Alternative Investments: Comparing Gold vs. Real Estate as an Inflation Hedge

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Before the Broadway smash *The Book of Mormon*, there was the television show, *South Park*. The two productions share more than their creative originators (Trey Parker and Matt Stone). For starters, they can be sophomorically crude and outright foul. The language is not for the faint of heart. But for the thick-skinned among us, they can contain insightful observations and wisdom all while making you laugh hard enough to lose your breath.

This discussion brings me to an old *South Park* episode in which one of the main characters, eight-year-old Stan Marsh, is suffering through a nasty break up with his girlfriend. In a rebellious protest, he decides to start hanging with the "goth" kids. It is then that Stan is instructed by the alpha goth that if he wants to be a nonconformist, all he must do is "wear the same clothes as us and listen to the same music as us."

While choosing to go the alternative investment route may not quite be considered a rebellious protest, the rise in popularity of alternatives and the rush into hedge funds *(link to hedge funds post)* and gold may be considered a bit like conforming to nonconformity. Such conformity may come at the expense of missing out on another potential alternative: commercial real estate investing, particularly in terms of fighting off inflation.

Gold as an Inflation Hedge

Gold has attained its popularity as an alternative asset due to a commonly held belief that it is the ultimate protection against inflation. While a long-feared consumer price inflation has yet to materialize, with the federal funds at or below 1% for nearly eight years, a fear of inflation may be considered paranoia by some. But, to note another observation from the realm of literature

(Joseph Heller's *Catch-22*), "Just because you are paranoid doesn't mean they are not out to get you."

It is not unreasonable to think that another 1970s style inflation could occur, in which the rise in the consumer price index could reach as high as 12% on an annual basis. Gold enthusiasts point to a couple of reasons why gold may serve as an inflation hedge.

First, while central banks may be able and willing to provide a seemingly endless supply of fiat (paper) currencies, the supply of gold is limited to the existing stock and what can be mined from the ground. Even a record production of 3,100 (metric) tons of new gold is less than 2% of the estimated world-existing supply of 171,000 tons. Gold bugs argue that even if governments devalue their currencies (by increasing supply), an investment in gold will maintain its value in terms of purchasing power.

In addition, gold supporters point to the fact that gold has served as a safe haven in times of crisis and a store of monetary value for thousands of years.

Drawbacks of Gold

Critics of the barbarous relic (as economist John Maynard Keynes so "affectionately" referred to gold), however, point to some disadvantages. First and foremost is the fact that gold is not a productive asset. Other than ceremonial (jewelry) value, there is no economic value in terms of producing anything, including a yield to the investor (unless the gold has been leased out to another entity).

As Warren Buffet once noted: "(Gold) gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again, and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head." As an old saying goes: When times get tough, you can't eat your gold.

Further still, gold as an investment does not get preferential tax treatment regarding long-term capital gains. Gold is taxed as a collectible, even if purchased via an exchange-traded fund, and it does not qualify for beneficial long-term capital gains rates (15% or 20%, depending on tax bracket). Instead, when gold is held longer than one year, gains are taxed at 28% (unless the current tax bracket is lower, in which case the current rate is applicable).

Real Estate: The Often-Forgotten Alternative

With the popularity of hedge funds and gold as alternative investments, it is easy to forget another class that serves as an alternative and a potential inflation hedge: commercial real estate.

Contrary to gold, real estate is a tangible asset and can provide a real return in terms of cash flow. During inflationary periods, the cash flows may increase as leases are up for renewal and subject to an increased market rate for rent.

While industrial and office properties may have lease cycles ranging from three to 10 years, apartment complex leases are typically one year, giving rents the potential to rise more quickly than other real estate sectors. The higher cash flow and the general rise in price levels during an inflationary environment are also likely to boost the underlying market value of the investment property.

Sophisticated investors have also long utilized commercial real estate investing, in part due to some significant tax advantages. Rental income can be reduced or “sheltered” by depreciation. Given that depreciation is a “phantom expense” in that there is no actual cash outlay, the investor gets to keep at least a portion of the income tax-free (or at least deferred).

With some forethought and strategy, a 1031 exchange can be used to defer capital gains (and depreciation recapture) on the sale of real estate if a new like-kind property is purchased. A savvy investor may be able to take the 1031 process a step further and use it as a vehicle to transfer property to heirs who will receive a new stepped-up cost basis on inheritance and thus eliminate the deferred capital gains and recapture taxes altogether. *(link to estate planning article)*

Avoiding the Popularity Contest

All this is not to say that gold does not have its uses as an inflation hedge or role in an alternative investment portfolio, but as noted, there are some drawbacks. Investors who look past the popular choices in alternative investment (the conforming nonconformist), may see that private real estate may also be a solid investment in an inflationary environment and comes with added tax benefits.

The benefits that real estate may provide don’t come without risk, however. A skilled and experienced manager can help seek out commercial real estate opportunities while assessing and managing risk from a professional perspective.