TCM INSIGHTS

GOLD: FACTS & PERSPECTIVE

Recently Warren Buffett reported that he made his first stock investment in March 1942—a time when everything appeared bleak for the free world. America was still recovering (mentally and physically) from Pearl Harbor, Japan was expanding unchecked in the Pacific, and the Nazis had a stronghold in much of Europe.

At the time, a $10,000 investment could buy about 300 ounces of gold—which looked like a good, tangible, safe-haven asset in a very turbulent world. Alternatively, the same $10,000 could have been hypothetically invested in the S&P 500 Index (index funds did not exist yet), with dividends left to compound. Conversely, an investment in gold would have set untouched in a vault or safe deposit box earning no dividends. If left untouched, today the investment in the S&P would have been worth about $51 million while the 300 ounces of gold would be worth about $400,000.

"In other words," quoth the sage, "for every dollar you could have made in American business, you'd have less than a penny of gain by buying into a store of value which people tell you to run to every time you get scared by the headlines."

The reason for such an astronomical difference in ending values is found in the investments themselves. By nature, businesses generate economic growth and productivity. They create jobs, reinvest in new plants, innovate, meet the needs of society, and over time raise the standard of living. On the other hand, gold does none of these things. It is a precious metal with a finite supply, and other than being used primarily for collector coinage and jewelry, creates no economic growth.

The Truth

Simply put, gold doesn't really go up; rather, the value of the dollar goes down. Gold's primary function is simply an inflation hedge. The sad reality is that it barely accomplishes this purpose over the long-term—and if one measures from any previous peak in gold's occasional popularity, it doesn't accomplish it at all.

A more recent example is helpful to understand this investing truth. In early 1979, the price of gold was under $300 an ounce. Then in July of that year, Carter's malaise speech set off a precipitous run-up, leading to a peak of $875 the following January.

Currently, gold is trading around $1,275 an ounce, while the Consumer Price Index stands at 3.22 times what it was in January 1980. This means that to maintain the idea that gold is an efficient inflation hedge, it would be selling around $2,800 an ounce to be worth what it was at its peak almost four decades ago (in real terms). Notably, the current dollar price is less than half that, meaning those who invested in gold at its last great peak have now lost half their money, assuming one defines money as "real purchasing power."

As powerful as this example is, however, it is a tangent off the point that Buffett was making, which ignored inflation. In January 1980 (gold's last great peak) the S&P 500 Index was valued at 111. Today it sits at over 2,700. In nominal terms, gold is up about half again versus its 1980 price, while the S&P 500 is up around 24 times where it was then. Netting out inflation, gold has lost half its real value while equities are up seven and a half times their beginning value.

The best inflation hedge was, is, and always will be quality stocks. They are the greatest generator of real wealth ever devised by man. Stocks are, after all, the only asset class that captures the full power of human ingenuity.

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