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The True Value of Gold

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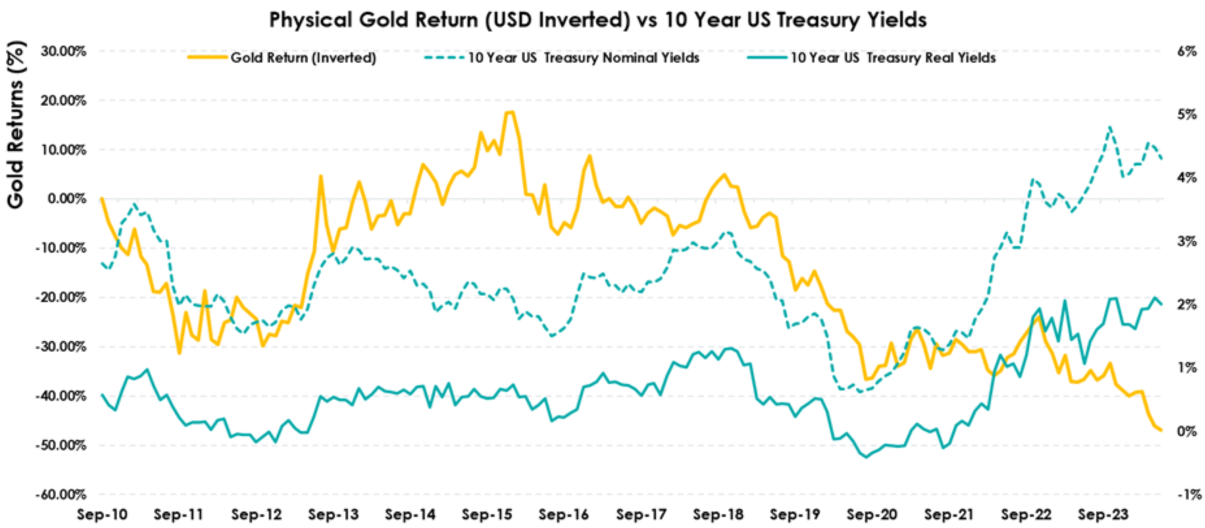
We have had many questions about gold over the past few months and thought it would be useful to explain in a little more detail our thinking on the asset and our thoughts on its role in a portfolio moving forward.

The allure of gold is understandable albeit slightly flawed. Gold is a stable element that does not rust or wither away like other materials, it is in limited supply, and its industrial applications are also restricted to about 12% of total reserves. Gold produces no cashflows, and therefore 1 kilogram of gold in the year 2000 BC is still 1 kilogram of gold today.

In the intervening years, its price has increased or decreased largely based on fear or greed. Over the last 200 years gold has barely outpaced inflation, having a 0.5% annualised real return in this period. Much better than cash but woefully worse than other asset classes.

So, what is the true value of gold? Since it produces no cash flows and cannot re-invest to create more gold or increase its mass, its value is mainly a function of anticipating what others will pay for it. During financial crises, gold prices tend to go up as other asset classes fall. The role of gold in a portfolio is therefore an insurance against extreme events and more importantly, to act as a store of value proxy for cash.

Over the past 14 years, our investment strategies have had exposure to Gold, as a Stabiliser, and gold equities, as a Growth asset. The reason for us allocating to Gold as a Stabiliser was driven by its long-term correlations to US government bond yields and in turn inflation expectations. The chart below illustrates this point clearly up until late 2021 but also highlights a breakdown in the longer-term correlation over the past three years. In the chart, the gold price is inverted, so it is rising when the yellow line is going down.



Source: Tacit Investment Management.

There are two ways in which this correlation can reassert itself. One is by yields on US bonds falling materially, the second is by the gold price falling back towards $1800. The question investors must ask themselves, is which is the most likely moving forward, and this will then dictate gold's role in portfolios.

Baron Rothchild said he only knew two men who could value gold – a clerk in the Banque de Paris and a Director in the Bank of England. Unfortunately, they both disagreed on its value. This is the difficulty with “investing” in gold. Its true value is opaque but its job in a portfolio is no longer clear either. We continue to research and discuss gold as a team as its behaviour is perplexing to us. Maybe the longer-term correlations no longer stand; in which case our outlook must change. But if they haven’t, this could be a value trap with no cash flows to offset a valuation fall.