ASPERA BULLETIN

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All That Glitters…

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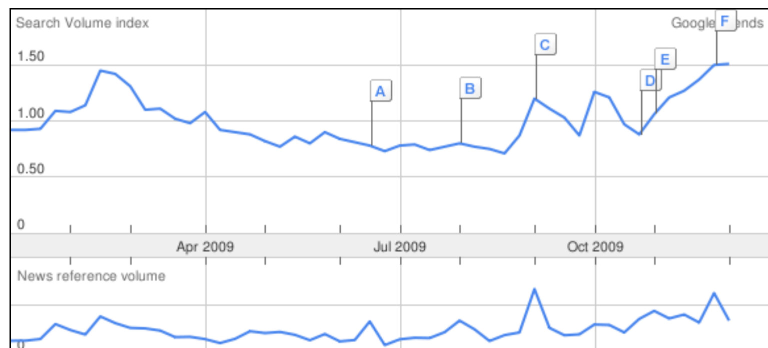
It's said that there were three wise men who visited Jesus after his birth. Two of them brought dried tree sap. The other brought gold. By my count, that makes one wise man and a couple of wise guys.

Gold has been receiving quite a bit of attention lately. After spending most of the year bouncing around the $950 level, gold broke through $1,000 in September and then staged a strong 2-month 20% rally. More recently, the metal has been receiving some attention because of its pullback from those highs.

The chart below shows the worldwide 2009 trend for the search term "gold price" in Google. Interest had been declining all year until gold broke through the $1,000 mark. Now, it seems everyone has an opinion on gold, and they're not afraid to share it. That's my cue.



My Personal History With Gold

By way of personal background, I first invested in gold back in 2002. Since that time, my precious metals securities have constituted my largest portfolio position. In terms of the idiot/genius cycle, this has been one of those rare cases in **which I've (so far) avoided any of the idiot phases**. Still, I'm looking forward to the final idiot phase in which I sell at much higher levels but am berated and ridiculed for thinking gold should ever be sold. When that day comes, I like to think that the cover of Time magazine will read "Gold $5,000?," dentists will be offering to replace gold fillings with ceramic for free, and Tim Geithner will be employed as a human canary in an underground Indonesian gold mine. But I'm getting a little ahead of myself.

When I first started buying gold it was trading at roughly $300 per ounce. It was a contrarian's dream. When I mentioned to my peers in 2002-2003 that I was bullish on gold, the reactions I received were similar to those offered when I opted for energy stocks in 1999 over internet stocks. There were some looks of horror, some tears of sympathy, some shaking of heads, some glazed eyes, and some offers to help with my resume.

In 2002, most of the gold bulls were folks who are called "gold bugs." These are people who are always bullish on gold. They tend to be socially awkward, mostly wear camouflage, and they constantly expect the currency to collapse, our political system to implode, and America to revert back to an agrarian society. They're always bullish on gold, guns, and John Deere hats. Unfortunately, if things ever get as bad as they fear, I'm not sure how useful their gold coins will be.

Aside from the gold bugs, no one wanted to hear about gold in 2002. At the time, I was managing money for The Hartford (HIMCO). I tried on a number of occasions to convince the powers-that-be that we should carve out a measly few hundred million dollars and dedicate it to commodities and precious metals. They respectfully declined, choosing instead to expand into credit derivatives a few years later, again confirming the strong negative correlation that exists between the amount of investor capital destroyed and the size of one's bonus check in the world of finance. If there is a hell, I'm sure it will eventually be overflowing with failed but wealthy investment managers busily trying to figure out how to profit from selling carbon credits to the devil.

I bought gold in 2002 for a number of reasons. The fact that the metal had been in a long-term secular bear market certainly caught my attention, but the same argument could have been made 10 years earlier with disastrous results. A catalyst is always needed, and the catalyst in 2002 was the action taken by Greenspan to lower interest rates over the course of 2001 to combat a slowing economy. In November of 2000, the federal funds rate stood at 6.50%. By the end of 2001, the rate had been dramatically lowered to 1.82%, a level not seen in 40 years.

Rather than let the excesses of the technology bubble correct, the authorities were trying their best to reinflate the economy. Sound familiar? Washington had telegraphed that it would stop at nothing to forestall a correction, and the magnitude of ammunition expended was staggering, though quaint by today's standards. Their actions were sowing the seeds of the next crisis. It was clear to me that we were headed towards an even larger economic dislocation and bubble. Although I couldn't predict the magnitude or timing of that next bubble (credit/housing), I was confident that it would result in a bigger bust than the implosion of the internet bubble. It wasn't difficult to imagine a rekindling of a love affair with gold in a world of increasingly destabilizing fiscal and monetary policy actions.

Gold is no longer the contrarian dream it was back in 2002. Much of the easy money has been made. Following such a strong 8-year bull market, you might expect that I'd be more likely to be a seller of gold and gold stocks rather than a buyer. Although gold is hardly undiscovered these days, the fundamental reason for owning gold today hasn't changed. In many ways, the case is even stronger today than in 2002, despite the higher price.

The Last Gold Bull Market

A look back at the prior 30 years helps to explain the disinterest in gold in the early 2000s. The last gold bull market occurred during the late 1970s. Between 1976 and early 1980, gold ran from $100 to $850 per ounce, an increase of 750% in only 4 years. However, had you been sucked into the frenzy at the peak of $850, you would have spent the better part of the next 21 years listening to your spouse mockingly refer to you as “Goldfinger” (released in 1964) while regularly thumbing through the divorce lawyer section of the yellow pages.

From a high of $850 in 1980, gold ultimately fell to $250 in 2001. That’s a 70% decline. That’s not adjusted for inflation. It also ignores the opportunity cost of missing a historic secular equity bull market over that same time frame. Chinese water torture would seem like a spa treatment in comparison.

As is typical when it comes to investor psychology, people tend to extrapolate the past into the future, and the longer the past trend, the stronger the belief that it will continue. Following a 20-year bear market, gold wasn’t going to attract much attention, particularly while most investors were still mourning the loss of Pets.com, Webvan, and Flooz.com.

Since 2001, however, gold has staged a steady march from $250 to its recent peak of about $1,200. The chart above is deceiving in that it isn’t geometric. This latest move looks larger than the late 70s bull market, but gold has *only* risen a little more than 4-fold in this cycle versus 8.5 times in the earlier cycle. Compare that to stock market returns. Furthermore, if we adjust for the ravages of inflation, gold would have to exceed $2,000 to reach the inflation-adjusted peak of 1980. As strong as this current bull market has been, it still falls far short of that move in the late 70s…so far.

Testing $1,000

Part of the unfolding drama with the price of gold for the last two years has been gold’s flirtation with the $1,000 level. You can see in the 10-year chart below that gold had toyed with the $1,000 level a few times between 2008 and this past September. Technically-oriented traders dumped the metal each time it failed to convincingly break through. There is nothing inherently magical about the $1,000 mark. It’s just a number. Psychologically, however, people do attribute significance to big round numbers.

Recall your initial shock with paying $2.00 for gasoline. You eventually adjusted to that new reality. The same thing happened with $3.00 gas, and it will happen with $4.00 and $5.00 gas as well. Gold had never traded north of $1,000 before, so it took the market some time to adjust to the prospect of $1,000 gold. More specifically, it took about 18 months and 4 failed attempts to crack through. Gold could always fall back below $1,000 again, but the idea of $1,000 gold is no longer an impediment to higher prices.

<u>Why Own Gold?</u>

If you take one point away from this piece, it should be the following: **Gold should be owned as a hedge against political incompetence and monetary mismanagement.** The key driver of gold prices is faith in our politicians and monetary authorities.

If the economy is being prudently managed, debt is being kept at easily serviceable levels, economic freedom is being promoted, money supply growth is being kept in-line with potential economic growth, and interest rates are commensurate with market-clearing levels, then there is little reason to hold gold. The dollar would be a strong and vibrant currency that would at least hold its value in such a world.

> *In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value.*
>
> Alan Greenspan (1966; pre-lobotomy)

We must remember that the dollar and the other currencies of the world are fiat currencies. They are legal tender only because the government says so and forces us to accept them as payment. The dollar is simply a faith-based paper IOU, backed by the government's monopoly ability to print even more dollars. Take your dollar bill to the bank and ask to exchange it and all you'll receive is another (perhaps crisper) dollar bill. This wasn't always the case. Dollars used to be redeemable into gold.

A dollar that was backed by gold had the virtue of limiting the ability of government to abuse the currency by printing too many dollars. The threat of the dollar holders redeeming their dollars for gold kept such money printing escapades in check. As government eventually realized, being tied to gold…well…limited their ability to abuse the currency. The final tie to gold was removed by Nixon in 1971 after the French, realizing that there were too many dollars in circulation relative to the supply of gold, began demanding gold for their dollars. The French were right, the U.S. was caught, and gold convertibility was ended. From that day onward, there has <u>yet</u> to be a limit to the amount of money our government can print or debt it can incur.

If government wants to expand (which is its nature) it has a few avenues. It can increase taxes and spend that new money, it can borrow money by selling Treasury debt to investors, or government can simply print more dollars and spend them. These last two avenues are where empires eventually gravitate. Increasing taxes isn't politically palatable since it can result in losing votes. Increasing debt has been a popular idea for some time. True, we're burdening future generations and reducing future growth, but that doesn't seem to bother voters too much. But even borrowing money pales in comparison to the perceived panacea of simply printing more dollars.

No government over time has ever been able to resist the temptation of inflation. The masses understand higher taxes. What could be easier or more tempting than funding your budgets, entitlement obligations, wars, healthcare "reform," deficits, and pet projects by just creating new dollars at seemingly no immediate

cost? People understand higher taxes. Many people understand higher debt. Few, however, really grasp the damage that inflation causes.

> *The power to create money is the most ominous power ever bestowed on any human being. This power is rightly criminalized when it is exercised by private individuals, and even today, everyone knows why counterfeiting is wrong and knavish. Far fewer are aware of the role of the federal government, the Fed, and the fiat dollar in making possible the largest counterfeiting operation in human history, which is called the world dollar standard. Fewer still understand the connection between this officially sanctioned criminality and the business cycle, the rise and collapse of the stock market, and the continued erosion of the value of the dollar.*
>
> Llewellyn Rockwell

We all have to hold our wealth in the form of some "currency." If you don't like dollars, you can sell dollars and buy euros, yen, or some other currency. You could also own gold. Gold has been around much longer than the dollar, euro, yen, or any other fiat currency. In fact, gold has functioned as a currency and served as a store of value for much of the last 5,000 years thanks to its unique characteristics. Gold is relatively scarce, durable, portable, divisible, and homogenous. Gold is not someone else's liability, and the government can't simply create more gold.

Flation?

Much of the analysis surrounding gold focuses on whether gold is a good inflation and/or deflation hedge. I find most of this analysis incomplete at best. Gold is unique in that it has at times either fully or partially backed our money supply, and, at times, the price of gold has been fixed. Most of the historical analysis of gold fails to take this into account. We would expect the price of gold to perform differently during inflation or deflation depending on whether gold is officially a currency or not and whether the price is fixed by the government or free to float.

Today, gold is not technically a currency, and the price is not fixed. As a result, we should generally expect to see gold appreciate as the money supply increases. Inflation alone won't drive gold higher. We had modest inflation throughout the 1990s, yet the price of gold fell. The fear of future escalating inflation due to monetary and fiscal mismanagement is today's driver of gold. It's a loss of control, the willingness to control, or the ability to control the growth of the money supply that matters. Fiscally, the threat of runaway deficits and debt are a major concern as the most politically palatable way of dealing with such a burden is through a further increase of the money supply.

Central Banks

Central banks are one of the largest holders of gold, and for years, they had been large and steady sellers of gold. This trend has slowed of late and may actually reverse next year. China's growing interest in adding gold to its reserves has received a good deal of press this year, but the most significant central bank development was the purchase of 200 tons of gold from the International Monetary Fund by India this past November. Few saw this coming as everyone believed that China would buy that gold. India's purchase has put the world on notice that a shift in the perception of gold by central banks is occurring. On a smaller scale, Sri Lanka and Mauritius also recently announced that they had bought gold.

Despite this recent buying, most central banks have a very small portion of their reserves devoted to gold. Japan has 2.3% of its reserves in gold, India has 4.0%, Russia has 4.3%, and China has 1.9%. Clearly, there is plenty of room for growth. Considering the pervasive concern about the dollar's status as a reserve currency, the impetus for central banks to diversify away from dollars is growing.

The benefit of this shift by the central banks may well be the establishment of a floor under the price of gold. Any significant drop in the price of gold is likely to be viewed by these central banks as a buying opportunity. The central banks are sensitive to unilaterally driving the price of gold higher through their purchases, so we're more likely to see them step in on pullbacks. The 200 tons of gold that India recently purchased was bought at a price of $1,045. We're once again nearing those levels. I would be very

surprised if India, China, and perhaps others weren't using this current pullback in the price of gold (and rally in the dollar) to increase their gold holdings.

If these foreign central banks were confident in the dollar, the future returns on U.S. bonds, and the health of the global economy, we wouldn't expect to see a growing interest in gold. These developing world central bankers understand that the actions taken by our Federal Reserve and politicians are a sign of distress rather than strength. The exchanging of unbacked paper money for gold by a growing list of central banks is a very important signal.

Supply

Gold bulls often point to the fact that annual gold production has been falling since 2000. As with oil, much of the easy to reach gold has been discovered and produced. At the margin, this is certainly supportive, but it tends to be over-emphasized, in my view.

Gold is unique in that it isn't consumed. Every barrel of oil that is produced gets consumed. It's gone forever. Gold, however, doesn't disappear. It doesn't erode. Vast amounts are not consumed in industrial processes. All of the gold ever mined is still out there somewhere.

On average, the amount of gold produced in a year is equivalent to 1-2% of the total existing stock of gold. The impact of annual changes in the rate of production pales in comparison to the decisions being made by the holders of the existing stock of gold. Whereas the annual production of a *consumable* commodity is of great importance to the price of that commodity, the same relationship is much less relevant for gold.

Mine production has indeed been falling this past decade, and this is due to the fact that miners experienced a 20-year decline in the price of their product while their costs kept rising. Even after the price of gold bottomed in 2001, it took some time for the mining companies to accept that the outlook had brightened. Even then, it took more time for the price of gold to increase enough to justify the risk and cost of new exploration. Furthermore, it takes many years of exploration, permitting, and development to bring a new mine on-line.

Will we see an increase in production in future years? There's a very good chance of this due to the improving economics of mining. However, high quality mines are rapidly disappearing. In 1950, miners could extract 12 grams of gold per ton of ore in the U.S., Canada, and Australia. Today, that figure is closer to 3 grams. And, even though the price of gold has been rising, costs have also been rising. We haven't yet seen huge earnings growth in the miners. That will come, and it will bring strong cash flow and pressure to do something with that cash. Increased exploration and development will certainly be one such use.

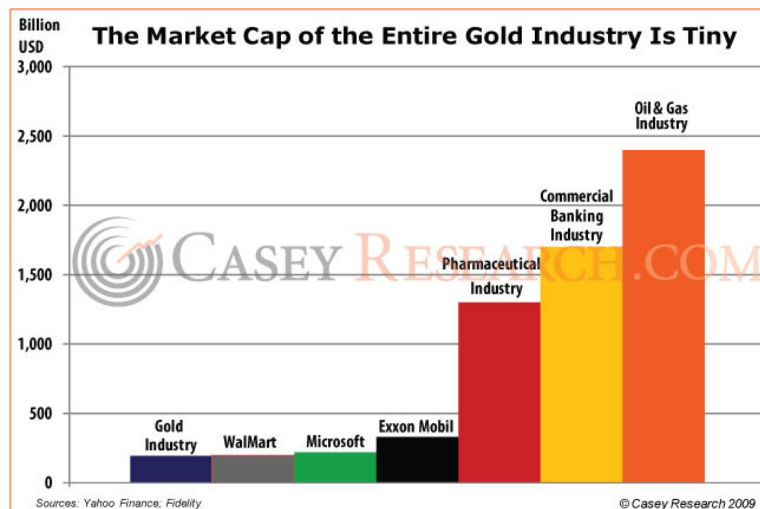
What we may well see beforehand, however, is an increase in acquisitions and mergers. The larger miners with deeper pockets can more easily increase their reserves by buying smaller miners with attractive properties and using their expertise to develop and expand those properties. This phase of the gold bull market is likely to begin soon and will help to drive the shares of the junior miners.

Demand

On the demand front, the other most significant development in recent years (along with central bank buying) has been the creation of gold and silver exchange traded funds (ETFs) which actually own and store the metals. These have been growing rapidly in popularity and give the "common man" easy access to gold ownership. No longer do you need to go to a gold coin dealer or worry about large commissions/premiums.

There has been a running debate as to whether the ETFs actually possess the gold they claim. There is a good case to be made that they may not actually own the full amount of actual gold that they claim, but few doubt that they are still significant holders of the metal.

The gold industry is tiny relative to other asset classes. Most people would be shocked to learn that the market value of the entire gold industry is equivalent to that of WalMart or Microsoft.



Given its small size, it wouldn't take much buying to have a large impact on the market value of the gold industry. Large institutional investors such as pension funds and mutual funds currently have very little exposure to gold and mining shares. Even an increase of 1-2% would have a dramatic impact on share prices. As the price of gold climbs and as the miners perform well, there will be increasing pressure on institutional investors to jump on board.

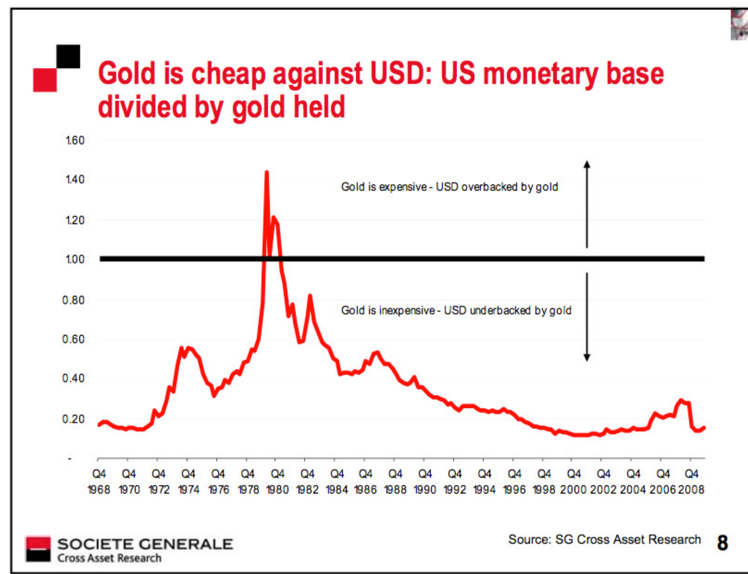
What the bulls neglect to mention is that it wouldn't take much selling to cause a significant drop in the market value of the industry. It works both ways. Still, there's clearly plenty of room for growth if central banks, pension funds, hedge funds, and individuals decide to increase their holding of gold and gold stocks by even a small amount. A couple prominent hedge funds have recently taken large bullish positions on gold. This may be the first step toward greater institutional ownership in the years to come.

Valuation

One of the knocks on gold is that it has no inherent value. It doesn't generate dividends or interest payments. It has no significant industrial use. So, how do you value it? This is a fair critique to some degree. We can't discount some expected future cash flows to determine a fair value. We can do this for the mining companies but not for the price of gold itself (though we need to forecast the price of gold to discount the cash flows of the miners).

Interestingly, this value criticism typically comes from overpaid economists and strategists who failed to see the unfolding gold bull market, the blowing and collapse of the credit bubble, and most every other major economic and investment event of the last 20 years. What exactly is *their* inherent value? Despite their wealth-destroying advice, I imagine they'd argue vociferously that their compensation (cash flow) doesn't adequately reflect their "value."

The most ardent of bears would argue that gold has no value at all. The most ardent of bulls, however, would argue that a fair value for gold would be north of $6,000 per ounce. The argument for this case is highlighted by the graph below. Since 1971, the value of our gold supply has typically been far below where it would need to be to fully back our currency. Today, the price of gold would have to exceed $6,000 per ounce to fully back our money supply. It hasn't traded high enough to actually back our monetary base since the last bubble, but that doesn't mean that it never will again, especially if we experience another bubble.



So gold, which can't really be valued, is worth somewhere between $0 and $6,000. That's not particularly helpful. The reality is that we can't really model an intrinsic value for the price of gold, but we intuitively know that gold must have some valuable purpose, some raison d'etre.

Quite simply, **gold's usefulness lies in the fact that it has served as a store of value and medium of exchange throughout history**. The debasing of currencies around the globe is reminding investors of this incredibly valuable role of gold. Governments can (and always do) inflate away the value of their fiat currencies, thereby wiping out the hard-earned wealth of their countrymen. Gold is a hedge against such abuse as it protects our purchasing power in such times.

Strategy

Clearly, I remain bullish on gold. If the price of gold is headed higher in the next few years, it's important to make sure that we're positioned to benefit from the rise.

Diversification

To ensure that we'll benefit from any future increase in gold and silver prices, we've diversified our exposure to the play. We have direct exposure to the commodities themselves through GLD or DGP for gold and SLV for silver. These track the returns of the underlying metals. DGP is levered and tracks twice the return of gold. In addition, we have exposure to gold and silver mining stocks. We own two mining ETFs – GDX and GDXJ. GDX consists of a basket of some of the largest (major) gold mining companies, such as Newmont, Barrick, and Goldcorp. GDXJ is a fairly new fund which owns a basket of junior miners, including a number of firms focused on silver exploration.

We also own a number of individual equities in various accounts, including Newmont (NEM), Agnico-Eagle (AEM), Yamana (AUY), Golden Star (GSS), Exeter (XRA), Mines Management (MGN), Entrée (EGI), Minefinders (MFN), Silver Standard (SSRI), and U.S. Gold (UXG). Newmont, Yamana, and Agnico are large cap miners. Silver Standard is a mid-tier miner. The rest are small-cap junior miners.

In general, the junior miners are more volatile than the majors, and the individual equities will be more volatile than the mining ETFs which will be more volatile than the metals themselves. While gold prices are up 22% so far this year, GDX is up 34%, and a number of the junior miners are up 100-300%. Our diversified allocation will ensure that we participate in what remains of this precious metals bull market.

Core/Tactical

Every security in our portfolios (not just gold positions) can be thought of as either core or tactical. Core positions are names that I expect to own for 2+ years. Tactical positions are shorter-term in nature and

include hedging positions (a more in-depth explanation will follow in a future Bulletin). Our precious metals position consists of both core and tactical positions. For the most part, we now have a full position in precious metals in most portfolios. By full position I mean that we're near the maximum core position that I'm comfortable holding as a percentage of the overall portfolio. Of course, this core position is larger for aggressive clients than it is for conservative clients.

Most of our metals positions fall into the core category. If gold is indeed headed to $2,000 or higher, this core position will be largely responsible for our performance over the next few years. Though gold will encounter significant swings as it climbs, the objective of the core position is to capture the primary move in precious metals. So long as the underlying thesis for owning this position remains intact, this is essentially a buy-and-hold-for-a-while strategy. We will occasionally pare back our core position when appreciation takes our weighting too high.

Shorter-term tactical positions consist of securities that we add during pullbacks (like the current one) with an eye towards selling them during the next rally. This is a "buy on dips and sell on rallies" strategy. This will augment the return we achieve in our core position. Our call option on SLV and our positions in MGN, SGLD, and AEM are examples of recent tactical positions.

Conclusion

Our leaders in Washington continue to assure us that all is well and the worst is behind us, yet gold continues to climb. The rise in gold since 2001 has been a warning that all is not well. Gold performs best in times of political and monetary mismanagement and when financial assets are performing poorly. Let's not be fooled by the rebounding stock market or government-induced improvement in economic indicators. It's evident that our country is becoming ever more dependent on debt and inflation. The fact that trillions of stimulus dollars have been spent with such limited impact is a terrible indicator for the economy but wonderful for gold.

To be clear, I am not a gold bug. As with any investment, there is a time to own gold and there is a time to avoid gold. This remains the time to own gold. Trying to predict how high the price of gold may rise is a useless endeavor. I expect to own gold until we experience a real gold bubble or until we see the political will to rein in the debt and deficit and to seriously defend the dollar. The latter may eventually occur but probably not until the American middle class finally decides to vote the bums out en masse. Unfortunately, that day likely won't come until we've experienced an economic shock even greater and more debilitating than that of this recent crisis.

> *There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion or later as a final and total catastrophe of the currency system involved.*
>
> Ludwig von Mises

The thesis for owning gold has evolved and strengthened over the past 7 years. The challenge, I hope, will be to not sell too soon. We've all seen the advertisements for "Cash4Gold" and similar businesses that people are flocking to in order to sell their gold jewelry. The bears point to this as a sign that gold is in a bubble. They have it backwards. When gold is really in a bubble, these businesses won't exist because no one will want to sell their gold.

Best,

Ken Bell, CFA, CFP
President
Aspera Financial, LLC

12/27/09