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Gold Could Still Have Further to Fall

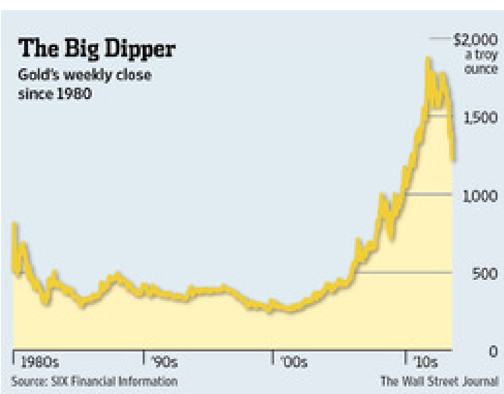
By MARK HULBERT

Is gold undervalued or overvalued? It is a question that is all the more relevant now that the precious metal is trading at $1,223.80 an ounce, having shed $700, or 37%, over the past two years, including more than 12% during June alone.

One study stirring much controversy among gold enthusiasts suggests it has more to fall.

The study—titled "The Golden Dilemma"—was published earlier this year by the National Bureau of Economic Research, a nonpartisan think tank in Cambridge, Mass. Its major finding is that, regardless of how you define gold's "fair value," gold sometimes trades well above it and at other times well below. An ancillary finding: Whenever bullion deviates significantly from fair value, it eventually returns to trade at that level.

Campbell Harvey, a finance professor at Duke University and one of the study's co-authors, concedes there isn't one agreed-upon definition of gold's value. But he says that he and his co-author—Claude Erb, a former commodities portfolio manager at TCW Group—closely analyzed all the criteria of which they were aware.



The list they studied included defining gold's value as a hedge against inflation, currency fluctuations, or low real interest rates, or as an insurance policy against hyperinflation or the collapse of the financial system. They found that each definition was unable to explain more than a small portion of gold's price swings over the shorter term.

While this finding is frustrating to traders who want to forecast gold's shorter-term moves, gold is hardly different in this regard than the other major asset classes.

Consider the price/earnings ratio, a popular valuation metric for equities. According to research conducted by Cliff Asness, co-founder of AQR Capital Management, which oversees $80 billion, the P/E ratio historically has been unable to explain more than 5% of the variation in next-year stock-market returns.

The situation improves when we focus on the very long term, however, according to Mr. Harvey.

When measured over many decades, gold is a decent inflation hedge, maintaining its purchasing power. His study therefore provides confirmation of the conclusion reached by a seminal book that enjoys almost biblical status among gold enthusiasts: "The Golden Constant," which was written in the 1970s by the late Roy Jastram, a professor of business at the University of California, Berkeley.

Gold bugs need to be careful drawing the proper investment implications of Mr. Jastram's conclusion, however, according to Mr. Erb, the co-author of the National Bureau of Economic Research study.

"For Jastram, the short run was the next few years, and the long run was perhaps a century," Mr. Erb said in an interview. "And over the short term of a few years, both Jastram as well as our recent study found that gold's track record as an inflation hedge is quite poor."

Consider: Investors who bought gold at its January 1980 peak of $875 an ounce are today still below water in inflation-adjusted terms. They even were showing a loss two years ago when gold was trading for more than $1,900.

The investment implication is to pay careful attention to gold's longer-term cycles before buying gold—or be willing to hold it for many decades.

So how should you decide where gold is in its long-term cycle? As a rule of thumb, the researchers urge investors to calculate a ratio of gold's price to the level of the consumer-price index. This ratio's historical average has been about 3.4 to 1, so it is a good bet that gold is overvalued whenever the ratio is well above that level.

When gold hit its high over $1,900 an ounce in September 2011, for example, the ratio was more than 8 to 1. In January 1980, the ratio stood at more than 11 to 1.

Unfortunately for the gold bugs, the current gold/CPI ratio—5.3 to 1—is still above average, even in the wake of gold's plunge over the past three months. To be in line with that average, gold would have to trade for $780 an ounce. "Note carefully," Mr. Erb says, "our research doesn't provide a basis for predicting when gold will once again trade at fair value, however—only that it will eventually do so."

Michael Bordo, an economics professor at Rutgers University and director of its Center for Monetary and Financial History, also isn't surprised by gold's pullback. Referring to the statistical tendency for high or low readings to eventually move back toward the longer-term average, he said in an email: "My research has shown that there is a lot of mean reversion in the nominal price of gold, reflecting the relatively steady very long run behavior of the real price of gold."

Mr. Erb acknowledges that his study's conclusions are controversial. But that is at least partly because the "gold bugs believe bullion has some exalted status that exempts it from the price fluctuations that cause every other major asset class to sometimes trade well above or below fair value," he says.

Also controversial is the suggestion that a gold/CPI ratio can be helpful for determining if gold is undervalued or overvalued, since many believe the CPI understates inflation. But gold will fluctuate wildly relative to whatever inflation index you choose, Mr. Harvey says, and it will inevitably regress to the mean following any period of extreme undervalue or overvalue.

If you believe, like the study's authors, that gold is still overvalued, you might consider an exchange-traded note that gains in price to the extent gold declines: PowerShares DB Gold Short, which carries an expense ratio of 0.75%, or $75 for every $10,000 invested.

If you believe that gold is undervalued, or just due for a rally following its recent plunge, you might consider the SPDR Gold Trust, an exchange-traded fund with fees of 0.4%. Another gold-oriented ETF is the iShares Gold Trust, with fees of 0.25%.

Still, there are more conservative—and cheaper—ways to hedge against inflation than by investing in gold. Investing in the U.S. Treasury's inflation-protected bonds, or TIPS, is one example. An ETF that does that is Schwab U.S. TIPS, with fees of 0.07%, or you can buy TIPS directly from the U.S. Treasury at TreasuryDirect.gov.

—Mark Hulbert is editor of the Hulbert Financial Digest, which is owned by MarketWatch/Dow Jones.

Write to Mark Hulbert at mark.hulbert@dowjones.com

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