GREYCOURT

White Paper No. 50: No Gold Digging For Me

June 2011

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"No gold digging for me… I want diamonds!"

- Mae West

Talk of gold is everywhere, as it usually is when the price has recently rocketed up. The words of Pindar are heard so frequently on CNN, CNBC and Bloomberg that you could be forgiven for thinking the speakers actually knew who Pindar was: [1]

"Khrysos [gold] a child of Zeus; neither moth nor rust devoureth it."[2]

Everyone from G. Gordon Liddy to prominent investment banks and hedge fund operators are weighing in with an opinion on the merits of gold in the current environment. The discussion is a mix of macroeconomic analysis, public policy debate, fear-mongering, traditional gold-bug obsession and the investment industry's deep longing for fees. What is an investor to make of this? This paper will bring some clarity to the current debate and provide investors with a framework for thinking about gold.

Before we begin, we should point out that the quote from Pindar, in the form it is commonly used, is incomplete. Let's allow Pindar finish his sentence:

"Khrysos [gold] a child of Zeus; neither moth nor rust devoureth it;

but the mind of man is devoured by this supreme possession."[3]

The reason we want to hear Pindar out is to emphasize the point that investing in gold isn't like investing in stocks, bonds or other securities. Gold has no yield – in fact, it has a negative yield, since it generally costs money to own it. There is no issuer whose business prospects we can analyze. We don't even buy gold because it makes us feel good, like an alternative energy deal we know in our hearts to be hopeless.

We buy gold out of fear, and what we fear is that the economic, social and political infrastructure we count on when we buy stocks and bonds is degrading and might go kerflooey. If

[1] Pindar was a Greek lyric poet of the fifth century BCE.
[2] Pindar, Fragment 222 (trans. Sandys).
[3] Ibid.

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that happens we don't want to be caught owning traditional securities – we want to be caught owning gold.

❖ The Dual Nature of Gold

Like its poor cousin, silver, but unlike most other commodities, gold was possessed of a dual nature for thousands of years. It was both a traditional commodity, widely used in industrial and jewelry applications, and it was also a form of money, used over the ages as a medium of exchange.

Note that gold use as a commodity (by the electronics and jewelry industries, 2,480 tonnes in 2010) is roughly in balance with annual production (2,573 tonnes in 2009). Annual production and consumption are a relatively insignificant 2% or so of world gold supplies, given that estimates of world gold inventories range from 120,000 tonnes to 155,000 tonnes. Remember that gold "consumed" in the manufacture of jewelry can also move back into the investment inventory. Thus, while gold is a legitimate industrial commodity, under some circumstances (as now) industrial use is almost a trivial influence on gold's price.

More important, currency is no longer exchangeable into gold and almost no one anywhere – at least in the developed world – will accept gold in exchange for goods or money.[4] That doesn't mean that gold has no value beyond its industrial uses, however. Many people believe that if most everything else went to hell, gold would suddenly become exceptionally valuable – usable to buy a whole host of things, including personal security, if necessary. This view of gold is nothing to sneeze at if you happen to live in a society that periodically confiscates its citizens' property and/or lives.[5]

However, it is not the people in Banana Republics who are mainly driving up the price of gold – it is ordinary investors, everyone from Grandma in Sioux Falls to hedgies in London to Gold Bugs in their survivalist shelters.

Since gold has no yield and no use other than as an industrial commodity, what has to be driving the gold price above its value as a commodity is *sentiment*. To paraphrase Warren Buffett, in the

[4] Actually, governments hold gold for reasons that are at least marginally monetary in nature, but individuals and corporations don't. Note that governments have been small but persistent sellers of gold since the 1980s.
[5] We hear a lot about how newly affluent consumers in China and India are propping up gold prices. Maybe so, but they didn't cause gold to triple.

short run markets are voting machines, driven by mass sentiment, while in the longer term markets are weighing machines, presumably establishing a gold price somewhere near its industrial value. It is hard to say what gold's price would be gauged solely as an industrial commodity, but let's say for the sake of argument that gold's floor price would be around $500/troy ounce.[6] Yet gold is in fact selling, as this paper is written, at something north of $1,500/oz. What gives?

❖ There Are Verities and Then There Are Verities

As we noted above, what tends to drive sentiment about gold – and therefore the price of gold – is fear: rising concern about things we think we should take for granted. For example, we think we should take it for granted that the United States has a sterling credit rating and that the bonds it issues (Treasuries) should have no default risk. We think we should take it for granted that the US dollar is and will remain the world's reserve currency, allowing the US to do a whole host of things that would get it in trouble if its name were, say, Greece. We think we should take it for granted that inflation will be kept under control, that the country won't fall too deeply into debt, and that we will remain the world's largest economy and most powerful country.[7]

These crumbling verities were never truly verities in the first place, but they also aren't things we want to have to worry about. Yet today, many people worry about all of them and almost everyone worries about some of them. This sentiment causes people at the margin to want to own gold. Maybe they want to own it because they think they will need it to buy things when everything really goes to hell. More likely they want to own it because they believe that the verities are going to continue to crumble, at least for awhile, and that some of them might break altogether. As things get worse, more and more people will turn to gold and the price will go up. Eventually, maybe things will start to get better and the price of gold will go back down – but we may all have sold out by then.

[6] One troy ounce is equivalent to 1.09714 avoirdupois ounces.

[7] We didn't even mention that we think we shouldn't have to worry about geopolitical shocks in the Middle East, Japan and Europe.

❖ The "Ancient" History of Gold

The US being a young country, we'll begin the "ancient" history of gold in 1879, when the US effectively adopted the gold standard by making currency the North had issued during the Civil War convertible into gold. The gold standard as we normally think of it was formally adopted legislatively in 1900, and by 1914, just in time for World War I (we're sure this is a coincidence), most of the major countries of the world were on the gold standard.

In 1933, however, FDR imposed a ban on US citizens' buying, selling, or owning gold. The idea behind the ban was to prevent "hoarders" from profiting after Congress devalued the dollar in January 1934. Congress' action raised the official price of gold from $20.67 to $35 per troy ounce, where it remained for many years. In other words (*nota bene*), the government degraded the currency and then prohibited citizens from buying gold to hedge against the degradation of the currency – a useful lesson to recall.[8]

In 1971, determined to show that it wasn't just Democrats who debased the currency, President Nixon ended US dollar convertibility into gold. For all practical purposes, that ended gold's dual role as both commodity and medium of exchange, returning it (after something like 2,500 years[9]) to a mere commodity once again.

Fast-forward to the end of the Stagflation Era, when the US economy was flat but inflation was unaccountably quite high. Gold hit an all-time-high of $887.50/oz. in January of 1980 before crashing to the $300-$400/oz. range, where it remained for many years. Note that for the price of gold to beat this 1980 record in real (inflation-adjusted) terms, gold would have to sell for more than $2,500/oz. today.

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[8] Among other effects, the startling rise in the price of gold set off a boom in gold mining, where production quickly reached levels not surpassed again until 1988.

[9] Although some gold coins were produced in Ancient Egypt, the first large-scale use of gold coins as money occurred under King Croesus (560-546 BCE), the ruler of what is now modern-day Turkey (or roughly the western half of it).

Source: Bloomberg.

Gold peaked in 1980 mainly because there was fear abroad in the land. People had come to believe that Stagflation was a permanent fixture of the American economy,[10] and that holding any traditional security – even, or especially, cash – was a fool's errand. In other words, gold buyers believed that whatever inflation was in 1980, it would get worse. After all, consensus expectations about inflation were already baked into gold's price of $887.50/ounce. But if you believed that inflation would get worse, you had to believe that hyperinflation was just around the corner.

In fact, the opposite proved to be the case. Paul Volker, then Chairman of the Federal Reserve, brought inflation to a sudden halt by plunging the economy into a recession – in fact, into two of them back-to-back. It wasn't pretty, but it worked, and the price of gold collapsed virtually overnight. If that wasn't bad enough, it stayed down for fifteen long years while the US equity market was enjoying the greatest Bull Market in history.

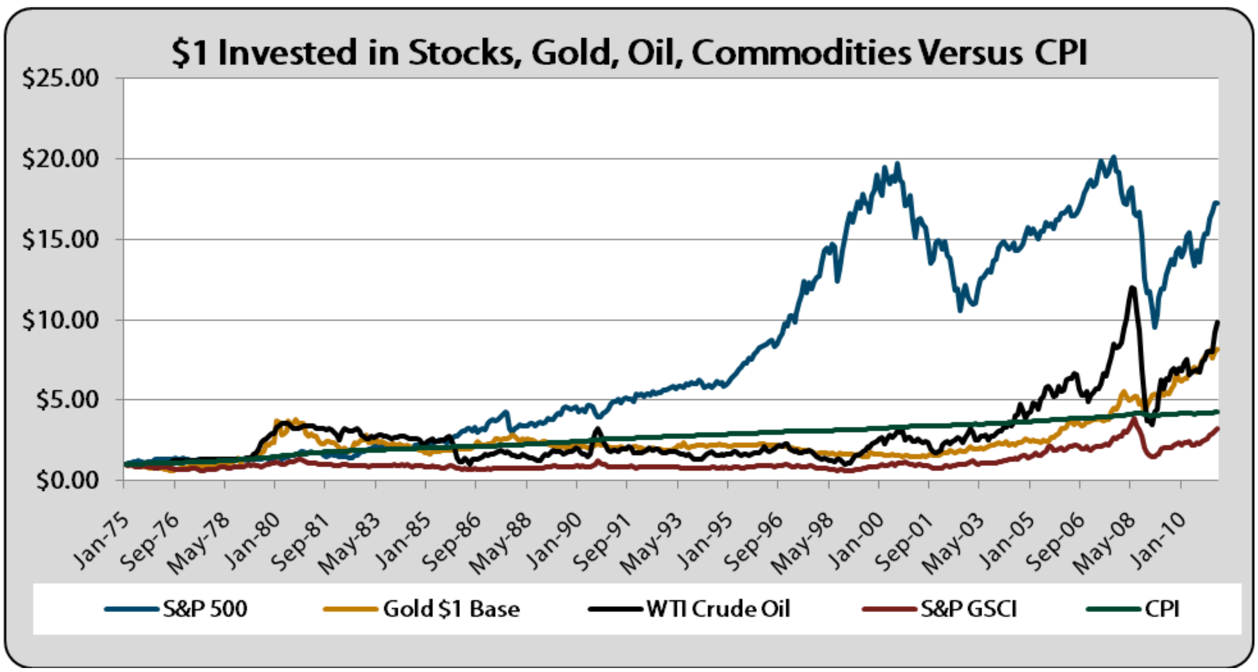
The point of this history is to gently suggest that gold isn't exactly an island of stability in a sea of turbulence. Gold is itself a tumultuous asset, subject to wild swings in its market value and to

[10] The Soviet invasion of Afghanistan was another factor.

regular manipulation by governments. That doesn't mean we shouldn't buy gold, but it does mean that if we do so we should be very, very careful.

❖ Gold As a Long-Term Investment

Viewed not as a hedge against everything going to hell, but instead as a long-term investment, gold is fairly uninteresting. From 1979 through 2008 (before the recent run-up), gold appreciated at an annualized rate of about 4.5% per year, with a whopping volatility of almost 20%. Compare the S&P 500's annual return of 11% and volatility of 15%. Better yet, compare boring old bonds' annual return of 8.7% and volatility of 6%. The following chart shows the longer term performance of gold against various other assets:



Source: Bloomberg. Please see the appendix for definitions of each of these indices.

People who buy gold and hold it for long periods of time – as opposed to those who buy it occasionally out of fear – aren't doing it for investment reasons. They are doing it for sleep-well reasons, and they know they are incurring serious opportunity costs. There are wealthy American families who have held gold bullion in Switzerland since the income tax was adopted in 1916, for example. They aren't thinking of it as an investment asset at all, and they don't even bother to follow the ups and downs of its value. For such families gold is an ultimate hedge and they sleep better at night knowing it's there.

Notice that an interesting phenomenon occurs when gold's price pops up and stays up, as it has done recently: many people move away from financial gold (ETFs, futures, mutual funds) toward hard gold (coins, jewelry, bullion). The actions of such buyers suggest that, at least in some quarters, trust in the very infrastructure of the investment world is decaying. If something that convulsive actually happened, we wonder how owners of hard gold would get possession of their assets (which are likely to be held in some company's vault in New York City), what they could buy with it and how they would keep it, unless they have raised their own private militia.

❖ Should We Buy Gold at $1,500/oz.?

Obviously, we don't know whether gold is going to go up, down or sideways. We can, however, suggest what an investor needs to believe if he or she is interested in buying gold at what is close to an all-time high.

If we were evaluating a traditional security that was now selling at three times its recent price, we would know how to proceed. We could look at the yield on the instrument (dividend or interest yield) and compare that to its historical yield and to the yield on similar securities. We could evaluate the issuer and develop an opinion about its condition and prospects. We could do a similar evaluation of the industry. We could present value the expected income streams.

But gold has no yield, no issuer and no purpose beyond its industrial uses. Therefore, traditional security analysis is useless. Gold is worth whatever someone is willing to pay for it, and what people are willing to pay is based in the short-term on investor sentiment. What, therefore, must investor sentiment be like to justify paying north of $1,500/oz.? It can't just be the crumbling verities we enumerated above: the US credit rating, risks in Treasury bonds, the vulnerable dollar, inflation, fiscal indebtedness, the decline of the US relative to emerging economies, geopolitical risk. No, it can't be those things because they are already priced into gold at $1,500/oz. What we must believe is that those things are going to get *worse*.

Of course, it's not hard to believe that at least some of the crumbling verities are going to keep on crumbling, and possibly break altogether. Inflation, which is very low now, could get a death-grip on the US economy if the Fed mismanages things. QE1 and QE2 might have helped prevent the economy from sinking into a Black Hole, but they haven't put GDP back on track. They *have* weakened the dollar and alarmed the rest of the world about our profligacy. QE2 is scheduled to end in June, but if the economy sputters and a double-dip recession during a presidential election year seems possible, the Fed will be under enormous pressure to launch QE3. That will be seriously problematic in many ways, but it will be very positive for the price of gold. And who knows what curses might bedevil the world emanating out of Europe, Japan, or the Middle East.

Many of the crumbling verities in the US have, directly or indirectly, to do with the massive cost of entitlement spending now and, especially, in the future, combined with the unwillingness or inability of Congress and the President to do anything about it. The recent warning by Standard and Poor's on the US credit rating was based mainly on this political gridlock. Democrats seem mindlessly wedded to keeping and even increasing entitlements, despite the obvious fact that they are bankrupting the country. Republicans seem mindlessly intent on keeping or lowering taxes, despite the obvious fact our bloated indebtedness needs to be paid down. Between the two of them, the US seems headed, like Rome before us, into decline and oblivion.

But let's not just blame everything on politicians – they are obviously taking their cue from the electorate. Half of that electorate doesn't pay taxes, and they are naturally eager to tax the other half to keep the gravy train from falling off the rails. Huge majorities of the voting public don't want to see Medicare or Social Security touched. The Silent Plurality, meanwhile, is clinically schizoaffective. On the one hand, we believe that entitlements are what distinguish advanced civilizations and that blowing holes in the safety net is an outrageous idea that merely puts the burden on citizens who are least able to bear it. On the other hand, we recognize that failing to control our spending will destroy the very civilization we are so proud of. Perhaps, say buyers of gold at $1,500, the US has already reached escape velocity on its journey to perdition: we are so attached to entitlements we can't afford that it's simply too late for us.

If this is our future, buying gold even at $1,500 probably makes sense, since the price is likely to go much higher. But it seems at least as likely that, just as the fear-mongers of 1980 proved to be horribly wrong, the fear-mongers of today might also be wrong. Nobody did anything about Stagflation until it was so awful the public threw Jimmy Carter out of office and brought Ronald

Reagan in to kick some serious butt. Today, no one is doing anything about entitlements and our crushing debt burden. But that doesn't mean that nobody will.

We would certainly agree that gazing up and down Pennsylvania Avenue is not encouraging. However, suppose we raise our gaze and look instead to the states. What we see there is not the massive defaults predicted by Meredith Whitney, but governors and legislators and even mayors doing the hard work of cutting spending and raising taxes. The restructuring is so painful in places like Wisconsin that people have taken to the streets in protest, making the place look a bit like Greece.

But while Wisconsin and Ohio and New Jersey and California get all the headlines, little Vermont might actually be a better harbinger of what the future could hold. Vermont is the only state that doesn't have a constitutional requirement to balance its budget, yet the state balances its budget almost every year. Thanks to an uncharacteristic bit of overspending, combined with a deep recession, Vermont recently faced a huge (for Vermont) deficit of $176 million for the upcoming fiscal year. Liberals demanded that the gap be allowed to persist, rather than cutting benefits. If the gap had to be closed, they demanded a 5% surtax on the "wealthy" to close the gap. Even some wealthy Vermonters pleaded with the state to increase their taxes. (Well, ok, it was Ben and Jerry.) But the legislature approved spending cuts, even though they fell heavily on programs for the elderly, mentally ill and drug users.

And, folks, these weren't crazed Tea Party budget-cutters: both houses of the Vermont state legislature are controlled by Democrats and the governor is himself a Democrat. These are people who care very much about programs for the unprivileged. They also happen to be people who know that uncontrolled spending, even in a good cause, is a very bad idea.

In other words, it's always darkest just before dawn. If Congress and the President take their cue from the states and begin to talk seriously about fiscal discipline, many of the crumbling verities will stop crumbing and begin to look positively reliable. As it did after the peak in 1980, the price of gold will collapse.

If you have despaired about the ability of the US to deal with its problems, or if you believe that most other people have despaired, you should buy gold at $1,500.oz. and even higher. But keep in mind the possibility that you could be wrong. Size the position so it won't destroy your lifestyle when the price collapses, as it always does and always will.

❖ What Is Greycourt Doing?

We are agnostic about whether or not the crumbling verities will continue to crumble or not. We recognize the problems and we worry about them more or less non-stop. We have also lived through gold booms in the past, and the end is always ugly. No one thought inflation could be brought under control any time soon in 1980, but by 1982 inflation was a distant memory – and it's still a distant memory thirty years later. Today people worry about Fed miscues and massive and growing government debt, but believe it or not, this, too, shall pass.

We reconcile our short-term worries with our long-term confidence not by buying gold or selling it short, but by building reasonably sized positions in diversified commodities – including gold. We pay close attention to sound entry points and we pay especially close attention to rebalancing our positions religiously. If gold goes to $5,000/oz. we will regret our caution. However, if gold collapses, we will be well out of harm's way.

Which reminds us of a story told by John Ruskin nearly a century ago. A man boarded a ship carrying his entire wealth in a large bag of gold coins. A storm came up and the passengers were ordered to abandon ship. Strapping the bag around his waist, the man jumped overboard, promptly sinking to the bottom of the sea. Asks Ruskin: "Now, as he was sinking, had he the gold? Or had the gold him?"

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❖ Appendix: Definitions of Indices

S&P 500 – An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

WTI Crude Oil – West Texas Intermediate Crude Oil is a type of crude oil used as a benchmark in oil pricing. It is the underlying commodity of New York Mercantile Exchange's oil futures contracts.

S&P GSCI – S&P Goldman Sachs Commodity Index - The S&P GSCI® is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully collateralized basis with full reinvestment. Individual components qualify for inclusion in the S&P GSCI® on the basis of liquidity and are weighted by their respective world production quantities.

CPI – Consumer Price Index –monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.