the advisor

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Golden

"O Gold! I still prefer thee unto paper, Which makes bank credit like a bark of vapour."
Lord George Byron
(1788—1824)

The most famous bond manager in the world, Bill Gross of PIMCO, recently disclosed that his flagship fund had dumped all holdings of US Treasuries and UK gilts. Why on earth would he do that?

As "...a representative of a $1.2 trillion money manager, historically bond oriented, that has been selling Treasuries because they have little value within the (US) context of a $75 trillion total debt burden. Unless entitlements are substantially reformed, I am confident that this country will default on its debt; not in conventional ways, but by picking the pocket of savers via a combination of less observable, yet historically verifiable policies – inflation, currency devaluation and low to negative real interest rates."[1]

Ideally, money is a medium of exchange and *a store of value* which may be readily exchanged for other assets. Mr. Gross's assertion is that US and UK bonds are simply too risky to hold because of the prospect for currency debasement and for higher inflation in each country.

Indeed, Britain's median inflation has risen from 2% at the end of 2009 to more than 5% now. The UK has been forced to tighten fiscal policy and may have to move soon on monetary policy (i.e. higher interest rates) resulting in potentially severe losses for bond holders. Can America be far behind? Mr. Gross is taking no chances.

So if the prospect of higher inflation - and we still think deflation is the greater imminent threat - and of currency debasement looms, what might be a good portfolio defence?

Commodities generally and precious metals specifically have been a good place to seek refuge. Demand for base metals (such as copper) is driven by the pace of economic activity. Demand for precious metals (such as gold and silver) is driven mostly by fear - a purely psychological activity.

While gold might not be the perfect currency alternative, those of "fiat" origin – that which is printed on paper and is backed by nothing more than faith in those doing the printing – are riddled with imperfections. Paper money is far easier to use than gold in personal and commercial transactions. However, compared to gold fiat money has not been a reliable store of value. For example, in 1932 an ounce of gold was worth about US$20, while lately an ounce of gold was worth approximately US$1,400. In this measure of relative value, since 1932 the U.S. dollar has lost almost 99% of its value in relation to an ounce of gold.[2]

Because gold has risen for ten years, many believe it is forming a financial bubble. A financial bubble is defined as a trade in high volumes at prices that are considerably at variance with intrinsic values. For this to happen, increasing amounts of capital must flow into the asset class, bidding up its price to irrational levels.

This supposed gold bubble - a 400% rise over the past ten years - is unexceptional in comparison to the upward spikes of 1,324% in the Nasdaq stock market of the late 1990s, the 954% rise in housing stocks in the last decade and the 882% rise in the price of oil. Furthermore, it appears that many of the "experts" who now assert that gold is in a bubble failed to recognise the development of the stock market and housing bubbles. In fact, many well-known investors who like gold now are the ones who saw the stock and housing bubbles for what they were. We know of no financial mania that did not include both the general public and its financial advisors pouring money into an already over-priced market. That is not yet the case with precious metals.[3]

If we are in a bubble for gold, it is a strange mania given the low prices of leading gold mining companies in relation to current and likely future earnings, cash flow, gold reserves, production capacity and ability to increase dividends.

In nominal terms, gold prices may be trading at all-time highs. However, investment flows suggest gold is nowhere close to being overbought. There is also a view that gold has no intrinsic value and is simply a specu-

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lative asset. The truth about gold is that most people simply don't own it - yet.

In their Gold Yearbook 2010, CPM Group noted that in 1968, gold held by individuals for investment purposes represented approximately 5% of global financial assets. By 1980 that amount had fallen to roughly 3%. By 1990 it had dropped significantly to 0.6%, and by the year 2000 represented a mere 0.2% of global assets. By the end of 2009, nine years into the gold bull market that began in 2000, they estimate that gold had increased to represent a mere 0.6% of global financial assets. Sprott Asset Management calculate this percentage increased to 0.7% of global financial assets in 2010, the same portion the world held over two decades ago.[4]

Though growing, the central banks of most emerging nations maintain a very small amount of gold relative to their overall foreign exchange reserves.

The Chinese authorities appear to be joining the gold party, possibly to take the heat off of their own "pegged" and undervalued currency, the renminbi. China is keeping 100% of the gold produced within its borders while encouraging its citizenry to purchase gold perhaps as a means of protecting itself from worldwide currency debasement. The Industrial and Commercial Bank of China (ICBC) and the World Gold Council developed a gold-based savings plan allowing small investors to make modest regular deposits and build up savings convertible to physical gold.[5]

In a portfolio context, precious metals have shown to have a low correlation to broad based equities; i.e. they have the potential to reduce risk and enhance return. The non-correlation to both the S&P 500 Composite Index and the S&P/TSX Composite Index is largely the affect of the market's utilisation of gold as a multi-purpose hedge. Last year, the sovereign debt crisis and concerns of a global currency war led to the use of precious metals as a hedge against fiat currencies. This year, with food and commodity prices rising, money is slowly transitioning out of the former trade as an alternative currency and into a hedge against inflation concerns.[6]

On a technical level, gold prices have recently shown strength particularly against the equity market and base metals. Within the precious metals sector, small-cap gold companies have recently been gaining relative strength against large-cap gold companies. Investors looking for portfolio diversification may want to consider bullion or Exchange Traded Funds that track gold through bullion or futures, whereas investors looking for ways to generate portfolio alpha might consider junior gold companies.[7]

Unlike fiat paper money, gold cannot be created by printing or by its electronic equivalent. There is no "central bank" for gold, and none is needed. Gold epitomizes faithfully, as it always has, the key monetary characteristic of being a reliable store of value.

We are agnostic about gold - neither gold-bugs nor bears. Precious metals are a notoriously volatile asset class. Nevertheless, precious metals are a good defence against currency debasement and ought to be considered for part of a prudently diversified portfolio. Until America responsibly addresses her debt situation, gold's future continues to look . . . golden.

Sources:

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