PCM Consulting

The Gold Standard

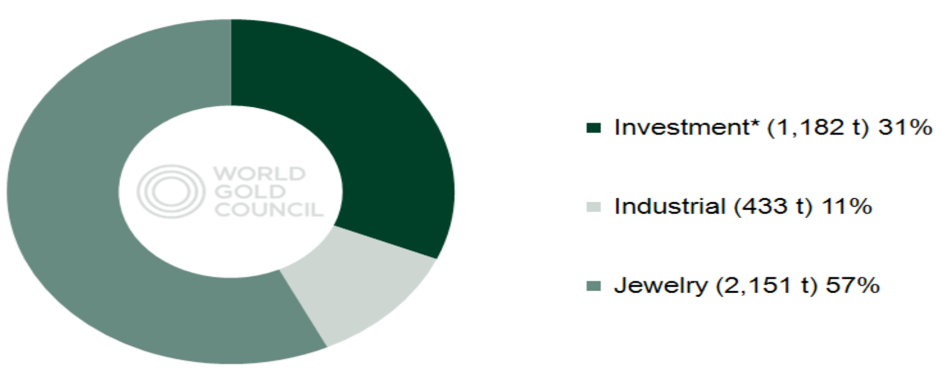
We are in an era of a global economy where traditions are crumbling and central bankers increasingly manipulate the economy. The question investors are increasingly concerned with: does gold still serve as a store of monetary value? Gold, a precious metal has a long history of serving as legal tender for goods and services particularly during times of financial and political stress.

Brief History

The troy ounce, which comes from the French town of Troyes where the measure was first put to use, weighs 480 grains, and twelve troy ounces equal one pound, which is the same as one sixteen-ounce pound avoirdupois. Troy ounces are heavier than the ounces we are used to employing. The modern convention is to express the weight of gold in grains and the price is expressed in troy ounces.

The main uses of gold are investment, industrial and jewelry as shown in the chart below:

Demand flows, 5-year average (Q4'05 to Q3'10)



Source: GFMS, WGC
* Includes identfiable and non-identifiable investment

No country currently uses the gold standard as the basis of their monetary system, although several central banks hold substantial gold reserves. The U.S. in the early part of the twentieth century adhered to the gold standard. In the early 1930s, the Federal Reserve defended the fixed price of dollars in respect to the gold standard by raising interest rates, trying to increase the demand for dollars. Its commitment and adherence to the gold standard explain why the U.S. did not engage in expansionary monetary policy. To compete in the international economy, the U.S. maintained high interest rates. This helped attract international investors who bought foreign assets with gold.

In April 1933 President Franklin D. Roosevelt issues an Executive Order which essentially confiscated all gold coins, bullions and certificates held by private citizens. Congress passed the Gold Reserve Act on January 30, 1934; the measure nationalized all gold by ordering the Federal Reserve banks to turn over their supply to the U.S. Treasury. In return the banks received gold certificates to be used as reserves against deposits and Federal Reserve notes. The act also authorized the president to devalue the gold dollar so that it would have no more than 60 percent of its existing weight. Under this authority the president, on January 51, 1934, changed the value of the dollar from $20.67 to the troy ounce to $35 to the troy ounce, a devaluation of over 40%. The outbreak of World War II essentially ended the Great Depression allowing countries to return to the gold standard.

Most countries adopted the Bretton-Woods system, which set the exchange value for all currencies in terms of gold. It obligated member countries to convert foreign official holdings of their currencies into gold at these par values. The U.S. held most of the world's gold so many countries simply pegged the value of their currency to the dollar, thus making the dollar the de facto world currency. Gold was set at $35 per ounce. In 1971, gold was re-priced to $38 per ounce, then again to $42 per ounce in 1973. As the dollar devalued, it motivated people to sell their greenbacks for gold. Finally, in late 1973, the U.S. government decoupled the value of the dollar from gold altogether. The price of gold quickly shot up to $120 per ounce in the free market. Since the Nixon administration the U.S. has been off the gold standard and gold has been used as an investment vehicle to protect against financial distress and as a hedge against inflation.

Supply and Demand

Two of the main factors that affect gold, as it does any commodity are supply and demand. Globally mining production has doubled since the mid-1980s. Since 2006 production has increased nearly 19%. China, Australia and the U.S. account for 32% of total production. The increased production was due in large part to the surge in demand for gold as an investment vehicle.

Globally demand grew 36% driven by a 58% increase in demand for gold bar and coin investments. The biggest acquirers of gold have been many of the Pacific-rim emerging market and Middle Eastern countries. Central banks, which have been net sellers of gold since 1988, were among the leading purchasers of gold. Central bank purchases are at a 40 year high and exceeded 450 tonnes in 2011. China’s Central Bank has doubled its gold reserves since 2003. In January of 2012, Kazakhstan, Belarus and Turkey were among the robust purchasers of gold. Total global Central Bank gold holdings stand at 18,384 tonnes or 58% of total bank reserves.

Private investors have been steadily increasing as well. The increases can be attributed to the ease in which investors in developed and emerging markets can access gold products. In the U.S., ETFs and mutual funds provide low cost easy access. Globally we have seen the rise in vending machines at banks and airports that allow private investors with the use of a bank debit card or credit card to purchase gold coins. The investment demand in the European region registered its seventh connective annual gain surging to a new record high of 374.8 tonnes.

This surge in buying has increased the demand for secure storage facilities. In addition to the Federal Reserve Bank in New York, JP Morgan, Barclay and the Bank of Nova Scotia have built new storage facilities globally. Although only open for less than a one year, he new facilities are nearing capacity.

The attractiveness of gold as an investment has taken many forms. As a store of wealth demand, increasing global tensions and debt worries, diversification, negative real deposit rates, threat of inflation in developing markets, deflation in developed markets and currency debasement have all contributed to driving demand higher.

In 2011, ETF gold demand was 154 tonnes about half of the strong demand seen in 2010. The first half of 2011 saw a marked slowdown in demand as profit taking suppressed new demand. The second half of 2011 saw a doubling of demand over the second half of 2010 driven by a response to the ongoing European debt crisis.

Taxation

[The following information pertains to U.S. taxpayers only and is not intended as nor should be considered personal tax advice. Always consult a tax professional before investing.]

The IRS considers gold a "collectible" and will tax your capital gains at a 28% rate. This designation includes all forms of gold (other than jewelry), such as...

- All denominations of gold bullion coins and numismatic/rare coins, gold bars, and gold wafers
- ETFs like GLD, SLV, etc. (closed-end funds have different rules; see below)
- Any electronic form of gold like GoldMoney and Bullion Vault
- Any "paper" or certificate forms of gold, such as Perth Mint Certificates and EverBank accounts
- All forms of pool gold, rounds, and commemorative coins

"Reporting" requirements can be confusing. It is true that precious metals dealers aren't required to report certain small sales to the IRS – but that doesn't relieve *investor* of the obligation.

There is a natural assumption by most investors that the tax treatment of gains and losses in many ETFs would be similar to a mutual fund. The assumption is incorrect. One ETF, GLD is organized as a grantor trust. The grantor trust for tax purposes is ignored so that the investor is treated as owning a pro-rata share of the underlying holdings, not the entity. Other structures will impose different tax rates and income tax reporting formats. Table I. below lists many of the most popular ETFs and tax rates and forms.

Table I. Gold Related Exchange Traded Funds

Sym	Name	ST Rate	LT Rate	Tax Form
GLD	SPDR Gold Trust	35%	28%	1099
IAU	COMEX Gold Trust	35%	28%	1099
SGOL	Physical Swiss Gold	35%	28%	1099
DGP	DB Double Long ETN	35%	15%	1099
DGL	DB Gold Fund	23%	23%	K-1
UGL	Proshares Ultra Gold	23%	23%	K-1
GLL	Proshares Ultrashort Gold	23%	23%	K-1
DZZ	DB Double Gold Short ETN	35%	15%	1099
AGOL	Physical Asian Gold	35%	28%	1099
DGZ	DB Gold Short ETN	35%	15%	1099
UGLD	Velocity 3x Long Gold ETN	35%	15%	1099
TBAR	RBS Gold Trendpilot ETN	35%	15%	1099
FSG	Factor Shares 2x Gold Bull	23%	23%	K-1
UBG	UBS Bloomberg Gold ETN	35%	15%	1099
DGLD	Velocity 3x Inverse Gold ETN	35%	15%	1099

Source: ETFDatabase

Investment Environment

Many traditional investors ignore gold as an option in times of global crisis and large tail risk markets. In what seems like a logical argument, gold is not a currency, does not pay a dividend or interest and is subject to irrational bubble markets. A closer look at this reasoning demonstrates the concerns are largely unfounded.

Gold has produced positive returns for the last 11 years with an average return of over about 17% for the 2001-2011 periods. During periods of major market turmoil gold has outperformed the other major asset classes. Many investors in what they believe are lowering their risk of owning gold buy commodity funds or commodity ETFs. As shown in Table II. below the selection and weightings of other commodity mask the return of any particular commodity.

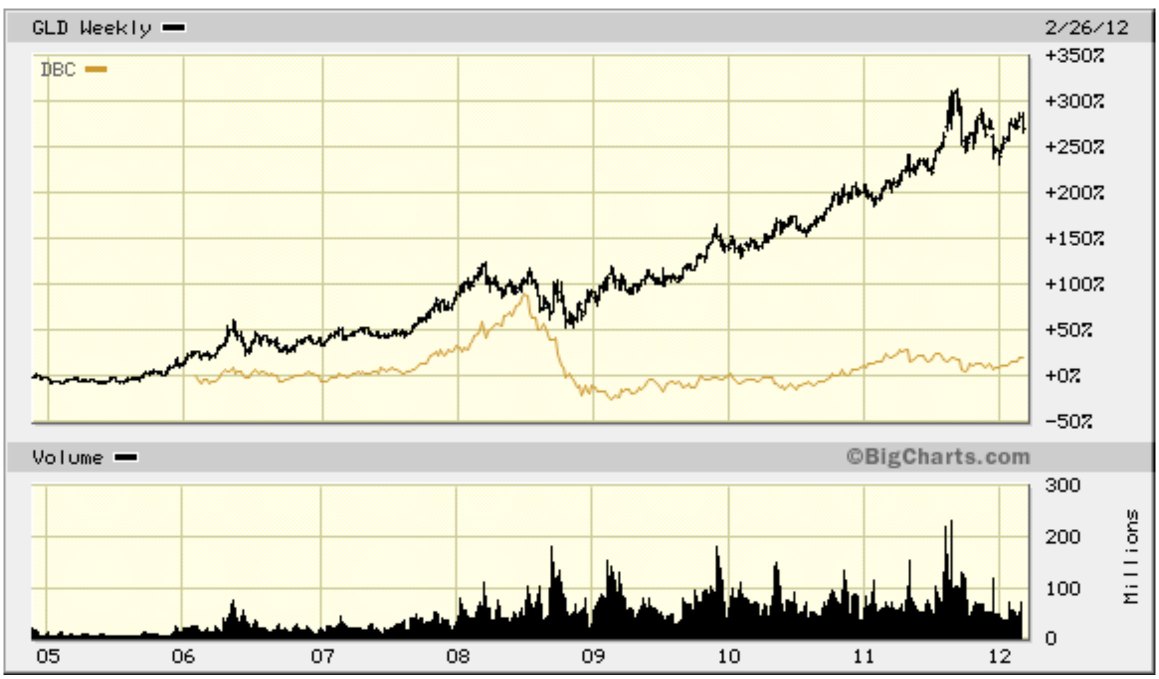
Table I. Sector Weights - Commodity Indexes

Commodity		GSCI	DBC	Rodgers	DJ-AIG	CCI
Energy		72.0%	55.0%	44.0%	33.0%	17.6%
Livestock		3.7%	0.0%	3.0%	7.4%	11.8%
Grains		11.6%	22.5%	20.6%	20.8%	17.6%
Metals		10.0%	22.5%	21.1%	30.1%	23.5%
Softs		2.8%	0.0%	11.3%	8.7%	29.4%

GSCI – Goldman Sachs Commodity Index
DBC - Deutsche Bank Commodity Index
Rodgers- Jim Rodgers Commodity Index
DJ-AIG – Dow Jones –AIG Commodity Index
CCI - Commodity Channel Index (formerly Reuters-CRB Index)

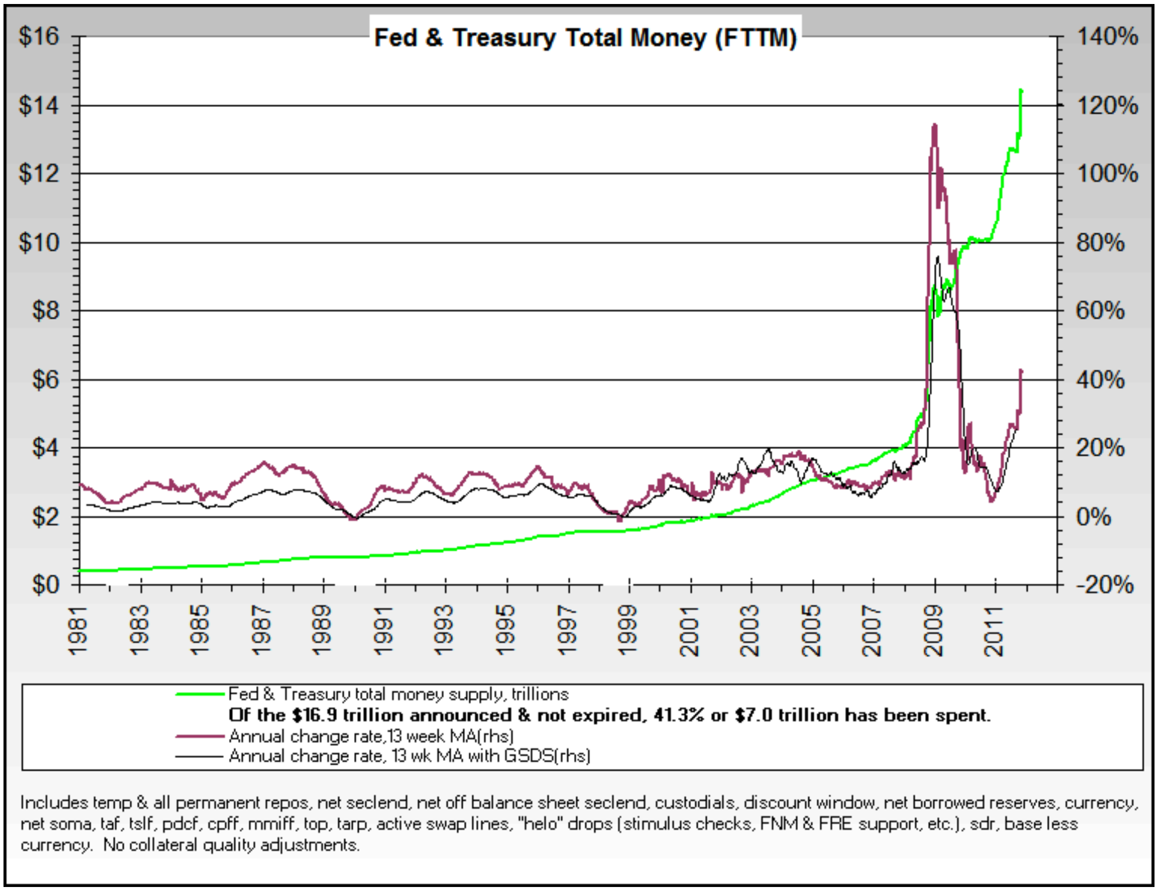
To further illustrate the wisdom of making gold a tactical allocation is seen in the chart below which compares the return of gold versus the Deutsche Bank Commodity Index ETF. The outperformance of gold is staggering for the time period shown.

Chart I. Return Comparison of Gold vs. Deutsche Bank Commodity Index ETF



Over the past 10-20 years those large tail risk events included Long-term Capital Management, 9/11, 2002 recession, Great Recession (December 2007-June 2009), Middle East tensions and the Sovereign debt Crisis. Gold has performed quite well.

Gold has also been a hedge against inflation. Most economist do not fear inflation currently as the Federal Reserve has forced interest rates to near zero levels. The Consumer Price Index (CPI-U) rose 3.1% in 2011 up from 1.5% in 2010. Somewhat forgotten in these tame numbers is the fact that housing which comprises 42% of the index has been mired in housing/banking crisis that led to the Great Recession. In addition, the Federal Reserve to counteract the financial crisis has increased the monetary base by 211% and the money supply growth has resumed its rise.



Typically, inflation lags money supply growth by 2-3 years. The appreciation of the price of gold typically accelerates once inflation in no longer contained.

Of more immediate impact to the price of gold is likely to be the growing unrest globally in terms of political tensions between warring parties, predominately in the Middle East. Other notable problem areas that need to be monitored include Russia and parts of the old Soviet Union, N. Korea and even China. Sides are already being drawn and tensions are escalating.

The real danger is these tensions are rising as major internal distractions are hitting many in the western world. These distractions are, of course, budget woes and mountains of debt (Debt will be discussed in more detail in Series Paper #4). The problem of course is that governments have put off making tough decisions on entitlement spending and the global recession has knocked budgets perilously into the red. Combine this with oil price spikes and food and water shortages and the probability for spikes in gold demand and prices are high. Despite the belief that gold is not a currency, many believe that in times of global stress not unlike we are facing, gold will be the backstop currency across many borders. Adding to the growing demand for gold is a resurgence of discussions that the U.S. Government may do just as they did after the Great Depression, confiscate gold coins in the U.S. Countries like China, Russia and several Middle East states are preparing to facilitate the trade of oil in currencies other than the U.S. Dollar which they believe is at risk. These are also countries with large gold reserves.

In these very volatile and risky times, investors in efforts to protect capital, purchasing power and liquidity may view it as prudent to allocate portions of their portfolios to gold. Despite the relatively large run-up in price, there are risk factors that might serve as a catalyst to propel gold to much higher levels.

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