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GEN TRUST
WEALTH MANAGEMENT

# *Special Note on Gold*

*April 2013*

## RECENT PRICE ACTION

From the morning of Friday, April 12th to the end of Monday, April 15th the price of gold fell over 13% to below $1385/ounce. This move was an acceleration of a price decline that began back last October when gold traded as high as $1800/ounce.


Source: goldprice.org

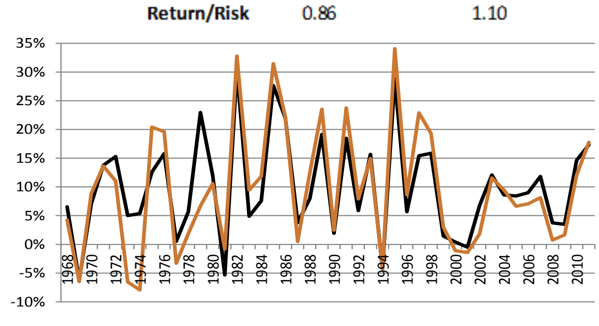
The most recent bout of selling pressure started last Wednesday, April 10th after Goldman Sachs issued a research note reversing its long-held recommendation that clients buy gold. The report cited the lack of appreciation in gold after both negative news from Cyprus and weak US economic data as an indication of waning interest in the metal. It also pointed to the firm's medium-term forecast of increased real yields as a driver of lower sold prices. The selling increased on Monday resulting in the largest one day price drop in 30 years (9.3%). Some European central banks were seen selling positions and fear spread that such selling would become pervasive. This forced several hedge funds to liquidate positions. Further adding jitters to the market was uncertainty about how GLD, the behemoth ETF, which holds more gold than the Japanese, Russian and European central banks combined, would hold up under the market stress. Retail and other sellers of GLD forced the ETF to liquidate 70 tons of physical gold (or 5% of its holdings).

## WHY DO INVESTORS CARE ABOUT GOLD?

Investors often use gold as an inexpensive hedge for the rare but costly environments of extreme inflation or deflation. Gold should not be thought of as a traditional commodity. It has little purpose outside of jewelry yet it has, for all of human history, been recognized as a store of value. Commodities such as oil are driven by macroeconomic factors like the demand for gasoline or the cost of drilling, but gold doesn't get consumed. Therefore, gold takes its price almost entirely from people's willingness to hold it versus other stores of value: it is an opportunity-cost asset or contra-currency if you will.

When governments print money with abandon and threaten to devalue their paper currencies, real yields are negative, or businesses offer poor returns because of a shrinking opportunity set, gold can be counted on to maintain wealth. Given the role it plays protecting a portfolio against such a terrible economic environment, many financial advisors advocate allocating 5% to 10% of a client's portfolio to gold. Historically, such an allocation has reduced the overall risk of portfolios as you can see below in the performance of a generic low-risk portfolio:

| *Since 1968 Based on Annual Returns* | 40% Equity + 60% Bond | 30% Equity + 55% Bond + 15% Gold |
|---|---|---|
| Risk (Standard Deviation) | 10.6% | 8.7% |
| Largest Annual Loss | 7.9% | 6.2% |
| Returns | 9.1% | 9.5% |
| Return/Risk | 0.86 | 1.10 |




Source: Morningstar, GenTrust Calculations



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## GOLD VALUATION

The primary challenge with gold is the difficulty in establishing a fundamental value. Unlike equities which have P/E or bonds which have yields, gold does not have an intuitive metric used to anchor its value. Some analysts will look at the value of gold vs. the historical real value of a currency or other financial security (e.g. the S&P 500), but such analysis is highly dependent on the starting point.

Others track the all-in production cost to mine new gold. According to Forbes, two of the largest gold miners (GG, ABX) reported their production costs between $1000-$1100/ounce. This is a useful metric to keep in mind if gold prices rise too high as increased demand can be partially met with increased mine production. As a floor, however, little prevents gold from falling below this level. After all, outstanding supply at 175k metric tons is barely affected by the additional 2.5k mined each year. And the metal is not consumed the way traditional commodities are. Every ounce ever mined remains in circulation in some form today.

Alternatively, one can analyze gold versus the sum total of money in circulation. If one converted all currency globally into USD one would have roughly $1100/ ounce of gold. This number, which is probably closest to the metal's fundamental value as a "contra-currency" is a moving target, however, as central banks globally continue to print money at an accelerating pace and credit and other forms of "money" continue to grow.

## GOLD FOR THE MASSES

Gold has had a great run over the last decade. As often happens in finance, strong past performance draws in a speculative investor base. Today firms advertise physical bullion on CNBC and offer to help convert retirement accounts into gold-denominated accounts. As we learned in the 90's tech bubble, when investing strategies go mass-market, price volatility increases.

A product which epitomizes the speculative boom is GLD, the $50 billion+ market-cap ETF which holds physical gold and provides both retail and professional investors an efficient method of ownership. As a hedge against extreme financial circumstances, GLD as a financial security is an inferior choice to physical bullion but this must be weighed against the cost of acquiring and storing physical assets. More importantly, the increase in retail ownership may make gold more susceptible to the same type of overreactions the asset is intended to protect against.

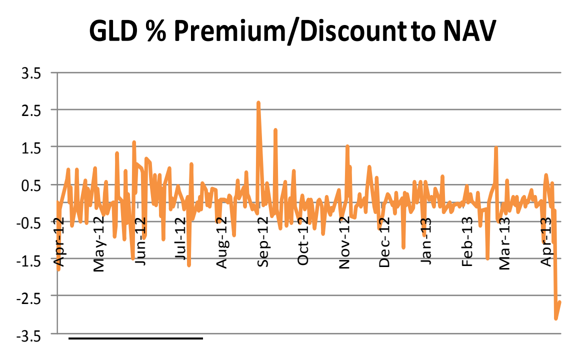
## OUR CURRENT POSITIONING

Since November, we have been underweight gold, holding 1-2% in most accounts, for three reasons:

1. We believed other assets such as equities offered higher expected returns increasing the opportunity cost of holding gold.
2. Monetary policy-induced inflation appeared several quarters off.
3. Gold historically exhibited price momentum and there has been a steady price slide since October.

Given the recent drop in prices, we will look for opportunities to rebalance into gold. The fundamental story remains; central banks globally are devaluing their currency. Also, the central banks reported to be selling gold hold a significantly smaller quantity of gold than the central banks which have said they may begin buying. Globally, real yields are negative and fundamental valuation floors, although inexact and some 20+% away, offer some cushion against further declines.

As with all investments, timing is key. GLD is trading at a discount to NAV suggesting there is still an imbalance between investor appetite for GLD and GLD's ability to physically trade the underlying bullion. There is uncertainty surrounding potential weak positioning of both retail investors and hedge funds. We remain vigilant with an eye towards buying when conditions stabilize.




Source: SPDR

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