Investors Deserve Equal Pay

SYNOPSIS

- Short-term volatility is a measure of emotion in markets, and both equities and gold are two highly volatile asset classes.
- Although the volatility of gold and equities has been on par with each other since 1980, gold has not paid anywhere near what equities have returned to patient investors.
- Keeping a small allocation to gold in a portfolio for the purposes of hedging inflation is fine, but don't expect this asset class to create any real wealth over time.

GOLD IS HIGHLY ERRATIC

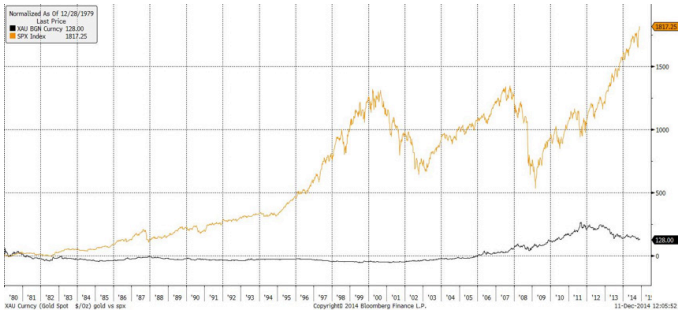
Short-term volatility is a measure of emotion, and equities are considered to be one of the more volatile asset classes. Those who have experienced the weekly and even daily swings in the S&P 500 over the past decade need little evidence to support this notion. What may actually come as a surprise to many is that gold is actually slightly more volatile than the S&P 500. The table below compares the volatility of each over various time periods going back to 1980.

ANNUALIZED VOLATILITY			
PERIOD	**GOLD**	**SPX**	**+/-**
DAILY	19.85%	18.23%	1.62%
WEEKLY	18.56%	16.54%	2.02%
MONTHLY	17.83%	15.30%	2.53%
QTRLY	15.57%	16.26%	-0.69%
ANNUALY	16.53%	16.48%	0.05%

It's important to remember that volatility is not always a bad characteristic of an asset class. In fact, volatility in equities is a long-term investor`s best friend because panic selling opens up wonderful buying opportunities for those who are patient.

However, if an investor is going to be forced to endure volatility, then he/she should expect a higher return over time compared to an asset class with less volatility. Furthermore, two asset classes with equal volatility should also pay investors the same.

The chart below shows that this fundamental principle of finance is not the case when it comes to large cap equities and gold.



Source: Bloomberg

The black line indicates the return progression for gold, and the orange line shows the return for the S&P 500 since 1980. Despite their similar levels of volatility, equities have blown gold away in actual return.

NOTE: *This chart does not account for dividends paid in the S&P 500, so the total return (dividends + capital appreciation) would be even higher if they were included. Gold pays no dividends.*

2080 Ringling Boulevard, Sarasota, Florida 34237 • Tel: (866) 641-2186 • Fax: (941) 918-0405 • www.gf-pc.com • info@gf-pc.com

Simply put, investors should be paid commensurate to the level of volatility within an asset class. If two asset classes have comparable volatility but different expected returns over a multi-year period, then investors are best suited to avoid the inferior of the two.

IMPLICATIONS FOR INVESTORS

Warren Buffett gave a speech at Harvard back in 1988, where he famously shot down gold by saying: "It gets dug out of the ground in Africa, or some place. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

To his point, gold produces no cash flow or earnings, so it cannot reinvest back into itself in order to grow over time. Gold pays no dividends, and investors have no opportunity to compound returns, which is one of the most powerful ways to create wealth over time. The bottom line is that gold has been a poor long-term investment, given its volatility, and will most likely continue to have subpar returns versus equities over the next decade. Therefore, owning a small position of gold as a hedge against inflation in a diversified portfolio is fine, but I strongly recommend keeping the allocation below 10%.

Sincerely,

Mike Sorrentino, CFA
Chief Strategist,
Aviance Capital Management