# Is Gold a Safe Investment?

The answer isn't as simple as you may think if you look at the big picture gold plays in the investing world.

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Gold is a physical commodity subject to the vagaries of supply and demand. The value of gold often changes quickly, and gold's price moves can be quite large at times. It also has a habit of performing poorly when the stock market is doing well.

For all these reasons, it's easy to jump to the conclusion that gold is an unsafe investment. Which would be true if the only thing you owned was physical gold or gold-focused mutual funds and exchange-traded funds (ETFs). If you use gold as part of a larger, diversified investment plan, however, it is not only safe to own but can provide you with positive returns when the rest of your portfolio is struggling. Here's why gold can be a safe investment, when used the right way.

## The drivers of gold demand

Gold's primary use is for jewelry, which makes up roughly 50% of gold demand. Another 40% of demand comes from the physical investment in gold by individuals and central banks, and includes gold coins, bullion, medals, gold bars, and demand from ETFs and similar products that invest directly in gold on behalf of others. The remainder of demand is largely industrial in nature (dentistry, for example).

Step back from those statistics, and it's clear that roughly 90% of gold demand is based on its intrinsic value. This is something of a historical issue, since the world basically chose gold as a currency thousands of years ago. In fact, at one point, most paper money was backed by a country's holdings of physical gold. That time has passed, of course, with fiat currencies now backed by the promise of a government to make good on its obligations.

IMAGE SOURCE: GETTY IMAGES.

Although governments have decided it's easier to be off the gold standard than on it, that doesn't change the central issue that backs gold's intrinsic value and safe-haven status: There's only so much gold in the world. The gold that's above ground being used in some fashion is estimated to be around 190,000 metric tons. The amount of gold in the ground that can be economically mined today is notably less, at roughly 54,000 metric tons.

This is a big issue: If someone wants another ounce of gold, they have to dig it up. And aside from hiding gold, there's no realistic way to make it disappear. Meanwhile, no one will be making any more of it (as Medieval alchemists proved long ago), leaving technological advances and price increases as the only ways to increase the economically viable reserve of gold. Although it is the balance between supply and demand that results in a price for gold, the physical nature of it is what provides its intrinsic value. By contrast, if the U.S. government wants another dollar, it just prints one.

## Gold is a volatile investment

So gold is a physical asset that we wear as jewelry or own in the form of coins and bars, with supply and demand driving the price. But to get an idea of what that means relative to other assets you need to look at some statistics, like standard deviation. Standard deviation is the degree to statistics, like standard deviation. Standard deviation is the degree to which the price of something varies from its average over a given period of time, with lower numbers suggesting less price variability.

Over the trailing five year period through March 31, 2018 the standard deviation of gold, using ETF **SPDR Gold Shares** (NYSEMKT:GLD) as a proxy (more on this gold-owning ETF below), is 16. The annualized return over that span was a loss of around 4%. Putting those two numbers together, there is a reasonable probability that gold will provide a gain of between 12% and a loss of 20% in any given period. That's a pretty big range that dips soundly into negative territory. By comparison, the standard deviation of the S&P 500 Index over the same span was a little under 10 with an average annualized return of about 13%, suggesting the expected range was between a gain of 23% and a gain of 3%. Which one sounds safer to you?

To be fair, standard deviation and annualized return vary over time. Moreover, investments sometimes break out of these statistical ranges. However, gold's standard deviation has been higher than that of the S&P 500 over the trailing 3-, 5-, and 10-year periods. Gold's higher level of volatility is the norm, not the exception.

## Gold is risky, and that's not all bad

The thing is, gold and stocks don't always do the same thing at the same time. For example, when the stock market is doing well, gold often lags behind. And since the market has a long history of heading higher over time, owning gold as your only investment would clearly be a risky proposition. But the interplay between stocks and gold is where gold's value lies for investors -- and why it can be a safe investment if you use it properly.

An important way to examine the relationship between assets is by looking at correlations. Effectively, how do two investments move in relation to each other. For example, the correlation between the entire stock market and just the midcap segment over the past 10 years or so is roughly 0.98. That means they move in virtual lockstep, as you might logically expect. Gold, however, has a correlation with the stock market of 0.04 over that same span. Essentially, gold does its own thing.

## A portfolio approach to owning gold

When you pair assets that move differently from each other, you create a more diversified portfolio. This is why mixing bonds with stocks is the foundation of so many portfolios. Bonds have a negative correlation with stocks, meaning they tend to go up when stocks are going down, and vice versa. Here's the interesting thing: Gold's correlation with bonds over the past decade or so is roughly 0.25, still very low. So gold doesn't track along with stocks, and it doesn't track along with bonds, either. Adding a small amount of gold to a stock and bond portfolio -- probably no more than 10% -- can help increase diversification and the ultimate safety of the entire portfolio.

A real world example here might help. Between Nov. 30, 2007, and June 1, 2009 (the deep 2007-to-2009 recession), the S&P 500 Index fell 36%. The price of gold, on the other hand, rose 25%. That's a particularly dramatic example, but it highlights why investors can benefit from owning gold despite the fact that it is a more volatile investment option. Essentially, when stock prices are going south, gold is likely to be appreciating in value as investors search out safe havens for their cash.

## How should you own gold?

So it should be pretty clear at this point that gold in and of itself can be a risky investment. But if you use gold appropriately, it can provide an offset to other assets that aren't performing well. And the interplay between gold and those other assets is what helps to create diversified portfolios. No, don't invest 100% of your saving into gold in any form. Yes, consider adding a small allotment of gold to your portfolio. But how should you invest in the metal?

## Physical gold: Not a great choice for investors

The most obvious answer is to run out and buy some gold coins, bars, or jewelry. This isn't the best option for investors. For example, there's a huge markup on jewelry, which makes it a very bad investment choice. But there's also likely to be a markup on coins and bars that gets put into the price quoted from dealers. After all, they have to make a living and be compensated for acting as the intermediary between buyers and sellers.

You also have to consider what you will do with the gold you buy in this scenario, which could mean buying a safe or paying for a bank safe deposit box. It's a perfectly fine way to own gold, if that's your goal, but it isn't the best way to invest in gold. And to fully benefit from the portfolio diversification gold offers, you'll need to rebalance your portfolio every so often as you take advantage of investors rushing to gold because it is viewed as a safe haven.

## Gold linked ETFs: Better, but...

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The next best thing to owning physical gold is buying an investment that counts physical gold as its primary asset. The easiest examples of this are ETFs like aforementioned SPDR Gold Shares. This particular ETF has an expense ratio of 0.40% and tracks gold prices pretty closely over time. It's probably the next best thing to physically owning gold, but unlike physical gold it can be easily traded.

That makes rebalancing a portfolio as simple as calling your broker -- for most investors selling gold coins or bars would require pulling them out of storage and taking them a dealer. The problem here is that an ounce of gold is always going to be an ounce of gold. Its value is tied totally to supply and demand. For a purist that's perfect, for most investors however it makes sense to find something that will track gold but provide's a little more upside.

## Miners: Still some notable issues

After that, investors are often attracted to gold miners like industry giants **Barrick Gold** (NYSE:GOLD), **Goldcorp**, and **Newmont Mining**. The shares of gold miners usually track the price of the metal and they can invest in their assets to increase production over time. The shares of miners, however, come with additional risks. For example, many miners are focused on gold, but that's not the only metal they produce. Barrick gets around 90% of its revenue from gold; the rest comes from copper and other sources -- it's not exactly a pure play.

And then there are operational issues, since mining is expensive, time-consuming, and often dangerous. A problem at a mine, a major exploration success, or any number of other operational issues can cause a miner's stock performance to diverge materially from the price of gold. Small miners, meanwhile, often provide the most upside opportunity and downside risk, since tiny moves in the price of gold can sometimes be the difference between these miners making a profit or losing money. And then there are companies like **Northern Dynasty Minerals**, where the only asset is a mine under development. The stock is cheap today, making it something of an option on the price of gold since the value of the mine (called the Pebble Project) won't be realized for years. But if the Pebble Project gets built, Northern Dynasty could see material stock-price gains.

At the end of the day, if you choose to get your gold exposure by owning mining shares, it might be best to buy a mutual fund that focuses on precious metals companies like the aptly named **Midas Fund** or an ETF like **Van Eck Vectors Gold Miners ETF** (NYSEMKT:GDX). Note, however, that mutual funds and ETFs like these usually have broadly diversified portfolios that will result in exposure beyond just gold miners. That's not inherently bad, but it does change the dynamics of the investment a little bit.

## Streaming: The best of the bunch?

Another option for investors is to buy a streaming and royalty company like **Franco-Nevada Corp.**, **Royal Gold Corp.**, or **Wheaton Precious Metals.** These companies provide cash up front to miners for the right to buy gold and silver in the future at contractually pre-set, reduced prices. Miners use the cash to do things like build new mines or expand existing facilities.

Rather than being miners, they are more like specialty finance companies that get paid in precious metals. The low prices they pay help to lock in wide margins regardless of the price of gold, and their investment approaches all result in wider mine diversification than you would likely get from owning a single miner. And all three of these companies have reliably paid dividends for years, which can help investors to stick around through the entire commodity cycle to achieve the full diversification benefit gold can offer. Streaming companies are probably the best all-around option if you are looking to buy gold, providing diversification, direct exposure to gold, and upside potential from the gold projects they back.

## So, is gold a safe investment? The answer is yes and no

This article started off looking to answer a very simple question: Is gold a safe investment? Like so many things in life, however, simple questions can have very complex answers. In the case of gold, it is a risky asset class, and it would be unwise to invest only in gold. However, because gold is viewed as a store of wealth, you shouldn't dismiss it as an investment option. Investors tend to flock to gold when they are scared, which boosts its value when assets such as stocks are falling. It just needs to be paired with a more broadly diversified portfolio so you can benefit from the non-correlated nature of gold's performance. And, yes, that will require rebalancing your portfolio every so often, maybe once a year or when allocations get materially out of line.

Then there's the question of how to own it, which is equally complicated, with coins and bullion, ETFs, mutual funds, miners, and streaming companies among the various investment options. However, if you take some time to get to know gold and the different ways in which you can get exposure to the metal, I think you'll find that it isn't as risky as some people think and deserves a small place in your otherwise diversified portfolio.