

All That Glitters Is Not Gold



William Hammer, Jr.

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“Operations for profit should be based not on optimism but on arithmetic.”

-Benjamin Graham

Having suffered a three year period during which “black swan” events became a black swan parade, many investors see hyperinflation as the next black swan.

Consequently, inflation-phobes around the globe are loading up on what they perceive as the best inflation hedge—gold. Yes, gold has historically been a reliable store of value, especially during uncertain and challenging times. Yes, gold cannot be created out of thin air like money printed during a potential QE3, so it cannot be diluted like currency. Yes, it is something that you can literally hold onto, unlike your paper ownership in stocks, bonds, or mutual funds. Yes, gold has delivered strong returns over the last two years. So why might gold not be a great investment?

Gold has no economic reason for delivering a return. For something to have an expected return, it must produce something. Commercial properties have tenants who pay rent every month. Bonds have interest payments. Stocks have earnings that can grow and be distributed to shareholders. Gold, by itself, produces no cash flow.

Given some basic facts about the current and future cash flows of an asset, a reasonably astute investor can estimate a fair value for that asset. But how can we estimate the fair value of something that never throws off any cash? A promising business might be a good investment at 15 times earnings, but is it still a good investment at 90 times earnings?

Gold, like all non-income producing assets, can only be valued like a Picasso painting, which has nothing to do with cash flow or economic value. The fair value of the Picasso, or gold for that matter, is whatever someone else is willing to pay for it. The price is set by opinion, not economics. Yes, the same can be said of the short-term fluctuations of stocks and bonds, but the market eventually gets those values right.

So how can we know if gold is a good investment if we have no way of determining a fair price? Are we paying

10 times “earnings” for gold or 200 times “earnings”?

With potential inflation on the horizon and a declining U.S. dollar, some might feel that investing in gold is a good idea. In theory, they might be correct. But at what price does the risk of gold outweigh the possible reward? At \$1400 an ounce? \$2000? \$5000?

Understanding price in relation to value is the heart of investing, so gold can hardly be called an investment since we cannot determine its price or true value. **We invest when we put our capital at risk in order to earn a return. The return we expect is based on the price we paid and on the future cash flows that the asset produces. Since we cannot know the relationship between price and value, gold is thus a speculation.**

With \$1 trillion in cash, we could buy the gold holdings of U.S., Germany, China, and the 17 countries of the Eurozone¹. For that same price, we could also buy every share of Walmart, Apple, Google, McDonald’s and General Electric². Which would you rather do? Which do you think would produce more value for you over time?

Regardless of whether the future brings deflation, stagflation, inflation, or hyperinflation, I would much rather own great global businesses with the ability to raise prices and that earn money every second of every day than sit around staring at my gold, hoping that someone else will pay more for it tomorrow.

So what role should gold play in a serious investment program? Howard Marks, Chairman of the \$70 billion Oaktree Capital, recently wrote in a shareholder letter, *“Gold has no financial value other than that which people accord it, and thus it should have no role in a serious investment program.”* I could not agree more.

If you must buy gold, understand that you are speculating, not investing. **FA**

¹ International Monetary Fund

² By no means am I recommending these specific companies. They are being used purely for illustrative purposes.

William Hammer, Jr. is the vice president for wealth management at Vanderbilt Partners, Melville, LI. He can be reached at 631-845-5100 x3810.

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