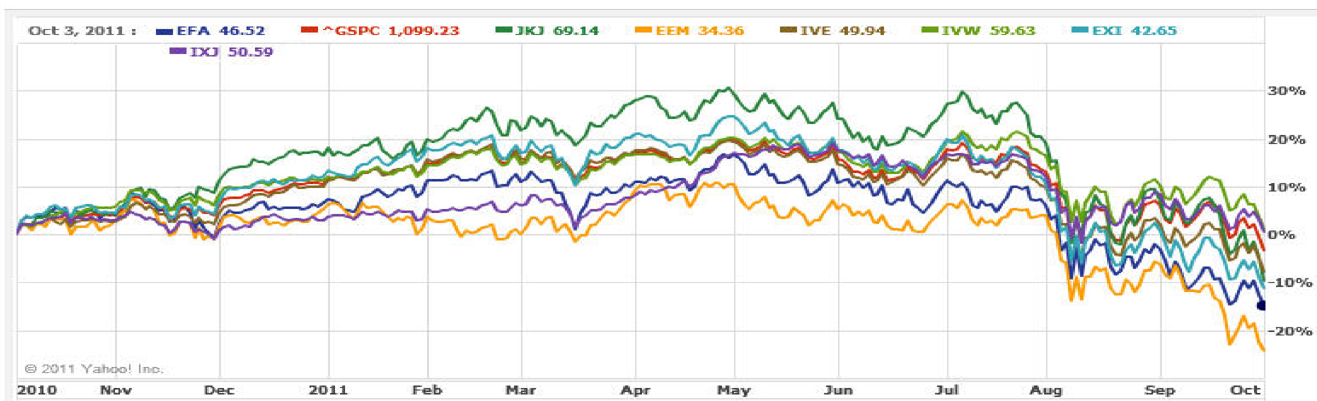
October 2011

# The Fear Trade

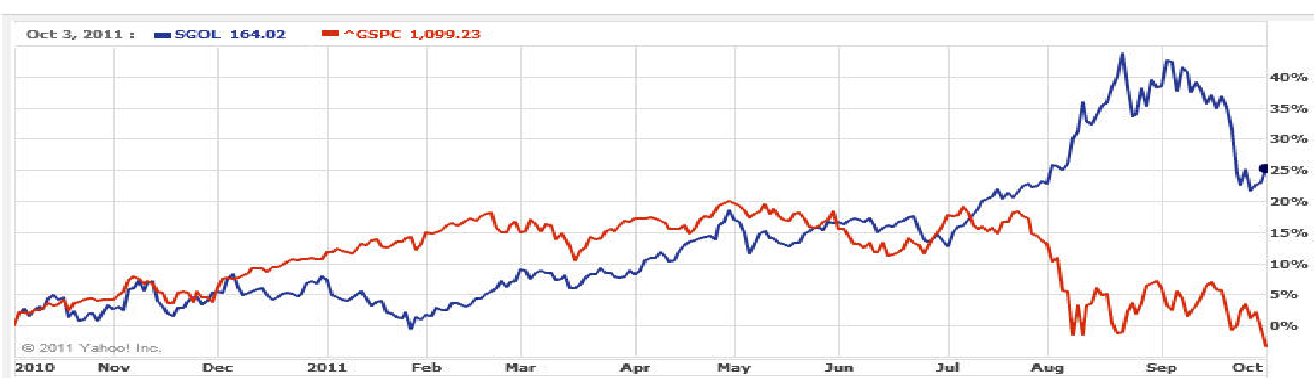
*Fear gives intelligence even to fools* – anonymous

For weeks now we have experienced the “risk on, risk off” trade. This is characterized by markets that lurch up then down in repeating cycles taking with them most everything in their path. Investors have either had an appetite for risk (risk on), or have run away from it (risk off). Very few have stopped along the way to analyze whether the particular stocks they bought or sold had any merit on their own. “Professional” investors have vacillated between days of optimism and depression displaying their emotions in their erratic trading activity.

During such periods stocks of all kinds begin to trade similarly, even when the prospects for them are very different. We describe this phenomenon by saying that equities are currently “highly correlated” to each other. Whether we are talking about large companies or small, growth or value, international or domestic, service providers or manufacturers, stocks of all kinds have moved directionally with each other. In a rare occurrence, the S&P 500 has outperformed most equity categories, including the ones we own, by a wide margin for the trailing 12 months and for the year to date as traders have jumped into and out of the stocks of this index (the red line is the S&P 500; the others are proxies for various equity categories for the trailing one year period).




During these times it is difficult to find shelter. Cash offers us a buffer against the downward slide, but pays very little, particularly when taxes and inflation are factored in. Our bond portfolios are basically flat for the past 12 months and are susceptible to rising interest rates. Energy, Real Estate and Commodities are being hit hard based on the growing consensus that the world economy continues to slow. The following graph compares the trailing one year performance of the S&P 500 (the red line) against an alternative investment. See how they tend to move opposite each other. These two investments are said to have “low correlation”.



Now for the punch line.  The blue line is an Exchange Traded Fund (ETF) that tracks Gold.  If you've read and remember my communications regarding this shiny metal in the past I'll pause here to let you gather yourself.

I'll also save you the trouble of asking the questions you may be dying to ask me.  Here goes.

**Why after all this time that you've bashed gold bugs as "special" are you now on the gold bandwagon?**
Bandwagon may be a little extreme, but I have opened my mind to the possibility that I may have missed some critical data when dismissing the metal in the past.  First, it is a holding that lately has had little resemblance to the performance of other financial assets (low correlation).  Second, many central governments still peg their currencies to gold and are stockpiling the metal as we speak.  China, India, Russia and Taiwan are accumulating gold as a hedge against the significant dollar holdings that they currently have.

**Isn't gold in a "bubble"?  Aren't we too late?**
The price of gold has risen dramatically over the past two years and clearly got ahead of itself in the past couple of months.  It has corrected approximately 20% from its recent peak.  This pullback was due to a combination of factors.  Hedge funds have liquidated sizeable gold positions that they had been accumulating in order to pay out exiting investors and meet margin calls (their equity holdings were crashing and gold was one of the few holdings that they held that was above water).  The US dollar has recently rallied as investors have flocked to it as a "safe haven" (it seems we are the best of the worst).  As the US dollar rallies relative to other currencies, the price of gold typically falls.  With the intervention by the Fed in "Operation Twist" instead of "QE3" the money supply has not been expanded (yet) as many were betting would happen.  An increased money supply typically leads to inflation and devaluation of the dollar, both good things for the price of gold.  Most of the factors that have pushed up the price of gold are still in place and the longer term trend is still bullish for gold.  The recent pullback affords us an opportunity to establish a position.

**How much do you intend to invest?**
Our target is to invest up to 7% of our *equity* holdings.  This is a far cry from the 25% of total assets recommended by some of the shills on TV.  We will "leg" into this position using a couple of purchases in the event that the price continues to weaken.

**How are you going to invest in Gold?**
In a couple of ways.  We will buy one half of our eventual gold position in the ETF - *Physical Swiss Gold Shares* (the blue line featured in the second graph).  It holds gold bullion based on the dollars invested in it and stores the gold in bank vaults in Zurich, Switzerland.  The bullion is independently verified and held by a custodian bank separate and independent from the manager.  The second half of the money is to be invested in either gold producers (mining operations) or companies that hold the mineral rights and receive royalties from the mining operations.  Most gold mining operations are extracting gold for a total cost of around $600-700 an ounce.  If the price of the metal holds above the cost of production, these companies are profitable.

Let me be clear about my reasons for adding the metal now.  I have contemplated adding gold for about 6 months, but was unwilling to step into a market that continued straight up with no pauses or pull backs.  I recognize that the price of a commodity should normally have some relation to the cost of production, or its economic value.  I admit that a price above this number is based on some amount of speculation.  I acknowledge that when seemingly everyone wants to own something this generally signals a bubble.  I also concede that in the event of Armageddon (which is prophesized by the "special" people) that few would be willing to trade food and shelter for a shiny metal.  With all that in mind though, I can't ignore the fact that this metal has provided a hedge due to its low correlation.  Gold is the umbrella at the ballpark.  We drag it along, hoping we won't need it, and drag it back to the car at the end of the game thankful that if it rained we had it, and if it didn't, we convince ourselves that it was because we brought it.  We will hold gold in a way that is easily disposed of when necessary.  When this storm passes we can put gold back in the closet with all the other stuff we've forgotten about.