

COMMENTARY

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Less Than Zero? What is gold's true correlation to the equity markets?

With the increasing investment demand for gold ETFs such as *SPDR Gold Trust ETF (GLD)*, one of the most frequently cited reasons for investing in gold besides as an inflation hedge, or as a hedge against a depreciating US Dollar, is that gold has a low (or negative) correlation with the stock market.

But is this always true? A closer analysis shows that this common view may not be true at all times. In fact, at times, this may be patently incorrect.

The simple answer is, it depends on one critical factor: time. Said another way, it depends on one's investment time horizon.

Historical Total Returns of Gold & Equities

First, it is useful to look at the historical performance of gold.

The following chart, which is based on Bloomberg data and is extracted from the *Amended & Restated Preliminary Prospectus for the Sprott Physical Gold Trust* dated January 25, 2010 and filed with the US Securities and Exchange Commission (SEC), shows the historical return of gold since August 1971, when the U.S. abandoned the gold standard.

What is evident from the chart is that over the past decade, and particularly since March 2001, gold has been an excellent investment rising from a low of approximately US\$ 250 per ounce to US\$ 1,128 on January 15, 2010.



What is more interesting is gold’s total return performance relative to other asset classes, namely the S&P 500 and the MSCI EAFE Index, which is a proxy for international equities.

As is shown in the following table, over the past 3, 5 and 10-year periods, gold has significantly outperformed both the S&P 500 and the MSCI EAFE Index.

Historical Total Returns (Compounded Annual Returns)	1-Year	3-Year	5-Year	10-Year	20-Year	30-Year	38-Year
Gold	38.3%	21.7%	21.7%	14.8%	5.1%	1.7%	9.0%
S&P 500 Index ⁽¹⁾	37.9%	(5.3%)	1.3%	(0.7%)	8.6%	N/A	N/A
MSCI EAFE Index ⁽¹⁾	49.1%	(4.8%)	5.1%	2.1%	4.6%	10.3%	10.4%
(1) The total return numbers for the indices are represented by the following: for the S&P 500, the S&P 500 Total Return Index; and, for the MSCI EAFE Index, the MSCI EAFE Gross Daily Total Return Index.							
(2) N/A: Total return data not available for these time periods.							
Source: Bloomberg, January 15, 2010; Sprott Physical Gold Trust, Amended & Restated Prospectus, January 25, 2010.							

As can be seen from the table above, over the past 10 years, gold has returned 14.8% annually, while the return on the S&P is negative at (0.7%), and the return on the MSCI EAFE is a paltry 2.1% per annum.

Correlation of Gold Relative to Other Asset Classes

When evaluating gold’s correlation to the equity markets, one must consider the critical factor of time. In other words, depending on one’s investment time horizon, gold may have a differing correlation with equity markets, as is shown in the following table.

Correlation of Gold Relative to Other Asset Classes	1-Year	3-Year	5-Year	10-Year	20-Year	30-Year	38-Year
S&P 500 Index	0.81	(0.49)	(0.18)	0.29	0.37	n/a	n/a
MSCI EAFE Index	0.78	(0.43)	0.10	0.64	0.64	0.45	0.62
(1) 1.00 indicates a perfect correlation; -1.00 indicates a perfect inverse correlation.							
(2) The total return numbers for the indices are represented by the following: for the S&P 500, the S&P 500 Total Return Index; and for the MSCI EAFE Index, the MSCI EAFE Gross Daily Total Return Index.							
(3) N/A: Total return data not available for these time periods.							
Source: Bloomberg, January 15, 2010; Sprott Physical Gold Trust, Amended & Restated Prospectus, January 25, 2010.							

To summarize gold’s correlation with other asset classes, as shown in the table above:

- 1-Year Time Horizon: Over the past year, gold has shown a surprisingly high *positive* correlation with both the S&P 500 and the MSCI EAFE Index. During the past year, gold’s correlation with the S&P 500 Index was 0.81, and 0.78 with the MSCI EAFE Index. This is in direct contrast to conventional wisdom.

- 3-Year Time Horizon: On a 3-year timeframe, gold has shown a distinct *negative* correlation with both the S&P 500 and the MSCI EAFE Index, which is completely counter to the dynamic experienced in the 1-year timeframe. Gold's correlation with the S&P 500 over the past three years was (0.49), while it was (0.43) with the MSCI EAFE.
- 5-Year Time Horizon: On a 5-year timeframe, gold tends to exhibit much less correlation (either negative or positive) to either of the indices. Over the past 5 years, gold has had a (0.18) correlation with the S&P 500 Index, while the MSCI EAFE Index has had a 0.10 correlation.
- 10-Year Time Horizon: Finally, to make things a little more confusing, on a 10-year timeframe, gold is mildly positively correlated with the S&P 500 at 0.29, while the MSCI EAFE shows a relatively strong correlation with gold at 0.64.

Conclusion

What does this analysis tell investors about the correlation of gold to equity markets?

Simply, time is a critical element when evaluating gold's correlation to equity markets. Over any short period of time, gold can be either positively correlated or negatively correlated with the equity markets.

However, over longer periods of time, gold tends to be less correlated with equity markets.

Disclosure: AI management own shares in GLD.

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