

PG PERSPECTIVES

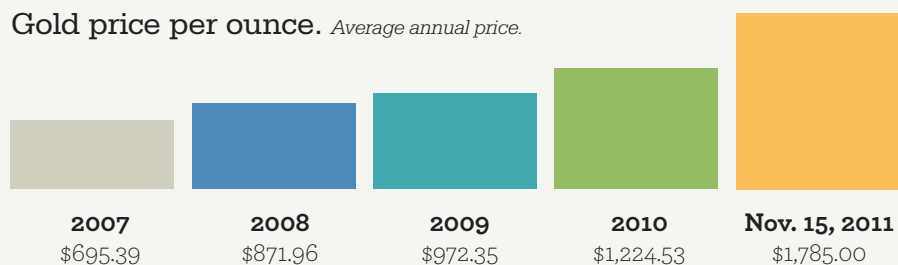
All That Glitters is Gold?

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CLIENTS OFTEN ASK OUR OPINION ON GOLD. Is it cheap? Is it a bubble? How much further will the price go up? When will it go down? Interestingly, the questions are similar to questions we were asked about technology stocks in the late 1990s. Then, as now, cautious investors were challenged to explain the persistent price escalation of an investment whose fundamental value was elusive. Then, as now, Wall Street financial products (the IPO boom for technology stocks and ETF explosion for gold) have been behind much of the investment craze.

We understand the excitement and confusion. Gold has performed extraordinarily well in an investment climate that has offered few profitable alternatives. **However, prudent investing requires a thoughtful approach that, to the extent possible, seeks to identify and understand the basis of an asset's value.** This article examines the factors that have contributed to the escalating price of gold and offers evidence suggesting that current prices are unsustainable. Further, we offer our perspective in favor of high quality stocks and bonds, rather than gold, for long-term investors.

Gold price per ounce. Average annual price.



Source: Bloomberg

What is behind gold's rise?

Gold is not an entirely useful metal. It features prominently in jewelry, dentistry and some electronics; but, otherwise, its commercial and industrial utility is limited. **In this way, gold differs from other commodities such as oil, copper, wheat and corn.** What's more, the world has been suffering through the worst economic environment since the Great Depres-



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sion. Therefore, it is unlikely that an increased demand for jewelry or expensive dental crowns has played a significant role in the price increase.

If commercial or industrial demand is not driving gold higher, what is? In a word: investments. In 2010, purchases of gold for investment purposes made up roughly 40% of total demand. These included purchases by central banks, gold ETFs, and the physical trading of bars and coins. The factors which have contributed to the explosion in *investment* demand are worth examining. Talk to any gold investor and two major themes emerge: *safe haven demand* and *inflation protection*.

Safe haven demand. Over the past several years, investors have turned to gold primarily in response to the turmoil of global economies. As developed nations fell into significant recession, they triggered severe volatility in major equity markets. Gold, along with U.S. Treasury securities, enjoyed an influx of capital as investors sought protection from the vicissitudes of the equity markets. This environment continues today due to the persistence of Europe's sovereign debt crises. The threat of another major downturn in global economic activity has investors maintaining risk-averse strategies.

However, thoughtful investors should ask, "At what point does gold present greater risk than safety?" The price of an ounce of gold has risen from just under \$700 in 2007 to almost \$1,800 today. At this price, is the value of the protection offered by gold justified by the extra \$1,100 that investors must pay? Moreover, the economies of many countries have returned to growth and European leaders are earnestly responding to the sovereign debt crises. What will happen to the price of gold when demand for safety wanes?

Inflation protection. Gold is also seen as a hedge against the impact of inflation on the U.S. dollar. Inflation reduces the real value of U.S. dollar-denominated assets, including Treasury bonds. Since the onset of the recession in 2008, the Federal Reserve has embarked upon unprecedented monetary policies to encourage economic activity. In response, investors have become increasingly concerned that inflationary pressures are building. Central banks, including China, have responded by diversifying their foreign reserves into gold. Similarly, retail investors — worried about the declining purchasing power of their savings — have flocked to gold as a store of value.

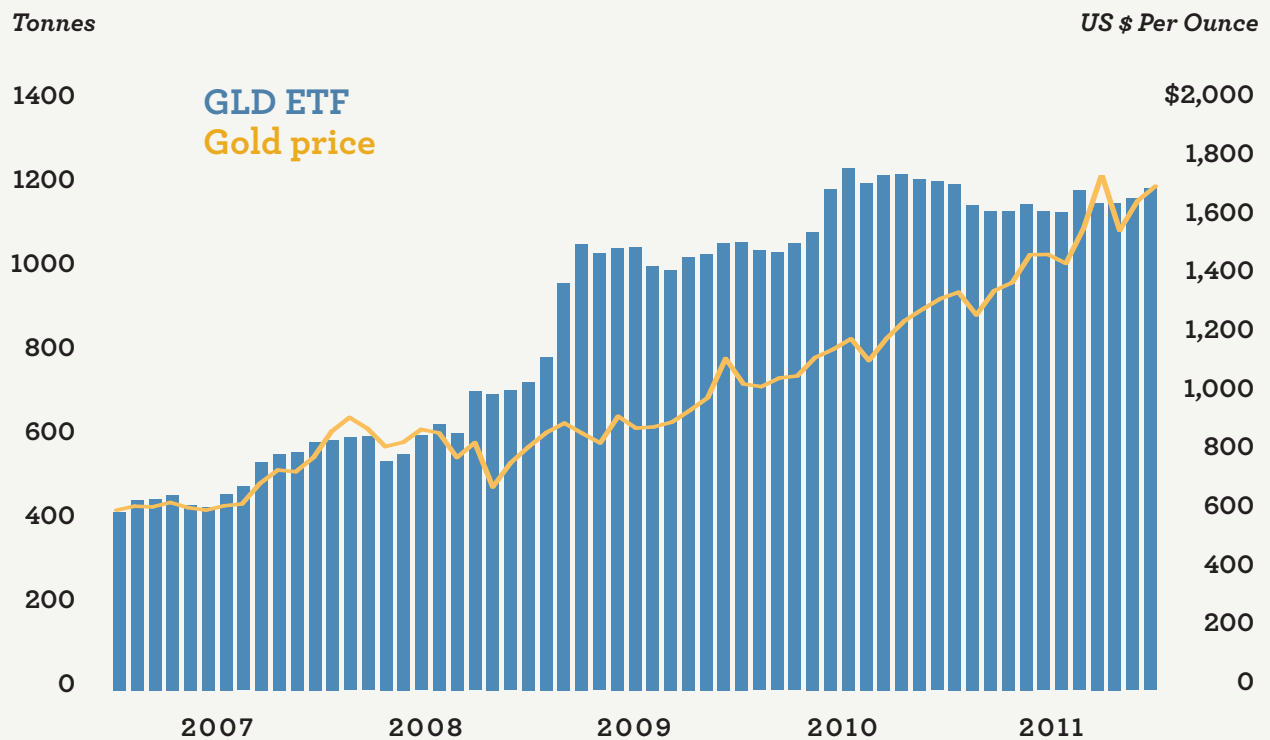
But, again, investors should question the extent to which the price of gold already reflects investors' expectations of a U.S. currency devaluation. For instance, gold has risen 157% since its pre-financial crisis price in 2007. This price escalation equates to a greater than 25% annual rise in prices over the past four years. Looked at another way, **assuming an aggressive inflationary rate of 10% a year, today's price of gold has already priced in 10 years of inflation.** Yet, should signs of inflation emerge, the Fed would likely take counter-inflationary measures, such as raising interest rates. Indeed, we believe any thought that we are headed for runaway inflation is extreme. >

Is gold's run unsustainable?

Perhaps most alarming is the correlation between the recent rise in the price of gold and the popularity of gold ETFs. From the beginning of 2007 to June 2011, gold assets held by ETFs have more than tripled from roughly 600 metric tons to over 2,000 metric tons. To put this amount in perspective, the entire worldwide demand for gold in 2010 was 4,000 metric tons. The rapid rise of ETF demand corresponds to a 157% increase in gold prices during that same period. A reasonable question to ask is, "In the relationship between gold prices and ETF demand, is the cart leading the horse?"

ETFs also make gold investing accessible to investors who can be notoriously fickle and short-term oriented: hedge funds and retail investors. If speculative investors embark on a race to unload their gold positions, the sudden reversal of ETF demand might potentially develop into a collapse. Indeed, the surge of gold ETF products in recent years bears a striking resemblance to the rise (and, therefore, potentially to the subsequent fall) of technology IPOs and technology sector mutual funds during the internet boom. A further concern is that *investment* demand does not consume gold. Rather, investors hold gold inventory for sale at a later date. These sales, when they

Holdings in Exchange Traded Funds (ETFs) and the gold price.



Sources: Gold price: Bloomberg; GLD ETF: exchangetraddedgold.com

occur, will not only evidence reduced demand, but will also add to the overall supply of gold in the marketplace which will compound the impact on prices.

During the 2007 to 2011 period, moreover, gold mining stocks have not experienced similar price gains. The lack of equivalent appreciation suggests a breakdown in the typical relationship between a commodity and its industrial production counterparts.

In the energy sector, for example, an oil exploration company's assets are typically calculated using a net present value formula. This calculation applies the current price of oil to expected future production. A similar valuation method seems to be missing among gold mining companies. Does this suggest that investors do not believe that the current price is sustainable over a longer period of time? Perhaps so. Furthermore, prices for commodities such as oil, copper, wheat and corn have risen on the expectation that emerging markets will increase global demand. Gold's rise, however, seems to be divergent, even antithetical, to this demand-driven explanation.

Finally, the rising price of gold has resulted in product substitution for commercial and industrial uses. Jewelry customers are increasingly opting for lower quality 14-karat gold as opposed to premium 24-karat gold. And dentists and electronics manufacturers are choosing cheaper alternatives, such as porcelain or silver. Therefore, **we believe that — given these substitution effects — the real, fundamental, consumptive price level of gold is likely between \$800 and \$1,000 an ounce.**

A better alternative for long-term investors.

How will an investment in gold perform in the near term? Or over the long term? No one knows. **Gold is a commodity with limited commercial or industrial use; its role in today's market is predominantly psychological.** Instead, we believe that long-term investors are best served focusing on investments with identifiable sources of value. We contend that growing companies with well-run businesses that generate solid earnings are ideal investments in today's challenging environment. Likewise, high-quality corporate bond investments generate income that can be evaluated using rigorous fundamental analysis. Gold, on the other hand, shares none of these traits. It is in a class by itself; for that reason, it bears watching carefully.

Further to this point, an examination of possible price appreciation and depreciation is worth contemplating. Our investment strategy considers companies with certain characteristics as potential investment candidates. Among these characteristics is a current market price that offers a substantial discount to a company's intrinsic value. Shares of many leading businesses currently trade at valuations that we believe represent discounts well in excess of 40%. These include major blue-chip companies as well as smaller companies in niche industries. Moreover, many of these businesses enjoy attractive growth prospects, which should allow them to further increase in value over time. In comparison, for gold to register even a 25% gain

from current prices, it would need to rise to more than \$2,200 per ounce. This would be an all-time high for the metal. On the other hand, a price decline to the high end of our consumptive value estimate of \$1,000 per ounce would entail a loss of 44%. Indeed, gold's reputation as a safe haven is dubious, to say the least.

Investors may question whether now, in the midst of recent negative headlines, is the right time to invest in stocks and bonds. Certainly, the global economy faces challenges: most notably, Europe's sovereign debt crises and the potential impact of a regional economic slowdown. Nevertheless, we also note reasons to be encouraged. Continued growth in the emerging markets, such as China and India, is contributing to rising demand for energy and agricultural resources. The U.S. economy, thanks to resilient consumer and business spending, appears on a sustainable recovery path. And, even in Europe, the debt crisis is forcing structural changes in countries such as Greece and Italy that will, over the longer term, benefit the region.

In the end, an investment in gold is highly personal. Few assets engender as much passion and debate as the yellow metal. Indeed, for many, gold may be as much a political or social statement as it is a financial investment. For these reasons, we believe that the rise in the price of gold is primarily related not to fundamental factors but to psychological ones. And, even though stocks and bonds may be volatile in the near term, the "real" value of these assets stands in stark contrast to the intangible value of gold. These assets, consequentially, can provide a degree of protection and growth that gold simply cannot match.

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