Why Gold Should Be Avoided As An Investment Tool

By James Nelson

Owning gold is an exciting prospect. Of course, owning gold has always been an exciting prospect. After all, there's an aura about the yellow metal.

But it's that very aura that makes gold hard to understand.

- Is it a currency?
- a commodity?
- jewelry and bling?

Investing vs. Asset Protection

But before the nature *and importance* of gold can be fully appreciated, we have to consider the difference between Investing and Asset Protection. The distinction will make more sense if we think of investing as "Asset Growth" and contrast that with "Asset Protection." Let's begin by considering investments, or Asset Growth.

Actually there are a couple of different reasons someone might want to invest. On the one hand they may be looking for an income stream (also called passive income) or they may want to simply increase the value of the investment (asset growth). In case you're confused, let's describe how both can be done using very common investment tools.

Investing for Asset Growth

If you purchase a three year Certificate of Deposit (CD) for $30,000 which pays 5% annual interest, with the interest accruing monthly, at the end of the term you will receive $34,699.59 back from the financial institution. In this case your assets would have grown by $4,699.59.

Compare this strategy to the "Passive Income" strategy found on the next page:

Investing for Passive Income

On the other hand, let's say your goal was for the $30,000 to produce monthly income. In order to accomplish that, you would purchase three $10,000 T-Bills with a 3-month maturity. You will buy T-Bill “A” in January, T-Bill “B” in February, and T-Bill “C” in March.

(T-Bill rates vary from month to month, but again let's assume that the interest rate is 5% annually. In this case you would receive passive income of $125/month for as long as you renewed the T-Bills, and as long as the interest rate remained at 5%.)

The Passive Income Payout

In April “A” will mature and you will be paid $10,125. But T-Bills can be set up to automatically renew. Since we’re looking for ongoing income, we would set up the T-Bill to reinvest the principle and pay out the interest. With it set up like this, you would get a new $10,000 T-Bill that would mature in July and $125 in you bank account. Again, when “B” matured in May, you would get a new T-Bill that would mature in August and another $125 in your bank account.

This recurring monthly $125 payment would then go on as long as you needed the passive income. When you were ready to something different with your money, you would instruct the Treasury Department not to renew your T-bills and you would get your $30,000 back.

Review: Investment Income is for ASSET GROWTH

Investment instruments, whether government backed securities such as CDs and T-Bills, or stocks and bonds, or real estate, all have one or a combination of these two goals. They are a means of turning our assets into growth or income vehicles.

This is not the ideal reason to hold gold. In contrast to an investment, gold functions best as an **asset protection tool**. But before we consider just what that means, we need to consider just what gold is.

GOLD

What Is Gold Anyway?

Gold is not money; it is actually a commodity. Put another way, gold has no intrinsic value, its only value is what a buyer is willing to pay for it. In this sense gold is similar to wheat and coffee and exactly like copper and palladium. All commodity prices, whether the commodities are the sort of thing we consume (wheat and coffee) or whether they are something with which we manufacture goods (copper and palladium), are ultimately determined by the market. If people are unwilling to pay $5.00 for wheat, the price will begin dropping to $4.75 or $4.50, or even $4.00 or $2.00—whatever the market is willing to pay. Once the price reaches that point, consumers will begin buying.

Of course, we all realize it's not quite that simple. Governments can impose price supports (such as the price of sugar in the U.S., which is completely disconnected from the world sugar price due to artificial price supports imposed by the U.S. government) or industry cartels can conspire to prop up prices, as OPEC does with the price of crude oil. But even though the system is not perfectly driven by supply and demand, by and large, for most commodities, it is the demand that determines the price, and the price that, in turn, leads to increases or decreases in the supply.

This is largely how the price of gold is determined. At the end of the twentieth century (and especially in the 1980s - but more about that later) gold prices were low and it was no longer cost effective for many gold mines to operate. As a result many operations were shut down and many gold-related companies ceased to do business. But in the last few years, gold prices have gone up dramatically. Mines that had ceased to be cost effective are being reopened and new gold deposits are being actively sought out.

The “Good-Suit-to-Gold” Ratio

But there's another dynamic at work that sets gold apart from copper or palladium. (Or wheat and coffee, for that matter.) For as long as history has been recorded, gold is also the “currency” of last resort. Gold seems to have an inherent value that human history itself has bestowed upon it. It is not an absolute value. For instance, we could not say that gold will never again go below $400 an ounce. But on the other hand, when financial instruments and whole economies begin to get shaky, people like to trade in their other assets for gold, because in bad times gold has *historically* always maintained its value.

I grew up hearing that a good suit had always been worth about an ounce of gold. (It was a way of figuring out how much to pay for a suit - check this week’s gold price.) In today's market, that means that a good suit should cost around $600. And in fact that is about what a good suit costs. Using this measure, if gold dropped to $400/oz, we might think it undervalued. If, on the other hand, the price rose to $1200/oz (and you don't have to look too far on the Internet to find

someone predicting that this will happen in the near future), based on the cost of a good suit, we might decide that gold is overvalued.

The “good-suit-to-gold ratio” is hardly scientific, but it is a way of understanding the dual nature of the yellow metal: While the price of gold is not fixed (since it’s actually a commodity rather than a currency), over time it's value in relation to other goods and services has remained fairly steady. There is a long and hallowed tradition of consistent value when it comes to gold.

Fiat Money

This is not the case with “fiat” money (literally, “money by order”). Fiat money is typically paper currency printed by a government that is backed solely by “the good faith and credit” of the government printing the money. The United States has had a series of essentially different currencies throughout its history, and several were fiat money.

Greenbacks

In the 1800s, U.S. currency was primarily “gold certificates.” In other words, you could trade in a paper dollar “gold certificate” for a one dollar gold coin. But the government needed cash during the Civil War, so in 1862 it began to circulate a new currency, U.S. Notes, that were not “gold backed,” but rather backed by “the full faith and credit of the federal government.” This new currency, green in color, became known as a “greenback” because it was backed, essentially, by itself, and not by gold. It was a loan, by the holder of the currency, to the U.S. government.

Breton Woods and Beyond

From after World War II until 1971, following the Breton Woods treaty, the value of American money was once again loosely connected to the value of gold. It wasn’t a true “gold standard,” but the government did have to keep a percentage of gold on hand. But in 1971/72 the U.S. dropped any pretense of a gold standard. The value of the dollar became completely arbitrary. The amount of money in circulation had no real relationship to the underlying goods and services, but rather was determined by order of the government. In other words we went back to a fiat currency like we had following the Civil War.

The historical fact is that all fiat currencies have failed. (The great financial disasters in the history of the United States are almost all related to the failure of the then-current currency system. History tells us that all governments that have been unencumbered by other rules and regulations have eventually printed money willy-nilly, in order to cover their deficit spending. When this happens the value of the money is reduced because there is not an equivalent increase in the value of the goods and services.

There Is More than One Kind of Inflation!

Monetary Inflation

This lack of discipline on the part of governments leads to a very specific sort of inflation. It works like this: Last month there were “X” number of dollars in circulation and the value of goods and services within the economy was “Y.” This month, the value of the goods and services “Y” hasn't changed appreciably, but there are now “X + 3” dollars in circulation. As a result, in terms of real value, each dollar is worth less.

As a government prints more and more dollars their real value conversely becomes less and less. Eventually people quit trusting the value of the currency in question. They want to be paid with something else. Suddenly and unexpectedly inflation can spiral out of control.

Thirty Years of Printing Money

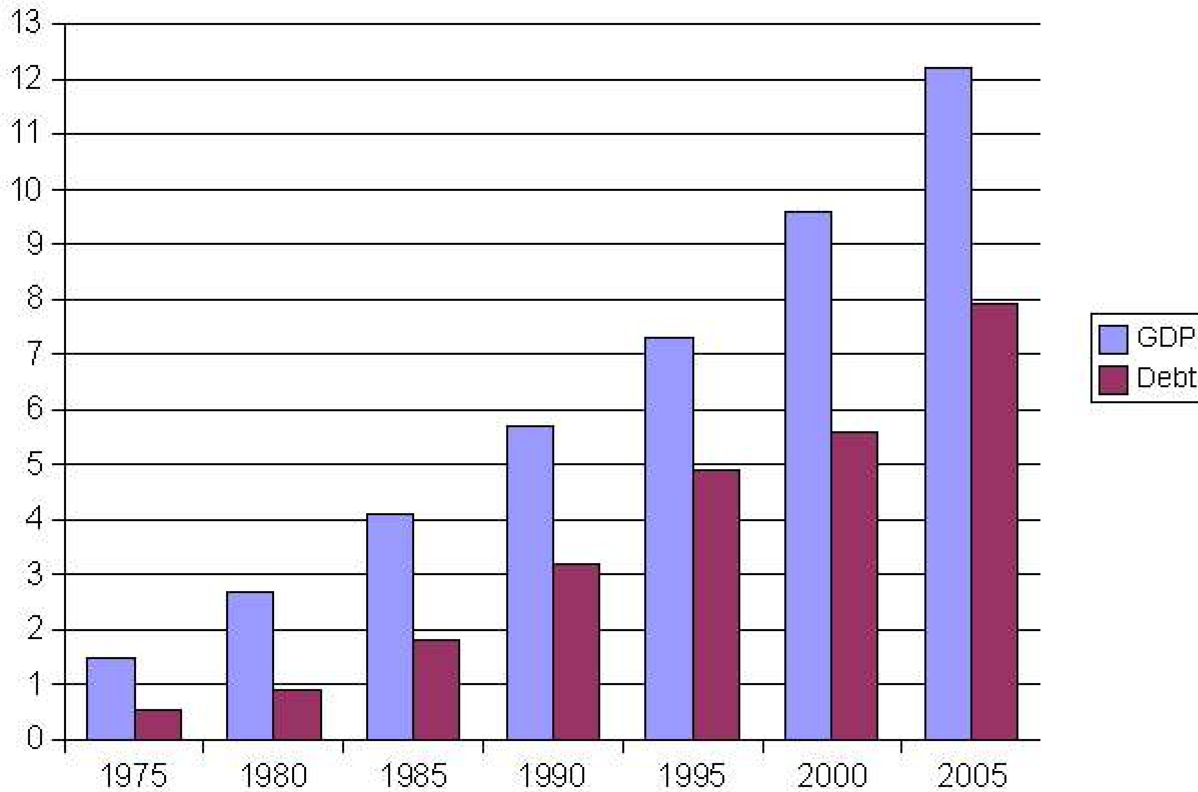
So far this has been theoretical, but let’s put it in real terms. The following spread sheet and chart shows the Gross Federal Debt (a rough measure of how much money is being printed) and the Gross Domestic Product (a measure of the total goods and services). It covers the years 1975 through the present in 5 year increments

Gross Federal Debt and Gross Domestic Product

	GDP (trillion $)	Debt (trillion $)	Percentage
1975	1.5	0.542	36%
1980	2.7	0.909	34%
1985	4.1	1.8	44%
1990	5.7	3.2	56%
1995	7.3	4.9	67%
2000	9.6	5.6	58%
2005	12.2	7.9	65%

From David Welna, Nat’l Public Radio, March 2006

Notice that both the debt and the G.D.P. (which is a measure of the size of the economy) are growing. The problem is that the debt is growing much faster. In 1975 it was only a third the size of the economy, but now it has doubled its size (in percentage terms) being about two thirds the size of the economy.



It is not accidental that this chart begins in 1975. I remind you (from a few pages back) that it was 1971/72 when the United States abandoned the Breton Woods agreement. This is when we transitioned from a gold-backed currency to a fiat currency.

With that in mind, let's re-frame the above information in terms of the dollar. This means that in the last 30 years, the Federal government has printed about twice as many dollars as were justified by the actual goods and services produced by the nation. Said another way, about half the dollars printed aren't backed by anything at all. And this means that in terms of goods and services, the dollar is worth about half of what it was worth when we abandoned the Breton Woods Accord.

This is the heart of *monetary inflation*. It's not something we necessarily feel in our pocket books But if people who hold dollars ever decided that the money isn't worth what everyone assumes it's worth, it could mean that the value of the dollar could decline dramatically.

The U.S. Treasury Dept says, "The Dollar Has No Value!"

The simple fact is that American money has no value in and of itself. It's value is rooted in the good faith that people have in the government's ability to repay its debts. If that good faith is lost, the money can become worthless. The U.S. Treasury says this very plainly on their web site. The following is an exact quote from U.S. Treasury information (emphasis added):

Federal Reserve notes are not redeemable in gold, silver or any other commodity, and receive no backing by anything. This has been the case since 1933. The notes have no value for themselves, but for what they will buy. In another sense, because they are legal tender, Federal Reserve notes are "backed" by all the goods and services in the economy. (From the US Treasury website.)

The Long Term Prospects of the Dollar.

As the U.S. Federal government prints more and more money beyond the underlying value of the goods and services of the American economy, two things happen. First, the value of the U.S. dollar in relation to other currencies goes down. As the value of the dollar goes down, people holding dollars begin to lose faith in it. The OPEC nations, for instance, are discussing with increasing frequency whether to demand Euros for their oil rather than U.S. dollars. Part of that is politics, but part of the motivation is the increasing distrust of the U.S. dollar.

This is not to say there is some sort of guarantee that the U.S. dollar will fail, but neither is there a guarantee that it will continue as a viable currency. As was said above, *historically*, all fiat currencies have eventually failed. (But as brokers like to remind us, past performance does not guarantee future results.) In this sense, there is a converse historical relationship between gold and the dollar. There is a long history to indicate that gold will maintain its value relative to goods and services. Similarly, there is a long history to indicate that fiat currencies (of which the U.S. dollar is one) ultimately become worthless.

Perception and Reality

There is a catch when trying to attach a true value to a fiat currency. Since the 1970s the value of most currencies "float" in relation to each other. No modern currency has an absolute set value and as a result the *perception* of strength and value can be far more important than any *underlying reality*. Even though the debt ratio has been increasing for three decades in the U.S., the U.S. Dollar remains the currency of choice in most of the world. As a result, the fundamentals (that is, the debt ratio) have had little effect on the actual price of the dollar. Consider the following chart of the US$ Index (which measures the US Dollar against other currencies).

The above chart shows prices from 1972 to mid 2007.
The highs of the two spikes are in Feb. 1985 and Jan. 2002.

Right after the U.S. went off the gold standard in the early 1970s, we see a decline in the dollar. But it has remained remarkably stable in the last 30 years, with a typical trading range between 80¢ to 100¢. In fact, the dollar has had the ability to spike in price when things look bleak around the world. But once again the US Dollar is sitting at the bottom of it's three decade trading range, and given the uncertainty surrounding the currency, one wonders if these support levels will hold?

And if the dollar does break through support . . . how low it can go?

Gross Domestic Product . . .
The Dollar Index . . . and Now . . .
INFLATION!

Based on the above information it would be easy to assume that things aren't too bad. If the US Dollar has held its own against other currencies, the situation can't be that bad. Right?

Wrong!!

Again, floating currencies against each other can be misleading, because the price of a particular currency is then determined more by perception than reality.

So, let’s return to a little bit of reality and bring the above discussion into focus.

Both monetary inflation and the US Dollar Index are a little bit slippery. They have no direct affect on our pocket books. They only affect us to the extent that they affect the perception of those who hold US Dollars.

Price Inflation

But there is another kind of inflation - *price inflation* - and this affects our pocket books directly. Let's put it into the context of the U.S. abandoning the Breton Woods accord in the early 70s. Inflation has reduced the value of the dollar to such an extent that a 2005 dollar can only purchase 24.7¢ of goods by 1972 dollar standards. In the 30+ years since we’ve turned to a purely fiat currency, the dollar has lost 75% of its purchasing ability. (Source: Robert C. Sahr, Professor of Political Science, Oregon State U., Corvalis, OR, 2006.)

Monetary inflation is relatively invisible. Price Inflation, on the other hand, is what we see and complain about every day. Price inflation is the fact that milk, bread, cars, houses, electric bills, and candy bars keep going up in price. On average, something that cost a quarter in 1975 cost a dollar in 2005.

Maybe that needs to be rephrased and seen in a larger font, because that’s frightening.

In the 30+ years since we’ve completely disconnected the dollar and gold, the dollar has lost 75% of its purchasing power.

Thirty Years of Gold

This is **precisely** why gold is important in terms of asset protection.

Let’s consider the price of gold in approximately the same time frame. In 1975 gold was around $150/oz. In 2005 the price peaked at around $540/oz. (And the price has gone up another $100 since then, but for purposes of comparison I want to use this 30 year period.) In percentage terms, the gold price in 1975 was only 28% of the price in 2005. In other words, *the price of gold went up about the same amount that the purchasing of the dollar went down.*

But it isn’t as simple as a one to one negative relationship between gold and the dollar. Remember, gold is not a currency, it is a commodity. And commodity prices can vary a great deal. So, within this thirty year period there was a huge spike in the gold price back in the late 70s. (This spike was connected to the Hunt brothers attempt to corner the silver market, if you

remember your economic history. They ran the price of silver to the moon and gold – also being a precious metal – followed right along.)

As often happens after a major market event, such as the Hunt brothers trying to corner the silver market, commodity prices went into a funk. That's exactly what happened to gold. Throughout the 80s the price was stagnant and even declined a bit, but by the end of the decade the price of gold once again began to move and realign itself with the inflationary realities of the US Dollar, as can be seen on the chart below.

Again, let me emphasize (as the above chart shows) that there is not a one-to-one correspondence between gold, the dollar, inflation, and money supply. But what is certainly true is that gold's value has remained relatively constant (in an inverse relationship) to the dollar adjusted for inflation.

Gold is a Bad Investment but a Good Asset Protect Tool

In terms of true asset appreciation, gold is not a particularly good investment tool. (In fact, it was a *horrible investment* during the 1980s!) But in terms of asset protection—holding on to the intrinsic value that your possessions represent—gold has been a remarkably good option in the last thirty years.

Of course, this has been the case throughout history.

Some people will look at the chart above and see in it two huge opportunities (and three for those willing to go short) in gold. They might disagree with my assessment and say that for those who could read the market, gold was a fabulous opportunity in the 70s and it is again a great opportunity right now.

The Difference Between Trading and Investing

At the beginning of this paper I differentiated between investing and asset protection. Let me now make a third distinction. Trading is a different activity still. Investors generally seek long term gains in a market. Investors are looking for underlying value that they can take advantage of.

Trading, on the other hand, focuses on market swings and technical analysis. The trader has to be nimble while the investor can be deliberate. Since gold is a commodity it can be actively traded. As I observed above, gold is akin to crude oil, wheat, and coffee. All these markets are "traded" (there's that word again!) on various commodity exchanges.

I traded commodities for several years. I've traded gold often.

But this paper is not about trading. This paper is about asset protection. And because of that, it looks at the world from a very different angle.

And there's a point to this rabbit track:

Investing, Asset Protection, and Trading are all great activities. Trading can produce a lot of income if you learn to do it well. But **If You Ever Confuse the Three** it can seriously damage your overall asset strategy!

In this paper we are not talking about trading. We are focusing on **Asset Protection**. It's very important to keep the distinction in mind.

Conclusion: Gold – Bad Investment but important for Asset Protection

It is my opinion that everyone ought to have a percentage of their assets in gold. But that is only a valuable strategy to the extent that you (the reader) believe asset protection (in contrast to investments or trading) is an important part of a financial plan. Looking at a short term chart of gold (the last five years), one would be tempted to view the yellow stuff as an outstanding investment vehicle. But before you become enamored with a chart climbing right off the top of the page, take a careful look at the previous decade, and put the recent price into the context of the relative value of gold throughout history.

The simple fact is that an ounce of gold still is about the same value as a finely tailored suit. The difference is that gold lasts a lot longer than a silk suit.

Note: The opinions expressed are not intended to be taken as investment advice. It is to be taken as opinion only, and Mike encourages you to complete your own due diligence when making any investment decision.

Addendum exclusively for Just Another Jim readers:

How Can the Average American Own Gold?

Gold is relatively easy to own. The simplest method, if you have a brokerage account, is the "streetTRACKS Gold Trust ETF." It's New York Stock Exchange (NYSE) symbol is GLD. Simply purchase shares of GLD and the value of those shares will track the price of gold exactly. The biggest advantage of the Gold Trust ETF is that since you don't physically own the gold, there are no storage fees.

Some argue that the whole point of owning gold is to have a hedge against complete economic breakdown. If Wall Street and the banking system collapse, it might be impossible to get to the assets set aside in the Gold Trust ETF. Those that hold to this view prefer holding physical gold (gold coins and ingots). Coins are typically 1 oz. in weight while ingots are typically 5 or 10 oz. Coins are readily available from reputable coin dealers, and ingots are generally available from online dealers, although it makes no sense to purchase anything except coins if you plan on keeping them yourself. If you purchase ingots, its best that they never leave a certified vault (as with BullionVault.com, below), because if ingots are ever removed from the vault, the gold has to assayed for purity (that is, melted and tested) before it can enter the official gold market again. Because of the work involved you lose a lot of money to expenses. Gold coins have a buy price and a sell price. You purchase coins at a discount to the current price of gold. (This is the buy/sell price, similar to what you find with the price of stocks.) Different dealers offer different discounts, so purchasing gold coins can be daunting to the inexperienced. For those who are interested, but a bit overwhelmed, there is a list of very reputable dealers listed below.

One method of investing in Gold is to use your IRA. Gold and silver coins minted in the United States (Gold and Silver Eagles) are recognized IRA investment instruments. Talk to your tax professional for guidance on how to do this.

For those that prefer owning actual, physical gold but don't want want it physically in your possession for security reasons, I believe the best alternative is an account with bullionvault.com. Run by renowned gold trader Paul Tustain, it offers, for the first time, a way that average individuals can own gold. BullionVault.com is located in London and they work with Brinks Security who manages three of the largest private gold depository vaults in the world in New York, London, and Zurich. The big advantage for Americans is that the account is held in London and the gold, if you so choose, can be held in Zurich. This creates a great deal of privacy and safety if the U.S. government and its financial infrastructure should ever fall apart. The other big advantage of BullionVault.com is that small investors are welcome.

Working with BullionVault.com is completely safe. Because the Brits have higher standards of accountability in the banking than their American counterparts, it is actually safer to bank in England than in the U.S. (in my opinion). But the American financial industry remains amazingly arrogant about the assumed superiority of the American system. I have an account with

BullionVault.com and in order to fund it, it was necessary to wire money from my bank to BullionVault.com's bank, which is Lloyds Bank in London. (This is the same group that insures everything from super tankers to skyscrapers to the fingers of famous violinists worldwide.) I have an account with Wells Fargo, and since they are one of the nation's largest banks that does a great deal of overseas and international business, I decided to wire the money through them. I assumed they were used to things like this.

The first banker I saw was shocked by my desire to send money oversees and called for a bank officer to talk some sense into my head. After a whispered discussion between the two I was escorted into the bank officer's office. "Are you sure you want to do this? "Do you know anything about this bank? It might be a shell corporation running a scam." (!?!?!?) It's Lloyds of London for pete's sake. I wanted to say, "Listen here you arrogant twit, I would trust Lloyds with my money far more than Wells Fargo, which has derivatives related to the subprime market coming out of its wazoo!!" But I didn't, I simply pointed out that Lloyds is older and has higher financial standards than Wells Fargo. She finally agreed and wired the money.

There is another, somewhat obscure option. Some people with long memories and a distrust of government argue that the only safe way to keep gold is in the form of collectibles. For many years it was illegal for Americans to hold gold up until the 70s, when this law was changed. Those concerned with this past precedent warn that those who hold regular gold coins (whether American, Canadian, South African, etc.) are in danger of having them confiscated by the government because the sales of all gold and silver currency have to be recorded and reported to the government. It is not my purpose to debate the merits and problems of such a view. I will only say that if this is a concern of yours, one solution is to hold collectibles (that is old coins) which are not considered currency by U.S. law and are therefore not subject to the reporting requirements of holding recently minted coins.

Purchasing collectible coins is a very daunting task for those who have not done it. I do not own any gold coins, so I'm out of my expertise here, but renowned investment and collectible guru, Steve Sjuggerud recommends the following dealers found on the next page.

Rare Coin and Gold and Silver currency dealers:

Burt Blumert
Camino Coin
P.O. Box 4292
Burlingame, CA 94011
Phone: 800-348-8001 or 650-348-3000
Fax: 650-401-5530
E-mail: burtblumert@comcast.net

Van Simmons
David Hall Rare Coins
P.O. Box 6220 Newport Beach, CA 92658
Phone: 800-759-7575 or 949-567-1325
E-mail: info@davidhall.com

Dana Samuelson and his team
American Gold Exchange
P.O. Box 9426
Austin, TX 78766-9426
Phone: 800-613-9323
E-mail: dana@amergold.com

Rich Checkan or Glen Kirsch
Asset Strategies International, Inc.
1700 Rockville Pike, Suite 400
Rockville, MD 20852
Phone: 800-831-0007 or 301-881-8600
Fax: 301-881-1936
E-mail: rcheckan@assetstrategies.com

And finally, don't take my word for it. Read about it for yourself. The best book on gold is *The Power of Gold: The History of an Obsession* by Peter Bernstein. The World Gold Council is also an excellent source of information. They can be found at www.gold.org.