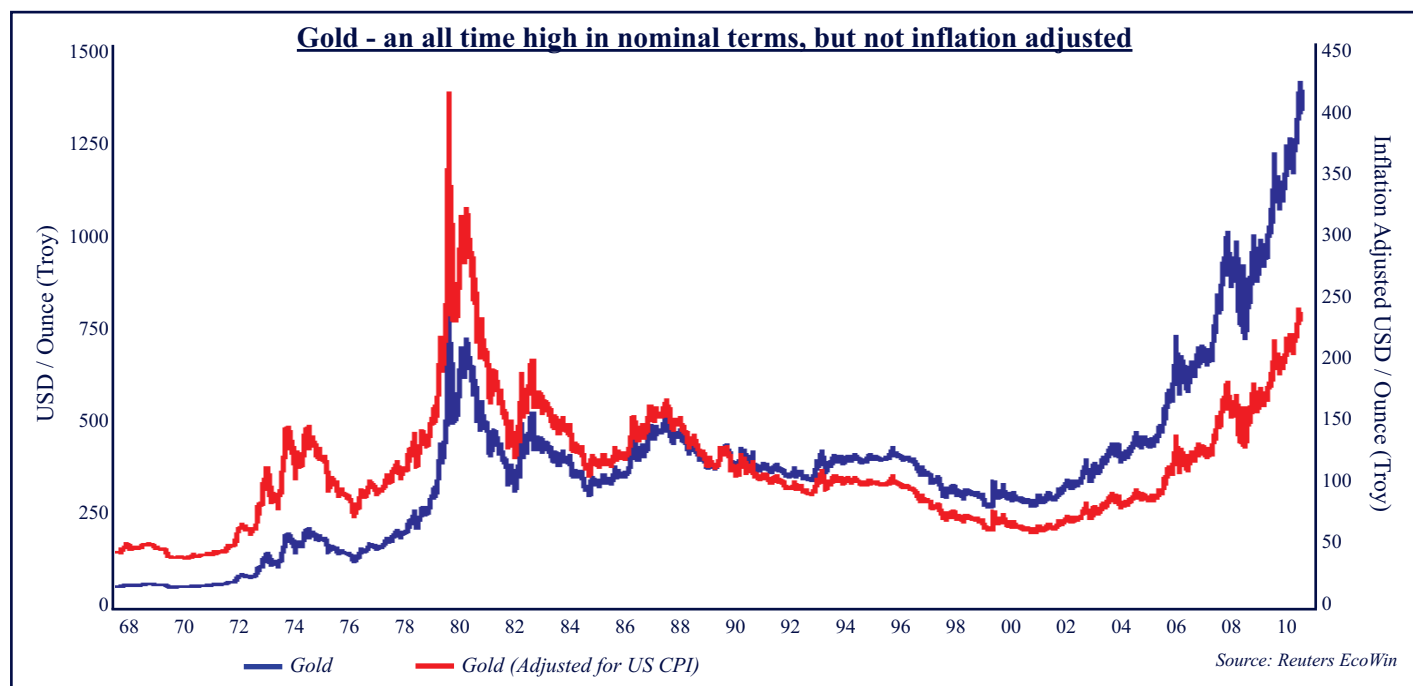


## BEWARE THE GOLD RUSH

In their seminal 1934 text, 'Security Analysis', Ben Graham and David Dodd, the fathers of value investing and mentors to Warren Buffett, defined investment as an operation "which, upon thorough analysis, promises safety of principal and a satisfactory return." Operations not meeting these requirements they termed speculations. With the price of gold touching record highs, at least in nominal terms, we are concerned that many investors are disregarding value and instead speculating on price momentum.

It is instructive to revisit a time when gold wasn't so popular. From a peak of \$850 per ounce in 1980, gold suffered a prolonged period of weakness, falling by over 70% and reaching a low of c\$250 at the end of the millennium. As the chart below shows, gold has fared significantly better since, as low prices revived demand from traditional sources, such as industry and the jewellery markets. Investment demand has also increased, with the first Exchange-Traded Fund ('ETF') to be backed by physical holdings of gold launched in 2003. Such instruments gave investors the opportunity to gain exposure to gold without the cost or difficulty of storing bullion or the equity risk of investing in gold miners.



Other factors contributing to the near exponential rise in the price of gold over the past three years include:

- Concerns that quantitative easing will lead to much higher inflation and the depreciation of western currencies have boosted the 'safe haven' appeal of gold. In inflation-adjusted terms, the price of gold remains below its all time high and would need to increase to c\$2,300 in nominal terms to match that reached in the early 1980s (though, in our view, the \$2,300 peak price is flawed – see reverse).
- In aggregate, central banks have become net buyers for the first time since 1988; European central banks have halted their sales of gold bullion and Asian and emerging market governments have stepped up their purchases.
- Sentiment towards gold has found further support as major gold miners have begun closing their forward hedging programmes, thereby signalling that they expect higher prices in future.

- With further rounds of quantitative easing a possibility and interest rates likely to be kept close to zero in the major economies for the foreseeable future, holding gold is inexpensive in terms of interest income forgone.

Given these supporting factors, it is difficult to see gold experiencing a major correction in the short term. However, the ‘bull case’ for gold is now widely known and, as such, is arguably already reflected in a price that has increased more than five-fold in 10 years.

Investors now considering making allocations to gold should first consider the following:

- Arguments for the gold price to reach c\$2,300, to top inflation-adjusted all time highs, assume that the record \$850 per troy ounce in January 1980 was a stable price, achieved in a liquid market. In fact, this record price was a short-lived spike in response to a combination of geopolitical factors and inflation concerns. As our chart shows, after reaching its peak, profit taking caused the metal to fall sharply: by more than 25% over the following five working days and almost 45% over the following two months.
- With production costs of gold at c\$470-\$500 for large mining companies, we would expect a significant supply response in the coming years as more mining projects become highly profitable. Much as low prices earlier this century slowed investment in new gold mines, high prices now are likely to promote higher production.
- Gold, unlike energy or agricultural commodities, does not get ‘used up’. All the gold ever mined is still in existence. One should take care not to confuse a rising price with a shortage. Such arguments proved false for oil in 2008 and even coal as far back as the Victorian era.
- Investment demand, driven by the accessibility of physically-backed ETFs, may be displacing the fundamental drivers of gold demand. This suggests that gold is now vulnerable to a change in sentiment. If positive sentiment begins to wane, momentum investors in gold ETFs may begin to reduce their holdings. At such a time, it is not clear where buyers will come from or at what price.
- Given that central banks were net buyers at previous highs in the 1980s and were large sellers at very low prices at the beginning of this century, their recent bullishness may be a contrarian signal.

In summary, we are acutely aware that investment bubbles often take asset prices further than even the most expensive valuation measures. We are concerned that, following a five-fold increase in price already, gold is being driven by speculation. In our experience, profitable investments are often the uncomfortable ones, requiring patience and the courage to bet against the crowd. These are the value investments, as set out by Graham and Dodd 75 years ago. We advise clients not to join the gold rush.

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