MORTON
CAPITAL MANAGEMENT

The Case for Gold in an Uncertain World

Introduction

If you gather a hundred people in a room, you will hear two hundred different viewpoints on gold. Cynics claim that gold is an "ancient relic" with no real productive purpose while advocates profess that it is a "store of value" in times of stress. Skeptics state that it's a commodity with no meaningful industrial use while proponents feel that it's the world's soundest currency, having survived thousands of years of booms and busts and maintained its purchasing power over long periods of time. We will look to address these countering points of view and explore how the current investment landscape makes the argument for gold more compelling than it has been in quite some time.

Fundamentally, the strongest argument against gold is that there is an opportunity cost to holding it. In other words, if you weren't holding gold you could be holding a bond or stock that is producing income. However, with interest rates being near all-time lows and stock market valuations near all-time highs, we'd argue the opportunity cost in the current environment is all but nonexistent.

We also believe that gold is more important than ever because traditional diversification is broken. Historically, investors have been able to depend upon bonds as a ballast in their portfolios to help counter their more volatile stock holdings. As we will discuss further, that traditional diversification paradigm has been brought into question in a world that is increasingly tied to moves in interest rates. In such an environment, the truly diversifying effects of gold are more important than ever.

Finally, in a global economy where central banks across the world are printing money, gold may be the one currency that can act as a true store of value. No one knows what the final result will be of the Federal Reserve's and other central banks' "grand experiment." One trend that is undeniable, though, has been gold's ability to hold its value over the long term as global currencies have steadily fallen.

Opportunity Cost and Extreme Valuations

We would like to start the conversation by confronting what we deem to be the most valid criticism of gold: it has no yield. This is otherwise known as the "opportunity cost" of owning gold. The New Oxford American Dictionary defines opportunity cost as "the loss of potential gain from other alternatives when one alternative is chosen." Many assert that an allocation to gold presents such a cost. After all, you can alternatively invest in a bond where there is a predictable cash flow stream or a stock that yields a dividend while also having appreciation potential. This reproach of gold carries weight as the shiny yellow metal is pleasing to the eye but produces no yield as it sits idly in your safe deposit box.

However, not all investment environments are created equal. There are times when the opportunity cost of foregoing traditional investments such as stocks and bonds is significant and other times where such costs are negligible. We believe the current environment falls into the latter category. Said another way, stocks and bonds are expensive! We believe the potential exists for disappointing stock and bond returns over the next several years; consequently, gold and other alternative assets warrant larger allocations than in more normally priced markets.

Let's focus on current valuations and take a look at the price of bonds in the current investment landscape. It is widely understood that interest rates are at historic lows, but many investors just take this interest-rate environment as a given. Market "experts" simply state that we are in a "low-interest environment" as a fait accompli rather than questioning whether these rates are "cheap" or "expensive." Interest rates are fundamentally a price, nothing more, nothing less. If interest rates are at all-time lows, then mathematically bond valuations have to be at all-time highs. Bonds are expensive across the globe and, in some cases, absurdly so. Take a look at the below chart of U.S. government 10-year Treasury interest rates going back to 1980.

USGG10YR Index (US Generic Gov't 10 Year Yield)

Source: Bloomberg

For the last three decades, bond investors have been spoiled by declining interest rates and therefore rising bond values. With interest rates so low, the math dictates that this trend will change. Rates can't go much lower and if/when we do have higher rates in the future, bond prices will go down as a result. The amazing thing about the paltry current yield shown above is that interest rates in the United States are actually higher than most developed countries around the world. Below is a list of comparable 10-year bond yields in other developed countries.

Country	10 Year Bond Yields%
Japan	0.44%
Germany	0.83%
United Kingdom	2.08%
France	1.13%
Spain	1.97%
Switzerland	0.06%

Source Bloomberg; Data as of 7/15/15

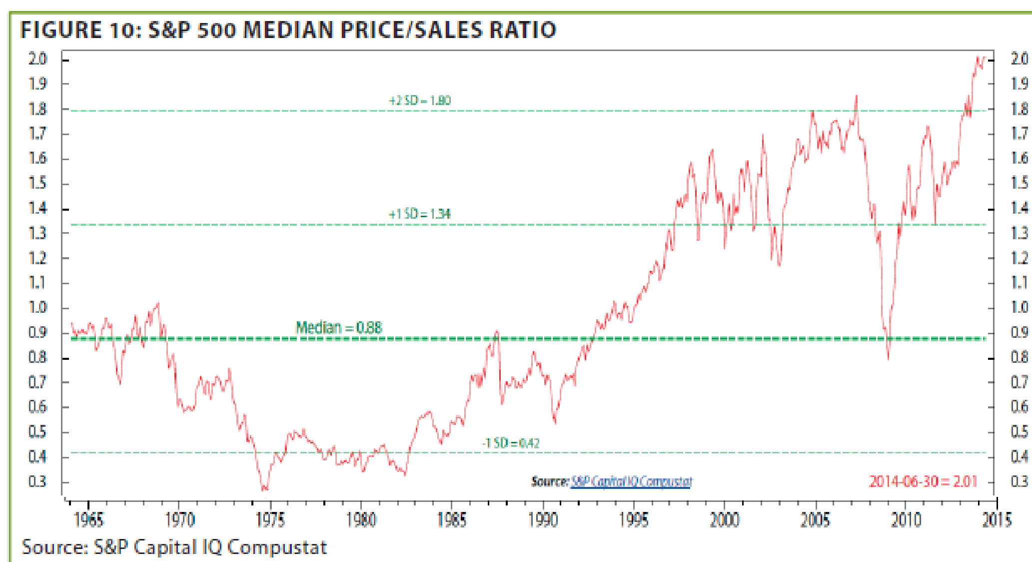
These yields are near all-time lows, in some cases going back several hundred years. Believe it or not, some of these rates have actually risen dramatically in the last several months. For instance, the 10-year German bund yield hit a low of 0.07% in April, meaning that over a 10-year period a purchaser of this bond would only make 0.7% in *total* profit. By early June, yields rose from 0.07% to about 1%, resulting in losses of roughly 8%. Purchasers of these bonds must have been distressed when over 100 years' worth of their 0.07% annual yield was wiped out in a matter of months by the 8% decline in the price of these bonds.

Perhaps even more absurd is when Nestlé corporate bonds actually sported a negative yield earlier this year. "Investors" somehow felt it was reasonable to *pay* for the privilege of loaning money to a corporation rather than the other way around. Similarly, in early 2015, Denmark mortgage rates for home buyers actually turned negative! It sure would be nice to have your bank subsidize your home purchase instead of charging you interest. The lack of logic in some of these examples makes it feel like we're playing a real-life game with Monopoly money.

Investors may try to rationalize these anemic interest rates by citing some of the current economic headwinds, such as debt crises in Europe and slow global growth. However, investors should question whether our current macroeconomic environment is so fraught with maladies as to warrant these extremely low yields. Over the last few centuries we've had numerous booms and busts, inflationary cycles, deflationary swoons, wars, pestilence, etc., and never before have we seen yields so low on a global basis. Instead of being warranted, we believe that these interest rates are irrational, utterly manipulated (as discussed later in this article) and expensive, to say the least. Buyer beware!

In such a low (and even negative) interest-rate environment, is there really an opportunity cost to owning an asset such as gold that also sports no yield? With bonds yielding virtually nothing and the potential for bond prices to depreciate meaningfully in a rising-interest-rate environment, we believe that the opportunity cost of owning gold is insignificant.

Let's move on to the stock side of the equation. While stocks may not be as flagrantly expensive as bonds, current stock valuations are also problematic. Take a look at the chart below, which shows the median price-to-sales ratio of the S&P 500 Index.



Source: Evergreen Virtual Advisor – January 2015

The facts have a way of jumping off the page and in this case the chart appears to be attempting to leap to the moon. Based on this market metric, the market is more expensive than it has ever been: more expensive than the 2007 pre-credit crisis and more expensive than the tech bubble of 1999.

With such high valuations as a backdrop, what are market experts predicting for stock market returns going forward? Research Affiliates, a well-respected independent research firm that advises on approximately $170 billion of assets, is predicting annualized real (inflation-adjusted) returns of less than 1% for both stocks and bonds over the next 10 years. GMO, a similarly respected institutional money manager with over $110 billion in assets under management and an excellent track record of predicting long-term returns, is forecasting *negative* real returns for U.S. stocks and bonds over the next seven years.

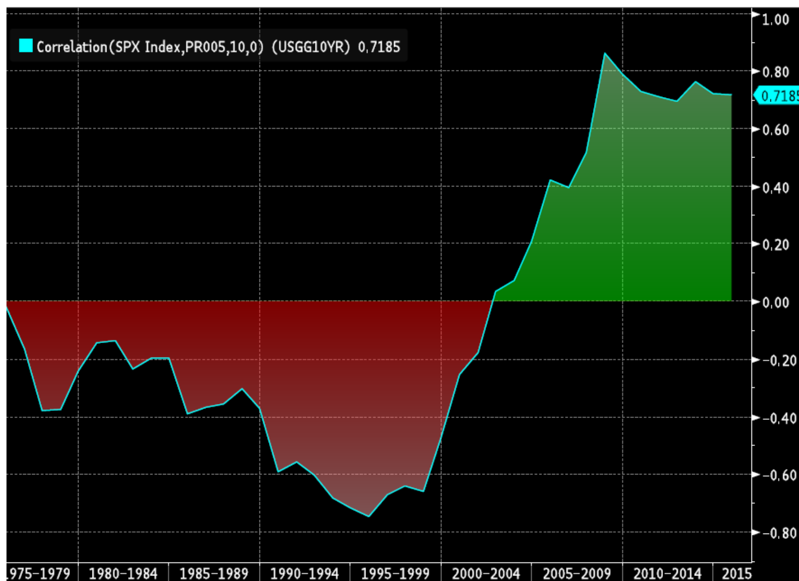
What is the historical record of U.S. large company stocks (as measured by the S&P 500 Index) when valuations are this extended and GDP growth is in the sluggish 2-3% range, as it has been for the last several years? The data shows that when these criteria (high valuations and low GDP growth) have historically been present, the next two years of annualized returns for the S&P 500 have been anywhere from -11% to -16% per year.

Now that we've alarmed you with the data, let us take a pause and state that despite valuations, the path of least resistance for the stock market is still up. While Isaac Newton wasn't pondering Apple stock when he conceived "a body in motion tends to stay in motion," this maxim tends to hold true for financial markets as well. But while it is tempting to be lulled into complacency thinking that these high-flying markets will continue their frictionless ascent, Newton understood that gravity is also a powerful force. Similarly, lofty valuations are powerful forces and the higher the tree, the bigger the bruise when the apple falls on your head. The more precarious the environment for stocks, the less opportunity cost there is to allocating to a non-correlated asset like gold.

<u>New Paradigm of Correlations</u>

Our industry is built on the notion that portfolio construction is enhanced through effective diversification. By combining assets that behave dissimilarly from one another, you can construct a portfolio that has a smoother return stream without necessarily sacrificing return. Stocks and bonds are the most classic historical examples of two assets that behave differently from one another and therefore are efficient diversifiers when combined in a portfolio. This conceptually makes sense because in times of collective optimism, investors tend to sell bonds and purchase stocks in search of higher returns. Alternatively, in challenging economic environments, investors eschew risky stocks in favor of the safety of bonds. Stated another way: bonds zig while stocks zag.

The mathematical concept regarding how assets move in relation to one another is known as correlation. We finance professionals are taught early in our careers that a negative correlation between stocks and bonds is sacrosanct and, consequently, their diversifying power is a truth that cannot be challenged. However, something interesting has taken place over the last decade or so. Take a look at the chart below, which shows the correlation between stocks (S&P 500 Index) and bonds (U.S. government 10-year Treasuries) over the last 40 years.



Source: Bloomberg

The negative correlation of decades past no longer persists and instead the correlation is now distinctly positive. This is great news when both stocks and bonds are going up at the same time but not much fun when the situation reverses. Why has this relationship reversed so meaningfully in recent years so that stocks and bonds now tend to behave in lockstep with one another? We believe it is an argument of cause and effect. The level of interest rates in the economy used to *result* from fundamental factors such as GDP growth, productivity, inflation, deflation or job growth, to name a few. Contrast that with today, where interest rates are aggressively used as a tool by central banks across the globe to *cause* changes in financial markets and behavior.

The low level of interest rates has distinctly driven stock market behavior in recent years. Perversely, when negative economic news has been released, the stock market has often rallied rather than declined as one would expect. The reason for this is that negative news reinforces the Federal Reserve's stance to keep interest rates at zero, which ultimately stimulates all asset prices, including stocks. However, there is no free lunch and we believe that when interest rates eventually rise (and bond prices correspondingly fall) stocks will face a difficult road.

Investors have been spoiled for several decades with bond returns acting as a ballast for their portfolio, generating positive returns in times of stock market stress. As the chart above shows, the tide has turned and investors may not be able to rely on their bond investments to stabilize their stock portfolio when the next downturn comes. We believe that when interest rates rise, stocks and bonds have the potential to perform poorly at the same time, resulting in inferior performance to what "diversified" investors have come to expect.

Let's bring this discussion back to gold and analyze its diversifying properties in relation to stocks and bonds.

Gold's correlation to:

S&P 500	BofA Merrill Lynch 10+ Year U.S. Treasury
0.04	0.03

Source: Zephyr StyleADVISOR – January 1979 to June 2015

A correlation of one implies perfect correlation between two assets while a correlation of zero implies that the two assets in question move independently of one another. The statistics above show that since 1979, gold has virtually no correlation to EITHER stocks or bonds . . . diversifier extraordinaire!

This low level of correlation between gold and traditional assets has been pervasive throughout very long periods of time. Academic dogma that instructs us to combine low correlation assets to efficiently diversify portfolios would seem to reinforce the role of gold in a portfolio. However, many ignore this valuable attribute of gold and therefore don't find a place for it in their investment portfolios. We believe it is time to take notice of the diversifying aspects of gold, especially considering the surprisingly high correlation between traditional stocks and bonds in recent years.

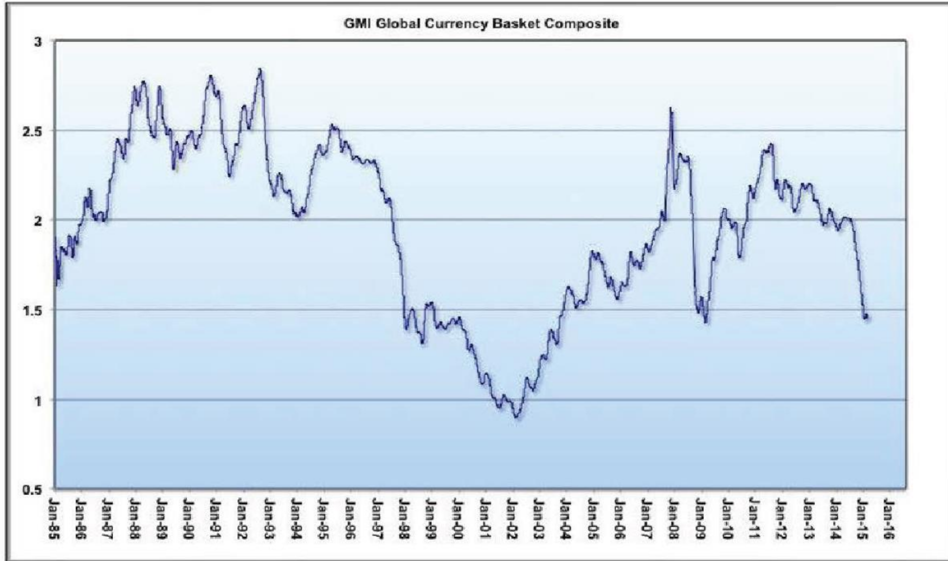
Gold as a Store of Value

In his testimony to Congress in 1912, J.P. Morgan stated, "Gold is money, and nothing else." We feel that many overcomplicate the role of gold and try to make inappropriate comparisons between gold and other asset classes. For instance, gold is commonly branded as an "ancient relic" or an "unproductive asset" that "doesn't spill off a dividend" and is therefore inferior to other investments that grow and/or distribute cash flow. We think this is comparing apples to oranges and that the role of gold should be boiled down to its more essential function: that of money.

What is money? The primary characteristics that define money are that it is a medium of exchange, a unit of account and, most importantly, a *store of value*. Gold serves these functions and has done so for thousands of years. Contrast that with other currencies that come and go over long periods of time and, most importantly, do not maintain their value over sustained periods.

In his latest research piece, Axel Merk of Merk Investments, an astute investor in currencies, eloquently stated, "While currencies move up, down or sideways against each other, all paper currencies are at risk of losing purchasing power due to inflation and the incentive for governments to print money to match their debt obligations. Gold, on the other hand, is a hard currency that cannot be easily 'printed' (production can be increased over time). . . . Over long periods of time (think one hundred years, not quarterly reports), gold has maintained its purchasing power."

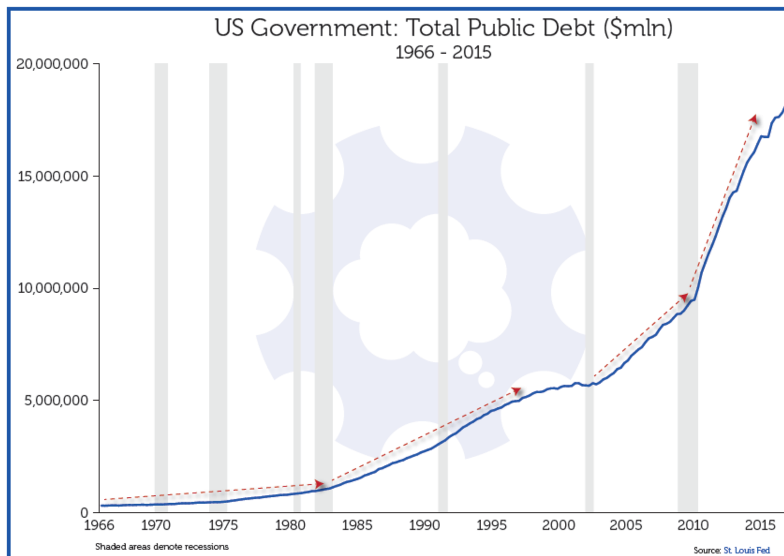
There are several important elements to Mr. Merk's comments. First, he makes the statement that currencies tend to move up and down against one another. This is evident in the below chart, which shows the performance of an equally weighted basket of 25 currencies against the dollar over the last 30 years.



Source: TTMYGH newsletter, 5/11/2015

There has been a lot of movement over these 30 years representing dollar strength/weakness versus other currencies. But, as you can see, this volatility was mainly noise, as the value of the dollar has basically ended up at the same level where it began 30 years prior.

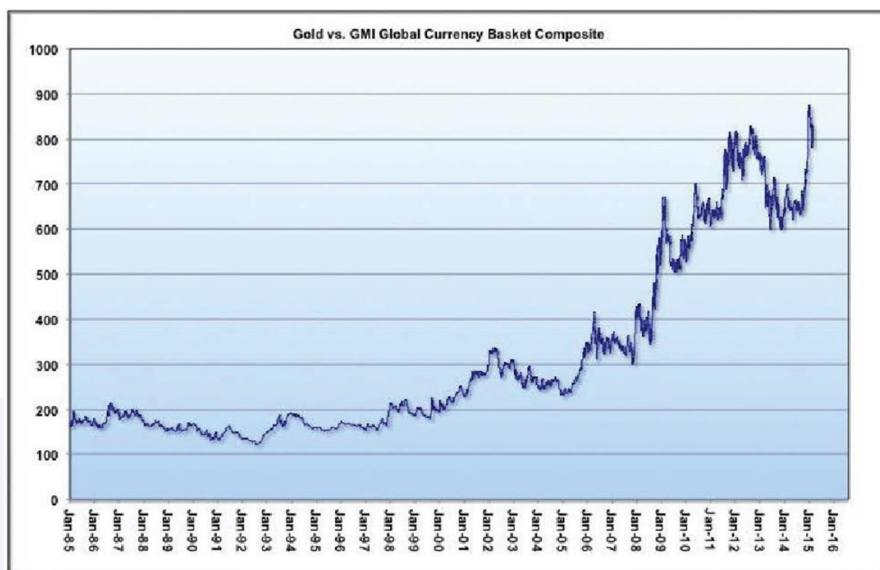
Mr. Merk also states that despite these currency fluctuations, *all* currencies are at risk of losing their purchasing power (through inflation) because governments are incentivized to print money to pay for their ever-accumulating debt burdens. Take a look at the below chart illustrating U.S. government debt over the last several decades.



Source: TTMYGH newsletter, 5/11/2015

Ouch! This growth of U.S. government debt has not been linear in nature but rather exponential. This debt explosion is by no means unique to the United States: most developed countries have debt growth patterns that look remarkably similar. Central banks have made it very clear that they will continue to print money to cover the increasing costs of these massive debt obligations. With these dynamics in place, paper money is no longer the "store of value" it once was. There is simply much more of it in circulation and consequently the value of a dollar (and other paper currencies) has not held its value over time.

Mr. Merk concludes his statement with the claim that unlike paper currencies, gold maintains its purchasing power over time. We previously presented a meandering chart of the performance of a basket of global currencies against the dollar over the last 30 years. Below is an illustration of this same basket of currencies versus gold instead of the dollar.



Source: TTMYGH newsletter, 5/11/2015

The term "worth your weight in gold" is not "worth your weight in dollars, yen or euros" for a reason. Gold is the one currency that simply cannot be printed and therefore it has displayed an impressive ability to maintain its purchasing power over time. All currencies have lost meaningful value compared to gold over extended periods; after all, gold does not grow on trees while dollars, yen and euros can be created out of thin air. Also, it's no coincidence that the gold chart above and the debt chart previously shown both sweep upwards to the right. As long as governments across the globe remain undisciplined in their approach toward debt levels and the supply of "money," we believe gold will continue on its upward trek over extended periods of time.

<u>The Yellow Brick Road Ahead</u>

While we have shared our concerns about asset prices and what we deem to be the reckless policies of governments and central banks around the globe, we do believe that the path of least resistance for asset prices continues to be up. After all, ultra-low interest rates and money printing to the tune of trillions of dollars across the globe is a recipe for further asset price appreciation. The foundation for this further appreciation, however, is not a fundamentally growing global economy but rather artificial stimulants we believe are unsustainable. This type of environment, where returns are based on manipulation and not fundamentals, is particularly challenging for us as investment professionals. At the core of what we do, we

are risk managers who evaluate investments through a disciplined process. When evaluating a particular investment, we rigorously ask ourselves if we feel we are being appropriately compensated for the risk we are taking. More often than not, of late, the answer to this question has been no. While there are still undeniably pockets of opportunity, they are becoming increasingly harder to find.

In recent years, we have transitioned client portfolios to more of a defensive stance and have less stock and traditional bond exposure than most in our industry. As you are most likely aware, we search long and hard for alternative assets that we believe can generate attractive risk-adjusted returns without directly correlating with traditional stocks and bonds. Our portfolios are not "cookie-cutter," and each client's portfolio and situation is unique. We believe that a modest allocation to gold, typically less than 5% of the overall portfolio, could have a meaningful positive impact over the long term. This allocation will vary depending upon the makeup of the rest of a portfolio. An example of a portfolio that would receive a lower gold allocation would be one with a larger weight in other real assets, such as real estate, that should also act as good long-term stores of value.

We know and expect that a position in gold will be volatile over the short term. We also know that as a firm we already look different than most in our industry and that we are further sticking our neck out with this allocation to gold in our clients' portfolios. The bottom line is that we are first and foremost fiduciaries and must follow what we believe to be the right course of action given the current facts and circumstances. We are not driven by a benchmark nor will we follow the collective herd so as to reduce our business risk as a firm. We simply must remain intellectually honest and follow the course of action that our analysis ultimately leads us to, even if that means we stand out further from the crowd.

We appreciate your continued confidence and support.

~ The Morton Capital Team

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