

WEALTHWISE

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McCain's Golden Rule

"Gold is for richer or poorer, in good times and bad, to wear and to hold, to hoard and to spend, with jewelry and coin, to inherit and bequeath, such that inflation, death and taxes need not taketh one ounce [1]."

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THE ROLE OF GOLD IN STAYING RICH

By Wesley G. McCain, PhD, CFA. From www.stayingrich.net

All money in the world today, except gold, is someone else's liability. Consider a checking account: You deposit money. It is your asset, but the bank's liability; if the bank becomes insolvent and cannot meet its liabilities, you've lost your asset.

Gold is different. People everywhere, throughout time, have cherished gold for its stable price, relative to other commodities. Only since 1975, when Americans regained the right to buy and hold gold, have prices been fluctuating fairly freely. In this discussion we explore gold's unique qualities and demonstrate that this characteristic of relative price stability persists today.



GOLD AS A METAL

Gold is both widespread and rare. All the continents have yielded deposits of gold, yet it is rare because it is both difficult and expensive to extract from the earth's crust. As of 2009, only 161,000 tonnes or about 5.175 billion troy ounces of gold have been mined since the dawn of recorded history.

Second, gold has many unique physical characteristics. It is the most ductile and malleable metal. A troy ounce (just over 31 grams or a bit heavier than six U.S. nickels) can be hammered into a sheet of metal of approximately 300 square feet. Gold is inert and highly resistant to corrosion. Ancient gold coins recovered from ships lost at sea hundreds of years ago are as pristine as on the day they were lost, unmarred by centuries of submersion.

In addition, pure gold is very dense with a specific gravity of 19.32. Its high density helps ensure that a coin minted with gold is difficult to counterfeit. Gold alloys easily with other metals like silver; this characteristic, plus its density, has made it the choice for coins for centuries.

Lastly, gold is beautiful and easily formed into jewelry. It has many industrial uses in electronics, but it is still primarily held as a store of value in the form of jewelry, coins, small bars and, by the world's central banks and wealthy, in 400 troy ounce bars.

GOLD AS MONEY



What is Money?

Is money a common unit of account like a measuring stick: an inch is always an inch? Is it a medium of exchange, the stuff you trade with others for what you want? Or is it a store of value that you can place under the mattress for a rainy day? Ideally, money is all three.

The perfect money has been described as having the following seven characteristics: value, portability, indestructibility, homogeneity, divisibility, stability of value, and cognizability [2]. Today, as in ancient times, gold fulfills all these criteria better than any other commodity or any national currency.

Over the course of history, many items and commodities have been used as money. Consider this passage, published in 1885:

... though furs have been employed as money in some countries, cattle in others, in Chinese Tartary cubes of tea closely pressed together, the shells called cowries on the coast of Western Africa, and in Abyssinia at this day blocks of rock-salt, gold and silver have been generally preferred by nations which were able to obtain them, either by industry, commerce, or conquest. To the qualities which originally recommended them, another came to be

added, the importance of which only unfolded itself by degrees. Of all commodities, they are among the least influenced by any of the causes which produce fluctuations of value. No commodity is quite free from such fluctuations. Gold and silver have sustained, since the beginning of history, one great permanent alteration of value, from the discovery of the American mines [3].”

Clearly, the relative price stability of gold was well understood then. It was also understood that gold, although relatively stable, was potentially vulnerable to supply shifts coming from new gold deposit discoveries.

This understanding of gold’s relative price stability is one of the primary reasons gold became money, and continues to be money today. The reasons for this stability are two-fold. First, nearly all the gold mined throughout history is still in existence; second, the annual production of newly mined gold is small compared to the existing stock of gold. Many “soft” commodities like wheat, cotton, coffee, and cocoa are used up in the course of a growing season and vulnerable to unpredictable weather and fluctuations in crop size from year to year. These factors, combined with a highly variable carryover inventory, can produce large price swings relative to gold.



Gold's History as Money

The first known pure gold coin was minted around 600 BC by the King of Croesus of Lydia. Throughout history there have been times when gold and silver served as money and circulated side by side in a fixed (determined by government) or floating (determined by supply and demand) ratio.

Metals like silver or copper were also used as money in ancient times because they exhibited considerable inherent price stability for the same reasons as gold. However, when the industrial revolution took hold, manufacturing uses for copper and silver emerged. Because of this new cyclical demand, these metals became less desirable than gold as a form of money. It is often said that because gold has only limited industrial use, and jewelry is largely for adornment, gold has no inherent value, only cultural value. However, gold's minimal role in indus-

try shields it from variable demand driven by business cycle forces. This insulation from market cycles and its physical characteristics yield gold's intrinsic value.

In 1696, Sir Isaac Newton was appointed Warden of the British Royal Mint and in 1699, Master of the Royal Mint, a position he held until his death in 1727. In 1717 Newton implemented a gold/silver ratio policy that had the effect of causing the exporting of silver and resulted in a de facto gold standard. England began minting gold sovereign coins in 1816 and by 1821 Great Britain was officially on the gold standard. Thus, from about 1700 until well into the twentieth century, gold has been used in the western world as money. During this period the world's monetary system migrated through various forms of gold standards, arriving finally, as we will see, at a pure paper fiat money.



Gold and Money in the Twentieth Century

For much of the last four centuries, paper currency represented a precise weight of gold and was redeemable for it. Gold's price was not fixed; rather, a specified quantity of gold defined a unit of currency.

On March 14, 1900, the Gold Standard Act changed the definition of a U.S. dollar's value from 371.25 grains of fine silver to 23.222 grains of fine gold, which set the price of gold at \$20.67 per troy ounce. (Here's the math: 1 troy ounce = 480 grains; 480 grains/23.222 grains of gold, worth \$1, = \$20.67,) Gold became legal tender and the dollar was freely convertible into gold.

In 1924, Lord Maynard Keynes referred to the gold standard as a "barbarous relic." Gold coins, although portable, easily divisible and quickly recognized, are heavy, subject to theft and less convenient than credit cards or paper money. Some argue that it's a waste of economic resources to mine gold when paper money is cheap to manufacture. Lastly, during the postwar years, some westerners argued that using gold as money provided an economic lift to apartheid South Africa and the Russian government.



The Gold Reserve Act of January 30, 1934 specified that the U.S. government would no longer mint gold coins nor redeem paper money for gold. The next day, President Roosevelt redefined the dollar's value as equal to 13.714 grains of fine gold, thus fixing gold's price at \$35.00 per troy ounce. ($480/13.714 = 35$) This 69.3% increase in the price of gold created an effective 40.94% devaluation of the U.S. dollar. The Act also stipulated that U.S. citizens were prohibited from holding gold and their gold was subject to confiscation under Part 406: Seizure and Forfeiture of Gold for Violations of the Gold Reserve Act of 1934 And Gold Regulations [4]. Under the new regulations, all gold was to be converted to gold bars and owned by the U.S. government.

From November 1961 until March 17, 1968, a group of central banks that formed a consortium called the London Gold Pool stabilized the gold price at \$35.0875 per troy ounce. During the period of the gold pool operations, private demand for gold grew because one ounce of gold was worth more than gold's controlled exchange rate to the dollar. Ultimately, a two tier market emerged:

the official settlements among governments, and the free market for private buyers [5]. It was still illegal, however, for U.S. citizens to purchase or hold gold. In January 1970, the U.S. dollar price of gold was \$35.20 per ounce. At the end of July 1971, the free market price had risen to \$42.70.

Then, on August 15, 1971, President Nixon ended the convertibility between gold and United States dollars and the right for foreign governments to exchange dollars for gold, setting the stage for a freer trading international gold price. Nixon's act is sometimes referred to as the closing of the gold window. Without the ability to redeem fiat U.S. dollars, nothing anchored the dollar to gold, or to anything for that matter. By December 1971, the price was \$43.80. When, on December 31, 1974, Americans regained the right to purchase and own gold, the price, in dollars, had risen to \$195.20 per troy ounce. The price increase from \$35.20 to \$195.20 per troy ounce of gold was an unofficial, but intentional, devaluation in the U.S. dollar of 82.1% during which American dollar holders were

prohibited from protecting themselves. By the spring of 1976, the currency prices of the major countries were freely floating and traded against one another without any formal connection to gold.

Despite the turbulence of these times, the price of gold maintained its stability when compared to other commodities. Since President Nixon closed the gold window in 1971, and probably before, foreign central banks have both secretly and publicly purchased and sold gold. In addition, some pundits have speculated that the gold price has continued to be subjected to central bank manipulation. In Tables I and II and Chart I below we show the standard deviation (a measure of variability) of the monthly percentage change in the price of gold compared with three metals: copper, platinum and silver. In addition, we show the data for cocoa, coffee, cotton, sugar and wheat. Because crude oil did not start to trade freely until later, we also have a table for a second time period that includes crude oil.

TABLE I

Comparison of Standard Deviation* in the Monthly Percent Change in Gold and Various Commodities From 1/31/1970 to 12/31/2009

	1/31/1970 to 12/31/2009	Standard Deviation of Monthly % Change	Standard Deviation Gold = 1.0
Metals			
Gold		6.0%	1.0
Copper		8.1%	1.4
Platinum		8.1%	1.4
Silver		9.1%	1.5
Softs			
Cocoa		9.4%	1.6
Coffee		11.6%	1.9
Cotton		8.4%	1.4
Sugar		13.8%	2.3
Wheat		8.1%	1.4
Average of all		9.2%	1.5
Average of all without gold		9.6%	1.6
Metals average without gold		8.4%	1.4
Softs average		10.3%	1.7

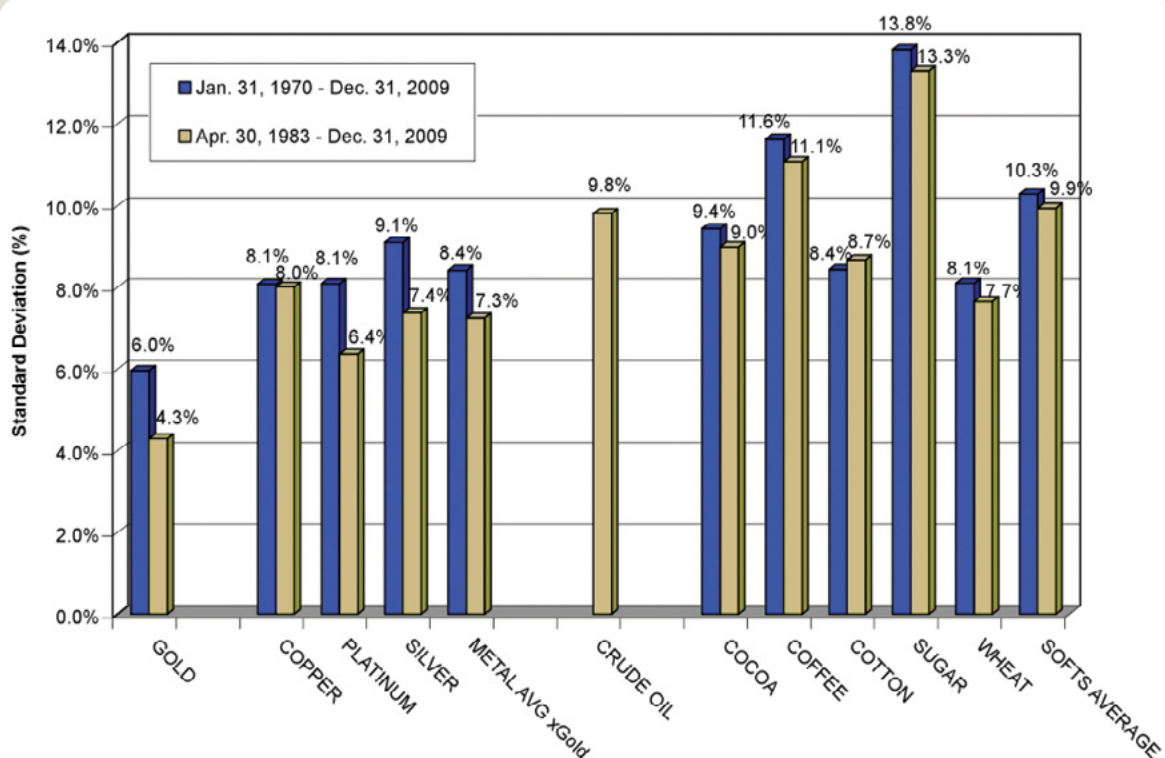
TABLE II

Comparison of Standard Deviation* in the Monthly Percent Change in Gold and Various Commodities From 4/30/1983 to 12/31/2009

	4/30/1983 to 12/31/2009	Standard Deviation of Monthly % Change	Standard Deviation Gold = 1.0
Metals			
Gold		4.3%	1.0
Copper		8.0%	1.9
Platinum		6.4%	1.5
Silver		7.4%	1.7
Crude Oil			
		9.8%	2.3
Softs			
Cocoa		9.0%	2.1
Coffee		11.1%	2.6
Cotton		8.7%	2.0
Sugar		13.3%	3.1
Wheat		7.7%	1.8
Average of all		2.0	2.0
Average of all without gold		2.1	2.1
Metals average without gold		1.7	1.7
Softs average		2.3	2.3

CHART I

Standard Deviation of the Monthly % Change For the Period Ending December 31, 2009



*Standard Deviation is used as a measure of risk; the greater the standard deviation, the greater the historical volatility and, therefore, the greater the risk.

Data Source: Global Financial Data
Calculations: www.stayingrich.net
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Tables I and II show similar results. Using the standard deviation in the monthly percent change of prices of gold and various commodities, gold is on average much less volatile than (1) the other three metals, copper, platinum and silver; and (2) less volatile than the other “soft” commodities, cocoa, coffee, cotton, sugar and wheat. In addition, consistent with the theory that metal (being nonperishable) should be less volatile than agricultural commodities; the agricultural commodities were on average more volatile than the metals for both periods. For the period since 1983, when crude oil started trading more freely, it is an estimated 2.28x more volatile than gold. The average volatility of all the commodities tested, excluding gold, was 1.61x more than gold for the period December 1970 to December 2009 and 2.1x more volatile for the later period that included oil. Chart I summarizes the data presented in the two tables.

During this period all these commodities, including gold and oil, were subject to various government and producer programs to manipulate the prices. Nevertheless, in this test of the inherent price stability of gold relative to other commodities, the results illustrate why gold continues to be a stable form of money.

IN CONCLUSION

Most commentators focus on gold’s unique physical properties when discussing its status as money. However, its inherent price stability relative to other commodities is another necessary factor. This stability must have been well understood in antiquity, but it was clearly articulated in academic writings in the 19th century. The small amounts of gold mined each year only minimally increase the total worldwide inventory of gold, contributing to its relative price stability when compared with other commodities. The demand for gold will fluctuate relative to national currencies, but the long term underlying demand for gold will grow with the population. While it is true that gold’s cost of production is very high relative to simply printing paper money, it is also true that throughout history paper money ultimately is worth no more, and frequently less, than its cost of production. (For an excellent history of paper money read *Fiat Paper Money: The History and Evolution of Our Currency* by Ralph T. Foster.)

Today, academic and less schooled commentators frequently state that because gold has very little industrial use, and demand

is driven mostly by the desire for pretty jewelry and intermittent investment demand, the price of gold should be very low. In fact, it is the very lack of an industrial demand that makes gold even more attractive as money. As we have seen, cyclical industrial demand for other metals increases their price volatility. In effect, the argument is that the desire to hold gold comes from some primitive cultural need. Perhaps these commentators are correct, but for the wrong reasons. The primitive need is to survive. If you wish to have money, throughout most of history, and in most countries today, gold is the money of choice. Gold is not someone else’s liability and, as a consequence, is not an investment; it is not an earning asset and costs money to store and insure. People choose gold to have money, not to make money. Gold should be a small, but very important part of everyone’s portfolio. The return on gold should not be compared with stocks, bonds or bills. It has a different purpose. That purpose is to ensure that you have money and stay rich.

And so we end where we started with my little saying:

“Gold is for richer or poorer, in good times and bad, to wear and to hold, to hoard and to spend, with jewelry and coin, to inherit and bequeath, such that inflation, death and taxes need not taketh one ounce.”



ENDNOTES AND ACKNOWLEDGEMENTS

[1] In 1974, while I was attending a wedding in New York City, my mind kept wandering to gold.

When the wedding vows were exchanged I wrote down these words and later that year and in 1975 used them in a few speeches.

[2] Mill, John Stuart. Principles of Political Economy. D. Appleton and Company, New York, 1885.

[3] Ibid. emphasis added.

[4] <http://www.fame.org>. Accessed July 20, 2010.

[5] Jastram, Roy W., and Jill Leyland. The Golden Constant: The English and American Experience 1560-1976. Edward Elgar, 2009.

I am indebted to the staff of Towneley Capital Management, Inc. www.towneley.com, for their thoughts and comments. I am also indebted to James Turk, Chairman of Goldmoney.com, for his critical reading and many suggestions. I am, however, fully responsible for any mistakes in facts or calculations.

INCORPORATING PRECIOUS METALS IN YOUR PORTFOLIO

Gold and other precious metals tend to appreciate in value during times of economic uncertainty. A modest position in gold can provide a hedge against rising price inflation and currency declines while helping to diversify a long-term portfolio. Although inflation is currently low, we believe that there is an increasing risk of price inflation.

For U.S. dollar-based investors, gold also helps hedge against the impact of the declining U.S. dollar. As the value of the dollar relative to other currencies falls, investors seek the stability of gold and other precious metals, driving up their prices. In this respect, gold acts more like an insurance policy for your portfolio than an investment vehicle.

At times, gold has also hedged domestic equity perfor-

mance. Through most of the last four decades, the price of gold has moved inversely to that of the U.S. stock market, as represented by the S&P 500 Index, making gold an excellent hedge against market volatility during this period. During the last decade, the correlation between the daily



spot price of gold and the S&P 500 was near zero. In the two worst years for the S&P 500 in the last decade, 2002 and 2008, the index lost 22% and 37%, respectively, while gold gained 24.7% and 5.4%, respectively.

Currently, our Multiple Mutual Fund Strategy, Global Balanced Strategy, and Inflation Protection Strategy include allocations of precious metals. In addition to helping the rich stay rich, Towneley employs these strategies for modest private investors and nonprofit organizations.

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