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Barry Ritholtz and the price of Gold!

Recently, an article appeared in Bloomberg online titled “Ten Reasons why Gold Bugs lost their shirts”, written by Barry Ritholtz, the CIO of Ritholtz Wealth Management.

He is a regular blogger, equity analyst and is frequently seen on Bloomberg Television as well.

The article also made it's way into the Australian media, and was carried by amongst other publications the Sydney Morning Herald.

Many in the mainstream finance media and asset management space have praised the piece. Unsurprisingly, it hasn't been quite so warmly received by certain sections of the precious metal community, but that doesn't alter the fact there are a couple of lessons in the article worth paying attention too, not just for gold as an investment, but for all asset classes.

This is a point Ritholtz himself makes when he says; *“This column is not an “I told-you-so” or an exercise in “Goldenfreude” (describing a “delight in gold bugs’ collective pain”). Rather, it is an attempt to learn some investing lessons from the epic rise and horrific fall of gold.”*

Whilst I dispute it's been a horrific fall (there was a correction of 30% only a few years ago too), it's safe to say 2013 won't be remembered fondly by precious metal bulls, which is obviously what he's referring to in that last comment.

Furthermore, knowing that he is well known to Doug Casey and the team at Casey Research (definite gold bulls and leading macro thinkers in my opinion), and that he has appeared debating ideas and investment themes with some of the leading lights of the North American wealth management industry (including John Mauldin), I don't in anyway believe Ritholtz he is anti-gold per se.

In fact he pointed out at the very start of his article that:

“As an investor, I am a gold agnostic: When used properly, the metal is a potentially valuable tool in an investment arsenal. There are times when it makes for a profitable part of a portfolio, as in the 2000s. There are periods when it is a speculative and dangerous trade -- such as the 2010s.

There have also been decades when it does nothing, earning no return, generating no income, essentially dead weight to a portfolio, as in the 1980s and 1990s.

As bullish as I am (and remain) on gold and precious metals in general, it's hard to argue with that assessment. It's an accurate representation of what's happened to the gold price over the last 40 years since Nixon took the US off the Gold Standard, although it does of course just look at gold from a return perspective, not allowing for the fact that many investors hold a small portion of their portfolio in gold at all times to hedge against tail risks and reduce the overall volatility of their portfolio.

With that in mind, let's have a look at the reasons Barry gave for Gold's sell off in full. Included below is each of the 10 reasons he gave, and following each of those (in blue text) are my thoughts on each of his points.

Reason 1. Beware the narrative. Humans love a neat tale with heroes and villains and conflicts that need resolution

Humans love a neat tale with heroes and villains and conflicts that need resolution.

On Wall Street, storytelling is a big part of the sales process, and gold was no different. Even though it had broken out in 2005, the Great Recession and bank bailouts of 2007-08 created a fertile environment for the Gold Narrative. It was a perfect combination of factors: Huge government intervention, a move away from true "free markets," coordinated central bank actions, unprecedented quantitative easing and zero interest rate policies would inevitably cause a huge debasing of currency and hyperinflation, or so the story went.

Gold is a haven in times of stress and a hedge against inflation when economies accelerate. It was under owned and yet an attractive alternative to assets with low real returns. Based on the amount of total outstanding fiat currency, gold would hit those \$US10,000 price targets. The problem with all of this was that even as the narrative was failing, the storytellers never changed their tale. The dollar hit three-year highs, despite QE. Inflation was nowhere to be found. If anything, deflation was the greater risk. The problem with storytelling is that it makes an investor feel good, even as the data show the opposite and the position goes against him.

JE comment: Barry is right to point out that investors or traders should always question the narrative, and make sure their perception of what 'should happen' in the economy is backed up by what is happening.

On this note, he's probably right that many gold bulls would perhaps be surprised that official inflation rates are still as low as they are today, although there are good reasons to question the accuracy and impartiality of official inflation rates. Nevertheless though, we certainly aren't experiencing runaway inflation rates, a function of low private sector credit demand, a soft economy and low/declining monetary velocity, which no amount of central bank stimulation has yet overcome.

Having said that, whilst some have bought gold to protect against hyperinflation, many also are buying gold as a hedge against over-valuation in financial assets, especially in light of a deteriorating global economy.

On this note, I would say that gold bulls merely need to be patient, as around the world central banks are still committed to zero interest rates and ongoing QE.

Bottom line, the full tale of today's monetary experiments is not yet told, and the heroes and villains are yet to reveal themselves in full.

Reason 2. Take Note of New Investment Products

One of the fundamental changes in this gold cycle has been the creation of a variety of new gold-related products. The mac daddy has to be the gold exchange traded fund (GLD). Called the "innovation that opened gold investing to the masses," it allowed people to invest in gold without opening futures accounts.

The World Gold Council is an organization created by global mining companies for the purpose of promoting the sale of gold. The gold ETF was their brainchild. Following "two decades of depressed prices and a growing glut of the yellow metal," they faced the possibility of having their funding withdrawn. So in November 2004 they threw a Hail Mary called the SPDR Gold Shares exchange-traded fund. It was a game-saving touchdown.

Anyone with an ordinary brokerage firm could now be a gold investor. By some estimates GLD has added \$US150 an ounce to the price of the metal. Nomura Securities analysts noted that "big shifts in gold ETF holdings" were highly correlated with "rises in the gold prices" Lipper called GLD the "fastest-growing major investment fund ever."

During its bull run, the fund was buying \$US30 million of gold daily. In 2012, the biggest single equity holding in self-directed 401(k) plans was Apple ... followed by the SPDR Gold Trust.

A slew of other gold ETFs soon followed. The Market Vectors Junior Gold Mine (GDXJ) came out at \$US100, rallied to \$US160, then collapsed to \$US30. Other exotic offerings were rolled out: UBS introduced the E-TRACS S&P 500 Gold Hedged (SPGH) - half S&P 500, half gold. It was perfectly hedged against making any money, as the soaring US equity markets were offset by the collapsing precious metals.

Perhaps the most paranoid new products were the physical "gold only trusts." There was the iShares Gold Trust (IAU), along with a numerous regional physical gold shares from ETFs in Switzerland and Singapore (Swiss, SGOL; Asia AGOL). These owned physical gold and only physical gold.

Theoretically redeemable by owners in gold in case of a financial emergency, these were designed to appeal to those who lacked trust in the financial system. The underwriters were apparently oblivious to the irony of offering the products through that self-same financial system.

You could even take the other side of the gold trade - though few did.

Direxion's Daily Gold Miners Bear 3X (DUST) is a triple-leveraged bet against gold. Despite being up 165.69 percent in 2013, it barely has \$US100 million in assets.

Salesmen always need something to sell. In GLD, they found the found a perfect vehicle to pull in the masses.

JE comment: Again there's some truth to this, although it must be stated that gold was at most been 2-3% of institutional asset holdings even when the gold price was closer to USD \$1900, so it's never been 'over-owned' in this cycle, at least relative to history and other secular high points.

With respect to GLD, whilst it's true that it did become a market darling, and that many individual investors used it for their 401k's and the like, it did also attract hedge fund and institutional money over the years. Whilst this undoubtedly helped push gold prices up between 2009 and 2011, I wouldn't classify those investors as long term. They probably saw gold trending, were making very little money in stocks at the time, and saw gold as a vehicle to outperform their peers in the short term. In 2013 in particular, as soon as gold headed lower, and equity markets started rallying, they reversed these positions, not necessarily because they have any major insight into the long term direction of gold (or equities for that matter), but because that's what the trends suggest they do, and they're chasing momentum (and yearly bonuses)

I'd also make the point that as of today, GLD holdings are at 5 or so year lows, so any 'excess froth' that might have appeared in the gold market in response to fears of hyperinflation or the European debt crisis etc. are well and truly gone

Reason 3. Ignore History at your own peril (or, everything eventually becomes a trade)

You cannot be in the market very long and grow attached to anything, as everything will eventually disappoint you. I call this my universal entropy theorem of investing, and it's why everything - from Microsoft to the 10-year bond, from Apple to gold - eventually goes to hell. (Just look at the stocks tossed from the Dow Industrials for more evidence).

Gold has run up only be to trounced in repeated massive sell-offs: 1915-20, 1941, 1947, 1951-66, 1974-76, 1981, 1983-85, 1987-2000 and 2008.

JE comment: I'm not sure about the massive gold sell-offs in gold prior to 1971, but there is no question gold is volatile, and particularly during 74-76 (a period in which the price action for gold is quite instructive for investors today), 1981 and in other instances he mentions, gold can go down substantially.

This is also true of equities, REITS, listed infrastructure and even bonds too, as Barry himself says, so it's not just relevant for gold. It certainly doesn't mean a balanced investor shouldn't have an allocation to precious metals today or that they were wrong to do so in 2013 if they wanted protection from certain market risks. A home insurance policy isn't a failure if your house doesn't burn down.

Reason 4: Leverage is always dangerous

History teaches us that any investment purchased via credit always runs the risk of margin calls. Whether it's dot-com stocks, no-money-down houses or subprime collateralized debt obligations, leverage eventually leads to liquidation.

Precious metals are no different.

Like all commodities, gold is purchased via futures contracts. The leverage involved is typically 15 or so to 1. Most of the time, the real world imposes a limit on how high an industrial metal, energy or agricultural product can run before its largest buyers cut back or switch to an alternative.

For example, carbon fibre can keep aluminium prices in check; natural gas is a cheaper (and cleaner) alternative to home heating oil. Chicken is a substitute for beef.

Gold has no real alternative. Platinum is much rarer - we mine only 6 per cent as much of the stuff each year. Silver is much cheaper, trading at 1/60th the price of gold.

This cycle brought many new gold enthusiasts into the futures market. Their inexperience with big leverage - stocks and bond purchased in brokerage accounts are limited to 2-to-1 margin - led to surprising wipeouts. Leverage of 15-to-1 requires only a 7 per cent downdraft to create a total loss of the initial investment.

The CME group, created in the 2007 merger between the Chicago Mercantile Exchange and the Chicago Board of Trade, is the world's largest commodities exchange. As gold headed toward \$US1000 in 2008, CME officials began to adjust margin requirements accordingly.

They stand as the counterparty of last resort, so raising margin requirements was a prudent risk-management move on their part.

Gold rallied faster than CME could raise margin requirements, however. The next two years saw a huge move, along with a spike in volatility. In September 2011, gold was swinging wildly as it made its ultimate high. Following what was the most volatile week in years, CME Group raised margin requirements by 21 per cent.

And that was pretty much the end of the run.

JE comment: I've seen many precious metal bulls argue this point, mostly because they (like myself) only buy real physical gold and silver, without using leverage.

On this point they're of course correct, in that they can't or won't be stopped out of a position due to some margin requirement.

Nevertheless, many participants who are trading gold, or using the futures market to 'place their bets' one way or the other on gold are using leverage, and this does magnify the returns both to the upside and downside, as it always has.

Perhaps the better point to make here is that for those who are long term investors in physical bullion, you just need to be aware that short term leveraged market participants, who aren't necessarily in gold for the long run, can and will continue to impact the day to day dollar value of your investment.

Reason 5: Maintain situational awareness

The concept of situational awareness comes from military theory, particularly aviation, representing the idea that a pilot needs to be fully cognizant of all the elements occurring in three-dimensional space, as well as those about to occur in the near future.

For the investor, situational awareness means not getting too caught up in the moment, and understanding the continuum of time. Instead of thinking of any event as a single instance in time like a photograph, consider instead a series of instances more akin to a video. Doing so forces the investor to think of the big picture, the 30,000 foot view.

As John Updike wrote, "The beauty of gold is, it loves bad news." ("Rabbit is Rich," p.247). Quite a few gold investors came to believe that the bad economic news had become permanent. But all cycles eventually turn; even the Great Depression ended. So, too, did this recession

JE comment: No real comment to add here, except that I, like many gold bulls remain fundamentally unconvinced that the Great Recession is really over, and that asset prices reflect the real economic reality.

Nevertheless, balanced gold investors would have to agree that, at present, the market consensus is that 'all will be well' in the global economy, and this has, for now at least, dented Western demand for precious metals

Reason 6: The Danger of one way Trades

What would make you reverse your biggest present holding? What facts or situations would force you to change your views and sell? If your answer to that question is, "Nothing," you have a huge, devastating flaw in your approach to investing.

One of the more fascinating lessons to be gleaned from conversations over the years with various gold enthusiasts is that exact concept of an "irreversible market position." It is based on a simple thought experiment that many portfolio managers and traders engage in when establishing a position.

Ask yourself, "What would make me reverse this position? What would make me sell this long or cover this short?" There is usually a long list of technical and fundamental answers. They may include break in support, a violation of a trendline, a decline in earnings, a slowing of growth, etc. Often, a simple modest price decrease is sufficient to get traders to cut their losses.

Yet many of the gold bugs I have spoken with over the past five years had no pain point. "I'll Stick With Gold" was a common refrain. There was no conceivable set of circumstances that could either reduce their ardor or their

holdings in the metal.

This is a dangerous mindset toward any investment, but an especially money-losing attitude when holding a commodity. The takeaway is that every position, no matter how compelling the underlying story, should have an exit strategy. Indeed, it is especially important with a "loved" holding - one that has a huge emotional investment and an unhealthy reliance on narrative.

JE comment: Barry's comments here are applicable to all investment options, not just gold. Certainly those who will hold gold through thick and thin might be accused of being one dimensional in their thinking, but are they really any different to the 'stocks for the long run' crowd (who conveniently forget the sometimes 20 year periods where stocks return 0% or less), or in Australia for example, those who insist it's always "the time to buy" property, and that property will double every 10 years.

However, as a 10 year gold bull who has the lion's share of his wealth in physical gold and silver, let me offer a preliminary (if not exhaustive) set of circumstances where I'd likely be inclined to hold less bullion and more financial assets

Economically

- Governments balance their budgets
- Governments cease bailouts (or promising bailouts) for the financial sector
- Central banks cease quantitative easing
- Central banks raise interest rates by a few percentage points

Markets

- Equities can be bought at valuations substantially below long-term averages, in line with typical bear market bottoms
- Bond yields more adequately reflect longer term inflation and credit risk
- Cash in the bank offers a reasonable real rate of return

Anyone dispassionately analyzing the global economy, the state of public finances the world over, the addiction of the market to monetary stimulus, and the challenge democratically elected governments have balancing budgets in the modern social welfare state knows we are not heading towards the world I've outlined above any time soon.

Barry Ritholtz himself has authored a book called "Bailout Nation" so he's more aware of this than most of us.

Therefore, what I think Barry might mean when he implies 'gold bugs' have no "*conceivable set of circumstances that could either reduce their ardor or their holdings in the metal.*" is that the 'gold bugs' he has spoken too have done their analysis on current global debt levels, the unsustainability of the social welfare state and current valuations in other markets and see no good way out for the global economy.

Therefore, they're holding their gold until the market forces a resolution one way or the other as regards to these matters, in the belief that gold, more than any other investment, will protect their wealth through these tumultuous times.

Last year was a reminder to these investors that there will be significant volatility and drawdowns in the gold price along the way, even if their long-term outlook is correct, which in my opinion it is.

Reason 7: What's in the price already

One of the differences between professional and amateur traders is recognizing what's in the price. By the time most rumors, whisper stories and headlines reach the average investor, the impact of the news is already reflected in the market. The expectation that well-known news might somehow be a price catalyst always surprised me.

What's that you say, the India wedding season was going to drive prices? Only if you believe this tradition dating back thousands of years is unknown to the gold market. Wait, China's central bank's gold reserves are growing rapidly? Who exactly is surprised by that?

Genuine surprises that are unknown to the market can move prices. Most of the narratives (See e.g. [this](#) or [this](#)) do not.

JE comment: This is a great comment, especially in regards to India's wedding season being a well-known source of demand, although I'd argue China is profoundly changing the gold market.

However, whilst is Barry is right that it always pays to consider what's in the price, lets put this question to today's gold bears, which is nearly everyone in the investment world right now

What's in the price already? I would argue quite a bit.

The successful ending of QE is in the price. A sustainable economic recovery in the US is in the price. Constantly rising equity markets are in the price. No flare up's in Europe or in China, or any major geopolitical tension is in the price. Continued GLD divestment of hundreds of tonnes of gold is in the price. Perpetually elevated short positions and negative investor sentiment are in the price. The terminal death of inflation is in the price.

With that in mind, whilst bulls might suffer somewhat more in the short term, there would seem to me to be a fair bit that could go wrong for the bears narrative in the years ahead.

Reason 8: What are the Fundamentals of Gold Anyway

Gold has no fundamentals. What is traditionally called fundamental analysis involves determining a company's cash flow, revenue and earnings. Commodities have none of these things.

What some people call fundamentals are really more akin to broad macro

debates. Determining the state of the economy, interest rates, gross domestic product, corporate earnings, debt, unemployment, inflation and the US dollar - then deriving their impact on gold - amounts to little more than guesswork. Forecasting what all of these parts of the economy are doing in advance is a near impossible task, at least with any sort of accuracy on a consistent basis.

The simple truth is that all tradable assets are worth whatever the next guy is willing to pay for them. With commodities, this is even more true, as they lack an objective measure of cheap or dear.

JE comment: This comment is as accurate as it is effectively useless. It's accurate in that gold lacks a cash-flow, revenue and earnings as Barry says. It's useless in that this has always been the case for gold, but hasn't stopped gold being a monetary medium of exchange and store of value for thousands of years, nor prevented it from appreciating at 9% per annum on average since Nixon closed the gold window, often preserving value in periods where the economy has weakened and other markets have suffered.

Even the most ardent of gold bears (and Barry doesn't appear to be one), would have to agree that gold is money, which is why central banks still hold it.

To argue that gold has no fundamentals is to argue that money has no fundamentals

If the GFC had one lesson for all of us, it's that there are period in markets where fundamentally, people want to get their hands of money no matter what, and they're willing to sell otherwise good assets at 50-60-70% below their previous highs in order to get their hands on it.

Reason 9: End of World Tales, Conspiracy Theories and other such nonsense

More than any other investment, gold seems to involve a stream of fantastic tales of imminent societal collapse. Every potential problem gets blown up into a coming apocalypse. Fiat currency leads to worldwide collapse, as the dollar falters and hyperinflation appears. All paper money is going to be worthless, so you better have some gold if you want to feed your family.

Except that the fear-mongering is always backward looking. The dollar had already collapsed by 41 percent from 2001-2008; we had very strong inflation in the 2000s, and much more moderate inflation after the financial crisis.

Then there are the theories of anti-gold conspiracies: Central banks are manipulating prices; the Bureau of Labor Statistics is hiding data showing how much worse inflation really is.

Gold is marketed through a combination of fear and dishonesty. (As opposed to various equity products, which are marketed through a combination of hope and dishonesty).

JE comment: I must say I had a chuckle at the last comment regarding fear and dishonesty as opposed to hope and dishonesty.

In all seriousness though, this argument that you only hold gold if you think the world is coming to an end is palpably rubbish (although I'm sure some there are some people have bought gold expecting some such scenario).

In the 1930's, the world didn't end, but gold investors protected their wealth whilst stock market investors lost 90% of their value, and had to wait 25 years to get it back.

In the 1970s, the world didn't end, but gold investors saw the yellow metal rise from USD \$35 to USD \$800 at one point, whilst bond and equity market investors lost a significant portion of their real wealth as a result of the Stagflationary environment.

In the past decade, gold investors have seen the price of they yellow metal rise from USD \$250 to USD \$1250, a 5 bagger return which has far outperformed equities, and protected capital through an environment including the NASDAQ crash, September 11, the sub-prime crisis, the GFC and the European debt crisis.

And whilst I can't claim to speak for all gold investors, I can say that I don't own gold because I think the world is coming to an end.

I buy it and still hold it because I think financial assets are significantly overvalued relative to the economic fundamentals of the global economy, and because I see politicians and central bankers around the globe committed to dead-end and highly dangerous policies that will likely reduce our overall prosperity.

The closest thing any of us have to a crystal ball is a history book, and it tells me gold will in all likelihood hold up much better through the coming 'years of reckoning' than anything else I might wish to concentrate my portfolio in

Reason 10: Attacking the Skeptics

The response to rational argument is often a revealing tell. Over the gold cycle, attacks on anyone with the temerity to challenge the gold narrative became ad hominem. Accusations of "selling out," being "in the Fed's pocket" and a "patsy for the administration" were just some of the personal attacks I witnessed.

Challenge anyone's belief on gold, and instead of having empirical, data-driven counterarguments made, the zealots responded with venom. Have a read of the comment stream of ZeroHedge.com for some true gems of the genre. They reveal an investment gone awry combined with a lack of idea as to what to do about it.

JE comment: Whilst again there's an element of truth to this, it's also safe to say that Keynesian economists and market commentators are just as capable of spewing vitriol to those who would disagree with their views on investment markets, governments, central bankers and society in general.

The most common critique of gold enthusiasts or those who are long precious metals is that we are anti-society, and take delight in a declining economy and

lower prosperity. I've even seen it said that to be pro-gold is to be anti-human progress or that it's a bet against the ingenuity and progress of man.

This has always struck me as kind of amusing when you consider that for most of the time we've had market based economies, and enjoyed all the incredible advancements in technology and rises in living standards those economies help bequeath, we've mined, processed, stored, traded and valued gold.

Not that I'm suggesting Mr Ritholtz is one of those people, but anyone that says to be pro-gold is to be anti-human progress is an incredibly poor student of history in my opinion.

Summary:

Barry Ritholtz's article was a useful piece to help understand that all markets (not just gold) can move violently, and when they do, more than not that it will be in the opposite direction to what the consensus is thinking at the time.

There were also some useful warnings in there about falling in love with an investment position, and that people should always keep their eyes open for news which might challenge their investment thesis.

Having said that, I don't see it as a critique of the medium to long-term outlook for gold, nor the fundamentals supporting higher bullion prices. More importantly, I don't see it in anyway reducing the sensible step many investors are taking today to protect their wealth, and hedge their other investments with an allocation to physical precious metals.

Warm Regards
Jordan Eliseo

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