

Investing Through Inflation

Why Isn't Gold a Currency?

Investing Through Inflation

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Why Isn't Gold a Currency?

Summary: In this era of fiat currency, where there is nothing tangible backing money, what is gold's role? It certainly has historically been a currency. Is it still a currency? What is its role in an investment portfolio?

A podcaster I respect was interviewing his friend, an international investor of some renown. The investor was espousing his views on deep value investing, purchasing public equities through the lens of private ownership; long term, conservative investing tips from a seasoned, respected investor. The conversation turned to gold. The interviewer was a gold advocate and asked about gold's role in a portfolio at which point the interview took an interesting turn. Gold advocates generally have a view that a gold position should be 5% - 10% of a portfolio. At the time I was advocating 5%. The gentleman calmly disclosed his gold position was 30% of his portfolio. Wowzer! The interviewer had no idea his friend had such a significant gold weight. The explanation was that he views gold as a currency and a better store of value than other currencies which were being debased, in his opinion.

This was a new perspective for me and I chewed on it over the next few weeks. Ultimately, I liked how it fit my thesis and I committed to moving my allocation from 5% towards 10% (30% was way beyond my comfort zone). The short version of the story is I stopped at 7%. The volatility increase in my portfolio from the additional 2% was too much for me. While I was pausing at 7% I tried to understand how this conservative investor could tolerate a 30% weight if my 2% incremental increase was personally troublesome. Where I settled was, I came to the conclusion that gold is in fact not a currency. In my view gold is a commodity that wants to be a currency. Therefore, if I like gold it's because it's a hedge that fiat currency will one day be replaced by a currency tied to a hard asset. Gold's role in history makes it the most likely candidate.

What is a Currency?

Economists have a set of criteria that defines a currency. A currency has to have the following properties;

- **Store of Value:** it can be saved and used later
- **Unit of Account:** it can be used to quote prices
- **Medium of Exchange:** it can be used to buy goods and services

Let's examine each individually.

- **Store of value** – Gold has an annualized volatility of approximately 15%. That implies that within the span of a year the value of your gold could range up 15% or down 15% two thirds of the time. One has to determine one's personal tolerance. For me, that turned out to be too high a range to consider it a store of value.
- **Unit of Account** – we don't generally think of consumer goods in terms of the price of gold. No one values the price of a car in terms of ounces of gold. From time to time researchers will talk about the value of oil priced in gold but it's an intellectual exercise more than a practical exercise.
- **Medium of Exchange** – I'll admit that I keep a small amount of physical gold nearby. That's because I've watched Casablanca too many times and the image of Rick Blaine (Humphrey Bogart) giving Ilsa Lund (Ingrid Bergman) the letters of transit is ingrained in my nostalgic heart. Back in reality though, one doesn't generally transact in gold.

If gold's not a currency, then what is it? It's a commodity. Just as lumber, copper and silver are commodities. Liquid markets exist for where producers and buyers can meet and transact. Gold differs slightly from these other examples in that the price of gold is higher than its industrial or intrinsic value. What explains its premium? Gold is a commodity, like the others, except unlike the others it has airs and wants again to be a currency.

In a scenario whereby this era of fiat currency ends, gold could be restored as the tangible backing of a new currency regime. Gold's role in a portfolio is a call option on this scenario. That is, holding gold is an option on the breakdown of the fiat system. Once you come to see it as an option you realize you size it as you would size a long-term call option. Large enough to benefit from the leverage if your call is right but small enough that if the option expires without value you can sustain the complete loss of premium. Finger in the air comfort level: 5%.

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