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Published on *AdviceIQ* (http://adviceiq.com)

The Anatomy of a Gold Bust

Submitted by Matthew Tuttle on Tue, 05/28/2013 - 9:00am

Gold had a great run-up in the past few years, and now the price is sliding. This is a cautionary example of how booms don't last.

Momentum investors buy hot individual stocks that enjoyed high returns in the past several months and try to capitalize on a rally. Plenty of folks tried to do this with gold, but failed to diversify. Momentum strategies tend to crash like that.

Up until recently, the most frequent question I got from investors was what I thought about gold. When it is in an uptrend I like it, and if it is in a downtrend I don't. It is currently heading down. In mid-April, gold prices [1] plunged all the way to $1,360 per ounce, down from nearly $1,600 two weeks earlier. Prices recovered a bit, but fell again in May.

Why are gold prices dropping? One reason is a recent World Gold Council report [2] showing that gold demand fell 19% in the first three months of 2013, from the previous quarter. The stronger dollar is making commodity futures less attractive for non-U.S. investors.

Federal Reserve board members are also stating publicly that they favor scaling back the program of quantitative easing – the central bank's $85 billion monthly policy of asset purchases that aims to lower interest rates and stimulate borrowing – as early as this summer. Mainly, as sources in a recent *Wall Street Journal* article [3] pointed out, investors are increasingly attracted to the strong gains and dividends in stocks. Gold does not pay dividends.

The gold bugs that swear by the yellow metal are seeing their net worth dwindle. Gold's recent drop reinforces a number of key lessons for investors.

Don't follow the herd. Assets that undergo parabolic moves like the rise and fall of gold and **Apple** (AAPL [4]) over the past few years, almost always retrace most, if not all, of that move. In other words, what goes up extremely fast usually comes down.

The reason for this is the herd mentality. In the case of Apple and gold, they both rose at a time of uncertainty and instability. People were legitimately concerned about runaway inflation from the Fed's expansion of the money supply, and even the dollar lost confidence after the 2011 debt ceiling debate and Standard & Poor's downgrade of U.S. debt. As Business Insiders' Joe Weisenthal points out [5], investors flocked to those two assets as a shelter in the storm, and left them once the clouds parted.

Pundits like Glenn Beck [6] television commercials touted gold by scaring individual investors about supposed economic collapse and inflation. Gold, they claimed, is a timeless store of value that always goes up. That argument is falling apart as the inflation didn't materialize and economic indicators are slowly improving. Piling into any asset class with the herd once it rallies rarely makes sense.

Beware of "sure things." Once everyone starts to accept that something is going to go up, that is the top. Gold's fall started when the consensus was that nothing would stop it from hitting $2,000 per ounce. We saw the same thing with oil a couple of years ago and Apple last year. Analysts [7] predicted a $1 trillion valuation for Apple throughout 2012 [8]. It's now less then half that.

Be very wary about "sure things" like this. It is very difficult to time the market. Too often, those who buy with the herd at the top sell with the herd as well.

Recency bias. Investors tend to believe that their most recent experience continues forever. Last year, a woman in her 80s told me that gold *always* goes up and has never lost money. History argues otherwise. Gold prices had a boom and bust in the early 1980s [9].

Instead of trying to predict tops and bottoms, make sure that your investments are in harmony with the trend and stay diversified.

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