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A gold enthusiast? Listen to the head — and history.

By Barry Ritholtz, Published: January 10

How much money did you make from gold's spectacular run from under $500 a decade ago to more than $1,900 two years ago? How much did you lose from the 38 percent collapse since its September 2011 peak?

Last year was the first time this century that gold ended the year down from when it began. But gold investors have been making investing and trading errors for what seems like forever.

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The mania for gold, like all manias preceding this one, is ending badly. And while gold may yet establish a comeback, much of the damage has already been wrought.

More importantly, did you learn anything from that epic boom and horrific bust? If the savvy observer approaches gold's rise and fall as an objective history lesson, there are broad principles to be derived and behaviors to be avoided. That is, if humans can ever begin to learn from experience.

Consider the following lessons as applicable to not just gold, but any investment:

1 . Beware the narrative:

As we noted in July, everybody loves a good story. The narrative form has been around for thousands of years longer than the written word. It is how humans transfer information. We love a tale of heroes and villains and conflicts requiring a neat resolution.

In finance, storytelling is a major part of any sales pitch, and gold is no different. The credit crisis and Great Recession created the perfect environment for the gold narrative to prosper. Bailouts and rescues and global coordinated central bank actions played right into the hands of the gold bug story. Both quantitative easement and zero-interest-rate policies were the perfect foils for what was described as inevitable: The collapse of the dollar (and all "fiat currency") and imminent hyperinflation.

Instead, the dollar hit three-year highs; inflation was nowhere to be found. Even as the

Federal Reserve kept up its policy of "QE infinity," gold kept heading lower. The problem with all of this was that even as the narrative was failing, the storytellers never changed their tale.

When it comes to investing, there are two problems with that kind of storytelling: It ignores actual data. And it makes investors feel good, regardless of what is actually happening.

2. Carefully examine new investment products:

The creation of the SPDR Gold Trust exchange-traded fund (NYSE: GLD) was a major shift in how investors could buy gold. More commonly called the Gold ETF, GLD was described as "the innovation that opened gold investing to the masses."

The back story is fascinating. GLD was a creation of the World Gold Council — an organization created by global gold-mining companies for the sole purpose of developing markets — after "two decades of depressed prices and a growing glut of the yellow metal," as the Wall Street Journal put it.

It was enormously successful: Lipper called GLD the "fastest-growing major investment fund ever." During its bull run, the fund was buying $30 million of gold daily. By 2012, the SPDR Gold Trust was the second-biggest equity holding after Apple in self-directed 401(k) plans

Salesmen always need something to sell. In GLD, they 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 eventually disappoints you. I call this my universal entropy theorem of investing, and it is why everything from Microsoft to the 10-year bond, from Apple to gold, eventually goes to hell. (Just look at how often stocks get tossed from the Dow Industrials.)

Gold has frequently had these run-ups only to get trounced eventually. See 1974-76, 1981, 1983-85, 1987-2000, 2008 and now 2011-14.

4. Leverage is always dangerous:

Physical gold (like all commodities) is purchased via futures contracts. The leverage involved is typically 15 or so to 1 — meaning, for every $1000 of gold futures you buy, you have to put up only about $67. To buy the same amount of stocks would require $500.

Any investment bought via credit always runs the risk of margin calls and, eventually, liquidation. It was true for the dot-com stocks, for no-money-down houses and for subprime collateralized debt obligations. It is just as true for precious metals.

When you buy anything with lots of leverage, it does not require a whole lot to go wrong to lose it all. At 15-to-1, a mere 7 percent price drop can generate a margin call, meaning you gave have to put up more capital or you lose all of your prior investment. With all of those newbie gold enthusiasts who were inexperienced in the futures markets, it is no surprise that there were plenty of wipeouts.

The CME Group, the world's largest commodities exchange, was concerned about all this leverage. It acts as both a clearing house for trades and as the guarantor of all contracts. It could get stuck holding the bag in the event of big price swings and bigger losses. As gold rallied past $1,000, the CME Group did the prudent thing — raising margin requirements. Even some pros were caught unaware by the increases.

In September 2011, with volatility increasing, the CME Group raised gold margin

requirements by 21 percent — leading to more margin calls, forced selling and liquidation. That marked the high point of the gold run.

5. Understand the circumstances of the moment:

In military aviation, the concept is called situational awareness. In a dogfight, pilots have to be aware of everything in all four dimensions — 3-D space, plus how things change over time.

The idea is important for investors, as well. Although gold does well when the news flow is bad, eventually, the cycle will turn. Bad news gets better as the economy recovers, people get hired, sentiment perks up, retail sales improve.

Quite a few gold investors came to believe that the bad economic news had become a permanent condition. They forgot that the Great Depression eventually ended, and so, too, did the Great Recession. They got lost in the moment — an expensive mistake.

6. Don't be unwilling to walk:

Try this simple thought experiment before making any investment: Ask yourself "What would make me reverse this position — what would make me sell?" Most professionals have a long list of factors. Often, a simple price decrease will get traders to cut their losses.

Not so with gold bugs. Whenever I asked that question — what would make you sell — the most common answer I heard was "I'll stick with gold."

This is a dangerous mind-set. It is especially important to have an exit strategy with a "loved" holding — specifically because of that big emotional attachment.

If *nothing* will make you reverse your biggest present holding, you have a huge, devastating flaw in your approach to investing.

7. Ask what is already reflected in the price:

This is one of the biggest differences between professional and amateur traders.

Pros in the gold market understood what was already reflected in the price — whether it was the Indian wedding season or moves by China's central bank that had an impact on demand. Genuine surprises that are unknown to the market can move prices. Most of the narratives (See this or this) do not.

8. Don't guess:

For people familiar with equity investing, where the focus is on earnings and cash flow, gold can be perplexing. Relative to equities, it has no fundamentals. It also has no cash flow, or earnings, or dividends.

Instead, some people tried to guess the direction of macro issues, such as interest rates, GDP, corporate earnings, debt, unemployment, inflation, and the U.S. dollar, to surmise where gold prices were going.

This is a near-impossible task. It is certainly not a reasonable basis for deploying your capital.

9. Ignore end-of-the-world tales, conspiracy theories and other nonsense:

As we noted in 2011, after a recession, the least rational rise (temporarily) to prominence. My advice then was to ignore them. Why? Because salesmen never let the facts get in the way of a good narrative.

Too many discussions about gold contain ominous forecasts about what the end of civilization is going to be like. Spurious correlations, ominous fear mongering seemed to be a key part of the narrative. Mix in one part dollar collapse and two parts hyperinflation, and the conclusion is you MUST own gold.

The problem is that fear mongering is about what has already happened — and not about the future. The dollar? It already collapsed 41 percent from 2001 to 2008. Inflation? We already had very strong inflation in the 2000s.

Gold is marketed through a combination of fear and dishonesty. At least various equity products are marketed through a combination of hope and dishonesty. It's a far less depressing sales spiel.

10. Listen to the skeptics:

Someone challenges the belief in gold, and instead of responding with empirical, data-driven counter-arguments, the true believers revert to personal attacks. Scroll through the comment section of the blog ZeroHedge.com to see the sort of nonsense that passes for debate. A lack of reasoned discourse is overcompensation for a weak investment thesis.

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The ups and downs of gold over the past 10 years are not unique. Like any other investment, people became emotionally involved with the trade. Mistake were made, money was lost.

Astute investors will learn something from watching and thinking about other people's mistakes. Hopefully, you can avoid repeating these errors when the next mania rolls around.

A longer version of this was published at Bloomberg View.

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