DOWLING
& YAHNKE
WEALTH ADVISORS

The Golden Ticket:
Should You Invest in this Precious Metal?

Gold is used today as a raw material in various industries and is also considered a precious metal. Historically, gold has been considered a medium of exchange and store of value. It was widely used as money before the introduction of paper currency. Although gold was once used as a medium of exchange, today it can be considered a speculative investment because it does not produce goods, services, and/or a cash flow.

Is Gold a Hedge to the Stock Market?

It is true that in times of crisis, gold can experience speculative price increases when stock prices are declining. For that reason, many investors are attracted to it, typically <u>after</u> stock prices have decreased and the price of gold has increased. However, we have no way of predicting stock market downturns. Therefore, having a permanent hedge in place might seem like a reasonable idea. Why don't we do it?

A Few Reasons (see table below for further data and disclosures):

1. The effectiveness of gold as a hedge against stock volatility is low, as indicated by a correlation of 0.06. An effective hedge would exhibit a negative correlation close to -1.0 with equities.
2. This near-zero correlation to stocks might suggest gold is an effective portfolio diversifier. However, gold also exhibits lower long-term returns compared to short- and intermediate-term government bonds, which are also considered an effective diversifier of stock market risk. Dowling & Yahnke's fixed income portfolio emphasizes shorter duration and higher quality bonds, which are better positioned to provide diversification and stability.
3. This can further be seen in how all these investments perform in months with negative stock market returns. While gold does have slightly positive returns, it trails meaningfully behind high quality bonds, which in addition also exhibit much lower volatility and negative correlations to stocks.
4. Another way to look at the cost of investing in gold is in terms of its volatility — essentially the same returns as short-term government bonds, with almost seven times the standard deviation.
5. Implementing a position in gold comes with substantial costs:
    - High storage, security and trading costs: Whether physically owning gold bullion or investing through an Exchange-Traded Fund (ETF), the cost of custody and insurance for gold erodes returns over time. For example, iShares Gold Trust ETF (IAU) trailed the price of gold by 0.35%[1] on an annualized basis.

- Unfavorable tax treatment: Gold investments are considered by the Internal Revenue Service (IRS) as collectibles, subject to long-term capital gains tax equal to the investor's ordinary income tax rate, up to a maximum of 28%. This is meaningfully higher than the 15% long-term capital gains rate for most other assets, or a 20% maximum rate applying to high-income earners. Short-term gains are taxed similarly with other investments.[2]

Monthly Return Data from 1/1979 to 6/2020 (498 observations)	Annualized Returns	Annualized Standard Deviation	Correlation to Russell 3000 Index
Russell 3000 Index	11.70%	15.24%	1.00
Gold Spot Price	5.10%	18.36%	0.06
One-Month US Treasury Bills	4.30%	1.04%	0.01
Bloomberg Barclays U.S. Government Bond Index 1-3 Years	5.90%	2.77%	0.06
Bloomberg Barclays U.S. Government Bond Index Intermediate	6.70%	4.15%	0.04
Monthly Returns for Months with Negative Returns for Russell 3000 Index from 1/1979 to 6/2020 (173 observations)	Annualized Returns	Annualized Standard Deviation	Correlation to Russell 3000 Index
Russell 3000 Index	-36.00%	11.77%	1.00
Gold Spot Price	2.40%	19.05%	0.03
One-Month US Treasury Bills	4.70%	1.04%	0.07
Bloomberg Barclays U.S. Government Bond Index 1-3 Years	5.90%	2.42%	-0.14
Bloomberg Barclays U.S. Government Bond Index Intermediate	6.70%	3.81%	-0.15
Source: Dimensional Fund Advisors			

Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

SUMMARY

The evidence presented above raises doubt about gold as an essential component in a portfolio. Over time, gold has not delivered significant growth relative to equities. While in real terms gold may preserve its value over long time periods, it does so with significant volatility, and it may not closely track inflation over shorter time periods. Moreover, gold's recent performance should not obscure the two decades in which it depreciated considerably. Finally, gold exhibits volatility more in line with other risk assets like stocks negating the potential benefit as a portfolio stabilizer.

[1] yCharts Annualized Return since Inception for IAU against Price of Gold in USD (1/21/2005 - 6/30/2020)

[2] https://www.irs.gov/taxtopics/tc409