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What's Gold Really Worth?

By Kevin Feldman

Determining an exact value for gold isn't easy, but the pressure to do so is diminished by the fact that, for most investors, gold shouldn't be a short-term investment.

The drop in silver's price earlier this month suggested that some major market players had decided that silver had risen far above a reasonable valuation. In the aftermath, some writers argued that the price drop of about 27% for the week of May 2nd was a reasonable correction. (In fact, my colleague Russ Koesterich thinks that silver still looks expensive.)

Since some investors still link gold and silver not taking into account the significant differences between the two metals, some market observers and gold investors wondered if gold, down about 4 percent last week, was also due to plummet. Is gold a bubble?

For reasons that I've blogged about before, particularly the purchasing of gold by central banks, I don't think it is. But one of the challenges in assessing the value of gold is that the usual metrics don't apply: gold doesn't pay interest or dividends or generate earnings. And for all practical purposes you can't use gold, as you might, say, real estate. In fact, gold, which must be moved, stored, insured and guarded, actually comes with built-in expenses.

So if you want to ascertain whether gold is undervalued, overvalued, or about right, how can you figure that out? It's a problem market observers struggle with; on Seeking Alpha not long ago, contributor Robert Shaw tried to calculate what gold would be worth if you used it to replace all the currency in the world. The Economist recently sought its value in how many barrels of oil or bushels of wheat you could buy with an ounce of gold. The magazine points out that gold has risen considerably against the dollar, which could plausibly be interpreted as the result of concern over the devaluation of the dollar. But gold has also risen substantially against the Swiss franc, not typically thought of as a weak or declining currency. And neither the United States nor Switzerland looks like they'll have to confront increased inflation any time soon, so the threat of it doesn't account for gold's rise relative to those currencies. Some of the increase, perhaps, from investors who fear the long-term prospect of inflation, but not all of it, and not even a majority of it.

How do you explain gold's appreciation against currencies as varied as the dollar and the Swiss franc? Because people want to hold on to gold for a variety of reasons. One of them certainly is as a hedge against inflation and/or a falling dollar; another is as a portfolio diversifier which is, most of the time, negatively correlated with stocks. And then there's just the psychological comfort that stems from the sense of gold as a safe haven.

Which brings us back to where we began: the substantial differences between gold and silver. I consider silver a satellite bet, something one invests in for a specific play. But gold is a long-term, core portfolio holding.

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