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THE FOOLS' GOLD OR THE REAL DEAL?

REVERSION TO THE MEAN

Gold moves in waves like other commodities. For example, gold went from a trough to a peak (April 20, 2001–September 5, 2011) and then from a peak to a trough (September 6, 2011–December 19, 2013). I call this Gold Wave VI since this was the sixth time that gold exhibited a clear cycle, pattern, or trend. Many self-proclaimed gold experts mistakenly forecasted that gold would surpass $2,000 per troy ounce. It did not happen. Any naysayers of Wave Theory were proven wrong again. Yet a reversion to the mean was inevitable. Amongst other dilemmas, the stock market collapsing from the tech bubble and then again from the real estate bubble drove scared investors to this precious metal. Gold looked like it was going straight into the sky. Eventually, however, a wave will reverse. Trees do not grow to the sky. Gold reached a nadir in August 2011 at $1,888.70. By April 2013, gold dropped to $1,361.10 per troy ounce. Gold plummeted to $1,195.00 by December 19, 2013 and lost -29 percent year-to-date. Hedge funds and other "smart money" investors began selling. Besides institutional investors, governments stockpiled the yellow metal for years, which also helped drive the price higher. As the United States and other economies recovered, investors turned to equities and focused less interest on gold. Recent sales occurred with gold ETFs during the first quarter of 2013. The reversal of the gold wave was not a surprise.

SUPPLY AND DEMAND

Like all commodities and other alternatives, gold revolves around supply and demand. Two market collapses, uncertainty in the market, war, and other turmoil helped sustain this wave. The real estate blowup and credit crises helped drive investors to gold. After the oldest and one of the biggest money market funds, the high-profile Reserve Primary Fund, "broke the buck" (its net asset value dropped below $1), gold appeared to be the security blanket of choice. The "Great Recession" caused a lot of interest in gold because some investors thought the world was coming to an end. Historically, investors flock to gold and other commodities when there are catastrophic or cataclysmic events that lead to uncertainty.

Fear of inflation, the growing deficit in the United States, sovereign debt, a likely double-dip recession, political stammering, and the tsunami in Japan along with their nuclear plants imploding all created a somewhat negative environment, which led investors to seek solace owning gold: The benchmark 100-troy-ounce Comex gold contract for December delivery has rocketed up 11 percent since August 2011 to a recent record of $1,817.60 a troy ounce, as investors across the globe scrambled to shield their wealth from the fears roiling the stock and bond markets.[1] Each of these global dilemmas includes other ramifications. For example, Greece's inability to pay its debts is wreaking havoc across Europe. "As the climate gets more poisonous and elections approach in France, Germany and Greece itself, the risk of a disastrous accident—anything from a disorderly default to a currency break-up—is growing."[2] If Greece failed, many other countries in the European Union might follow, causing even bigger problems.

Fear has a way of feeding upon itself. The fear of a government having difficulty will create more fear, which can drive investors further to gold. Gold went up in value to $1,800 when investors thought France would get downgraded. Typically very stable, France unexpectedly added to the European nightmare. The fear became real and the inevitable occurred.

France was downgraded, which resulted in the number of AAA-rated countries dropping once again.

Central banks have also helped lift the price of gold by buying an unprecedented amount of gold in 2010–2011: "From 1989 to 2008, the world's central banks disposed of a net 190 million ounces at an average price of about $398 each, according to data from the World Gold Council. Since then, they have bought back a net 28 million ounces—at nearly three times the price. If the world's central banks were a single entity, this sell-low-buy-high approach would be perverse."[3] Gold or any other alternative will be affected by institutional investors or the smart money. "Retail investors do not qualify, because they rarely matter when it comes to influencing a company's share price. In spite of collectively holding around 40 percent of U.S. equity, they do not move prices, because they do not trade very much. The real drivers of share prices are institutional investors, who manage hedge funds, mutual funds, or pension funds and can hold significant positions in individual companies."[4] The price of gold trended up but experienced a lot more volatility because of the smart money flowing in and out of it.

While Greece's debt obligations looked ominous and threatened Europe as a whole, the United States also raised concern with its own pending debt obligation; an August 2, 2011 payment that was due and the question of whether or not Congress would or would not raise the federal government's $14.29 trillion borrowing limit remained unanswered, causing more concern. "Gold futures have marched higher for 10 consecutive sessions as investors stocked up on the metal amid wrangling over the U.S. debt limit and amid worries about the European Union's ability to stave off a default by one of its debt-laden members, Greece."[5] Possible defaults with government debt were now on both sides of the Atlantic during 2011 and 2012. Historically, the United States has had the highest rating of AAA since 1941. Yet the United States faced a possible downgrade in US Treasury securities whether or not the default actually occurred. A lower rating translates to higher costs for the United States and forced debt reduction. A downgrade would invariably lead to investors demanding a higher interest rate because of increased risk. When investing, anything can happen. No security or market is invincible. "At $9.7 trillion of securities outstanding, Treasuries are one of the most liquid markets in the world. Treasury debt made up 95% of total issuance of fixed-income securities in the U.S. in 2010 and make up the bulk of U.S. triple-A rated assets, according to data from Barclays Capital."[6] If investors believe the dollar and US debt are not as safe as they thought, they will flock to precious metals like gold. As a result, gold exceeded $1,600 a troy ounce and reached $1,602.10 on Monday, July 18, 2011.

Once again, gold was a safe haven for investors. Bad news such as the United States getting downgraded will motivate people to buy even more gold. "Gold's long rally has bolstered that belief. Bullion futures rose 2% to $1,888.70 per troy ounce on Monday in New York trading, up for the sixth consecutive trading day and 16% this month. Prices have risen for each of the past 10 years, and are up 32.9% in 2011, which would make this year the biggest percentage gain of the long bull market in gold if the gain holds."[7] Gold reserves increased globally. "So far this year (2011), a net 6.7 million ounces have been added to official reserves world-wide, according to the World Gold Council. That is more than all of last year and almost 2.5 times this year's net inflows to physically backed exchange-traded funds."[8] Economic turmoil causes investors to rush to gold and other precious metals. Gold's sibling, silver, also went up and rallied to a 31-year high of around $50.00 in April, 2011.

GLOBAL GOLD

Gold bugs (as those diehard fans of buying gold are described) are not just domestic. Jewelry continues to be the dominant holding of gold rather than ETFs, mutual funds, and other forms of gold. Gold is desired everywhere. Investors around the world seek protection in gold, especially during trying times or economic upheaval. India is a large buyer of gold for jewelry. India is one of the biggest markets for gold jewelry. Close to India, with regard to gold consumption, is China. The demand from both countries is great: "The data show that gold's ascent is being driven by extraordinary demand from India and China, where rising prosperity is making it easier for millions of people to buy gold in all its forms, particularly jewelry."[9] Total demand in China was 294 tonnes in the first quarter of 2013, a rise of 20 percent on the same quarter the previous year, and total demand in India was 257 tonnes, up 27 percent on the same quarter

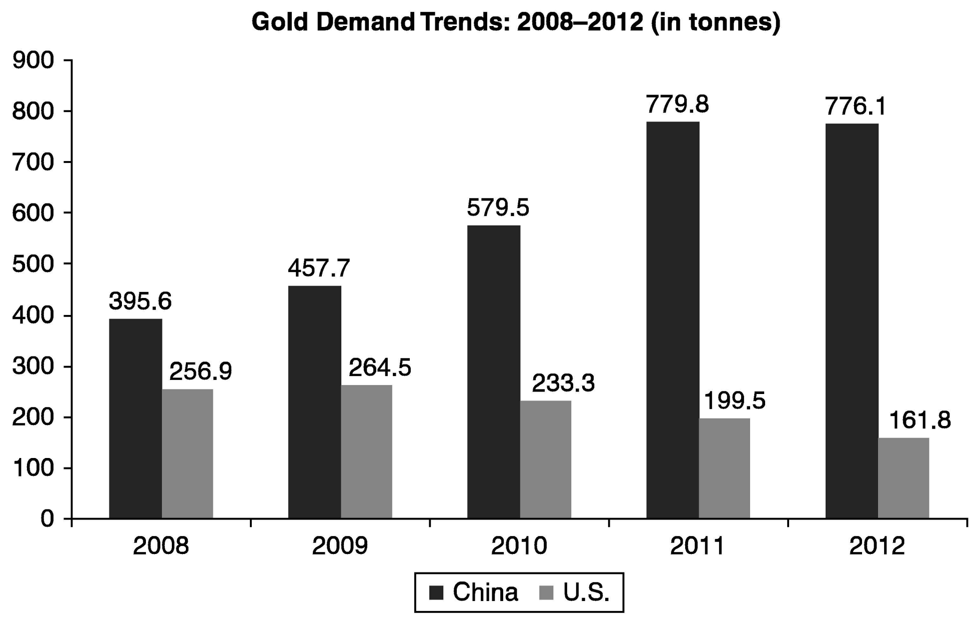

Figure 8.1 Trends in Gold Demand (in tonnes).
Source: "Global Demand Trends," World Gold Council, 2008–2012.

in 2012.[10] China now dwarfs the United States with regard to buying gold (Figure 8.1).

China was the main driver behind gold going up early in 2012: "The Chinese have been loading up like never before on gold ahead of the Lunar New Year, which falls on January 23 this year. It is a time of gift-giving that takes place during family dinners, with the older generation giving money to younger members."[11] War, natural disasters (such as tsunamis, cyclones, hurricanes, fires, tornados, or earthquakes), political upheaval, financial storms, health-care epidemics such as the plague, or any other large-scale calamity causes investors to invest in gold. In troubled times gold can act as a safety blanket. Jewelry is easily carried out of one country into another and the precious metal carries value everywhere.

The United States clearly holds the most gold but other countries are adding to their stockpiles as well. Figure 8.2 is a chart of gold held by various countries throughout the world. According to the World Gold Council, the United States has 76.1 percent of its reserves in gold holdings (8,133.5 tonnes) as of December 2012.

WAVE REVERSAL

What happens when the wave reverses? Commodities move in waves, like all alternative investments. When the world's problems subside, gold may

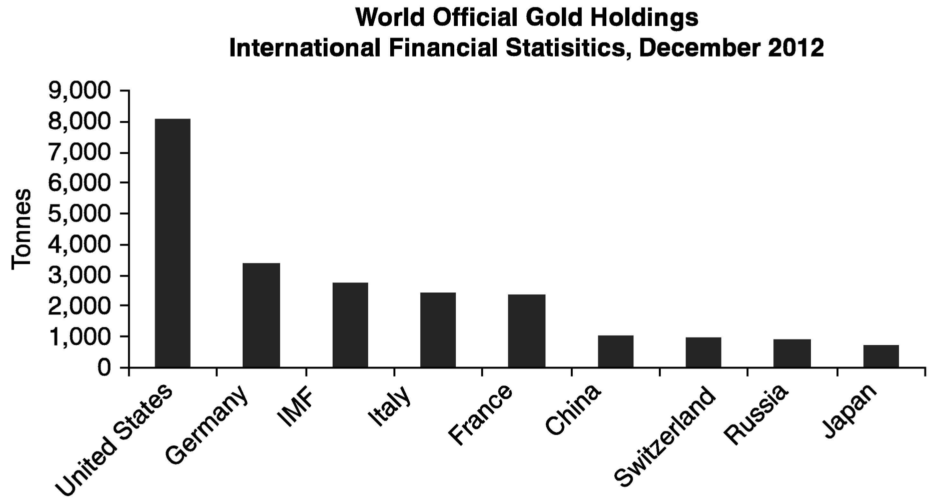

Figure 8.2 Gold Holdings Across Countries.

Source: "World Official Gold Holdings," International Financial Statistics, World Gold Council, December 2012.

reverse directions. Which country will start selling first? Will smaller countries like Cyprus exaggerate any problems they have in order to unload gold supplies first? Like a retail investor, no government wants to look stupid and left holding the bag. Even toward the end of 2011, the demand for gold was weak. Even with all of Europe's woes, gold declined in value. "The problem for gold is that demand for Treasuries is leading to a rising US dollar. That hits gold, which is priced in dollars, by making it more expensive for buyers who hold other currencies."[12]

Numerous investors and reporters told me that they thought gold just went straight up and that there were no gold waves. However, this myopic thinking is erroneous. Gold has historically had many waves. Gold has had not just one but many waves and I believe there have been around six different domestic waves. Gold and other alternatives exhibit short- and long-term waves, which one should explore before making an investment. It is not inconceivable that gold will experience another correction. It has been a long time since gold had a major correction and those corrections tended to be infrequent. From 1999 to 2011, gold experienced three declines greater than 20 percent, but snapped back each time. But this time around might be different.[13] The more information one has, the better it is to make a prudent decision. Some investors look at price while others look at weight. Others use both.

Alternatives typically revert to the mean when they are overvalued or undervalued, similar to the tech bubble in 2000 or the real estate bubble in 2007. Market peaks and bubbles ready to burst typically present danger signs, like having numerous companies filing to go public in a particular sector. The gold wave will likely reverse, as it has in the past. Commodities typically revert to the mean.

WAVE PEAK SIGNALS

Amongst other things, when a commodity or sector dramatically increases or decreases in price, M&A follows. However, not all of these M&A deals are successful. For instance, gold miners did poorly compared with gold over a couple of years from 2010 to 2011 despite the run-up in the underlying commodity, gold. "It's true that mining stocks can magnify gold's moves. That's because of the enormous influence the metal's market price has on a company's earnings. Once bullion advances beyond its production cost, price changes flow directly to the producer's bottom line. But investors and advisors should remember that while this may happen, there's no guarantee it will."[14]

Investors should also be wary of numerous companies going public in one sector. Frequently, this is a sign that they might have poor performance. How many search engines exist today when there were at least ten around the time of the tech bubble? Typically, there are only 1–3 leaders. Not every company can be a leader in a particular sector. For example, a total of 12 global mining companies were priced during the first week of June in 2011. Glencore International PLC's IPO, which raised $10 billion on May 19, 2011, was one of the largest. However, Glencore dropped after its IPO: "The IPO immediately propelled Glencore, with a market value of $59 billion, into the FTSE 100 Index, which tracks the U.K.'s biggest companies, although the stock had fallen 28.2 percent from its initial price as of Aug. 8."[15] Figure 8.3 is a chart of year to date global mining volume, January 1–June 9.

"Many big deals have performed poorly—most notably Glencore, whose shares are down about 31% since its May IPO. At one point in August, of the 20 European IPOs this year larger than $200 million, 19 were either trading lower than their issue price or had been pulled."[16] Arch

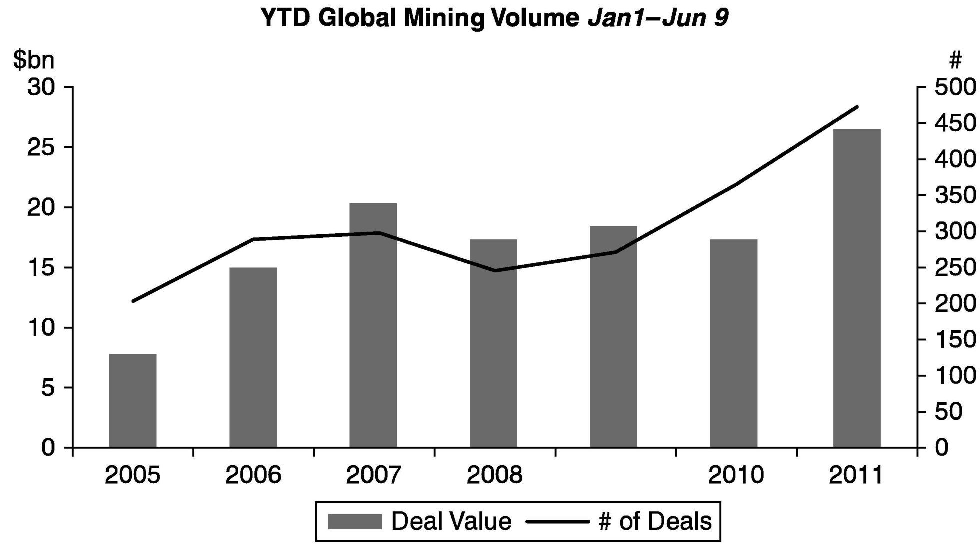

Figure 8.3 Gold Mining Volume: 2005 to 2011.

Source: Vidushi Gupta, "Two Largest 2011 Global Mining ECM Deals Price in Q2," Dealogic, June 10, 2011.

Coal Inc. priced a follow-on offering, raising $13 billion and was the largest US mining company since CONSOL Energy.

BUBBLE TROUBLE

Investors sometimes find themselves in a bubble and tell themselves, "This time is different. It will only go higher and I might miss out." However, thinking such as this is often wrong. "When investors have been experiencing some years of abnormally high or low returns, they begin to believe that those returns probably will not return to the long-term mean returns for that asset class. They also generally lose sight of the fact that those long-term average returns imply that the asset will at some point produce returns as far (and sometimes as often) below the mean as above the mean."[17] It is easy for someone to think gold will just go straight to the moon and never correct. Negative news helps drive investors to gold and make them fearful. The more negative news, the more investors flock to gold. Investors tend to overreact to negative news.

Buying gold is not the same as purchasing a growth company like Microsoft. One can buy gold miners, which is different from buying the actual commodity. Gold, as we know, can fluctuate in value. It also pays no dividend. Commodities such as gold are traded with futures: "A future contract is an order that you place in advance to buy or sell an asset or commodity. The price is fixed when you place the order but you don't pay for the asset until delivery date. Futures markets have existed for a long time in commodities such as wheat, soybeans, and copper."[18] Commodities have risk including unforeseen risk. For example, there is risk where an investor buys or sells futures. "The failure by regulators to detect allegedly falsified bank statements at Peregrine for at least two years has again raised questions about their ability to protect customers of futures brokerages. Last fall, futures regulators failed to detect problems that led to the implosion of MF Global Holdings Ltd."[19] Those who bought gold in 1973 paid approximately $106.48. By 1979, gold prices were around $459.00, more than a four-fold increase over six years. Just like today, gold was a hot topic back then and investors wondered whether or not to jump in, wait, or take a pass. Hypothetically, if one invested at the beginning of 1980, how did they do? Gold continued its ascent to $594.90, but then the wave crested, and from 1981 on there was a reversal and the beginning of a decline for gold. By 2001 gold dropped to $271.04. Those who jumped in at the high got burned. Investing in gold is by no means risk-free, as evidenced by those who lost more than 50 percent over this time period. What happened after 2001? Gold formed a new wave (Gold Wave VI), abandoning its trough to reach a new high over the next nine years. Gold reversed its course more than a decade later after hitting an all-time high. In August 2011, gold started to correct.

THE GOVERNMENT AND GOLD

Government action can affect any commodity or alternative investment including gold. Moreover, various governments buy and sell gold as well as can write or create new laws. "The CFTC was once seen as sleepy and toothless, but the Dodd-Frank law handed the agency arguably more power than any other regulator. Under the law, the CFTC is supposed to police the derivatives market and force once-private transactions onto open exchanges, in full view of regulators."[20] Gold was not so much a target with new rules as oil. Oil shot straight to the sky and regulators were concerned that it was because of market manipulation. As commodities play a larger role with investors, ETFs and mutual funds are facing increased regulations. ETFs were viewed negatively by regulators for a period of time but there was no evidence of any foul play or misuse. ETFs are liked by investors and are not going away. In other words, the market is growing for ETFs and they are competition for actively managed mutual funds: "Exchange-traded funds are posing a new threat to the $7.8 trillion market for active mutual funds by challenging the notion ETFs are only good for tracking benchmarks."[21]

While the search for the oil manipulators proved fruitless, an even larger problem developed called MF Global. MF Global was a firm specializing in commodities that caused problems for both investors and customers. One of the most astute self-made billionaires in the United States, Michael Flowers, and his private equity firm, J.C. Flowers & Co., had an investment in MF Global: "The fallout from the collapse of MF Global, which had hundreds of thousands of customers, is already being felt in Washington, where regulators on Friday vowed to crack down on some of the practices that enabled the firm to place risky bets."[22] The entity as well as the advisor where one buys alternative investments is extremely important. One might successfully invest in gold or other commodities but then be thrown a curve ball if the company they entrust goes under and their money is lost, stolen, or tied up in bankruptcy. Michael Flowers and many less sophisticated investors were duped. Oddly, the US government failed to find anyone culpable.

GOLD CORRELATIONS

Alternative investments tend to hold up reasonably well in down markets compared with equities and bonds. By diversifying alternative investments, one can possibly lower risk and increase returns. Typically, there is a low correlation between alternative investments (such as commodities or hedge funds) and stocks or bonds. "Portfolios of less than perfectly correlated assets always offer better risk-return opportunities than the individual component securities on their own. The lower the correlation between the assets, the greater the gain in efficiency."[23] Gold is another fine example of an alternative investment with a low correlation to equities. It is important to know your assets so they are not too highly correlated. One might add one type of alternative investment, thinking the assets are not correlated but there might be more in common than the investors believe. For instance, a hedged equity, macro, event driven, and commodities asset allocation has low correlation with fixed income. On the other hand, US Equity has low correlation with macro and commodities but a higher correlation with hedged equity and event driven/relative value.