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ASK: NUS ECONOMISTS

A golden investment but not without risks

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IS GOLD a good hedge against inflation? Is it always a good investment?

An asset is considered a good hedge against inflation if changes in its returns systematically offset changes in the general price level of a particular country.

In recent decades, real assets such as precious metals and real estate have displayed a steady growth rate, generally keeping up with the 2-3 per cent annual US inflation rate. Before the recent financial crisis, for instance, the United States' real estate sector was steadily producing a handsome annual return of above 6 per cent from 2000 to 2006. However, not only has there been a significant decline in the US real estate sector – the Housing Price Index fell by 23 per cent from 2007 to 2010 – its recovery is still uncertain.

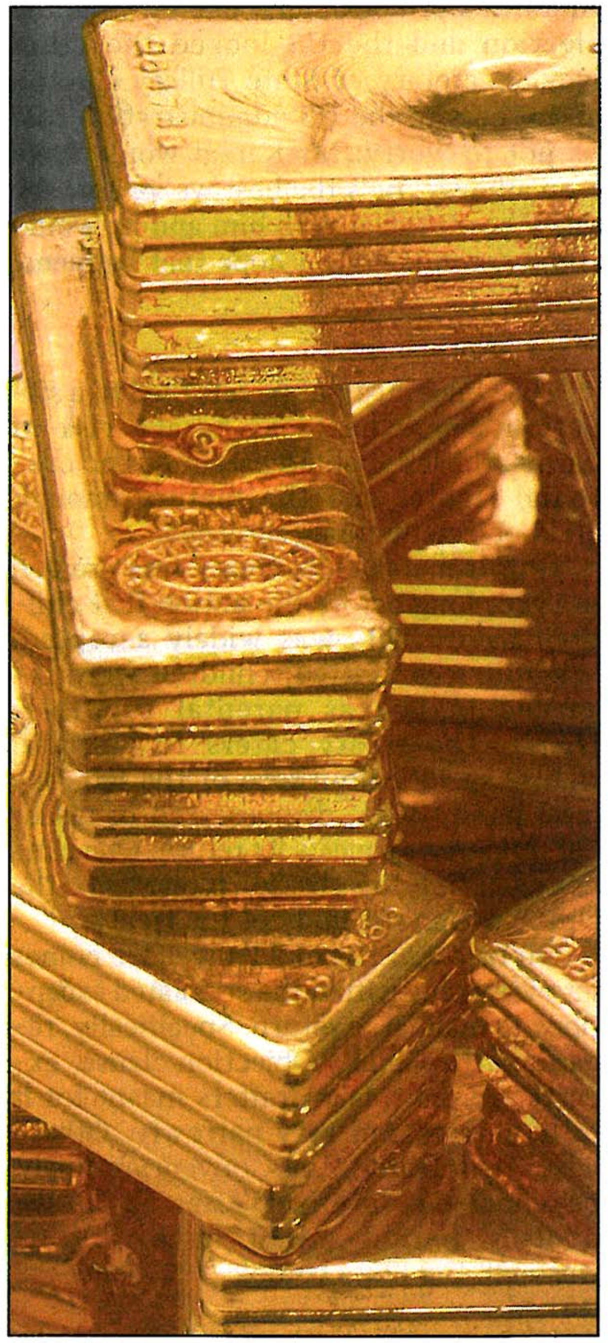
Meanwhile, gold prices have steadily risen and provided investors with approximately a 190 per cent return on an investment with a 20-year horizon. Though gold is denominated in US dollar, and the purchasing power of the dollar has decreased by about 35 per cent over the same 20-year period, the annual return on gold is still about 4.4 per cent.

For these reasons, US investors nowadays are attracted to gold. Worry that the massive fiscal and monetary stimulus packages that the US government introduced in response to the 2008-09 financial crisis might spark inflation in the near future is an additional reason to buy gold.

Moreover, precious metals are more accessible than real estate and require smaller initial investment amounts. Some researchers also believe that adding gold to a well-diversified bond and stock portfolio may provide diversification benefits in terms of lower volatility and higher overall return.

That said, investors need to be cautious about their investment timing and holding horizons. The monthly correlation between the consumer price change in the US and change in gold price was actually -0.06 from January 1991 to March this year. Instead of profiting from March to December 2008, gold investors actually experienced a price decline of approximately 16 per cent. If inflation is the chief concern over the short-term, investors can easily purchase Treasury Inflation Protected Securities or TIPS instead.

Furthermore, considerations that may apply to US investors may not be applicable to Asian investors or to those heavily invested in Asian countries. For example, the residential real estate sector in Singapore experienced a much smaller fall and a faster recovery over the 2007-09 timeframe than the US real estate sector. The current private residential price level is again close to its peak.



Gold is attractive but there is evidence that it is not a good hedge or safe haven in Japan and Australia, or in the emerging markets of Brazil, Russia, India and China. ST FILE PHOTO

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Moreover, the Singapore dollar is actively managed by the Monetary Authority of Singapore to maintain a low inflation rate – an average of just 1.4 per cent from 1994 to 2010. Therefore, gold may not be that attractive to – and it is certainly not the only option for – local investors.

Indeed, there is evidence that suggests gold is not a good hedge or safe haven in Japan and Australia either, or in the emerging markets of Brazil, Russia, India and China.

Another word of caution for individual investors: gold does not only attract retail investors but also large institutional players, such as central banks. While many central banks are currently supporting the gold price by buying gold for their reserves, they may change their behaviour one day and sell gold and push down its price. Central banks have different investment incentives as compared to retail investors.

Lastly, investors should also consider other important factors – such as change in gold supply from mining and scrap – before putting their savings into gold.

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