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10 Reasons the Gold Bugs Lost Their Shirts

By Barry Ritholtz - Jan 8, 2014

It has been quite the ride for gold: from under $500 an ounce a decade ago, to above $1,900 in 2011, gold gained more than 400 percent. Since its peak of ~$1,921.15 on Sept. 6, 2011, however, the shine is off the yellow metal. Gold plummeted 38 percent, recently breaking below $1,200. Yesterday's close is within 5 percent of the lows, at $1,241.

If a 20 percent drop is described as a bear market, and a 30 percent fall is called a crash -- what do we call gold's almost 40 percent plummet?

This column is not an "I told-you-so" or an exercise in "Goldenfreude" (describing a "delight in gold bugs' collective pain"). Rather, it is an attempt to learn some investing lessons from the epic rise and horrific fall of gold.

As an investor, I am a gold agnostic: When used properly, the metal is a potentially valuable tool in an investment arsenal. There are times when it makes for a profitable part of a portfolio, as in the 2000s. There are periods when it is a speculative and dangerous trade -- such as the 2010s. There have also been decades when it does nothing, earning no return, generating no income, essentially dead weight to a portfolio, as in the 1980s and 1990s.

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In 2013, for the first time in 13 years, gold was negative on the calendar year. It began 2011 at ~$1,405 and ended at ~$1,540. In between, it peaked above ~$1,900, giving back most of the year's gains. It closed 8.7 percent higher than where it began 2011, after rallying nearly 35 percent earlier in the year. Unless something radically changes in the near future, that may very well be the peak for this secular cycle.

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Not very long ago, metal analysts were tripping over one another to put ever-higher price targets on gold, with forecasts of $2,500, then $5,000 and even $10,000 an ounce. Individual investors, institutions and foundations were buying the metal as fast as they could, regardless of price.

What a difference two years make. The mania for gold, like all manias, is ending badly. Some gold

fans may argue that the cycle is not over yet, and they may be correct. However, any asset class that loses almost 40 percent of its value in two years is worthy of further study, a teachable moment of what not to do in a trade.

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I jump on any chance I get to take courses in the School of Real World Investing -- especially when someone else is paying the tuition. What lessons can investors take from this debacle? Some of the following relate specifically to gold, but the bigger concepts are applicable to any investment.

Let's get busy:

1. Beware the Narrative: Humans love a neat tale with heroes and villains and conflicts that need resolution.

On Wall Street, storytelling is a big part of the sales process, and gold was no different. Even though it had broken out in 2005, the Great Recession and bank bailouts of 2007-08 created a fertile environment for the Gold Narrative. It was a perfect combination of factors: Huge government intervention, a move away from true "free markets," coordinated central bank actions, unprecedented quantitative easing and zero interest rate policies would inevitably cause a huge debasing of currency and hyperinflation, or so the story went. Gold is a haven in times of stress and a hedge against inflation when economies accelerate. It was underowned and yet an attractive alternative to assets with low real returns. Based on the amount of total outstanding fiat currency, gold would hit those $10,000 price targets.

The problem with all of this was that even as the narrative was failing, the storytellers never changed their tale. The dollar hit three-year highs, despite QE. Inflation was nowhere to be found. If anything, deflation was the greater risk.

The problem with storytelling is that it makes an investor feel good, even as the data show the opposite and the position goes against him.

2. Take Note of New Investment Products: One of the fundamental changes in this gold cycle has been the creation of a variety of new gold-related products. The mac daddy has to be the gold exchange traded fund (GLD). Called the "innovation that opened gold investing to the masses," it allowed people to invest in gold without opening futures accounts.

The World Gold Council is an organization created by global mining companies for the purpose of promoting the sale of gold. The gold ETF was their brainchild. Following "two decades of depressed prices and a growing glut of the yellow metal," they faced the possibility of having their funding

withdrawn. So in November 2004 they threw a Hail Mary called the SPDR Gold Shares exchange-traded fund. It was a game-saving touchdown.

Anyone with an ordinary brokerage firm could now be a gold investor. By some estimates GLD has added $150 an ounce to the price of the metal. Nomura Securities analysts noted that “big shifts in gold ETF holdings” were highly correlated with “rises in the gold prices" Lipper called GLD the “fastest-growing major investment fund ever.” During its bull run, the fund was buying $30 million of gold daily. In 2012, the biggest single equity holding in self-directed 401(k) plans was Apple ... followed by the SPDR Gold Trust.

A slew of other gold ETFs soon followed. The Market Vectors Junior Gold Mine (GDXJ) came out at $100, rallied to $160, then collapsed to $30. Other exotic offerings were rolled out: UBS introduced the E-TRACS S&P 500 Gold Hedged (SPGH) -- half S&P 500, half gold. It was perfectly hedged against making any money, as the soaring U.S. equity markets were offset by the collapsing precious metals.

Perhaps the most paranoid new products were the physical “gold only trusts.” There was the iShares Gold Trust (IAU), along with a numerous regional physical gold shares from ETFS in Switzerland and Singapore (Swiss, SGOL; Asia AGOL). Theses owned physical gold and only physical gold. Theoretically redeemable by owners in gold in case of a financial emergency, these were designed to appeal to those who lacked trust in the financial system. The underwriters were apparently oblivious to the irony of offering the products through that self-same financial system.

You could even take the other side of the gold trade -- though few did. Direxion’s Daily Gold Miners Bear 3X (DUST) is a triple-leveraged bet against gold. Despite being up 165.69 percent in 2013, it barely has $100 million in assets.

Salesmen always need something to sell. In GLD, they found the found a perfect vehicle to pull in the masses.

3. Ignore History at Your Own Peril (or, *Everything Eventually Becomes a Trade*)**:**

You cannot be in the market very long and grow attached to anything, as everything will eventually disappoint you. I call this my universal entropy theorem of investing, and it's why everything -- from Microsoft to the 10-year bond, from Apple to gold -- eventually goes to hell. (Just look at the stocks tossed from the Dow Industrials for more evidence).

Gold has run up only be to trounced in repeated massive selloffs: 1915-20, 1941, 1947, 1951-66, 1974-76, 1981, 1983-85, 1987-2000 and 2008.

4. Leverage is Always Dangerous: History teaches us that any investment purchased via credit always runs the risk of margin calls. Whether it's dot-com stocks, no-money-down houses or subprime collateralized debt obligations, leverage eventually leads to liquidation.

Precious metals are no different.

Like all commodities, gold is purchased via futures contracts. The leverage involved is typically 15 or so to 1. Most of the time, the real world imposes a limit on how high an industrial metal, energy or agricultural product can run before its largest buyers cut back or switch to an alternative. For example, carbon fiber can keep aluminum prices in check; natural gas is a cheaper (and cleaner) alternative to home heating oil. Chicken is a substitute for beef.

Gold has no real alternative. Platinum is much rarer -- we mine only 6 percent as much of the stuff each year. Silver is much cheaper, trading at 1/60th the price of gold.

This cycle brought many new gold enthusiasts into the futures market. Their inexperience with big leverage -- stocks and bond purchased in brokerage accounts are limited to 2-to-1 margin -- led to surprising wipeouts. Leverage of 15-to-1 requires only a 7 percent downdraft to create a total loss of the initial investment.

The CME group, created in the 2007 merger between the Chicago Mercantile Exchange and the Chicago Board of Trade, is the world's largest commodities exchange. As gold headed toward $1,000 in 2008, CME officials began to adjust margin requirements accordingly. They stand as the counterparty of last resort, so raising margin requirements was a prudent risk-management move on their part.

Gold rallied faster than CME could raise margin requirements, however. The next two years saw a huge move, along with a spike in volatility. In September 2011, gold was swinging wildly as it made its ultimate high. Following what was the most volatile week in years, CME Group raised margin requirements by 21 percent.

And that was pretty much the end of the run.

5. Maintain Situational Awareness: The concept of situational awareness comes from military theory, particularly aviation, representing the idea that a pilot needs to be fully cognizant of all the elements occurring in three-dimensional space, as well as those about to occur in the near future. For the investor, situational awareness means not getting too caught up in the moment, and understanding the continuum of time. Instead of thinking of any event as a single instance in time like a photograph, consider instead a series of instances more akin to a video. Doing so forces the investor to think of the big picture, the 30,000 foot view.

As John Updike wrote, “The beauty of gold is, it loves bad news.” ("Rabbit is Rich," p.247). Quite a few gold investors came to believe that the bad economic news had become permanent. But all cycles eventually turn; even the Great Depression ended. So, too, did this recession.

6. The Danger of One-Way Trades: What would make you reverse your biggest present holding? What facts or situations would force you to change your views and sell? If your answer to that question is, “Nothing,” you have a huge, devastating flaw in your approach to investing.

One of the more fascinating lessons to be gleaned from conversations over the years with various gold enthusiasts is that exact concept of an “irreversible market position.” It is based on a simple thought experiment that many portfolio managers and traders engage in when establishing a position.

Ask yourself, “What would make me reverse this position? What would make me sell this long or cover this short?” There is usually a long list of technical and fundamental answers. They may include break in support, a violation of a trendline, a decline in earnings, a slowing of growth, etc. Often, a simple modest price decrease is sufficient to get traders to cut their losses.

Yet many of the gold bugs I have spoken with over the past five years had no pain point. “I'll Stick With Gold” was a common refrain. There was no conceivable set of circumstances that could either reduce their ardor or their holdings in the metal.

This is a dangerous mindset toward any investment, but an especially money-losing attitude when holding a commodity. The takeaway is that every position, no matter how compelling the underlying story, should have an exit strategy. Indeed, it is especially important with a "loved" holding -- one that has a huge emotional investment and an unhealthy reliance on narrative.

7. What’s In the Price Already?: One of the differences between professional and amateur traders is recognizing what’s in the price. By the time most rumors, whisper stories and headlines reach the average investor, the impact of the news is already reflected in the market. The expectation that well-known news might somehow be a price catalyst always surprised me.

What’s that you say, the India wedding season was going to drive prices? Only if you believe this tradition dating back thousands of years is unknown to the gold market. Wait, China’s central bank’s gold reserves are growing rapidly? Who exactly is surprised by that?

Genuine surprises that are unknown to the market can move prices. Most of the narratives (See e.g. this or this) do not.

8. What Are the 'Fundamentals' of Gold, Anyway?: Gold has no fundamentals. What is traditionally called fundamental analysis involves determining a company’s cash flow, revenue and

earnings. Commodities have none of these things.

What some people call fundamentals are really more akin to broad macro debates. Determining the state of the economy, interest rates, gross domestic product, corporate earnings, debt, unemployment, inflation and the U.S. dollar -- then deriving their impact on gold -- amounts to little more than guesswork. Forecasting what all of these parts of the economy are doing in advance is a near impossible task, at least with any sort of accuracy on a consistent basis.

The simple truth is that all tradable assets are worth whatever the next guy is willing to pay for them. With commodities, this is even more true, as they lack an objective measure of cheap or dear.

9. End-of-World Tales, Conspiracy Theories and Other Such Nonsense: More than any other investment, gold seems to involve a stream of fantastic tales of imminent societal collapse. Every potential problem gets blown up into a coming apocalypse. Fiat currency leads to worldwide collapse, as the dollar falters and hyperinflation appears. All paper money is going to be worthless, so you better have some gold if you want to feed your family.

Except that the fear-mongering is always backward looking. The dollar had already collapsed by 41 percent from 2001-2008; we had very strong inflation in the 2000s, and much more moderate inflation after the financial crisis.

Then there are the theories of anti-gold conspiracies: Central banks are manipulating prices; the Bureau of Labor Statistics is hiding data showing how much worse inflation really is.

Gold is marketed through a combination of fear and dishonesty. (As opposed to various equity products, which are marketed through a combination of hope and dishonesty).

10. Attacking the Skeptics: The response to rational argument is often a revealing tell. Over the gold cycle, attacks on anyone with the temerity to challenge the gold narrative became ad hominem. Accusations of “selling out,” being “in the Fed’s pocket” and a “patsy for the administration” were just some of the personal attacks I witnessed. Challenge anyone’s belief on gold, and instead of having empirical, data-driven counterarguments made, the zealots responded with venom. Have a read of the comment stream of ZeroHedge.com for some true gems of the genre. They reveal an investment gone awry combined with a lack of idea as to what to do about it.

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The rise and fall of gold reflected all of the usual errors that emotional investors make. An honest postmortem will allow you to identify the mistakes that were made, and maybe even learn something from them.