

ASPERA UPDATE

Intelligent, Independent Investment Management

The What And The Why Part 1: Precious Metals

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Aspera offers independent fee-only investment management and advisory services throughout the Triangle area and nationwide.

Every client portfolio is separately managed.

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“The one permanent emotion of the inferior man is fear – fear of the unknown, the complex, the inexplicable. What he wants above everything else is safety.”

Henry Louis Mencken

Ideally, this would be the time of year when the markets fall into a mild coma and allow all of us in the asset management industry a slight reprieve to finish (or start) our holiday shopping, sample the latest in homebrewed eggnog, and chase “Mrs. Claus” around the tree. Unfortunately, the slow motion disaster in Europe, a toppling Chinese real estate market, the continuing global debt binge, the collapse of MF Global, and legislative constipation in D.C. have no “pause” button.

To make matters slightly more maddening, the past few months have been particularly unkind to our precious metals positions. Gold and silver miners seem to be processing coal this holiday season instead of their usual shiny ingots. Of course, these pullbacks are to be expected. I’ve been through this countless times with these securities over the last decade. It is a normal, inevitable, and healthy component of a long-term secular bull market. Still, these pullbacks can be unnerving for some, particularly those who haven’t worked with me for long (as in many years). What elicits a shoulder shrug from me may produce night terrors in others.

I fully expect to generate solid returns over time, but as I always stress, I have no control over the short-term path of returns. Weak short-term results are no more a cause for concern to me than strong short-term returns are a reason for celebration. My only concern at all times is whether our portfolios are positioned appropriately relative to the long-term risks and opportunities that exist.

This multi-part series will focus on what we own in our portfolios and why. Hopefully, this format will allow for a more detailed yet digestible discussion of our portfolio positioning. The better you understand what we own and why, the easier it is to focus on our long-term goals and ignore the constant bombardment of short-term noise.

Part 1 of this series will be a review and update of what has long been our largest exposure – the precious metals sector. I strongly recommend a review of two prior pieces, particularly for newer clients. The first was written in December of 2009 and is titled “All That Glitters...” The second was a fairly recent update from this past September entitled “Did The Gold Bull Just End?” Both are available through Aspera’s website under the “Archives” tab.

Precious Metals - What Do We Own?

My approach to this sector for the past decade has focused on ensuring participation in the long-term precious metals bull market. The worst thing that could happen would be to put all of our money into one gold mining firm which ultimately fails. We do not want to be right about the bull market in gold and silver but bet on the wrong pony and actually end up losing money. **In order to ensure that we benefit from whatever upside may lie ahead for the precious metals, I have very deliberately taken a diversified approach to this sector.**

We have exposure to gold and silver as well as a diversified basket of precious metals mining equities. This helps ensure that we at least capture a good portion of the moves in this sector. Hopefully, over time, we'll be able to add incremental value by opportunistically rotating between securities, but the primary goal is to capture the bulk of the moves that this space delivers.

The mining equities in particular demand reasonable diversification. In just the past few years, I've owned miners which have appreciated over 5-fold. I've also owned miners that have fallen over 50% at times. The recent experience of Agnico Eagle offers a reminder of the risks that even the best mining firms face. Agnico recently had to close one of its core producing mines due to unstable geology. This immediately halted about 16% of the company's production, and the company has written off its entire investment in the mine. **Mining is a very time-consuming, expensive, and risky endeavor.**

Political risks also haunt the mining group. Venezuela has nationalized mines in recent years, effectively destroying much of the value of the firms which owned those mines. Governments can also rewrite laws to demand higher royalties from or greater ownership of mining firms. Obviously, this would immediately negatively impact the economics of a mine as well as the value of the mining firm.

The prudent and intelligent strategy is to own a basket of metals and mining equities. We diversify away a good deal of risk within the sector and guarantee that we will benefit if we're ultimately right about where the price of gold and silver are headed. **Our more aggressive accounts have a higher weighting to precious metals than conservative accounts. They also have greater exposure to the junior mining equities, which I expect to ultimately deliver the greatest appreciation but which will also provide ample volatility.**

Why Are We Invested In Precious Metals?

In a broad sense, we like the precious metals space because it offers a degree of safety against monetary mismanagement and political ineptitude. It is protection against the massive fiscal debts which continue to accumulate throughout the world as well as the near inevitability of continued paper money conjuring. Simply put, **it is a hedge against political and monetary idiocy, and such idiocy is in ample supply these days.**

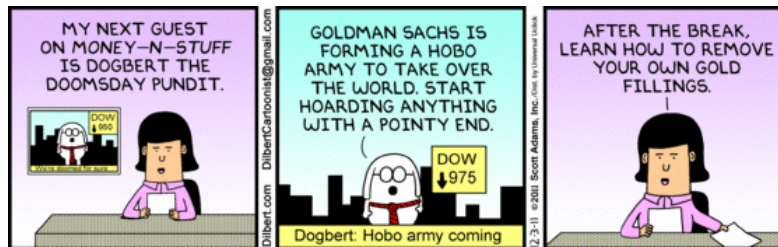
I see our political and monetary leaders faced with three general options going forward:

1. End the stimulus and let the great debt bubble (here and abroad) deflate. This would result in large-scale defaults, numerous bank failures, an immediate and severe recession, and the potential implosion of the global monetary regime.
2. Follow the Japanese model, and continue to kick the can down the road. Suffer slow/no growth for years while banks recapitalize and bad debt is slowly written off. Administer enough stimulus to keep the economy sputtering along **as long as the bond market permits cheap financing (low interest rates).**
3. Attempt to inflate the debt away and spur export growth by printing money.

In simple terms, if you believe that the authorities both here and abroad are about to abandon their efforts to prevent a deflationary spiral, then there are few assets worth holding. Cash (which yields

nothing) looks very good in such a world. Gold and the mining equities actually did very well during the Great Depression, but there's no guarantee that the same would hold true this time.

On the other hand, **if you believe that the authorities will do everything they can to try and prevent a severe recession/depression, rising social unrest, the implosion of Europe, and the domino collapse of many systemically important banks, then I can think of no better asset to own than gold and silver.** This is the world we've been largely living in for many years, and there's no reason to believe that the same misguided leaders will respond differently in the period ahead. When faced with the choice of a certain death versus a stay of execution, the decision is easy.



In the 2Q11 Quarterly Review I pointed out that the Fed would need some cover before enacting another large-scale easing program. Nothing has changed. **The Fed would like to see declining commodity prices, weak employment data, deteriorating economic growth, and a decent drop in the equity market in order to more easily justify cranking up the printing presses.** We have seen commodity prices moderate, but we probably need to see more deterioration in the economic and employment outlook before the Fed brings out the big guns again. **Additionally, a 10-20% drop in equities from current levels would provide further support.**

At some point, these stars will align, and we'll see more stimulus. **It doesn't hurt that the new voting members at the Fed in 2012 have demonstrated a bias toward more easing (stimulus).** Bernanke had some push back this past year from a few members who were concerned about the Fed's quantitative easing experiment. Bernanke will encounter much more unanimity as 2012 begins. [To clarify, I strongly believe that the easing to date and any additional stimulus from the Fed is terribly misguided and will lead to greater problems in the future. It is, however, very good for the precious metals sector.]

I suspect we'll also see some significant easing out of Europe at some point. Either the European Central Bank (ECB) will ease as part of an agreement among Euro members to formalize a real fiscal union, or we'll see printing by national central banks after the euro area breaks up. Another realistic option would be for Germany to exit the Euro (perhaps with some other fiscally-prudent Northern European countries), leaving an ECB in place with the political will and latitude to devalue the Euro.

In addition to the supportive fiscal and monetary back drop, there are a number of other factors working in favor of gold:

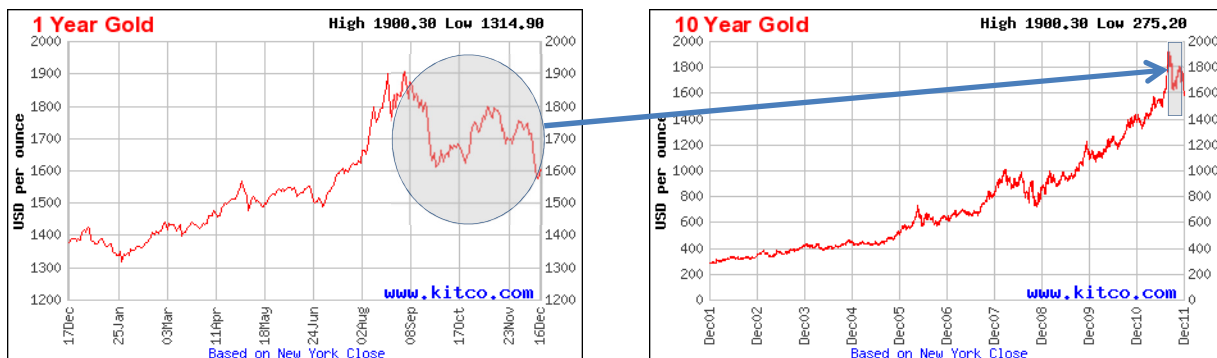
- After years of selling, central banks are now net buyers of gold.
- Gold producers are no longer selling their gold and silver forward.
- The metals are more accessible to investors than ever before.
- Actual physical ownership minimizes or eliminates counterparty risk.
- Supply is facing constraints. There are few easily accessible, large deposits left.
- The precious metals sector is very underowned by investors.

What's Behind The Recent Slump?

It's often difficult to pinpoint the precise reason/s behind a pullback in a particular sector or market. However, a few factors seem to be involved in the recent decline of the precious metals space.

- There has been hope that the ECB would unleash a massive quantitative easing (QE) program. This hasn't happened yet, leading some traders to head for the exits.
- The same can be said for our own Fed. Adoption of a large QE3 program is still on hold.
- The banking/funding crisis in Europe has resulted in a dash to raise cash. At such times, sellers often unload those assets in which they have gains and which are liquid (easy to sell). Gold would be an obvious candidate.
- The miners have been weak this year and are subject to tax-loss selling, which has likely been occurring of late. We could see this pressure abate as we head into 2012.

The charts below show the price of gold over the past one and ten years. As volatile as the price has been in recent months, the 10-year chart adds some context. Still, let's not take too much comfort in the steady climb shown over the last ten years. As I'll discuss shortly, there is no reason that the price of gold couldn't suffer a serious decline (the drop in recent months is merely modest) at some point before rocketing to new highs.



Are You Worried About The Recent Decline?

I haven't lost a wink of sleep over this latest pullback. I've owned this space for a decade now and have been through similar declines. **I've been through this type of pullback in every single one of my most profitable investments over the last 20 years.** You simply need to know that these pullbacks are inevitable and that trying to time and trade the rallies and pullbacks is often fruitless at best and destructive at worst.

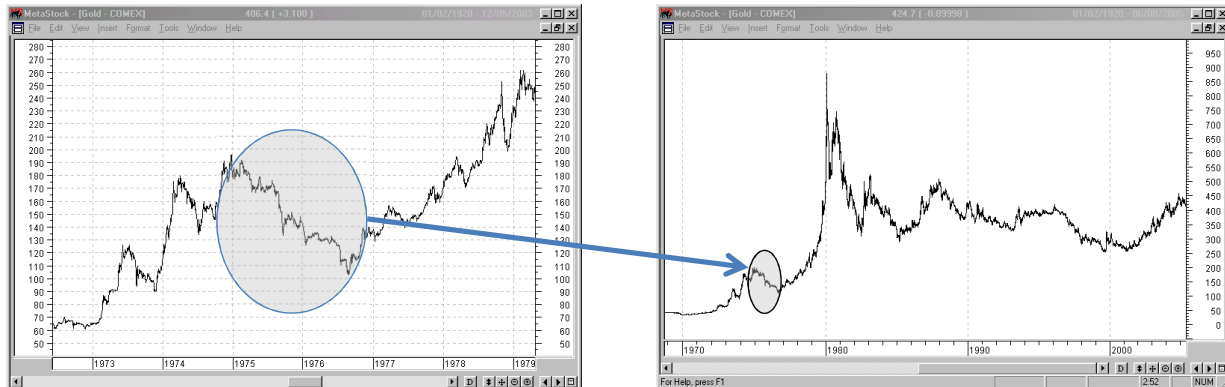
The key is to examine whether any of the reasons for the pullback affect our longer-term thesis for owning precious metals securities. It's clear to me that nothing has changed. The bullish case for gold and silver today is as strong as it has been at any point in this cycle.

Where Is The Near-Term Bottom?

The short answer is that I don't know. No one does. It may have been last week, it could be tomorrow, or it could be a year or so off in the future. **Recall that the last great gold bull market was during the 1970's. Before that bull market made its final parabolic move higher, the price of gold fell by nearly 50% between early 1975 and late 1976.** I've long discussed the fact that great bull markets do not run

straight up. There are always pullbacks, some of which can be very significant and/or last for an extended period. **These pullbacks tend to shake the weak hands out and set the stage for the next leg higher.**

This is a critical reason why it's important to ignore short-term results. If you blow out of your positions during such a decline or pause, you miss the real move. The following two charts show the dramatic drop in the price of gold right in the middle of the last great gold bull market. Gold fell from nearly \$200/oz to almost \$100/oz over a 16 month period. This must have shaken the faith of many, and I'm sure many investors gave up and sold. Over the next few years, gold skyrocketed from \$100 to \$800.



Will we see a similar dramatic decline at some point before a final parabolic phase? I don't know, but **it's important to recognize that such dramatic declines are certainly possible within the context of a powerful secular bull market.** We've had two modest pullbacks in the past 6 months, but a serious conviction-shaking sell-off can never be ruled out. **Regardless of the magnitudes, I can assure you that this current pullback will not be the last.**

Will There Be A Bubble?

It's impossible to definitively predict a bubble. All one can do is recognize whether the ingredients for a bubble exist, and I have long seen the potential for a bubble in the precious metals space. It's easy to envision a scenario unfolding in the coming years in which massive deficits and debts and slowing economic growth result in unprecedented money printing and a loss of confidence in paper money. The mountain of derivative securities which exists and the resulting counterparty risk could further erode the confidence in fiat currencies. We already live in a world in which every nation seems intent on encouraging exports through a weaker currency. The desire for a weak currency is unlikely to abate any time soon, and that will help underpin the precious metals.

Importantly, the precious metals space is terribly underowned by investors. Few individual or institutional investors own gold, silver, or mining equities. Amazingly, after 10-years of rising gold prices, this sector still gets little respect. It's difficult to argue that we've seen a bubble already when so few have participated. A modest shift higher in exposure to this space would have a dramatic effect on security prices. Investors who today can't name two gold mining firms may be tripping over themselves to buy any mining equity at any price before this cycle is over.

Interestingly, gold shares an important characteristic with the internet stocks of 1999. Both are challenging to value by conventional means since they don't generate cash/earnings. During the internet bubble, we were all encouraged to value firms based on how many site visitors they had rather than their economic prospects. In a similar fashion, in a bubble environment we might see the "experts" (who mostly now hate precious metals) offer outlandish forecasts for gold and silver prices based on ridiculous metrics that are difficult to fathom today. Don't forget that Wall Street loves to sell a story or concept. Should we find gold miners becoming the new darlings of Goldman and Merrill, we'll know the end is nigh.

Still, I am not predicting a bubble. I simply want to point out that the ingredients are coming together nicely for a bubble. Should a bubble develop, it could still be years away. Bubble or no bubble, I expect strong performance from this sector given the political and monetary path on which we're traveling.

When Will We Sell?

Let me again be very clear. **I plan on living a long life, and I have no intention of passing my precious metals securities on to my now 3-year old daughter when I die.** These securities will be sold long before then. **I have a very clear exit strategy,** and there are very concrete events that I am looking for to signal our move to the exits.

1. **A Gold/Silver Bubble:** This is the one we're all rooting for. Our best case scenario would have us selling our holdings as the entire space goes parabolic. Should this unfold, we will gradually sell all of our precious metals exposure. We are sure to sell a bit early, leaving some money on the table.
2. **Monetary Tightening:** If governments and central banks were truly trying to protect the value of their paper money, the price of gold would be plummeting. Gold-backing is not necessary for a strong or solid currency. A gold-backed currency doesn't prevent a government from cheating and printing more paper than is backed by gold in storage. A fiat currency can be a strong store of value if its supply is tightly controlled. Should we see our Fed adopt policies geared toward strengthening the dollar long-term, this would be a signal to sell our metals positions.
3. **Better Opportunities Elsewhere:** As always, we will rotate our investments if we can find better opportunities elsewhere.

What Should We Expect Going Forward?

If you know what to expect, surprises should be minimized.

1. **You should expect continued volatility in this space.** The precious metals sector is one of the more volatile sectors of the market. Big moves in both directions occur in a fairly compressed period of time. We will see more of this. Furthermore, you should expect silver to be more volatile than gold, the mining equities to be more volatile than the metals, and the smaller junior miners to be more volatile than the larger equities with producing mines.
2. **You should expect to have a relatively significant exposure to the precious metals space for some time to come.** This cycle could still take many years to play out. Until one of our exit indicators is triggered, I see no reason to hop off of this roller coaster. So long as monetary policy is tilted heavily toward easy money policies, we want to be involved in this sector.
3. **You should expect to have a heavier exposure to this space the more aggressive you are.** In addition, aggressive clients will have more exposure to the more volatile mining equities, particularly the junior miners. Conservative clients will have their precious metals exposure more focused on the metals themselves as well as the larger, more-established miners. I carefully monitor the risk exposure in our portfolios and am quite comfortable with the portion of the portfolio invested in precious metals across all risk baskets.
4. **There will be some trading activity.** We will shift funds between gold, silver, and the miners as relative valuation changes. We will add tactical positions at times, and we will trade to capture tax losses within taxable accounts.
5. **This space will continue to be a key driver of performance.** We will experience strong weeks, months, and quarters at times when this sector catches fire, and we will also experience weak performance when the space temporarily falls out of favor.

6. **Importantly, our performance will not track the stock market, the bond market, or any other common benchmark.** Short-term performance relative to some benchmark imparts little useful information, whether the comparison is good or bad. **We will remain focused on achieving strong risk-adjusted performance over the course of a full bull and bear market cycle.**
7. **We should all expect this investment to pay off over time. I own this space because I view the upside as being very compelling relative to the risk.** The facts and therefore my view are always subject to change, but **I can think of no other investment I would rather own at the moment.** We could always see further weakness in these names, but I expect this group to boost our returns over time. Equally important, I expect these securities to help preserve the purchasing power of our money in the uncertain period ahead.

Conclusion

I hope this discussion has been helpful. It's important to understand what we own and why. My hope is that such an understanding will help you roll with the punches. Chasing short-term performance is a weapon of mass wealth destruction. One of my investment strengths lies in being able to foresee and ride out long-term secular themes. These never move straight up. **Most investors fail to fully participate because they can't stomach the inevitable pullbacks that accompany any bull market, and they get shaken out on pullbacks. It is just an unavoidable reality that there will be "nose-holding gut checks" from time to time. Our precious metals exposure is Rip Van Winkle-like. We need to let it sleep. There will be periods of sweet dreams and the occasional nap jerk, but the results of the entire slumber should prove fascinating.**

Of course, we don't just own precious metals securities. In Part 2 of this series, I'll discuss the yield component of our portfolios. This will be most relevant for my conservative clients, but I'll tackle a couple of concepts which are important for all of us.

Best,

Ken Bell, CFA, CFP
President
Aspera Financial, LLC

12/19/2011

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