QUANTUM CAPITAL MANAGEMENT, L.L.C.

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"We learn little by being right, and tend to grow overconfident in the process. Among my biggest errors has been the tendency to overstay brilliant decisions, especially when those decisions were controversial at the time I made them."
—Peter L. Bernstein

The Economics of Gold

Today we will chat about the economics of gold, our determination of its value to us and a bit about our investment philosophy. This essay was started some five or six Thursdays ago. As usual, portfolio management duties, research obligations and other responsibilities relegated it to the expanding graveyard of unfinished essays that inhabit our network hard drive. A necessary condition to completing a thought, organizing it in a coherent manner and committing it intelligibly to print, is time. In the case of your portfolio manager, time has been at a bit of a premium. Some of you are aware that, a couple of years ago, I embarked on an intellectual journey of sorts. The folks at Columbia University were kind enough to indulge me in this academic pursuit, and I have recently completed a formal study. I am often asked why I would commit to such a seemingly arduous task given my responsibilities, age and station in life. Depending on who asks the question, I typically respond in one of two ways. To some, I reply that with the exception of health and love, there is no greater privilege known to man than to allow himself the gift of intellectual endowment. I recount how I relished accessibility to these wonderful sophists and often engaged in spirited discourse with some of the world's greatest scholars. I describe how I cherished the process; the analysis of the nuance and symbiosis of economics and finance as well as the study of strategy and applied value investing at the school of Graham and Dodd. Indeed, I found the effort a gratifying and yes, somehow even a noble undertaking. To others, I simply reply that I don't golf; that it was more fun than a boat and probably cheaper than a mistress. Curiously, both replies seem to generate the same reaction: a reflective pause, a knowing grin, and then a nod of sympathetic approval.

Last month, we parted with more than sixty percent of a commodities position that we had built over a three year period. (We sold one hundred percent of our gold related equity positions in the institutional small capitalization funds.) It had grown to upwards of twenty percent of total assets with the majority of the weighting and most visible positions in gold. The gold was the hardest to part with. Now it comprises approximately seven percent of assets. We did not lose a friend. We did not lose a reaffirmation of our collective brilliance. We lost no key to speculative riches. We sold some metal, pure and simple. We determined, to the best of our ability, that gold bullion and most gold related equities were, at the time, overpriced and there were better opportunities for our capital.

We intended, if necessary, to defend the sale of the precious metal, given our view that it would most likely continue its ascent, just as trade confirmations were arriving in client mailboxes. But lo and behold, the price of the metal reversed and moved steadily lower. We received a few thank you notes and acknowledgements of our ethereal insight and uncanny ability to see the future. Thank you for the accolades, but we don't deserve them. The timing was pure luck and the price of an ounce of gold could have just as easily run to one thousand dollars or more.

Our decision to sell any asset is purely valuation based. We have no more ability to predict the short term direction of prices than we can predict next fall's fashion. Anyone who represents that they enjoy this level of precognition, in our humble view, is a fraud. Below we will attempt to provide you with some insight into our thought process. A process that we use to determine the value of an ounce of gold in dollar terms. It is not comprehensive. It is most certainly imperfect. But, for our purposes, we believe it to be valid. It is our interpretation of the economics of gold. Please read on.

It is not easy to dispassionately sell an investment that has proven profitable, irrespective of the tax consequences. Invariably we sell too much too soon, or too little too late. But we are forever mindful of the Bernstein quote at the beginning of this essay. Alert readers will note that we have used it before. We have. It's that important. In fact it is framed and prominently displayed in our office. At Quantum, we prefer to hold investments as long as we continue to believe that the intrinsic value of what we own is higher than the price. Value is measured in broad ranges of whole numbers. Decimal places imply a false sense of precision that doesn't exist in all but very few investments. The value of any investment is relative to the needs of the investor and gold is a most difficult asset to value. We have often stated that we determine the value of an asset by the present value of its future cash flows. Gold, however, pays no interest or dividends; it pays no rent. Its stream of cash flows sum to the grand total of two: cash out when you buy it, and cash in when it is sold.

We are also curious about the shifting fundamentals in the marketplace. The market for gold, until recently had been inhabited by producers such as gold mining operations and users: industrial companies, jewelry producers, central banks, a few monetary intellectuals and fewer still curmudgeonly types who store it alongside gunpowder and canned goods. A quick perusal of the supply and demand flow analytics will show hedge funds, institutional and retail investors growing dramatically as a percentage of the entire gold market. It is difficult to determine why gold has suddenly been embraced by the investor class. Is it a rational response to the portentous imbalances of which we have written? Or is it just because the price is going up? We have our suspicions.

Gold, like most commodities, has a range of valuations bounded by a demand-driven price ceiling and a supply-driven price floor. Over time, it should consistently price out at a base value of an entrepreneurial price of extraction adjusted for the rate of inflation. Consistently, which is the operative word, it does not. Erratic demand dynamics often result in wild price fluctuations reflecting the animal spirits of man; ranging from moribund ambivalence to starry-eyed optimism. But, because it is scarce, durable, malleable and dense, and because it enjoys a five thousand year old pedigree, gold perseveres as a store of value. The price of gold reflects, or should reflect over time, the nominal costs of labor, property and equipment (including overhead), technological advances, productivity enhancements, and a market return on investment capital deployed to extract it from the earth. Because its extraction requires effort, risk and diminution of resources, more than anything, it is a measure of said effort, risk and expended resource. This measure, for our purposes, we will call intrinsic value. Gold represents real intrinsic value. There is a market for it as an industrial commodity, as jewelry and of course as a combined store of value, unit of account and medium of exchange – money.

Conversely, a dollar over time loses value. It can be printed at “essentially no cost” according to the current Federal Reserve chairman, and its accumulation typically constitutes a negative real return on capital. A dollar proliferates at a rate closely correlated with the power of politicians, the complacency of the electorate and the degree of moral hazard that has metastasized in the economic system. It is backed by the full faith and promise of the same government that brought you the continental, a currency which spawned the affectionate phrase “not worth a continental,”—according to Costantino Bresciani-Turroni in *The Economics of Inflation*, a wonderful treatise on the effects of inflation in Germany during the period 1914-1923: “In the past the money that had suffered the greatest depreciation was probably the so-called “continental money,” issued by the American Colonies during the War of Independence. In 1781 that money was worth *a thousandth* part of its original value.”—and the “greenback,” a contemporary term of art that has evolved from what was once the numismatic equivalent of the scarlet letter. (During the Civil War, on or about 1863, the government in response to a dwindling gold stock suspended the convertibility of dollars into gold. Until this point the gold-backed U.S. dollar enjoyed a consistency of color, black ink, on both the front and the back of the bill. The greenback, as the name implies, was printed in green ink on the back side of the note. The intention behind this branding was to alert the recipient of this currency that its buying power was guaranteed, not by gold, but by the full faith and promise of the government that printed it. A promise that was deliverable as long as inflation was contained—it wasn’t—and, as holders of confederate currency might argue, so long as the war was won by the guarantor.) The U.S. dollar, in its current form, has lost approximately 94% of its purchasing power since 1914 when the third and current version of the Federal Reserve was formed. It loses, on average, about 25% of its purchasing power per decade. We believe that continued acceleration of the rate of growth in the nation’s debt relative to the national output, of which we have written about and spoken often, will result in an accelerating decay in the purchasing power of the U.S. dollar. The dollar, in the short term, is at risk. The dollar, in the long term, is a fool’s bet. You own gold not so much for what it is, but for what it isn’t.

If you love it so much, why did you sell it?

We can hear you thinking. Yes, we like gold as an asset. But no asset class gets a lifetime pass. The short answer is: we thought the price got ahead of the value. We are fully aware that the “gold $8,000” rallying cry of James Turk, a fervent gold bug, has stoked the coals a bit and given gold bugs a sense of propriety and comfort in the fact that most of them feel they remain relatively conservative in their respective outlooks for a $1,000 - $1,500 price per ounce.

Our take on this however, is that there are a few ways to look at gold as an investment. One can look at gold as a hedge or think of it as a speculation. We distinguish between the two by the degree of hope and clairvoyance required to justify the price paid. There are some analysts who believe that technical analysis provides them with the signals that gold is moving substantially higher. The size and persistency of the upside move will be confirmed by market “action” and supported by previously attained price levels. We have tried to understand technical analysis at different points in our career. We are intrigued by the supply and demand information that it appears to yield. We keep stumbling, however, on what we perceive is an efficacy problem at inflection points and in our own lack of time to pursue this voodoo-science to a proper end. Consequently, we put this method of owning gold into the speculative category. There are other very smart analysts who believe, any day now, that macroeconomic fundamentals argue the monetary wheels are about to come off the wagon, the result of fiscal profligacy and a monetary system that invites failure. We agree with the “why” and even the “how” in most cases; it is the “when” part of the argument that causes us to scratch our head. We agree with their points about fiscal profligacy and a defective monetary regime. We suspect that the build of the debt to GDP ratio combined with malinvestment into nonproductive assets, could lead to a monetary accident and the “when” could be sooner rather than later. Where we differ is that we believe that a monetary accident is possible, but not probable. We believe that the price of gold will inflate at a rate much higher over the next decade than it did in the last. We just don’t see hyperinflation as a high probability event. The primary reason that we consider a better than twenty percent gold position at the price of more than seven hundred dollars an ounce, too speculative for our tastes, is that the dollar not only has to fail against hard assets like gold but it has to fail against other currencies as well.

The most ardent gold bugs hyperventilate when they fantasize about Weimar Germany in 1923. A point in time when the Reichsmark dropped 99.999 percent against other currencies. The suspension of the conversion of Reichsbank notes into gold, initiated on July 31st, 1914, caused, in part, a hyperinflationary rate of 3.25 percent x 10^6 per month (prices doubled every 49 hours). A proverbial wheelbarrow full of money (paper Reichsmarks) was required to purchase a loaf of bread. The ardor is palpable as they dream of 18th century America, when John Adams, junk bond salesman, eventually known as the second president of our fledgling republic, traveled hat in hand, to convince the bankers of Amsterdam and Paris to invest in, at the time, the presumptively named United States of America. This was at a time when the U.S. was engaging in a 40:1 reverse split on the previously mentioned “continental money.” A government edict to turn hard earned money into less. You received one new and improved dollar for forty of those nearly worthless pieces of paper that you used to call money – Can you imagine the confidence this would instill today? Not very encouraging and you can see why the gold bugs salivate when they daydream about the possibilities.

However, what we think they may be missing is that <u>all</u> currencies today are of a fiat genre and all monetary systems are defective and managed by central bankers of a similar ilk. The interdependence of the global economy, the predilection of central bankers to err on the side of political expediency and our interpretation of *no arbitrage pricing theory*, argues that all major currencies would have to collapse in order for there to be enough persistent demand for gold at hyper-inflated prices. If this were not the case, we would have Japanese bus drivers bidding up oceanfront estates in The Hamptons. Temporary supply-demand imbalances can cause gold to spike in U.S. dollar terms in the short run but in order to sustain nosebleed level gold prices, one would have to throw purchasing power parity out the window. We would also argue that, in the United States, our traditions of the rule of law and the efficient dissemination of capital, in addition to our ability to obtain personal property and defend one's rights to ownership, provides a compelling case that despite its many flaws, the dollar may still be the best house in a bad neighborhood. And unless the international pastime of "gaming" the current dirty floating exchange rate system through competitive currency debasement (to enhance trade competitiveness and shrink debt relative to assets) gets out of hand, gold will price out at ever increasing levels, but it will not grow exponentially. In fact, a deteriorating equity market is starting to yield some individual non-gold related values that we find much more appealing. Could we change our mind? Sure. It is just a question of price relative to value.

We can hear the roar of disapproval from our skeptical colleagues in mid-town Manhattan all the way down here in the epicenter of capitalism, southern New Jersey. What about exogenous events? What if governments the world over do, in fact, engage in competitive currency debasement and it gets away from them? What about the monetary risks that mere mortals cannot possibly identify in prospect? To these valid questions, we reply that we cannot and will not speculate on cataclysmic outcomes, the probability of occurrence which is beyond our capability to measure. Especially when it costs us five to ten percent a year to make the bet. What we will do however, is hedge against these outcomes, no matter how remote, should their realization lead to material deleterious effects to the real value of our portfolios. In order to compound capital it has to be protected. That is our standard of defense. And we are fully aware, that at the end of the day, our standard is nothing but an educated guess.

In short, the value of gold, in the long run, is an entrepreneur's steady state price of extraction. The difference between the entrepreneur's price and the current market price of gold is the long term implied rate of currency debasement, inflation. Simple algebra allows us to determine whether the implied long term rate argues trend inflation, global monetary meltdown or somewhere in between. The imputed inflation factor and our level of ownership of gold allows us to take a sober look at our holdings and notwithstanding the aforementioned imprecision, determine whether we are hedging or speculating in the market.

It wasn't very long ago that gold was priced significantly lower than it is today. The opportunity costs of owning it were very low. Short term treasuries earned less than two percent. They now earn a respectable five percent or more. We believe that they will garner even higher yields in the future. Interest rate cycles are "epochal" according to the *Grant's Interest Rate Observer*. We believe we are three years into a new long term secular trend in interest rates. For today, given our approximately seven percent position in gold and gold equities, exposure to reasonably priced companies with revenue streams denominated in foreign currencies and the highest weighting of short term treasuries in our history, we feel that we have met the aforementioned standard. In the mean time, we have our micro hats on at Quantum. Expensive markets can turn even the most resolute fundamental analyst into a macroeconomist. Equity prices are not cheap from a historical perspective, but they appear to be coming down. Catnip to a value guy. Markets with deteriorating prices relative to value provide us with the opportunity to deploy our valuable capital effectively. This is our element. This is where we are most comfortable.

Best Regards,

John Hughes

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