PRECIOUS METALS INVESTING

Making Money in Troubled Times

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*Keynote Speech Presented by **Nick Barisheff** at the Empire Club's 15th Annual Investment Outlook Luncheon*
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Today's topic at this 15th Annual Investment Outlook is "Making Money in Troubled Times". This may be quite a challenge in 2009 if investors continue to do what they've always done. However, there is always a bull market somewhere and making money in troubled times is possible if you correctly identify the dominant trends and adjust your portfolios accordingly.

After 2008, many investors will relate more to Will Rogers who famously said that:

"I'm not so much interested in the return on my money as I am the return of my capital."

For most investors, 2008 was a painful year with many portfolios experiencing capital losses of 30-70 percent.

In 2009 and years to come, precious metals will not only continue to preserve capital but increase in value, as more investors continue to seek a safe haven from the financial crisis that we experienced in 2008.

A review of 2008 is in order to better understand what lies ahead in 2009.

2008 was the year of:

- Massive government bailouts
- Increasing money supply

While I have written about the growing imbalances and vulnerabilities for a number of years, and last year's annual report warned investors to "Batten Down the Hatches", even I was surprised by the depth and the speed with which the global financial system unraveled. Unfortunately, there is not likely to be much improvement in the foreseeable future.

Yet throughout the financial turmoil of the past year, gold preserved investor wealth and outperformed all other asset classes except bonds. Over the past five years, gold has been the best-performing asset.

To understand why this is the case, it is crucial to realize that gold is primarily a monetary asset, and not simply a commodity like copper or zinc. That's why central banks hold over $792 billion as part of their currency reserves. That's why the turnover of physical bullion in London is over $20 billion a day. That's why precious metals trade on the currency desks of most banks rather than the commodity desks. That's why gold should be compared to other currencies – not commodities.

At an increase of 5 percent in US dollars for 2008, gold performed extremely well, considering the Dow lost 38 percent. Gold's performance was somewhat muted in US dollars, largely because of the extraordinary demand for dollars caused by deleveraging.

Gold's performance against other major currencies was even more pronounced, as global equity markets lost between 30-70 percent.

Gold rose:

- 9% in Euros
- 45% in British Pounds
- 25% in Russian Rubles and
- 38% in Brazilian Reals

Gold increased by 31 percent in Canadian dollars, while the Toronto Stock Exchange lost 35 percent of its value.

Only the Japanese yen rose against gold, due to the exceptional demand for yen produced by the unwinding of the Yen Carry Trade.

Now let's take a look at some of the other factors in 2008:

- The US government and the Federal Reserve spent $3.2 trillion in 2008 bailing out institutions that were "too big to fail", and committed another $5 trillion - that's over $8 trillion.
- $8 trillion is nearly twice the cost of the space program, the Vietnam War, the invasion of Iraq, the Korean War and the Savings & Loan crisis - combined.
- In contrast, the bailout of Long Term Capital Management in 1998 amounted to a 'mere' $3.6 billion, and Worldcom's bankruptcy was $103 billion.

The end result will be inflation, not just in the US but in the UK, Europe, China, Russia and Canada, all of which have adopted similar bailout programs.

We can only hope that these bailouts will work and not morph into stagflation or hyperinflation.

Rising inflation is already on the cards. In 1971, when the US abandoned the gold standard, total M3 money supply stood at $800 billion. Since then, the Federal Reserve has increased the money supply well in excess of GDP growth.

In 1987, Alan Greenspan took over as Federal Reserve chairman and opened the money supply floodgates. He expanded the US money supply by $6.5 trillion during his 19-year tenure to $10 trillion – more than all of the previous Fed chairmen combined. Ben Bernanke surpassed Alan Greenspan's record by adding another $4 trillion in just the last three years.

While there's been much talk about deflation, the increases in the money supply we are witnessing clearly contradict this view. As Milton Friedman said:

"Inflation is always and everywhere a monetary phenomenon. As the government increases the rate at which it prints money, the result is too much money chasing too few goods and services."

While the rate of M3 money supply increases has declined from 16 percent at the beginning of 2008 to 9 percent currently, money supply has still increased. For deflation to occur, money supply must actually decrease, not simply slow the rate of increase.

In addition to the fact that money supply data points toward inflation, we have Ben Bernanke as Fed chairman. Deflation is unlikely to occur under Bernanke's watch. He made it clear in his PhD thesis, and in recent speeches, that he will avoid deflation by using every tool at the Fed's disposal to create as much money as it takes – even if he has to throw it out of helicopters.

The resulting growth in money supply will ultimately lead to a declining US dollar and higher inflation. This will result in higher gold prices.

Looking ahead to 2009, it seems many people believe the crash of 2008 was just a correction, and that real estate and equity markets will soon recover.

Current data does not support this argument.

While we all like to be optimistic, as investors it is critical to be realistic and adjust to changing circumstances.

We can hope that real estate prices and the stock market will recover.

We can hope that job losses will stop, and that consumers will start spending again and the economy will recover.

Unfortunately, this is just wishful thinking.

Until consumers feel confident about their jobs, the value of their houses and the safety of their savings, they will curtail spending and the economy will not improve.

During the past 25 years we have experienced the longest equity bull market in history. However, markets move in long cycles, and the next 20 years are unlikely to be a continuation of the past. Warren Buffett noted that the stock market "went exactly nowhere" for 17 years from the end of 1964 to the end of 1981.

On an inflation-adjusted basis investors didn't break even for another 14 years.

From the time gold became freely traded in 1971 to 1981, precious metals soared:

- Gold rose 2,300%
- Silver rose 2,400%
- Platinum rose 900%

For investors, the takeaway from all this is that while a "buy and hold" strategy may work during a bull market, it doesn't work during a bear market.

The crash of 2008 is not a simple correction, as the financial imbalances that became clearly evident last year have been building for decades and are unlikely to correct in a single year.

In 2009 and beyond, the 6-year upward trend for precious metals should continue, while real estate, equity markets and even bonds will likely decline. One factor is the massive imbalance between financial assets and above-ground bullion.

Today, annual gold production is about 2,500 tonnes, a decrease of 200 tonnes from its peak in 2006. This annual production represents an increase in the global supply of above-ground gold of about $68 billion.

Contrast this with the estimated $10 trillion increase in global money supply expected to fund the bailout and stimulus programs. This disparity in growth cannot continue without a significant price adjustment in gold.

At the end of 2007, above-ground privately held gold bullion amounted to less than $650 billion, and the total amount of silver and platinum bullion was less than $5 billion. Put together, this is less than 1/3 of 1 percent of the estimated $187 trillion of global financial assets.

As more investors come to realize the implication of this vast disparity, and adjust their portfolios accordingly, even a small shift away from the $187 trillion of financial assets to precious metals will result in dramatic price increases, and may ultimately lead to shortages of even the largest bullion bars. Last year investors experienced shortages of the smaller wafers and coins, with premiums running as high as 10-40 percent for gold and 30-100 percent for silver.

In addition, China, Russia and the OPEC countries are considering substantial increases to their gold allocations in order to diversify their US dollar risk. Any reallocation by these countries will drive prices much higher.

Citibank predicts gold soaring to $2,000 an ounce sometime in 2009.

Ultimately, the exact number is very hard to determine – and it doesn't really matter for long term investors.

Over the next few years precious metals will continue to outperform real estate and equities, and probably bonds. Precious metals will continue to hold their purchasing power whether we experience deflation, inflation, stagflation or hyperinflation.

Yet even after six years of gains, most portfolios have no allocation to precious metals whatsoever. As a result, ***most portfolios are neither balanced nor diversified. This means investors are not protected from inflation, or from currency or market declines.***

Equally important, most portfolios are not aligned with the current investment trend, which has been moving away from paper assets towards hard assets like precious metals for the past six years.

During these uncertain times, the question investors should be asking is:

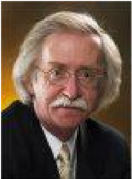
What percentage of my portfolio should be in precious metals bullion?

The exact allocation will vary with each investor. However, Ibbotson Associates recommends between 7-16 percent just for proper diversification, while Wainwright Economics recommends between 18-47 percent in order to immunize portfolios against inflation.

To make money in these troubled times, you will need an even higher allocation in precious metals than those recommended by Ibbotson and Wainwright. Furthermore, given our experience in 2008, it is critical that investors hold actual physical bullion and not a paper proxy or derivative. Physical bullion is the only asset that is not someone else's liability.

The single point to remember from these comments is that, no matter what your allocation to bullion turns out to be, it should certainly not be zero.

In order to adapt to current global changes, investors need to rethink their investment strategy and their portfolio allocations, because the next 20 years are going to be completely unlike the past 20.



Nick Barisheff *is President and CEO of Bullion Management Group Inc., a bullion investment company that provides investors with a cost-effective, convenient way to purchase and store physical bullion. Widely recognized in North America as a bullion expert, Barisheff is an author, speaker and financial commentator on bullion and current market trends. He is interviewed monthly on Financial Sense Newshour, an investment radio program in USA. For more information on Bullion Management Group Inc. or BMG BullionFund, visit: www.bmginc.ca.*