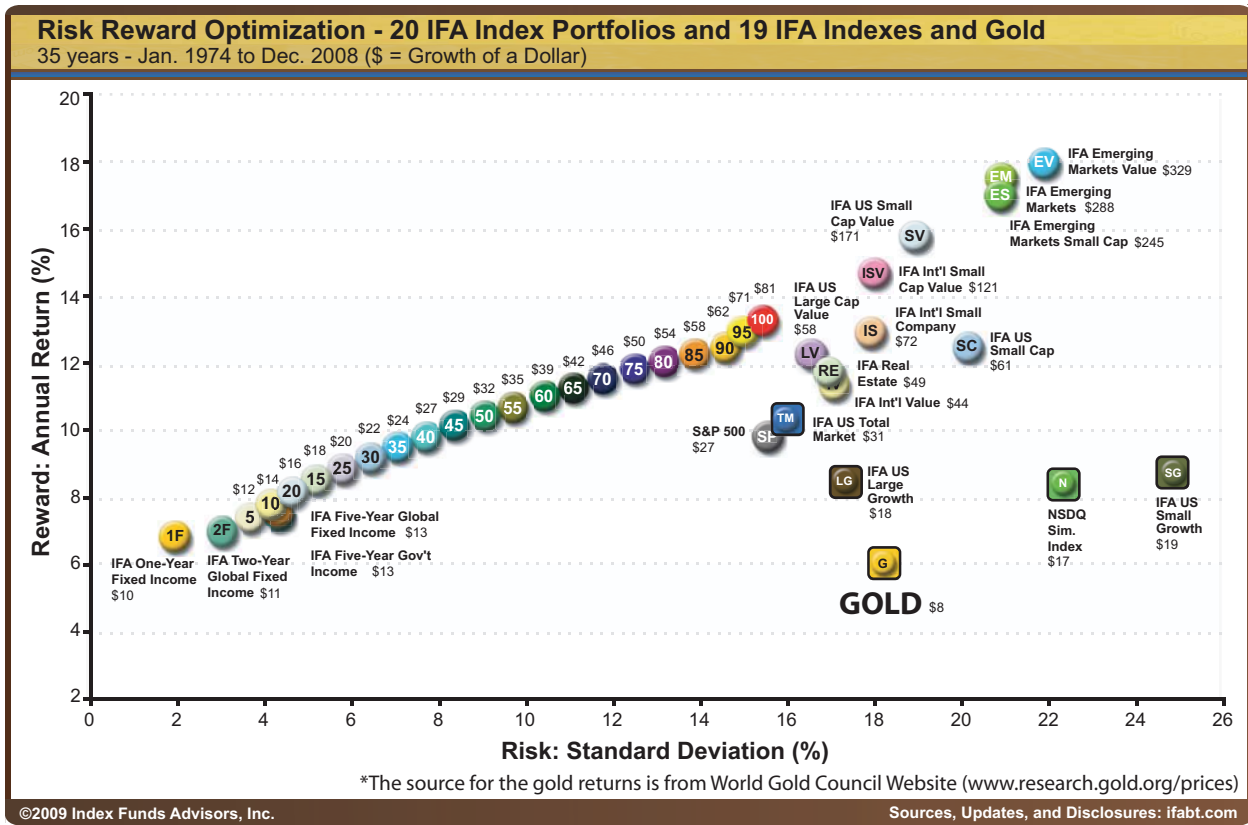
So what does the long-term historical data say about gold? It says gold’s a sucker’s bet!

The longest term data we have comes from Morgan Stanley Capital International which covers the 48-year time period from 1945 to 1992. During this period, gold had an annual return of 4.9%, but its risk was 26% (as measured by standard deviation of monthly returns); compare that to US Treasury Bills which would have given you an annual return of 4.8% (almost identical) with a standard deviation of about 3%! Over the 48-year time period, gold investors took on 9X more risk to achieve a measly 0.1% higher return. That, my dear friends, is called uncompensated risk, aka “a sucker’s bet.”



When we look at the most recent 35-year period, gold delivered a return of 5.34% with the risk sitting at 17.6%. But here again we see you could have purchased a treasury bill that would have netted a 5.68% return with a risk of just 0.89%. So you would have taken over 17 times the risk for a lesser return.

Take a look at the risk and reward chart below for the past 35 years. The gold-colored button marked “G” plots the 35-year risk and return characteristics for gold. Compare these metrics to those of the IFA Index Portfolios, which ALL achieved higher returns and with less risk. When you look at long-term data like these, it is virtually impossible to make a compelling case for the addition of gold to any portfolio.



BREAKING NEWS

As I write this piece, scrolling headlines have posted the following: “Gold Prices to Rise in 2010”! Before you back up the truck to the mint, you should know the asserter of that statement was none other than the president of the Gold Trading Association, so much for an unbiased source with no conflict of interest.

In contrast, IFA has analyzed the commonly cited merits that would support adding commodities (gold and others) to a portfolio. Research conducted by Truman Clarke, Ph.D. and former Professor of Economics at USC (someone who stood nothing to gain from gold trading) unearthed a few facts you likely won't hear from the peddlers of the commodity du jour:

The addition of commodities to a portfolio did not provide returns in excess of the Treasury bill return. The addition of commodities to a portfolio did not improve diversification for stock and bond portfolios. “Commodity futures do not appear to be effective inflation hedges for stock and bond portfolios.” Like last year's spike in oil and its subsequent spill, or the real estate boom followed by an epic bust, speculative investing leads to extremely disappointing outcomes — the sort of outcomes that can easily be averted by those who invest according to long-term historical data.

Data! Data! Data! Don't make an investment without it!