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Gold by Alice Roth

Pitfalls in diamond investment

Some guidelines on liquidity, quality and term for the smaller investor.

Investing in gem diamonds—once almost solely the province of wealthy old European families—has in the last two years become a fad among American investors seeking the ultimate inflation-hedge. As with gold and silver, the diamond craze died down somewhat this spring when the Federal Reserve jacked up interest rates, making it difficult for investors to finance such ventures.

Between February 1979 and February 1980, prices of investment-quality diamonds doubled and in some cases tripled. But between March and early May, as the Fed's measures took effect, gemstone prices declined on average by 25 to 30 percent.

Beginning in April, De Beers, the cartel which has controlled the world diamond market for the last 50 years, intervened in its traditional fashion to stabilize the market. De Beers began to reduce both the amount and the quality of rough stones offered at its London "sights." Since De Beers' Central Selling Organization (CSO) markets 80 percent of the world's diamond output, the 250 or so cutters and dealers who are permitted to attend either accept De Beers' offer or depart empty-handed.

After De Beers began to slash new supplies, the market firmed up, rising about 5 percent from May to late August. At last week's "sight," the CSO changed its tactics somewhat, increasing supplies but still holding back the higher-quality stones.

Market experts expect that investment diamonds will show strong gains between now and the end of the year. Jack Backer, who heads a New York-based diamond brokerage firm, expects a 20 percent increase in the price of polished stones. This may be reinforced by an increase in De Beers' wholesale prices, which he expects to occur in November. Hertzy Hasenfeld, one of New York's leading diamond cutters, is somewhat less optimistic. He expects a 5 to 10 percent jump between now and Christmas, but "nothing spectacular."

In my view, the diamond market should be approached with caution. There are indications of a new credit crunch ahead, as the Fed is moving to raise rates at the same time that corporations are more illiquid than at any time in postwar history and the U.S. Treasury is financing a $60 billion deficit.

This negative factor must be weighted against the prospects of a Middle East or Indochina explosion by mid-October. Even more than gold, diamonds are a highly portable, internationally recognized store of value which the wealthy traditionally turn to when political chaos or war endangers their fortunes. The much-feared destabilization of Saudi Arabia would unquestionably send diamonds, gold and silver through the proverbial roof.

However, diamonds are probably not a good investment for the average American investor. Diamonds are not as liquid as gold and the investor who wishes to realize his profits cannot always count on being able to resell his diamonds quickly and expeditiously. Markups of 10 to 40 percent exist between the cutter's price and that of the diamond dealer from whom the investor purchases the stones.

In many cases, the investor will have to sell at the cutter's price and forego a larger portion of his potential profit. Few dealers offer buy-back guarantees. Bernard Cirlin, publisher of the widely-respected *Precious Stones Newsletter,* recommends that the investor be prepared to hold onto his diamonds for at last three years before taking profits.

This is decidedly not a market for persons who wish to trade—go in and out quickly—or for those who may be forced to sell under pressure.

For those who can wait, however, diamonds promise handsome profits, largely due to the formidable strength of the De Beers monopoly. De Beers' strategy has been to achieve a steady increase in the dollar price of diamonds in real terms and, since 1949, it has never had to roll back wholesale diamond prices.

In sum, to invest successfully in diamonds, one should be prepared to tie up large sums for years at a time and already have considerable exposure in more secure inflation hedges, such as gold.

In a subsequent column, I will elaborate some tips for those who do want to venture into this tricky branch of the international commodities markets.

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