The Golden Question: Can Gold Stabilize Your Investment Portfolio?

Gold has a storied track record as a safe haven asset that stretches back centuries. Investors have long flocked to it for its defensive characteristics in times of volatility; recently, its reputation as a potential inflation hedge has also buffed its shine. For the first time in a decade, more investors preferred gold to stocks as the best long-term investment in 2023. But there is good reason to believe that this may be a somewhat myopic view.

In part, that's because gold has a fairly weak track record of outperforming riskier assets over longer time horizons. Stocks have outperformed gold over the past 10, 20, 30, 40, and 50 years, and over the full period since the dissolution of the Bretton Woods system in 1971.

Total Return	10 Yr	20 Yr	30 Yr	40 Yr	50 Yr	1971-2023
LBMA Gold Price Index	5.6	8.4	5.7	4.3	6.0	7.8
S&P 500 Index	12.0	9.7	10.2	11.3	11.2	10.8

Source: Morningstar Direct

Against less-risky assets, gold has a better track record. Gold has beaten bonds over the past 10, 20, and 30 years. Ultimately though, it falls short over the 40-year period and since the inception of the Bloomberg US Aggregate Bond Index in 1980.

Total Return	10 Yr	20 Yr	30 Yr	40 Yr	1980-2023
LBMA Gold Price Index	5.6	8.4	5.7	4.3	6.0
Bloomberg U.S. Aggregate Index	1.8	3.2	4.4	6.2	6.8

Source: Morningstar Direct

So why hold gold then? There are other potential benefits besides total return. The two primary ones are downside protection and inflation hedging – let's look at both in more detail.

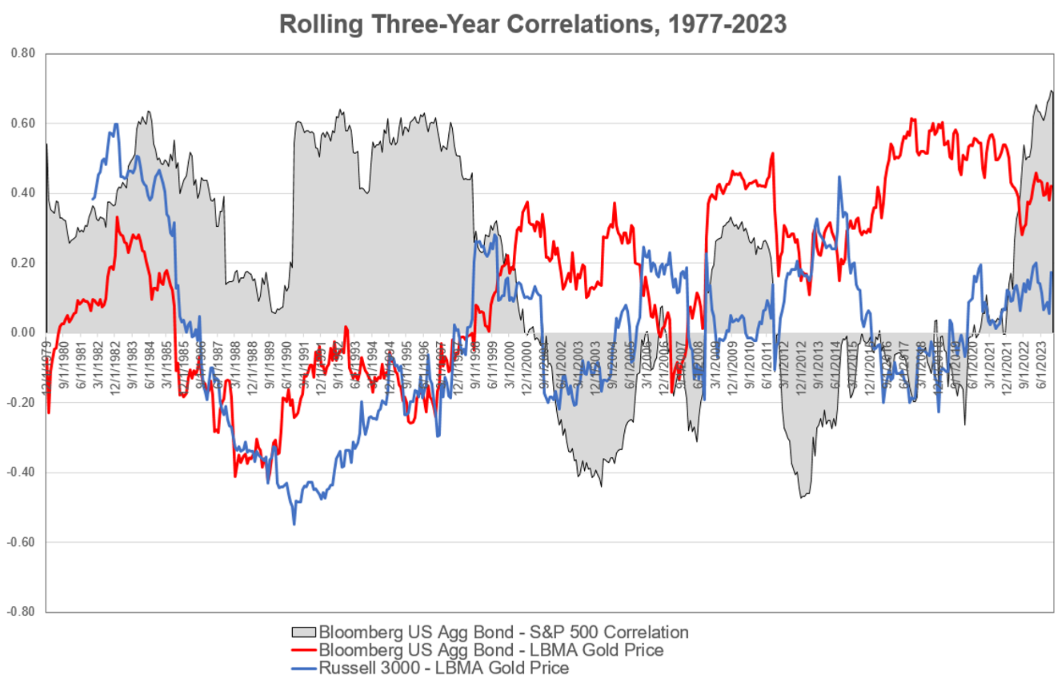
DOWNSIDE PROTECTION

The research on whether gold (or any precious metals) serves as portfolio protection is mixed. The main argument in its favor is that gold has delivered positive returns in four of the last seven bear markets (defined as an S&P 500 drawdown of >20%) and outperformed stocks in all seven.

But it's not enough to outshine stocks at their worst – plenty of investments can do that. To qualify as truly diversifying, an investment should also exhibit a low or negative correlation to other asset classes.

(Correlations are an important input for asset allocation—especially low or negative correlations—because they allow us to study how the building blocks for a diversified portfolio interact. When an investment has a low correlation to other asset classes, its price is likely to move independently of those other asset classes, marching to a different drum. When an investment has a negative correlation, it means that if the price of a related asset increases, the price of the asset in question is likely to decrease.)

Gold does hold up on that score. The metal typically exhibits low, but variable, sensitivity to traditional asset classes like stocks and bonds. Promisingly, its negative correlation shines through during periods when correlations between stocks and bonds start to spike. For example, in 2022, when a 60%/40% portfolio of stocks/bonds (as represented by the S&P 500 and the Bloomberg Barclays US Aggregate Index) fell 16%, the price return of the LBMA Gold Index was essentially flat. [1]

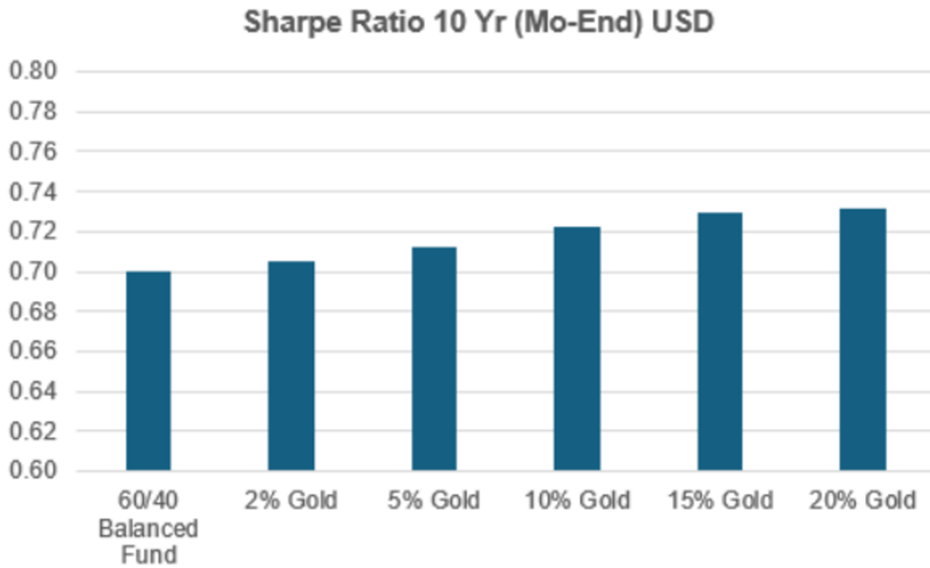


Source: Morningstar Direct

The crucial test, though, is whether these diversifying properties improve the return profile of a multi-asset portfolio overall. That means examining the Sharpe ratio, a return metric that adjusts for risk.

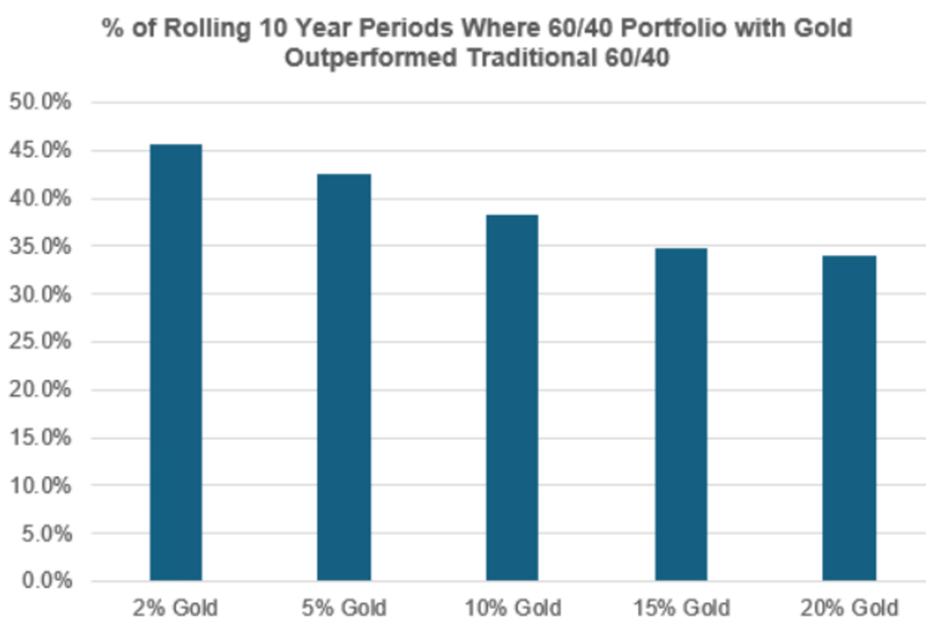
Initially, gold looks slightly more compelling in this context. Adding gold to a 60/40 portfolio did modestly improved risk-adjusted returns over the past 10 years.

[1] Morningstar Direct.



Source: Morningstar Direct

But ultimately, the results are heavily time-dependent. Gold has improved Sharpe ratios in less than 50% of the 10-year rolling periods since the inception of the S&P GSCI Gold Index in 1977, suggesting that it is generally not additive on average.



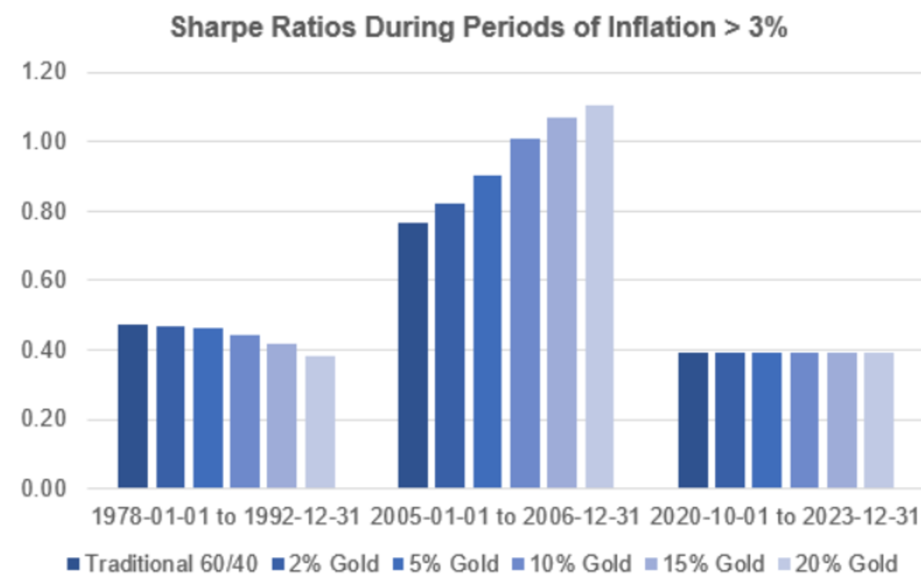
Source: Morningstar Direct

Although gold typically outperforms risk assets during acute periods of crisis (returning ~25% during both the Great Financial Crisis and the initial months of the COVID-19 pandemic)[2] , its performance advantage wanes over extended periods of time. In other words, gold can be an incredibly lucrative asset if you know exactly when to get in and out. But timing the markets accurately is extremely difficult, even for the most skilled tactical traders.

[2] Source: Sprott

INFLATION HEDGE

Gold bugs sometimes argue that since gold has outperformed the Consumer Price Index (CPI), it can serve as an inflationary hedge in a financial portfolio. If that was the case, gold should have improved performance during periods of elevated stock-bond correlation as inflation ramped up. Unfortunately, that only appeared to be the case in one of the three periods we examined.



Source: Morningstar Direct

Why is this so? Even if an asset outperforms inflation, it must exhibit a strong positive or negative linear relationship to qualify as a hedge – something that gold, like other supposed inflationary hedges such as Treasury Inflation-Protected Securities (TIPS) and bitcoin, historically lacks.

9 Yr Correlation to US BLS CPI	
S&P GSCI Gold	-0.07
S&P 500	-0.03
Bloomberg Commodity ex Pre Metals	0.34
Bloomberg US Short-Term TIPS	0.04
Bloomberg US TIPS	-0.13
S&P Bitcoin Price Index**	-0.11

**9 Year correlations used due to the inception of the S&P Bitcoin Price Index in 2014.*

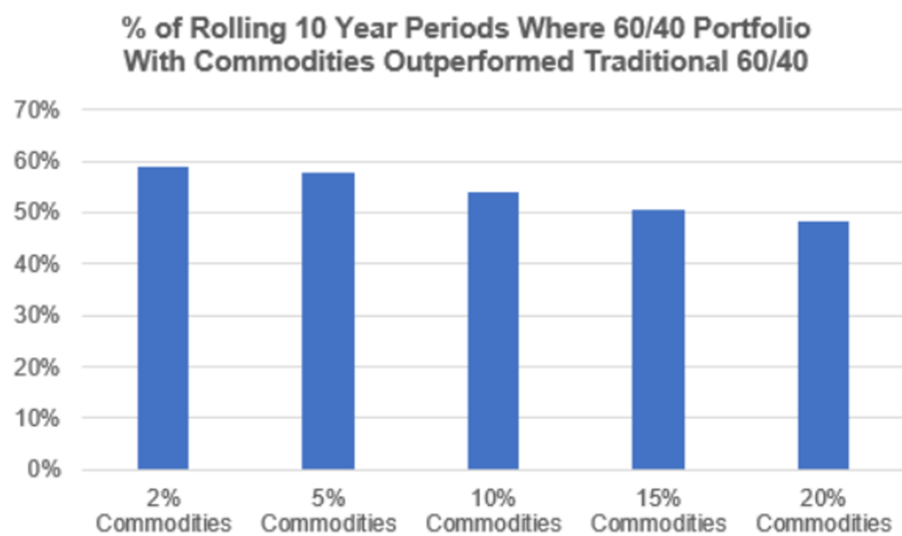
Source: Morningstar Direct

When there is no observable mathematical relationship between two variables, there can be sustained periods of divergence, as observed in the October 2020-December 2023 period.

CONCLUSIONS

Based on this research, while gold has the potential to curb portfolio risk, there is mixed evidence to support the argument that it has added value to investor portfolios. Gold has not outperformed stocks or bonds over the long run. It historically does well during severe equity market drawdowns and has exhibited a low-to-modest correlation to equity and bond markets overall. But there are many other ballasts at an investor's disposal, particularly alternative strategies; gold must also enhance performance to truly earn its spot on the roster. On average, it does not appear to have done so. Nor does it enhance an investor's ability to maintain purchasing power in inflationary environments.

That being said, gold can have a role to play in a diversified multi-asset portfolio as part of a broader commodity basket. To demonstrate this, we re-ran the above study, swapping the S&P GSCI Gold Index with the broader S&P GSCI Index, allocated across 28 different commodities. (Gold is the largest component of that index, at roughly 13% as of December 2023.) Unlike with gold on its own, here, the scales tilt in favor of a small allocation.



Source: Morningstar Direct

This is, by definition, backward-looking research, and past performance is no guarantee. There is certainly the possibility, however remote, that the peacetime investment paradigm that has existed in the post-WWII era could fracture. Hyperinflation or global disaster could strike at any time; in that case, however, it will be unlikely that investors can access the values stored in their investment accounts through traditional means. For these events, physical gold is likely to prove a more stable store of value. If calamities are your concern, it is best to have gold in a safe rather than on a statement.

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