GOLD RUSH

March 2010

What is that building worth? If you have been in the real estate market at any point in your life, you learned that ultimately a property is only worth what someone is willing to pay you for it. This is true of all assets. Buy anything for less than you sell it and you make money. Many assets either provide a reason to hold value or provide value in the future. A return is not dependent only upon one's hunch that it can be sold for more later. With a building, you expect to get value from its use or from rental income. Bonds, savings accounts, CD's and the like offer interest payments and maturity values. Stockholders share in the profits and future profits of the companies they own. We call things that have such expected returns "investments".

Commodities and precious metals possess no such generators of value. They are just something buyers **hope** to sell for more. We call these "speculations." We should have reasons for our investment decisions which are rooted in economic logic and portfolio theory, not fear or worse, anecdotes. Components of a diversified portfolio should have expected returns. Gold, for instance, does not produce anything; it has no projected earnings stream and therefore no expected return. Gold is just a metal.

~ ***"We spend huge amounts of money digging it up from underground. Then we spend huge amounts of money storing it back underground and pay men with guns to protect it. People looking down from Mars would be baffled."*** ~

- Warren Buffett

We are going to pick on gold because it has received the most amount of press this year and therefore seems to have prompted the most questions from clients. With no generator of return, gold instead is touted based on four themes: 1. Supply and demand factors 2. Inflation protection 3. Protection against a weaker dollar and 4. Protection against severe economic recession or a depression. The stories told based on these themes can sound well reasoned, but do they really tell the full story?

We can't help but be skeptical. Every time the stock market does poorly, people tend to take notice of all sorts of alternatives. It is a normal reaction, but good decision-making is not enhanced by the media's attention to these things. We believe gold has gotten so much attention largely because it has hit all-time highs recently. This is standard behavior for the business media and a form of chasing what is hot at the moment. Other commodities have not received so much attention even though the themes cited above would typically apply to them as well. Take oil, for instance. In the summer of '08, most of the talk about oil called for higher prices based on supply and demand factors, inflation concerns and the fact that oil is priced in dollars. A weak dollar would make oil prices rise. As the price of oil collapsed, the same themes were retold but applied to gold. Today, at little more than half of its '08 prices, you hardly hear any talk about oil.

The supply and demand theory of gold goes something like this. There is a limited supply and it is difficult to extract more, therefore prices will continue to rise. Naturally, there is more to the picture. According to a January 2009 article in *National Geographic* magazine, nearly 70% of the world's gold is used for jewelry. Economics 101 teaches us that if supply is not growing, prices can only rise if demand increases. How high does demand for gold jewelry get when the price of gold is so high? Did you buy or receive a lot of gold jewelry this Christmas? For most, the answer is "no" and the reason for the lack of purchases was higher prices. Something else must be driving the interest in gold.

Gold is often touted as an inflation hedge. The view on this is highly dependent upon the time frames examined. If we look at the 1970's, gold prices spiked while inflation averaged 8.8% and gold looked

like a good hedge. All periods since then tell a different tale. Inflation subsided but remained after the 70's, yet gold did not track inflation. Instead it plummeted 69% to $297 over the 29 months ending June 1982 and failed to sustain any appreciation for two decades. In fact, it did not regain its 1980 high for 27 years! Adjusting for inflation, for an ounce of gold to buy what it could in 1980, the price would need to be about $2,350 today. In this most recent decade, the metal's price has risen, but with inflation running only 2.6%, inflation does not explain the increase.

Historically, over long periods, stocks have much higher after inflation returns than gold with less volatility. Figure 1 shows the relative returns and volatility of several measures including the total US Stock Market since January 1975 when it became legal for ordinary citizens to own gold, after FDR's order to confiscate most forms of the metal in 1933. Over shorter periods, short term and intermediate government bonds have provided a reliable modest after inflation return with only a small fraction of the volatility gold has displayed. Since the inception of US Treasury Inflation-Protected Securities in 1998, these government issued bonds provided almost identical after inflation returns to gold with only one-sixth the volatility. Something else must be driving the interest in gold.

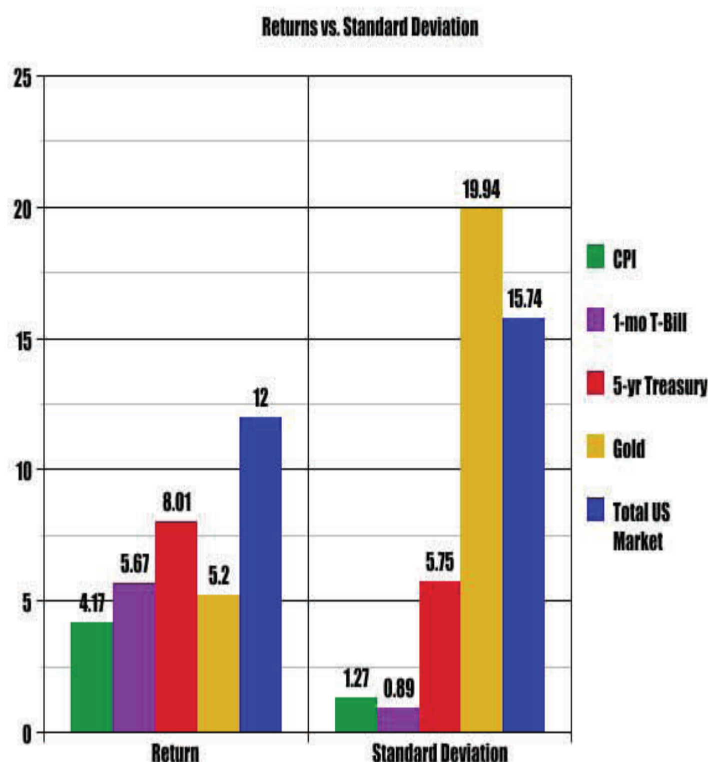

Figure 1 1975-2009 Data Sources: London Bullion Market Assoc., Dimensional Fund Advisors

That brings us to the most fashionable reason today for gold's rise – a falling dollar. Gold has been used on and off as money across many civilizations through history. Many people touting the demise of the dollar see gold as a potential currency. Worries about the increasing US government deficits and the national debt brought about by the credit crisis, stimulus bills and the Great Recession make stories about the dollar collapsing plausible to many.

While people get wrapped up in the story, few have looked at the actual behavior of the dollar. While off against the Japanese Yen, if we compare today's US Dollar with the level of the dollar against the Euro when the recession began in late 2007, or its levels pre-crisis, we find the dollar has actually risen slightly. The dollar is up even more against the UK Pound. Something else must be driving the interest in gold.

Have you ever almost been run off the road? For a while, you drive more cautiously. The more acute the scare, the more likely you are to appreciate being alive and what you have because the idea of being gone in an instant is more top of mind. The recent economic near-miss has a lot of people giving more credence to doom and gloom scenarios. Most of the people who claim to see a coming economic catastrophe tout gold as a safe haven. Those of a certain age may recall an abundance of similar prognostications in the late 1970's.

~ ***"Gold is a religion; it's not an asset class." - Billionaire Mark Cuban*** ~

Safe is a relative term but an unemotional examination indicates gold is not at all safe. Figure 2 shows the change in average monthly gold prices since 1975. You can see that the positive returns that kept gold ahead of inflation in the 70's came in a very short period at the end of the decade. When that run ended, it ended sharply. Gold can move quite quickly. In fact, only this most recent spike has given gold a positive inflation adjusted rate of appreciation since 1975.

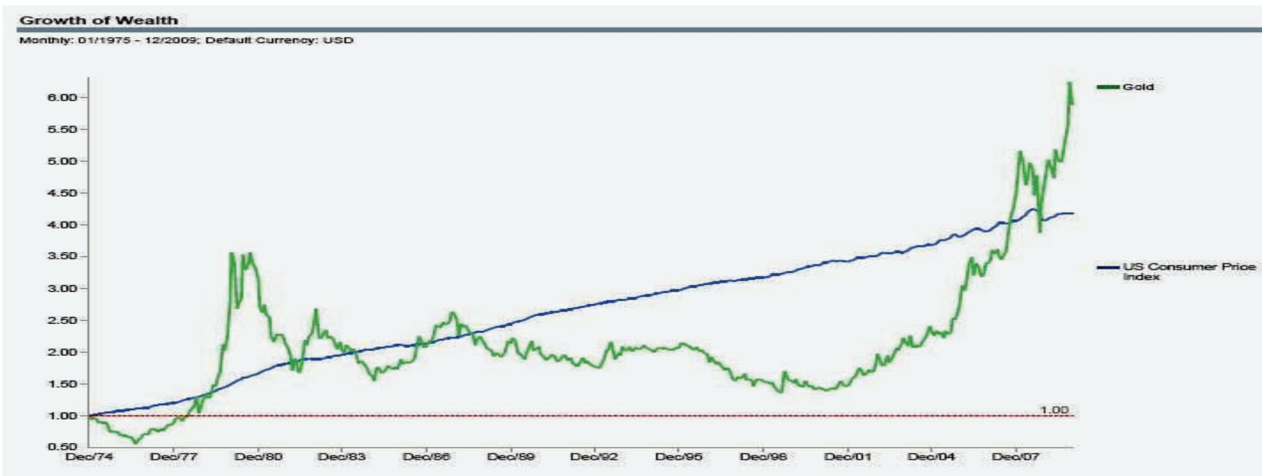

Figure 2

If one believes that under a financial meltdown scenario gold will do well, one should recall that gold prices dropped 21% from $903.50 on October 8, 2008 to $712 a mere 12 trading days later. Gold recovered but so did stocks, with stocks out performing gold in 2009.

The really dour prognosticators even hold out gold as safer than government bonds because we can't trust the government and their ineptitude will bankrupt the country. What is puzzling about this logic is that if the government is that bad, what would prevent Uncle Sam from confiscating gold like it did in 1933 under the crisis brought about by the Great Depression? Where are we supposed to keep the gold even if it isn't confiscated? How do you use it to buy anything? Wouldn't using it tip off everyone that you own some? How safe would that be?

The farther down that path you go, the more likely it is that you may determine that if things go that badly, the portfolio is the least of our worries.

Gold is off from its December high, so we might not be hearing as much about it. However, if those highs are revisited, you can count on the hysteria rising again.

Understandably, people want to flee uncertainty. But modern finance teaches us that this is not the task of the investor. Periods of volatility weed speculators out from investors. Real investors do not confuse the inevitable periods of poor performance with a failure of markets and capitalism. The disciplined, long-term investor does not react to short-term variance in markets by seeking alternative, protective "asset classes," but instead develops a temperament that turns the urge to flee into a desire to remain patient and disciplined. Long-term investors accept—even embrace—the risk that comes with expected return.

We can't prove that gold is going to go in any particular direction. There's nothing wrong, per se, with putting some assets in gold or any other commodity as long as you recognize it as a speculation and don't put your most important goals at risk. You may even make some money but you should be aware of one often overlooked aspect of owning gold. The IRS considers gold a collectible, not a capital (investment) asset thus profits are taxed up to 28%, not capped at 15%. As a result, in a taxable account, your gold speculations will need to be almost twice as "right" as many of your traditional investment decisions.

Reaction to recent markets or an arbitrary shift away from the instruments with expected returns that comprise the bulk of a plan are common causes of investment failures. Understanding what you're doing and why is one key to success. We must distinguish investing from speculating. This discernment is part of our role in protecting our clients' interests. We have no axe to grind. If we thought gold was a sound investment, not a speculation, we would buy accordingly. All this "sure thing" talk reminds us of the same types of sentiment we heard about tech stocks and real estate. Buyer beware.