

Golden Opportunity

GOLD! The word, the glitter, the prospect of unfathomable wealth, has been the cause of murder and mayhem, wars and unrelenting fascination for as long as history has been recorded. Gold is so important that it is synonymous for money. But having gold nuggets or gold coins, or gold futures contracts, does not mean your portfolio value is rising or safe. This article will explore the past, present and futures of gold and the relationship to currency for perspective on how it can be part of a portfolio.

Most of the gold supplied to the market each year goes into manufactured products, and the remainder goes to private investors and to monetary reserves. Gold has a long history of use as currency or as a reserve backing for other forms of money, but less so today. The gold standard is not currently used by any government, having been replaced completely by fiat currency. A closer look at gold and currencies will explain the portfolio value of this commodity.

Somewhere Over the Horizon

Investing in the financial markets necessarily involves an ability to change perspectives over time. Diversification is a good investment principle but will not protect from systemic risk. Dr. Charles Schaap says, "Diversify into things going up." He does not believe it is wise to hold assets that are declining in value for the sake of being diversified.

To profit from price one must not care whether price goes up or down but know what to do to make money. The example in Figure 1 shows that if gold was purchased at the end of 2007, there is no gain at the end of 2008. Trading the commodity means timing the buying and selling for profit opportunity.

If gold bars or Krugerrands are purchased, then the physical possession of that gold remains the same regardless of the market price. Investment is a choice to risk capital with the hope of gain. Ownership is for the sake of ownership whether or not there is gain.

Diversification of a portfolio means varying the asset classes. Stocks are one asset class. Gold is another. Owning stock is an equity stake in a company. The value goes up or down, changes with the market and the paper certificates can be worth nothing. The value of gold goes up and down, changes with the market but is never worth nothing. Therein lays the major difference. You may not have a profit, but you will own a tangible asset that is always gold, whatever the monetary value.

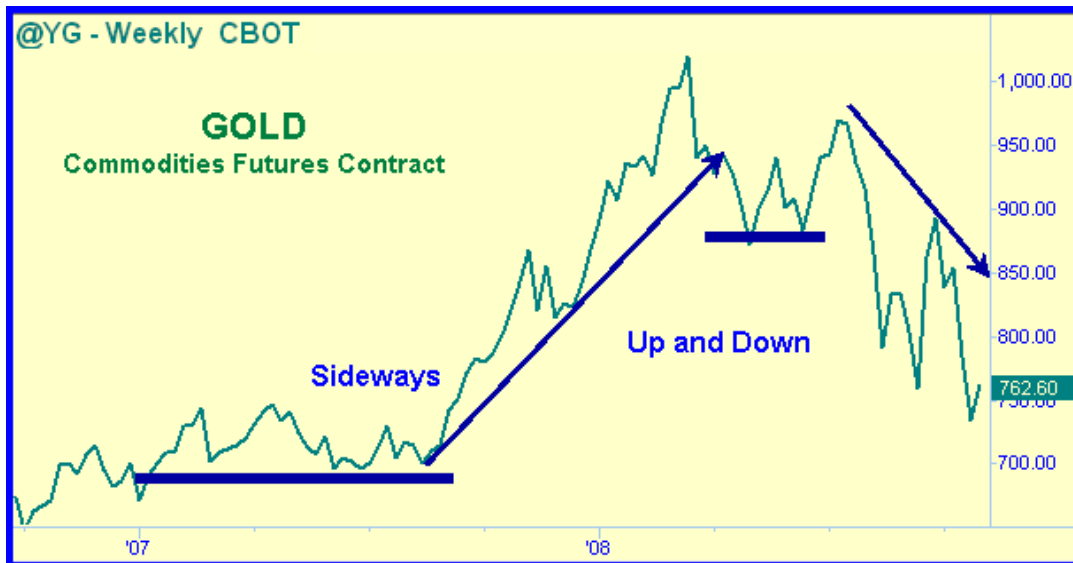


Figure 1: Gold Futures Price goes up, down and sideways. The commodity is the same, the price is not.

Source: TradeStation

Increasing wealth means using money to make more money, and having assets that are gainfully employed. The process of increasing wealth is when an asset is purchased and then sold for a profit.

Portfolio planning also takes into consideration intent. Is the intent to increase wealth or to have gold which can at any time be traded for food or shelter? Both goals can be accomplished with knowledge of the markets. Gold held for an emergency is different than buying a futures contract or stock in a gold industry company. Holding gold against an emergency does not necessarily increase wealth, it can be part of one's wealth, but it can decrease in value, too.

Let's compare buying gold Kruggerands to buying a home. Whether the price of the home goes up or down, you still have a home to live in and it is part of your estate. Whether the price of gold Kruggerands goes up or down, you still hold them and they are part of your estate. Now let's look at buying shares of a stock like GLD. (Figure 2.) If the price goes down from where you buy it, you have lost money and the paper may even become worthless.

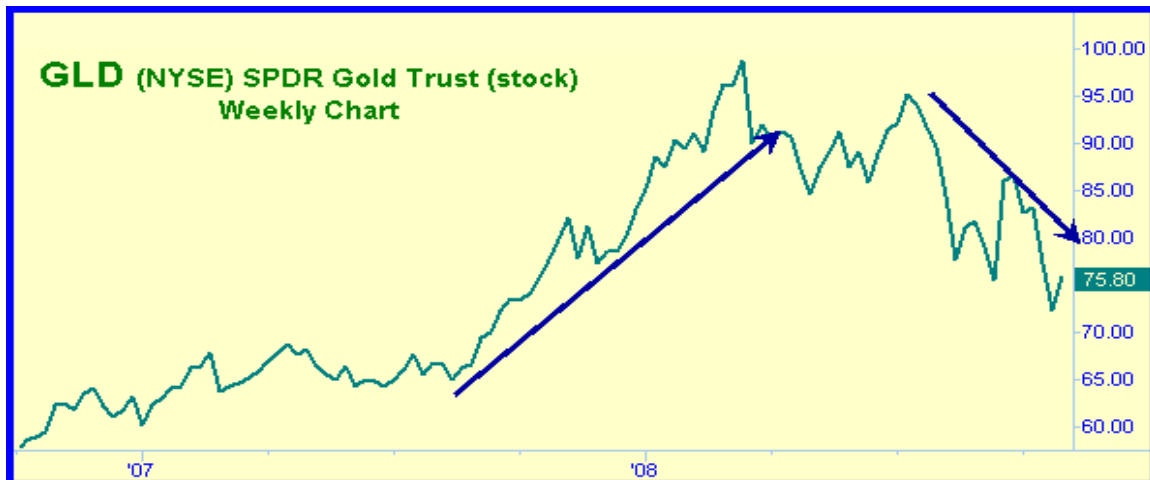


Figure 2: This is the gold trust GLD, compare to Figure 1. It follows the movement of gold, but it is not gold.

Source: TradeStation.

Gold: Past, Present and Futures

There are two ways to invest in the gold market. Buying the physical commodity gold is to have ownership, price will fluctuate but ownership is final. Buying a futures contract or stock is speculation; you do not own any gold but can make a profit.

A gold futures contract is a legally binding agreement for delivery of gold in the future at an agreed upon price. The contracts are standardized by a futures exchange as to quantity, quality, time and place of delivery. Only the price is variable. The contract refers to the commodity 'gold'. Gold stocks are not a commodity in this sense. Stocks from the gold industry, i.e. GG, GLD, sell shares but do not represent any form of gold ownership.

Gold bullion is any type of gold product that is sold for the gold content. The price of gold bullion, in whatever form, follows the daily spot price of gold. The gold bullion market is international. The demand is global. Gold is being traded somewhere in the world at virtually every hour of the day.

The 'safety' of owning gold is having it in hand. Take this old custom: a woman in India cannot inherit and everything she owns, except what she wears, will become the possession of her husband. The family seeks to protect her by draping her in gold on her wedding day. The gold is her safety net.

The Golden Rule

Nothing is gold except gold.

The term 'flight to safety' is usually a reference to gold, the 'currency of last resort.' The premise is that if there is an economic collapse and paper money becomes non-negotiable, then gold will retain value. Gold is a form of money. Currency is any form of money of any country, and money is anything that can be exchanged or bartered for something else. Gold may not be in demand in the event of an economic collapse; sometimes food has more value than metal.

If the desire is to have commodity money as an alternative medium of exchange, buy gold bullion. The Swiss franc is not 'safer' or more valuable than the U.S. Dollar (see Figure 5). Foreign currencies do not replace 'gold' since no country is on the gold standard.

A purchase may require more or less gold, depending on demand, but gold is usually acceptable currency everywhere.

Only gold is gold. Gold stocks are not redeemed for gold. Gold futures contracts are seldom redeemed for gold. Buying into a gold fund or index is not having possession of the commodity gold. Buying foreign currencies is not a substitute for the commodity gold. (Figure 4)

Ownership of gold is accomplished only by purchasing gold bullion. Gold bullion is any type of gold product that is sold for the gold content. It can be gold coins, gold bars or gold jewelry.



Figure 3: Gold Bullion

Source: Photos courtesy of Northwest Territorial Mint/NWTMint.com

Truth and Consequences of Currency Trading

Money and gold may seem the same, and they can all be equally acceptable currency; but they are different. Money is anything acceptable as payment. Currency is often country specific and is represented by paper notes issued by the government; it is 'money' but it is not gold. Gold (also silver) is money and a medium of exchange. Gold can be currency and it is more, it is a tangible asset and the only investment not monetized by debt.

Gold is priced in U.S. Dollar and Figure 4 diagrams the inverse relationship.

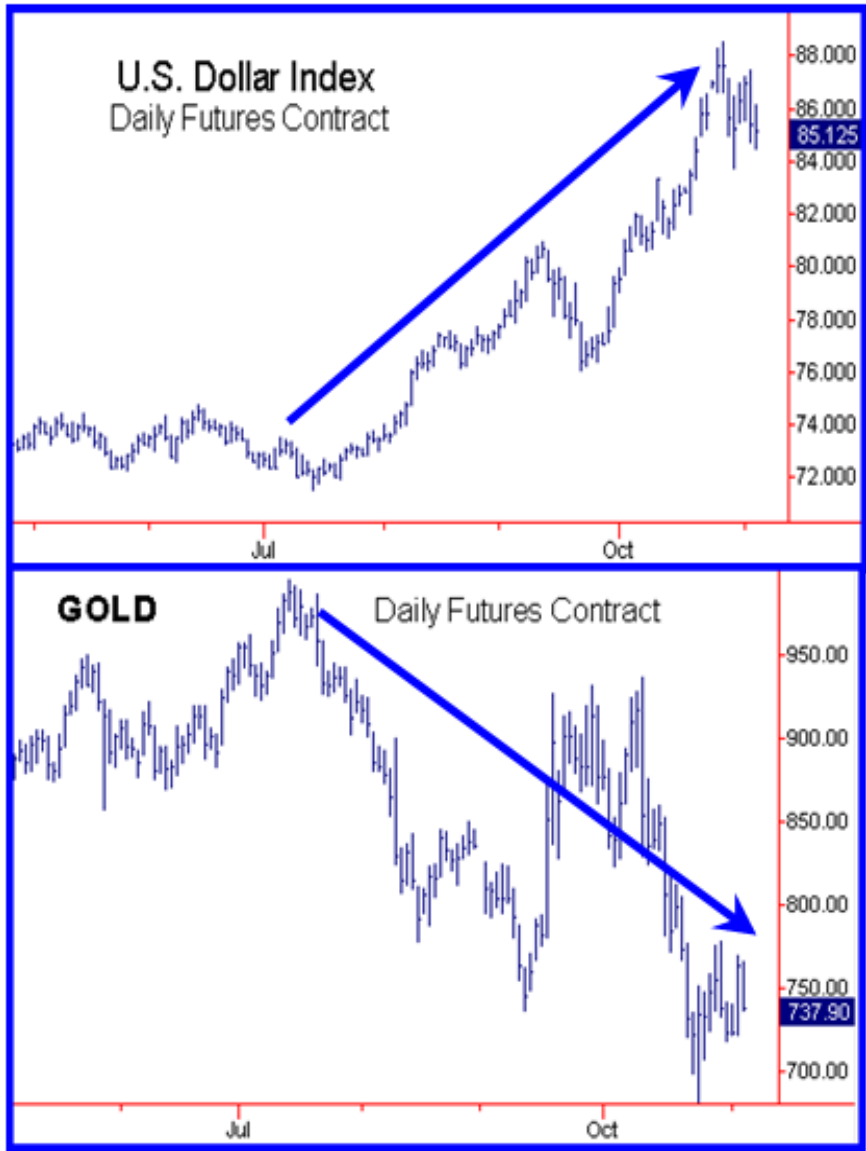


Figure 4: Gold and the U.S. Dollar are inversely correlated. When the dollar rises, gold prices fall.

Source: TradeStation

The next chart (Figure 5) shows an inverse relationship of the dollar and the Swiss Franc. The Swiss Franc moves opposite the U.S. Dollar. The Swiss Franc is positively correlated with gold. Correlations are a good management tool for making allocations in a portfolio.

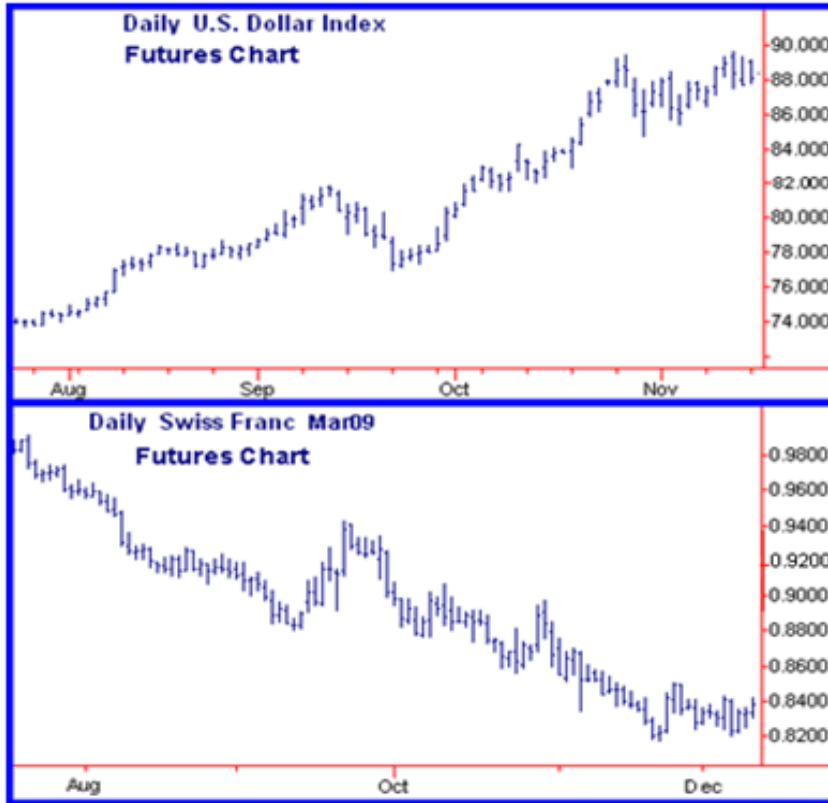


Figure 5: The U.S. Dollar and the Swiss Franc are inversely correlated.
Source: TradeStation

The foreign exchange market (forex or FX) refers to the market for currencies, any time one currency is purchased in exchange for another. The foreign exchange market does not imply any representation of gold. It is plainly one country's currency against another. Fiat money is redeemable in nothing; gold always retains monetary status.

(To learn more see, Common Questions about Currency Trading)

The next chart is a cross rate compared to gold. A currency pair that does not include the dollar is called a cross rate. Pairs of non-US dollar currencies are called crosses; they do not replace another currency. No country's paper notes are convertible into pre-set, fixed quantities of gold.

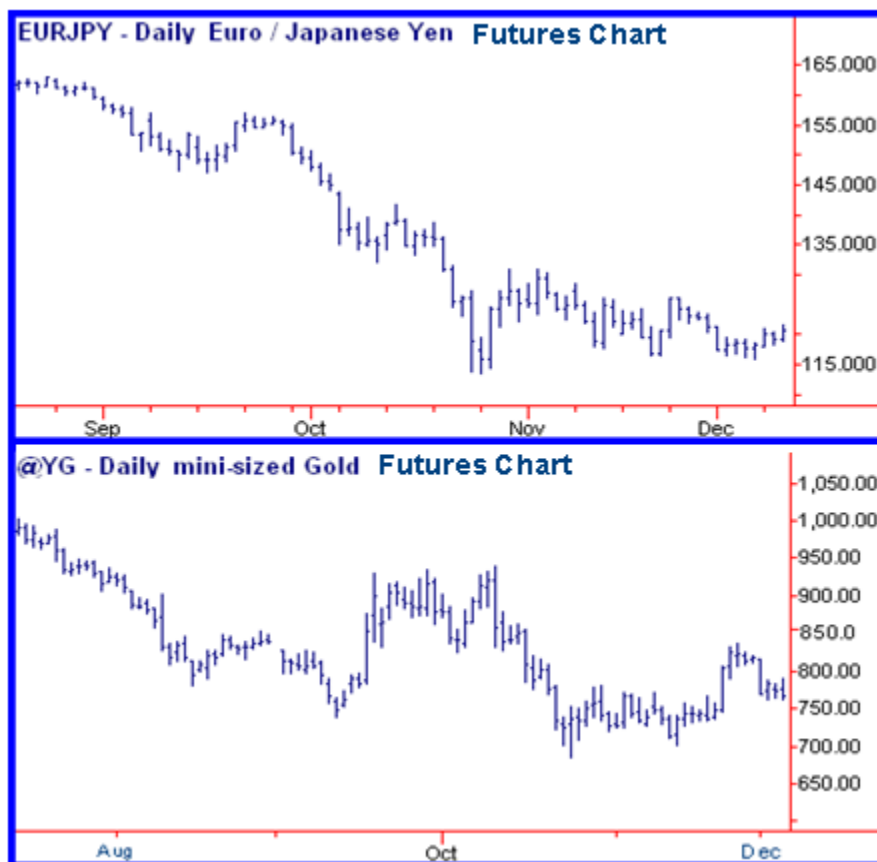


Figure 6: Cross rate currency pair compared to gold, a positive correlation.
Source: TradeStation

The Euro / Japanese Yen pair is positively correlated to gold (Figure 6), the price is up or down at the same time. The purchase of gold and this currency pair is not diversified as the loss or gain is twice as much. (See Article: [Tales From The Trenches: Perfectly Negative Profitability](#))

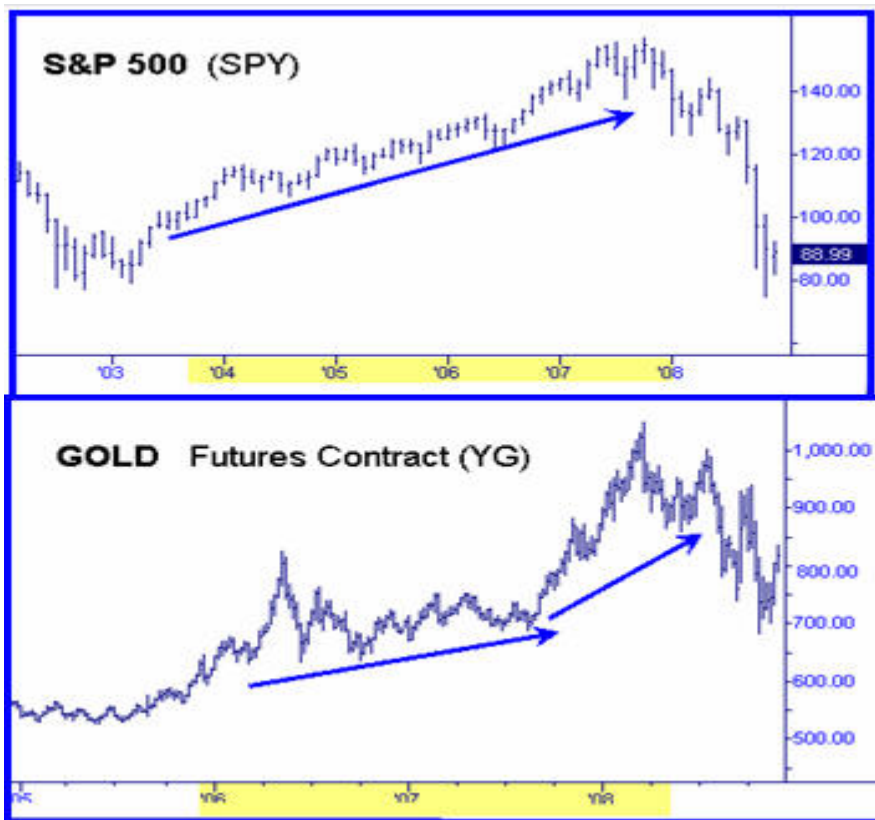


Figure 7: A Gold chart and the S&P 500.
Source: TradeStation

In Figure 6, the SPY was already moving up years before gold started moving up. From 2004 to 2008, the SPY is up 50%. Gold did not start rising out of range until late 2007. The stock market fell back to the 2004 lows and gold prices are also lower. Commodities lagged the equities market for this time cycle. Portfolio management is more effective when cycles of the economy are taken into account.

It is a common saying that commodities will protect portfolios from market risk. There is market risk, systemic risk and price risk in every asset class. The only protection for a portfolio is the wise management of assets. What we learn is that holding gold does not ensure appreciation of assets. The Midas touch is really good money management.

THE END

By Candy Schaap (New Bio)

Candy Schaap and husband, Dr. Charles B Schaap, are a trading team. Dr Schaap is the author of "ADXcellence" and "Invest with Success". Candy started her career hedging futures for a large corporation and has 25 years of trading experience in futures, options, stocks and bonds.

She does consulting, lecturing and writes financial articles. She publishes a weekly Trade Journal and mentors the TraderDoc 'Loot Camp'. She can be reached at TraderDoc5050@yahoo.com

Sources: The London Gold Exchange
Invest with Success by Dr. Charles Schaap
Ross Hansen, Northwest Territorial Mint

Words to know:

Commodity money A payment form that uses the product that directly results from the commodity of which it is made. Examples of commodities that have been used as mediums of exchange include gold, silver, copper, salt, peppercorns, decorated belts, shells, alcohol, cigarettes, barley and sugar. Commodity money is similar to barter, but is distinguishable from it in having a single recognized unit of exchange.

Krugerrand A one-ounce gold coin of the Republic of South Africa.

Gold Bullion - Any type of gold piece (including jewelry) and any gold product that is sold for the gold content. The piece of gold must be valued at the daily spot price of gold. Gold coins or bars must be worth at least 15% more than their metal value on sell back to qualify as bullion.
Investopedia says: There are 49 countries which forbid ownership of gold by their citizens, but allow holding gold coins and gold jewelry.