Q: Is gold a good equity hedge?

Brian Lockhart, CFP®: On the surface, gold is not a particularly effective hedge against equity market risk because there is no direct economic theory or compelling fundamentals that suggest gold and stocks are negatively correlated when stocks are correcting. There are certainly periods of time when gold did well when stocks were performing poorly but there simply is not sufficient data to suggest gold would consistently serve as an effective hedge against equity risk.

This may miss the point, however. Gold always has been considered a “safe haven” and that is unlikely to change in the foreseeable future. To the degree that stocks are retreating from a non-systemic risk event, the markets’ assets often flow to a safe haven like gold. Gold tends to be very effective when safe haven assets surge in price, whether gold or Treasuries. The challenge is that many equity corrections do not involve a flight into safe havens, so hedging with gold in those periods would not be effective.

I would view gold as a currency hedge, particularly against the U.S. dollar, since it is the reserve currency of the world. There is compelling data that shows negative correlation to the greenback. Because inflation typically causes a currency to fall, gold is imputed as an effective hedge against inflation, although that relationship is known to break down. I would also be in the camp that gold is a good hedge against Central Bank policy errors.

Clint Pekrul, CFA: Gold has been in the headlines recently, given its recent move higher. Currently, an ounce trades for roughly $1,570, which is roughly 16% higher than it was a year ago. I think some investors view gold as a safe haven in times of turmoil. It’s a rare, precious metal that cannot be devalued like currencies. So, I can see how gold can be considered a store of value. Indeed, if you look at the recent history of gold price returns, they do exhibit a low to sometimes negative correlation to other asset classes, such as equities. In particular, when stocks fell almost -40% in 2008, gold prices rose roughly 9%. Likewise, when equity markets fell in 2000 through 2002, gold prices moved higher.

But the long-term history of gold is quite clear – its return is highly volatile and cyclical. Furthermore, gold has no intrinsic value. It does not pay a dividend or coupon. My take is that gold’s primary purpose is a means for speculation, and not an investment. Gold’s real, or inflation-adjusted, return over the past two centuries is essentially zero. To me, this means you have to actively trade gold and get the timing right if you want to use it as an effective equity hedge. Bonds, specifically Treasuries, can be quite volatile over the short-run, but at least we get paid to hold them as a dedicated part of an overall portfolio.