

GOLD – THE ASSET CLASS THAT GLITTERS...BUT WHY?

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When market volatility rears its head, the investment merits of gold resurface. For instance, as of March 9, 2020, the S&P 500 Index was down 13.6% while gold was up 8.6% – a difference of more than 2,000 basis points. In other words, if any asset class has a defensive nature, it's gold.

That said, gold is often a misunderstood and mistimed asset class. From an investor's perspective: What drives the price of gold? What are the advantages and disadvantage of using it in a diversified portfolio? What investment vehicles give the most access to gold?

What drives gold?

Unlike many asset classes, gold has a tangible quality. You can touch, feel, and make jewelry out of it, but what drives the price movement of gold in the markets? Turns out it's a few different quirks specific to gold as an asset.

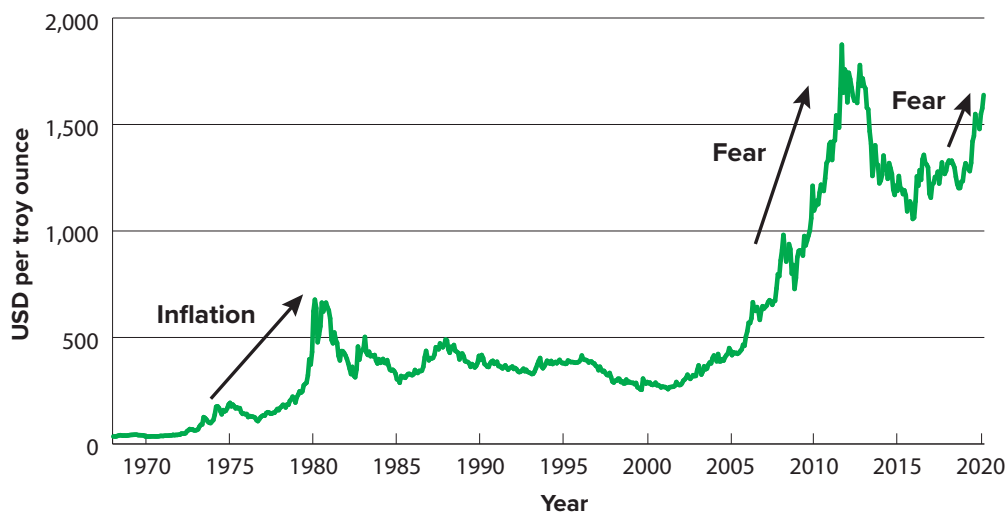
Fear: The fourth quarter of 2018 provides a good example of investors' tendency to flock to gold in hard times. During the quarter the S&P 500 fell 13.52% while gold rose more than 7%. This is yet another example of a 2,000 basis point difference occurring in a short amount of time. When investors are fearful, they flock to gold as a perceived safe haven. Some investors find comfort knowing their investment is backed by a hard asset.

But fear does not always work in gold's favor. In instances when stock market fears are running at abnormally high levels, investors may liquidate gold in order to raise cash. Those instances are rare and usually short lived, however.

Inflation: Gold can also be a hedge against inflation when inflation is high and persistent. One notable example occurred from the mid-1970s to early 1980s when inflation was a pressing problem.

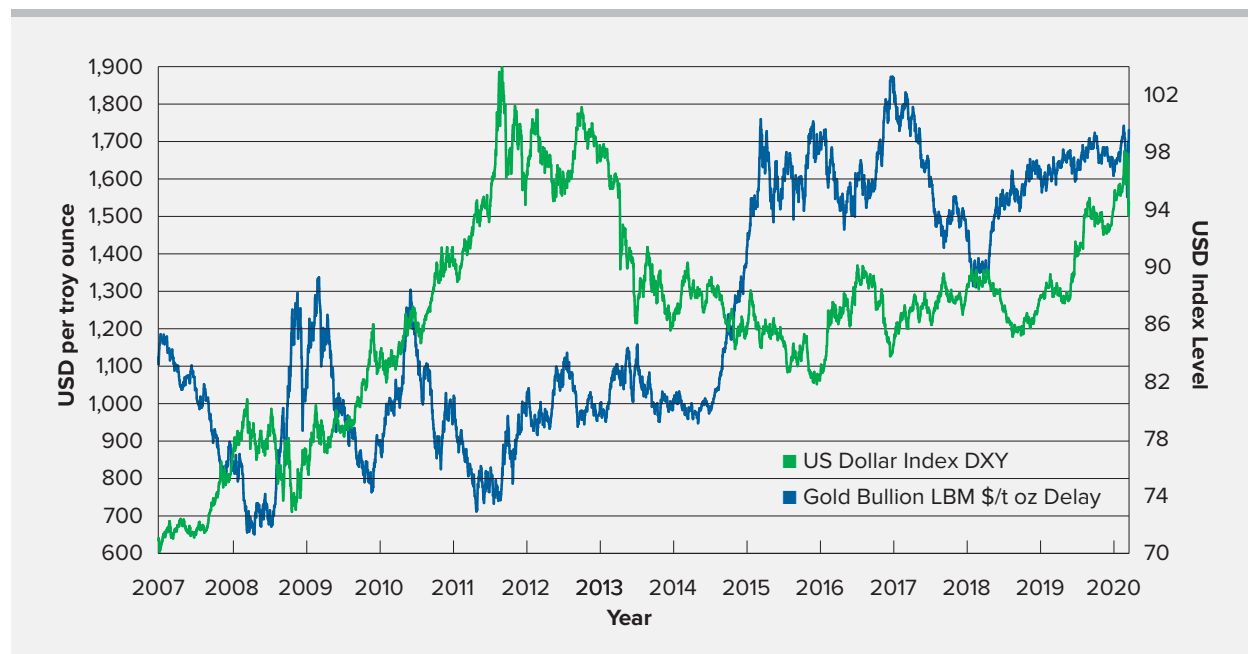
GOLD AS AN INFLATION AND FEAR HEDGE

Global Gold Price



The dollar: Gold tends to have an inverse relationship with the U.S. dollar. When the dollar increases in value relative to other currencies around the world, the price of gold usually falls in dollar terms. The reverse is true when the dollar loses value relative to other currencies. The chart below shows this mirror-image behavior.

GOLD AND THE DOLLAR – MIRROR IMAGES



Source: Thomson Reuters Elkton

Advantages and disadvantages

One of the first advantages of gold is that it usually has portfolio diversification benefits. For example, the correlation between gold and the S&P 500 tends to be low if not negative at times. In other words, gold zigs when stocks zag.

GOLD – LOW CORRELATION TO EQUITIES

	5-Year Correlation with Gold
S&P 500 TR USD	-0.03
MSCI EAFE USD	0.07
MSCI EM USD	0.29
Russell Mid Cap TR USD	-0.03
Russell 2000 TR USD	-0.19

Source: Morningstar, Inc. as of February 2020

Another advantage of gold is that the average person knows exactly what it is – it doesn't have a lot of complexities. If investors so choose, they can actually buy gold coins or bars to hold in their hands.

Since gold is a commodity with a seemingly limited supply (outside of market-driven demand tied to inflation and fear), investors often take comfort knowing that demand will consistently exist as a material for making jewelry and for its use in the electronics, aerospace, and manufacturing industries.

However, one of the most notable disadvantages of gold is that it does not pay a dividend. It is an asset that has no cash flow prospects whatsoever. As such, it can be at a disadvantage when demand for income is high.

Since there is no long-term income or cash flow, another disadvantage is that gold is naturally a speculative investment. Investors can significantly damage long-term portfolio returns if they mistime investments.

If your client seeks to purchase a significant amount of physical gold, there are storage costs to consider (assuming he or she keeps it safe in a depository).^{*} Paying to store gold can be a tough concept for some investors to embrace.

The last potential disadvantage is that gold is not necessarily a tax-friendly asset class. It is taxed as a collectible. Based on current tax law, gains that are realized from the sale of collectibles that are held for more than a year are taxed at the maximum federal rate of 28%, rather than the 20% rate that applies to most other long-term gains.

How can I access gold?

Easier and often more cost-effective ways to invest in gold include ETF and mutual fund investments. However, before putting money in these vehicles, investors should look closely at each fund's underlying holdings. Why? Because some funds will own true gold bullion while others may just own gold mining companies, an important distinction.

Gold mining stocks may directionally track the price of gold, but by investing in them you invest in a public company and the issues that come with it. How will the company's capital allocation decisions impact their share price? Are revenues rising or falling? Do they have so much debt that they're on the verge of bankruptcy? All of these issues are nonexistent when investing in physical gold. In the end, gold mining companies are a nice diversifier, but they may have more correlation to traditional equities than physical gold does.

If your clients want to invest in something that tracks the spot price of gold in a cost-effective way, consider the SPDR Gold Trust, ticker GLD. SPDR Gold Trust is a large, liquid ETF with over \$50 billion in assets under management and an expense ratio of 40 basis points. It can be accessed via *MAPDirect*.

For a list of available gold-related funds, please look in the Sector section of the Research Lists in the Morningstar Advisor Workstation.

^{*}Waddell & Reed advisors cannot sell, recommend, or provide investment advice as it pertains to physical gold.

MAPNavigator Recommended Funds

For more information contact Ryan Hodapp at 913-236-3849 or rhodapp@waddell.com

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