Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

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Gold: Insurance against Government Misbehavior

> Every single currency in history has eventually fallen against gold – most dramatically in times such as these, times of surging liabilities and an increasing inability to meet them. Gold is the only currency, the only credible store of value whose quantity cannot be expanded to meet the spending needs of governments in distress.
>
> *Hard Money*, Shayne McGuire, 2010

> "We are in a very grave state of affairs, and we must not shy away from this fact."
>
> Mario Draghi, European Central Bank President, January, 2012

For most of the 20th century, gold was not a key element of an investment portfolio. In 1924, British economist John Maynard Keynes famously called the gold standard a "barbarous relic." During the Great Depression, most countries left the gold standard. In April 1933, President Franklin Roosevelt invoked the anti-hoarding section of the Trading with the Enemy Act (1917) and made it illegal for U.S. citizens to own gold (except for jewelry) due to the "economic emergency." U.S. owners of gold and bullion were obligated to turn it in to the Federal Reserve and received paper money worth $20.67 an ounce. A year later, the Roosevelt administration in the Gold Reserve Act of 1934 then effectively devalued the U.S. dollar by 41% through raising the price of gold to $35 an ounce.

At the Bretton Woods Conference in 1944, a new global monetary order was established by the 44 Allied nations who participated. It included the creation of the World Bank and the IMF (International Monetary Fund). One of the chief features of the Bretton Woods Agreement was that each nation agreed to a system of fixed exchange rates, tying its currency at a fixed rate to the U.S. dollar, which in turn was anchored to gold at $35 an ounce. In 1971, with the dollar under increasing pressure, President Nixon suspended the U.S. dollar's convertibility into gold, thereby causing a global system of fiat money. Some investors may remember the events in the 1970s which caused the price of gold to soar more than twentyfold by 1980: huge anti-war protests in the final years of the Vietnam War, Watergate and the resignation of President Nixon, the twin OPEC oil shocks, and soaring inflation and interest rates. The chart below traces the price of gold since 1971:

**Price of Gold
1971-2011**

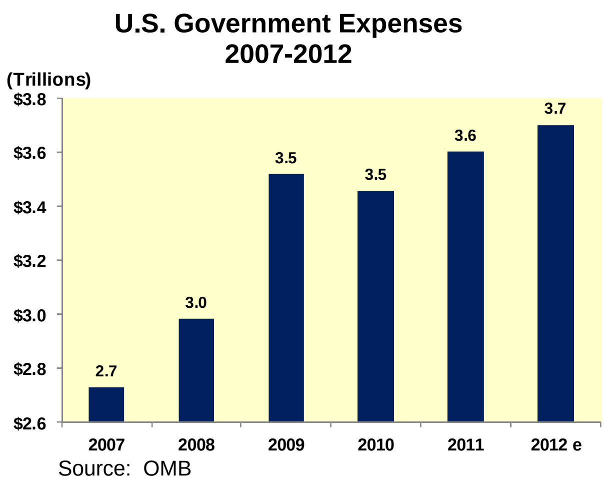
Source: Bloomberg

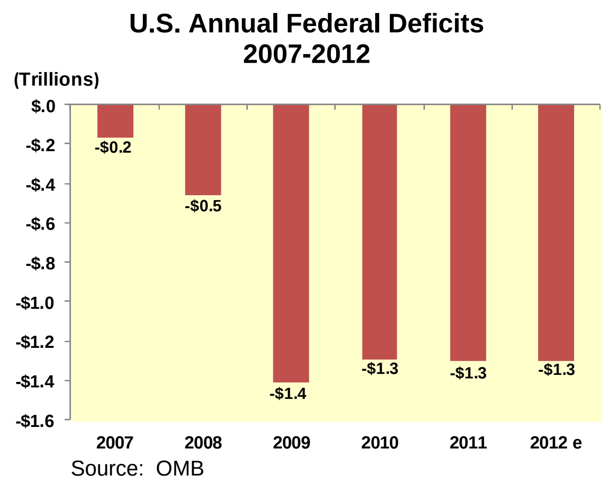
The Case for Gold

From the founding of the American republic until 1934, the official U.S. Government gold price remained essentially the same at $20 per ounce. An amazing period of stability! Then, from 1934 to 1971, the U.S. price of gold was set at $35 an ounce. Clearly, investing in gold during this 181-year period would have been a mistake. The chart on the previous page, however, demonstrates that there have been more recent periods (1971-1980 and 2000-2011) when gold has been a terrific investment. Why should investors consider diversifying into this asset class in 2012?

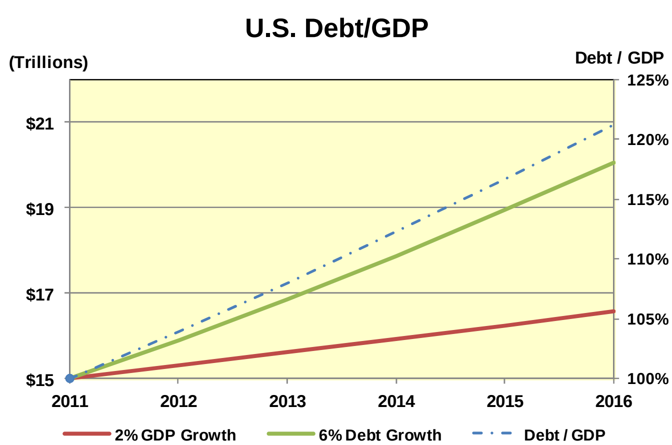
There are five reasons why investors might consider buying gold now (despite its 600% climb since 2001): 1) the increasing demand for gold from both Asian investors and central banks, 2) the relatively small and slowly growing supply of physical gold, 3) the possibility that institutional investors may increase their asset allocation into gold, 4) the depreciation of the U.S. dollar by the Fed through the monetization of U.S. debt, and 5) insurance against government fiscal and political mismanagement.

Most investors realize that all bull markets come to an end. Why then should the bull market in gold continue? The main reason is that government deficits in Europe, Japan, and the U.S. are still excessive. The charts below show Federal spending since 2007 and the resulting huge annual budget deficits:





The consequence of these deficits is that U.S. Debt (gross) is currently more than $15 trillion – 100% of GDP. Moreover, there does not appear to be any plan emerging from Washington to cut spending in the foreseeable future. Standard & Poor's has already downgraded U.S. debt to AA+. Additionally, U.S. economic growth has been feeble, with annual GDP growth averaging only 1.8% over the past six quarters. The chart below shows the worsening U.S. Debt/GDP ratio using conservative assumptions:



Using these assumptions (i.e., that the deficit falls from 8.7% to 6% of GDP annually), the U.S. Debt/GDP ratio by 2016 will increase to 121% – the same as Italy's current ratio. A loss of confidence by foreign investors who own over a third of U.S. Treasury debt would likely trigger significant sales of this debt, causing much higher interest rates and downward pressure on the U.S. dollar. An investment in gold is an insurance policy against government's inability or refusal to adopt policies necessary to close the deficit. Since the beginning of recorded history, gold has been a key asset in times of trouble.

Other Reasons to Buy Gold

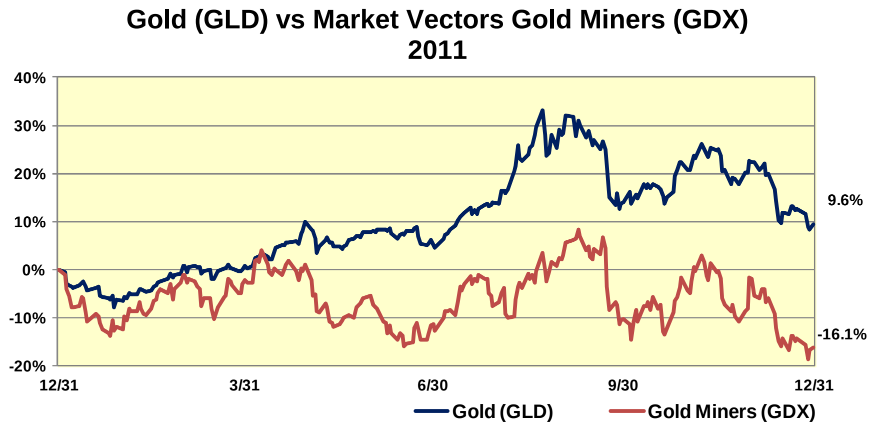
Much-needed austerity measures in Europe and the U.S. are politically unpopular and therefore difficult to implement. While Europe is in the midst of a serious crisis, many observers believe that the U.S. is not far behind. It is likely that the U.S. will run large fiscal deficits for the foreseeable future and will monetize this debt through the Federal Reserve's purchase of U.S. debt. These policies can lead to serious inflation and even to the hyperinflation that various countries (including Germany, Argentina, and Brazil) experienced in the 20th century. When a crisis arrives, gold is an asset which historically has maintained its value through political and economic crises. There are also positive supply and demand factors in the gold market. Global gold production peaked in 2001 at 2,600 tons of gold, and the current annual production of gold adds only 1.5% to the current supply each year. Demand for gold also shows positive trends. While central banks dumped much of their gold in the 1980s and 1990s, this trend has reversed with central banks more recently buying gold. Currently, almost 50% of the demand for physical gold comes from India and China and is growing. Finally, according to the World Gold Council, the total of investors' holdings of publicly traded securities and commodities in 2010 was $146 trillion, of which gold represented only 1%. Institutional investors have generally not included gold and equities in gold mining companies in their asset allocation. If pension funds, insurance companies, and mutual funds were to allocate only 2-3% of their investible assets into gold, this would provide enormous demand for gold. The gold ETF, SPDR Gold Trust, only has a market capitalization of $60 billion, and the market capitalization of the entire global mining industry is around $475 billion.

The Case against Gold

For most of the past two centuries, an investment in gold would have been a big mistake for a U.S. investor. And, for the two decades from 1981 through 1999, an investment in gold would have meant a loss of 53.8%. For U.S. investors, since 1971 gold has only worked well in times of political instability (the 1970s) or during times of government fiscal mismanagement (the last decade). Thus, one of the real risks in investing in gold now is that the timing may be wrong, following the sixfold run-up since 2001. Should the politicians in Washington enact policies to spur economic growth and cut spending, the price of gold could drop significantly. Aside from using gold as insurance in troubling times, investors have generally shunned gold as an investment because there are few metrics to judge its value. It is an inert metal whose value has generally been found in jewelry and more recently industrial use. An investment in gold produces no cash flow. Unlike corporations whose shares are valued on their ability to pay a growing stream of current or future dividends, gold pays no dividends (although shares in some gold mining companies do). The price of gold has also been extremely volatile in recent years. This is largely due to the high volume of trading on the gold futures exchanges with little or no influence from the actual physical fundamentals. Trading by hedge funds and other investors in levered paper contracts (gold futures) dwarfs the actual physical trading by a factor of 100:1. This is the main cause of the extreme volatility. Finally, if real interest rates were to rise significantly, the opportunity cost of holding gold would put downward pressure on the price of gold.

Gold ETFs or Gold Mining Stocks?

The chart below shows the divergence in investment performance in 2011 between the price of gold and a key index of top world gold mining stocks:



Source: Bloomberg

During 2011, the gold ETF (GLD) increased 9.6%, while the gold miners index (GDX) dropped 16.1%. The junior gold miners index (GDXJ) dropped 34%. In the past, gold mining shares, which are, in effect, leveraged plays on gold, have provided greater returns than gold on the upside but have lost more in gold bear markets. In 2011, this was not the case. The stocks of world class gold mining companies such as Barrick Gold and Newmont Mining, which pay dividends, were down in 2011 and are now selling at modest P/Es of 10 or lower. According to some analysts, concerns about lowered gold production, rising capital expenditures, higher taxes on resource companies by governments, and ill-conceived acquisitions were the cause. A number of well-known investors and hedge funds were hurt in 2011 by selling gold and buying the gold shares. Over longer periods, it would seem rational that the share prices of large, well-managed gold miners would be closely correlated with the price of gold, but perhaps there is a paradigm shift underway.

Summary

From our founding in 1994 until 2008, we at Bradley, Foster & Sargent were more persuaded by the case against owning gold than the case for it. However, commencing with the financial Panic of 2008, the arguments for owning gold and gold equities have grown stronger. A good case can be made that gold acts as a hedge or as insurance against the U.S. government's continuing fiscal mismanagement and the lack of political courage in Washington (and in most developed nations) to tackle these urgent economic and political problems. It is also likely that if and when the U.S. government makes a determined effort to close the budget gap, many self-interest groups and individuals will be aligned against the project. It may, in fact, require a full-blown crisis such as the current one in Europe for the U.S. to take the necessary actions to balance the budget. We earnestly hope that this is not the case, but until we see action rather than words, the rationale for allocating a portion of a portfolio to assets that hedge against government fiscal mismanagement, such as gold and gold equities, makes eminent sense.