Financial Analysts Journal ›

Volume 62, 2006 - Issue 2

Alternative Investments

Do Precious Metals Shine? An Investment Perspective

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Pages 98-106 | Published online: 08 Apr 2019

Cite this article https://doi.org/10.2469/faj.v62.n2.4085

Abstract

The investment role of precious metals in financial markets is investigated by analysis of daily data for gold, platinum, and silver from 1976 to 2004. All three precious metals have low correlations with stock index returns, which suggests that these metals may provide diversification within broad investment portfolios. Moreover, the data reveal that all three precious metals have some hedging capability, particularly during periods of "abnormal" stock market volatility. Financial portfolios that contain precious metals perform significantly better than standard equity portfolios.

Precious metals have recently become of increasing interest worldwide to investors and politicians. Gold, for example, following a sustained bear run in prices lasting more than 15 years, has regained its luster in the eyes of investors through double-digit annual price appreciation.

We examined the investment role of precious metals in financial markets through the analysis of daily price and return data for gold, platinum, and silver from 1976 to 2004. Gold and silver are traditionally perceived to be "investments of last resort" and have a central investment role in many countries, but platinum is normally used for industrial purposes and plays only a small role in investment activity. So, we included platinum as a control metal for comparative purposes.

This study differs from previous research in the area in several important ways. First, we examined the properties of precious metals in a global context by examining their relationships to both the S&P 500 Index and the MSCI Europe/Australasia/Far East (EAFE) Index. Second, our study covers almost 30 years of precious metal price data and includes the bull run of the late 1970s, the bear period of the 1980s and 1990s, and the strong performance of precious metals in the early 2000s. Third, we used recent improvements in volatility modeling to examine the hedging properties of gold, silver, and platinum within a time-varying context. Finally, by comparing the investment properties of gold and silver with platinum, we were able to differentiate the unique investment characteristics of gold and silver from that of their industrial counterparts.

We found that all three precious metals have low correlations with the S&P 500 and EAFE, which suggests that they have the potential to provide diversification within broad-based investment portfolios. Moreover, and most importantly, all three precious metals have some hedging capability, particularly during periods of "abnormal" stock market volatility. The real benefits of holding precious metals come during periods of market uncertainty but not necessarily in market downturns. From a risk management standpoint, precious metals are possible alternatives to financial derivatives and are clearly of more importance in those countries where derivative markets in equities have not been established.

An examination of precious metals as part of a broad-based equity portfolio shows that their inclusion can be of great benefit. Including precious metals in a passive buy-and-hold strategy improved the efficiency of portfolios in the study. Furthermore, our results suggest that over the past 25 years, the optimal weight of gold in broad-based international equity portfolios was approximately 9.5 percent, significantly higher than is seen in most funds' equity portfolios today.