CLARITY IN THE CRYSTAL BALL
Gold and Asset Allocation

MCS White Paper **September 2013**

Executive Summary

- Long-term investors rarely think in full historical context
- Gold is the only asset present throughout economic history
- Every asset class, including gold, is necessary at times.
- Successful allocation considers all assets based on current conditions

Introduction

Every investor wants to make a profit. Methods vary but the objective is always the same. Institutions and individual investors discern the future with crystal balls so they can earn profits and/or avoid losses.

For most investors asset allocation is the “default” strategy. They believe (or hope) some asset classes will gain value each year, others will fall, and a properly diversified portfolio can deliver positive long-term results. What they miss is that even ten years is not really “long term” in full historical context.

People have been buying and selling assets for centuries. Stocks and bonds, as we know them today, are actually recent innovations. Different factors mark each stage of economic history. The only asset present for all recorded history is gold.

Gold was originally valuable because it is scarce and portable. As the medium of exchange, gold became the foundation for all other assets. Economic history would look very different without this foundation.

While gold is important, it is not always *equally* important. Asset allocation strategies optimized to work in a particular few decades can easily under-weight or over-weight gold. If they miss the mark on gold, they may well miss the mark on other asset classes, too.

We believe the better approach is to allocate by *time* instead of asset class. Certain economic conditions are favorable to stocks. Others are less favorable. Certain conditions work well for bonds, while others do not. Our goal is to be in the asset classes that fit optimally in current circumstances.

In this paper, we will look at gold with two thoughts in mind. First, gold is important because it is the basis for every other valuable asset. Second, gold illustrates how owning an asset can be either critically necessary or devastating, based simply on the calendar year.

Our goal is to help readers understand the relationship of gold, currencies and other asset classes. We believe managers who achieve high historic risk-adjusted returns use this approach to navigate financial markets successfully.

To understand what follows, readers should keep one simple statement in mind. In a free market, *prices* are a function of *supply* and *demand*. This is true for gold and all other assets.

We will begin by reviewing gold's three distinct periods over the last 200+ years – roughly corresponding with the history of the United States.

1792-1933: The Age of Gold

Today we can hardly imagine a world where housing prices never skyrocketed, grocery prices stayed constant, and transportation and energy prices never rose. Yet for centuries, the value of money was as solid as the gold that fully backed it.

Between 1792 and 1933, gold's dollar price held steady around $19 an ounce – and the dollar was worth 1/19 an ounce of gold. An early 1900s consumer with a dollar could buy approximately the same goods and services as one in the early 1800s.

Today, the cost of living rises relentlessly every year and impoverishes millions. The age of gold was a financial paradise in comparison! In this period gold worked quietly in the background. Most people received the benefit whether they owned it directly or not.

Unfortunately, the days of solidly valued assets ended very quickly.

1933-1971: The Age of Partial Gold

After holding steady for so long, gold prices rose very suddenly to $35 in 1933. This was when President Franklin Roosevelt renounced the domestic gold standard, removing the public's ability to exchange their U.S. Dollars for physical gold.

The lost monetary discipline had a predictable effect: The money supply began expanding significantly faster than the economy. The result was inflation, or generally rising prices for almost all goods and services.

There was one exception during this period, however. Foreign governments could still demand gold for their U.S. Dollars at any time. The freshly printed dollars helped "pay for" government largesse and foreign wars, but inflation was at least partially limited.

1971- ___: The Age of Fiat Paper

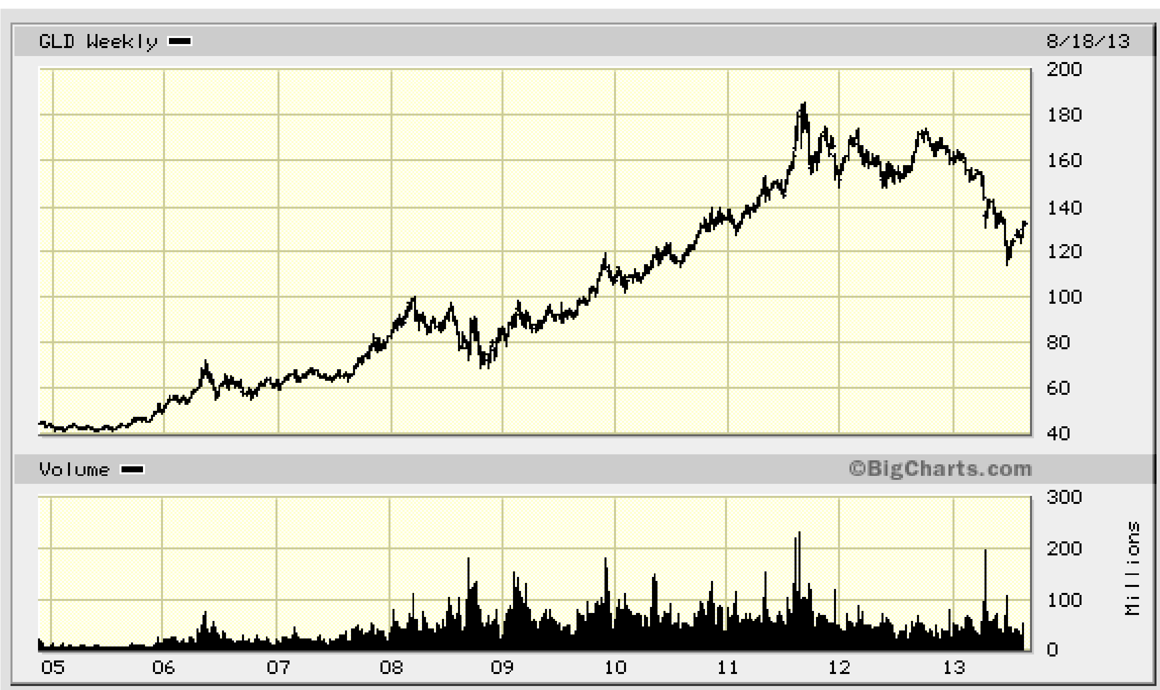
Readers alive during the 1970's may remember gold was $35 an ounce in 1971, and had been so for almost forty years. Between 1971 and 1980, gold went from $35 to $850. After a long flat period, gold rose again and reached $1,795 in 2011.

Obviously, something important happened in 1971. What was it? In that year, President Richard Nixon totally severed the U.S. Dollar's link to gold bullion. This removed the last loophole and even foreign governments could not exchange Dollars for gold. The age of unlimited fiat paper began.

With the Federal Reserve now able to create unlimited amounts of inherently worthless dollars, inflation soared and the value of each dollar plunged. Effectively a "hidden tax," inflation captured the savings of every American to fund the government.

Despite their professed "long term" focus, many investors rarely look back in time more than a year. Inflation erodes the value of every dollar in circulation. This chart of SPDR Gold Trust (GLD) is a good illustration.

Chart 1: Gold (Source: bigcharts.com)



In this atmosphere, short-term bias combined with tunnel vision creates a "You missed it" attitude. Investors feel they should always be in the market. Continuous buying and selling is rarely a good idea, with or without a plan. Likewise, long-term asset allocation can reduce returns when it ignores or misunderstands the impact of inflation and the stabilizing influence of gold.

The Ultra Factors: Supply and Demand

As we said in the introduction, prices are a function of supply and demand. We call these the "Ultra Factors." These interact with four other primary factors: Inflation, Deflation, Interest Rates and Currency Valuation. We will briefly consider each and then consider investment implications.

Inflation vs. Deflation

We will start with some baseline definitions.

- ***Inflation*** is "A persistent substantial rise in the general level of prices related to an increase in the volume of money and resulting in the loss of value of the Currency."
- ***Deflation*** is "A fall in the general price level or a contraction of credit and available money."
- ***Disinflation*** is an in-between period in which inflation rates slow toward zero.

Both these macroeconomic forces come from changes in the underlying money supply relative to the supply of goods and services. Neither can occur in an economy with a true gold standard. Inflation and deflation are a consequence when the money supply grows or shrinks at a substantially different rate than the economy.

Both Inflation and deflation affect an economy's general price levels. Price changes in particular sectors may be unrelated. Energy prices can rise without general inflation. Computer prices can fall without general deflation. In both cases, supply and demand factors specific to the sector moved prices. Inflation and deflation relate to economy-wide price levels.

Inflation is a result of the money supply growing faster than the underlying economy. Deflation, which is less familiar to most of us today, is the opposite. It happens when the economy grows faster than the money supply. The 1920's are a good example.

True inflation and deflation are purely monetary phenomena. Their general price changes are symptoms of an underlying monetary disorder. Central bank policies that prevent the economy from functioning normally are the usual suspects.

Which monetary disorder is more likely? Relatively more money is chasing after relatively fewer goods and services. Money supplies are currently exploding. The Federal Reserve can create unlimited dollars and no one can officially exchange them for gold. In this environment, deflation seems unlikely.

Nevertheless, Wall Street and the banking establishment seem very afraid of deflation and unconcerned about inflation. Could their fears be clever attempts to distract investors from the real inflationary threat?

Interest Rates

Long-term interest rates usually track inflation very closely. More precisely, they track inflation *expectations*. When potential lenders expect higher inflation – as they did in the 1970s – bond prices will fall and interest rates rise to a level that compensates lenders for this risk.

Here again we see money supply is the underlying issue. Excess money leads to general y higher prices. Interest rates are essentially the price of money itself, and this price goes up along with others. Inflation and higher interest rates go hand in hand.

We can see this in these long-term interest rate charts, showing the ten-year bond yield from 1700 to present and Treasury rates since 1900. In both charts, we see rates stayed in a relatively narrow range for decades – until the age of Fiat Paper. The inflationary 1970s coincided with sharply higher interest rates.

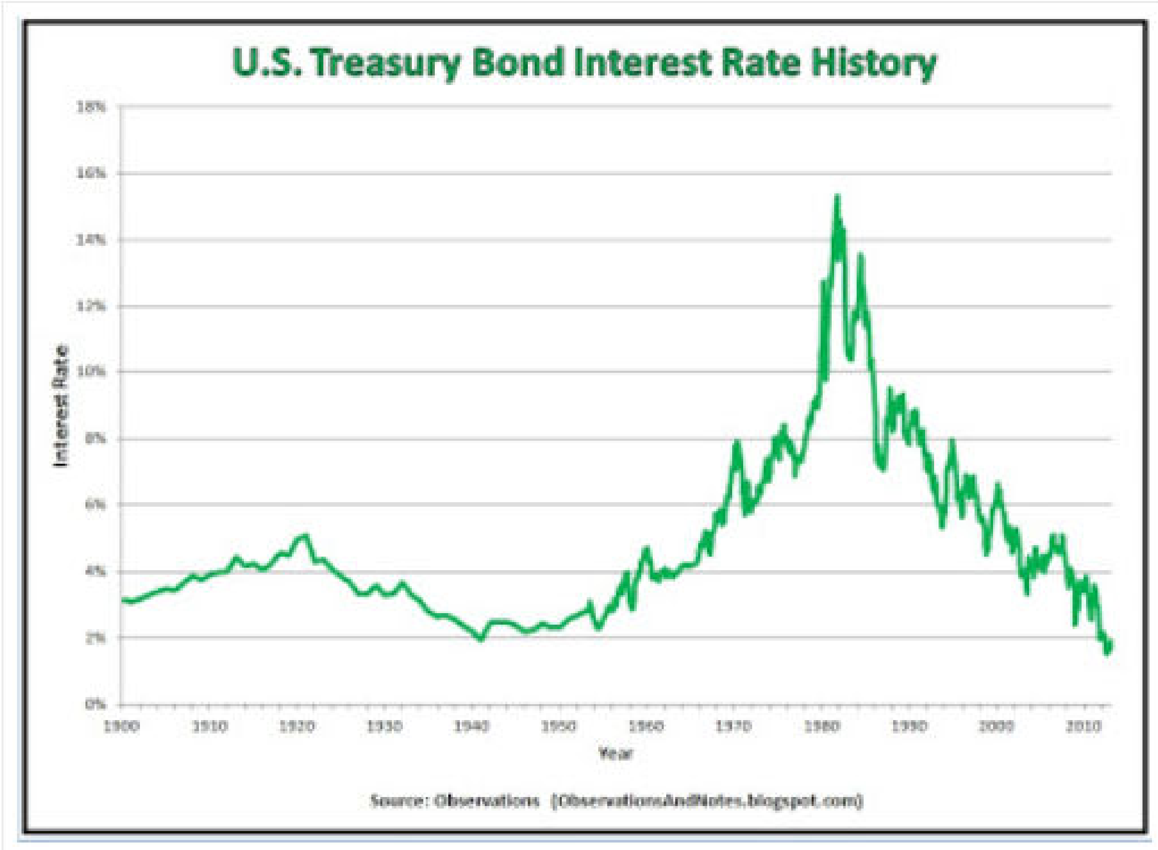
Chart 2: U.S. Treasury Yield (Source: Global Financial Data)

The US 10 yr Constant Maturity Yield

Click to enlarge

Souce: Global Financial Data

Chart 3: U.S. Treasury Bond Interest Rate History



Inflation grew rampant after 1971, when the Federal Reserve gained unlimited dollar-printing power. Lenders (i.e. bank depositors and bond investors) responded to this new risk factor by demanding higher yields.

Inflationary rising-rate environments can decimate bond portfolios. By attracting capital away from equities, they can also send stocks into a deep and extended bear market.

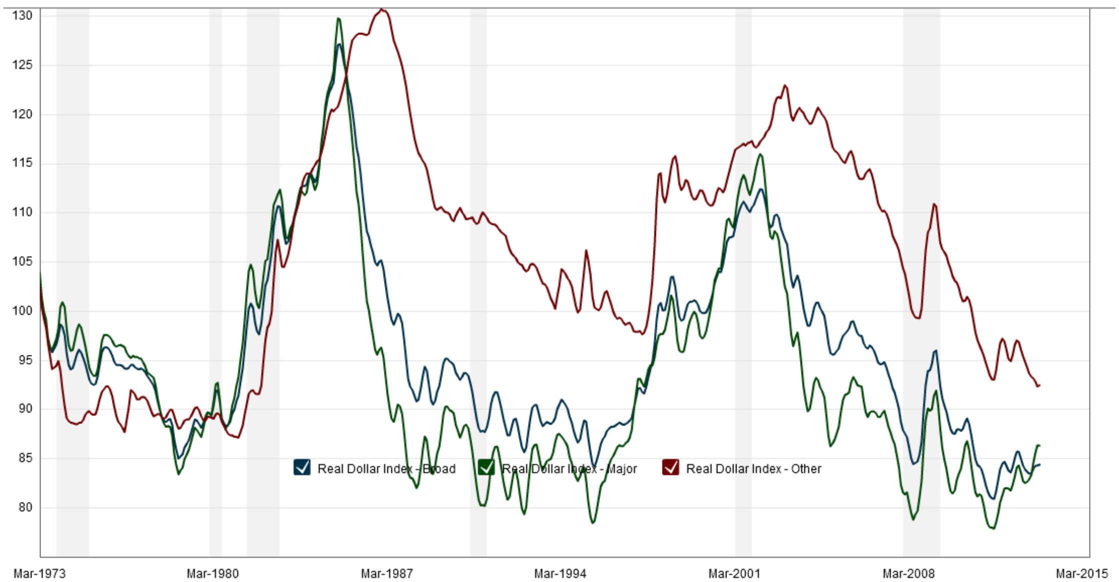
We see inflation hurts stocks, bonds, and paper-based assets in general. Where can an investor hide in such periods? Gold is the only asset class that can thrive in widespread inflation. Excess monetary growth devastates virtually everything else. Investors without gold exposure are defenseless against inflation.

Currency Valuation

Historically, gold typically trades opposite the Dollar. A stronger dollar generally makes the gold more expensive to buy in other currencies, which weakens demand. In market panics, however, both gold and the Dollar can become “safe havens” against riskier currencies.

Over the longer term, the Dollar is *not* a safe haven as the Federal Reserve creates new money and debases existing currency. The ongoing fear of "currency wars" highlights the fragility of paper money.

Chart 4: U.S. Dollar (Source: Macrotrends)



Currency and trade wars reduce faith in paper money even further, eventually leading investors toward gold. The 1971 devaluation could re-occur any time. Chart 4 illustrates the impact of quantitative easing and similar policies on the US Dollar.

Investment Strategy Implications

Understanding the relationships between inflation, gold, timing and asset allocation helps guide our decisions at Metropolitan Capital Strategies. We always consider how to protect our managed assets against these risks before committing capital to the markets.

While inflation risk may seem low now, it is not zero. The data and graphs above show how a combination of factors determines the gold price. Any one factor is rarely decisive.

When looking into the crystal ball, these specific factors will show whether owning gold is a good idea at any given time. If your analysis indicates little or no change in these factors, a zero gold position may be the right choice. If, on the other hand, your analysis mirrors ours, you probably foresee very volatile gold prices in the near future.

While short-term direction is unclear, the Federal Reserve's attempts to "stimulate" growth by adding liquidity create the conditions for higher gold prices. We think favorable conditions for gold may come sooner instead of later.

Fortunately, our Metropolitan strategy adapts to changing conditions. If circumstances suggest a higher gold weighting is wise, we can make such a change in relatively short order. Managers who rely on fixed or semi-fixed asset allocation methods will take longer to adjust.

Every analyst and investor has an opinion based on his or her interpretation of the data. Buying gold or any other asset class simply as part of an asset allocation plan – or no plan at all - can be fruitless.

We believe understanding the data - and waiting for the right moment – is the key to success. Those qualities truly are worth their weight in gold.