

GOLD in the New Millennium

Why Individuals and Asset Managers should Own Precious Metals for the Next Decade



December 2011

GOLD AND PRECIOUS METALS PAPER - OVERVIEW

The purpose of this paper is to communicate to individual investors and asset managers the evidence that an allocation to Gold, as well as other precious metal investments, will be one of the key ingredients to growing and, most importantly, preserving their wealth in the following decade. The paper is divided into seven sections, which are as follows:

Section 1: The New Millennium – Incorporating Gold into Diversified Portfolios

The paper will begin by asking two very simple but important questions: *Would investors have benefited from an allocation to Gold in the last decade, and what impact would this allocation have made on the performance of diversified portfolios?* To answer this, we look at the returns (and risk) characteristics of various asset classes and balanced growth portfolios, and assess the impact an allocation to the metal would have had on portfolio returns.

Section 2: Understanding Gold – A Look at the Gold Market

This section looks at some of the fundamentals of the Gold Market itself, including production, ore grades, deposit discovery, stock to flow ratios and the liquidity and size of the physical gold market. In this section we'll also look at why gold is 'not just a commodity'.

Section 3: The Gold Price – Where is it Now:

This section analyses where Gold is in the current cycle, and looks at its value based on several metrics of historical relevance. The data will demonstrate conclusively that Gold, despite the decade long bull market, is nowhere near a 'bubble' today.

Section 4: Traditional Asset Classes:

A review of valuation levels of the Equity, Property and Bond Market (focusing on the USA).

Section 5: The History of Money:

Gold has been used as money across the millennia. In this section we'll look at Gold vs. Fiat currency as a store of value through time to gain an idea of where our monetary system is headed.

Section 6: What Could Stop Gold and Price Predictions:

A review of what stopped the last Gold Bull Market, and a comparison with where we are today, followed by some potential price forecasts for the yellow metal.

Section 7: What to Do Now:

Preliminary recommendations on how a balanced portfolio of assets can be constructed to incorporate an allocation to precious metals & benefit from this continuing bull market.

We hope that you find the information and evidence contained within this presentation informative, and it provides some service in helping you decide where to deploy capital going forward. Incorporating Gold and Precious Metals into a portfolio is something all investors should consider in this environment.

December 2011

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Section 1: The New Millennium

The Story of Gold

A look at how gold has performed since the turn of the century and the impact it would have had on investor portfolios

SECTION 1: THE NEW MILLENNIUM – THE STORY OF GOLD

This paper starts with a simple question: *Would investors have benefited with an allocation to gold and other precious metal investments since the turn of the century?*

The table below, which highlights results up until the 30th September 2011, provides a clear answer

Asset Class Returns since December 1999

Asset Class	Index	1yr	3yr	5yr	10yr	Since 99
Australian Shares	ASX 300	-8.71	-0.10	-0.71	7.25	6.47
American Shares	S&P 500	1.14	1.23	-1.18	2.82	-0.39
World Shares	MSCI World	-4.71	-6.79	-7.26	-3.08	-3.67
Emerging Market Shares	MSCI Emg Mkts	-16.46	-0.87	-0.53	7.56	5.27
Australian REITS	ASX 200 Prop Trusts	-6.24	-11.83	-13.29	0.94	2.70
Global REITS	UBS GREIT	0.99	-3.03	-5.53	5.04	8.82
Direct Property	Mercer Unlisted Property	10.16	0.68	6.06	9.47	9.66
Australian Fixed Income	UBS Composite Bond	9.04	7.82	7.04	6.22	6.81
Global Fixed Income	Barclays Global Agg	7.79	10.25	8.53	8.02	8.30
Global Credit	Barclays Global Credit Agg	6.78	12.35	8.07	8.08	8.38
Cash	UBS 90 Day Bank Bills	5.01	4.54	5.55	5.43	5.51
Commodities	GS Light Energy	2.47	-8.44	-2.04	4.14	3.41
Gold	Spot price	23.88	22.73	22.16	19.51	15.75
Silver	Spot price	37.86	34.82	21.31	20.54	15.72
Gold Shares	HUI Gold Mining Index	3.20	18.75	11.86	22.04	18.16

As you can see, since the turn of the century, Gold, Silver and Large Cap Gold Mining stocks have significantly outperformed the broader share markets, the sovereign and corporate debt markets, and Property. With the exception of Gold Shares this year, Gold, Silver and Gold Shares have been the top three performers over all measurable periods throughout (1yr, 3yr, 5yr, 10yr and Since December 1999).

The size of the outperformance has been substantial. Gold and Silver are some 6% pa ahead of the next best asset class (Direct Property). Whilst Gold Shares are over 8% pa ahead of Direct Property, they are between 12-20% ahead of the Australian and Broader Global share markets, which to this day comprise somewhere between 50-60% of Australian Balanced Growth Portfolios.

Gold and silver have also comprehensively outperformed the broader commodity markets, especially over the last 3 years since the GFC started.

Even compared to defensive assets liked fixed income, which have performed particularly strongly over the last few years (yields have never been lower in the US), precious metals have provided far greater price appreciation and portfolio protection – both leading into and after the GFC.

Looking ahead, considering the spectre of sovereign debt default that is haunting Europe and may well spread to Japan and America, as well as the inflationary threat courtesy of continued monetisation efforts globally, investors should be extremely cautious in assuming that the debt market will continue to provide the capital protecting diversification it has over the last decade.

Looked at in aggregate, the above data conclusively demonstrates that an allocation to Gold, Silver and other precious metal related investments would have proved extremely beneficial to investors since the peak in equity valuations at the turn of the century!

Incorporating Precious Metals into a Balanced Portfolio

Whilst Precious metal investments would have significantly added to investor returns this century, without exception large Australian Asset managers still to this day do not incorporate a meaningful allocation to Gold in their client portfolios. Most do not even have Gold as an option within their strategic asset allocation, meaning it is an asset they still do not consider when assessing their options to deploy client capital. At most, diversified balanced growth funds (which make up some 80% of Australia's \$900Bn non Self-Managed Super Industry) incorporate a 2% allocation to physical commodities. As we will see in section 2, Gold makes up between 3-7% of the broader commodity indices. Accordingly, a traditional diversified balanced growth fund has had, and continues to have exposure of less than a quarter of one-percent to the best performing asset of the decade.

The table below highlights how investor returns would have been improved had asset managers incorporated even a 5-10% allocation to precious metals. Firstly, it shows the return an Australian investor in Median, Upper Quartile and Lower Quartile Balanced Growth Portfolios received since the turn of the millennium, up until September 2011. (Returns of median, upper & lower quartile portfolios are based on the Intech Survey for Balanced Growth Portfolios)

The table also includes 4 theoretical portfolios.

- 5% Gold: 95% of Median Portfolio + a 5% Physical Gold Allocation
- 10% Gold: 90% of Median Portfolio + a 10% Physical Gold Allocation
- 5% PMA: 95% of Median Portfolio + a 5% Precious Metal Allocation
- 10% PMA: 90% of Median Portfolio + a 10% Precious Metal Allocation

* The Precious Metal Allocation (PMA) was a weighted calculation based on 34% of the Gold Price Movement, 33% of the Silver Price Movement and 33% of the move in the HUI Gold Bugs Index.

Balanced Growth Portfolio Performance Since December 1999

Portfolio	1yr	3yr	5yr	10yr	Since 99
Upper Quartile Manager	-0.40	1.32	0.67	5.11	5.51
Median Manager	-1.73	0.69	-0.08	4.49	4.24
Lower Quartile Manager	-3.93	-0.49	-0.77	3.88	3.87
Median Manager with 5% Gold	-0.49	1.93	1.41	5.39	5.04
Median Manager with 5% PMA	-0.38	2.25	1.42	5.63	5.23
Median Manager with 10% Gold	0.79	3.06	2.53	6.15	5.67
Median Manager with 10% PMA	1.00	3.70	2.54	6.62	6.03

The above review of balanced portfolio returns highlights a couple of key points. Remembering table 1, since Dec 99 an investment in cash (as represented by the UBS Bank Bill Index) has returned 5.51% annually, which is in line with the return for Upper Quartile Balanced Managers. What this indicates is that, since December 1999, **fully 75% of Australians would have earned a better return taking no risk and holding cash, rather than pay the 'professionals' who have managed their super.** With the strength in Australian Home Prices this decade (up by more than 7% pa), Australians would also have been better served by simply paying down their mortgage. The desultory returns that Australians have earned investing in super go back even further, with analysis by the Industry Super Network indicating that the 15yr return for retail funds to June 2011 was only 3.66%, **less than cash.**

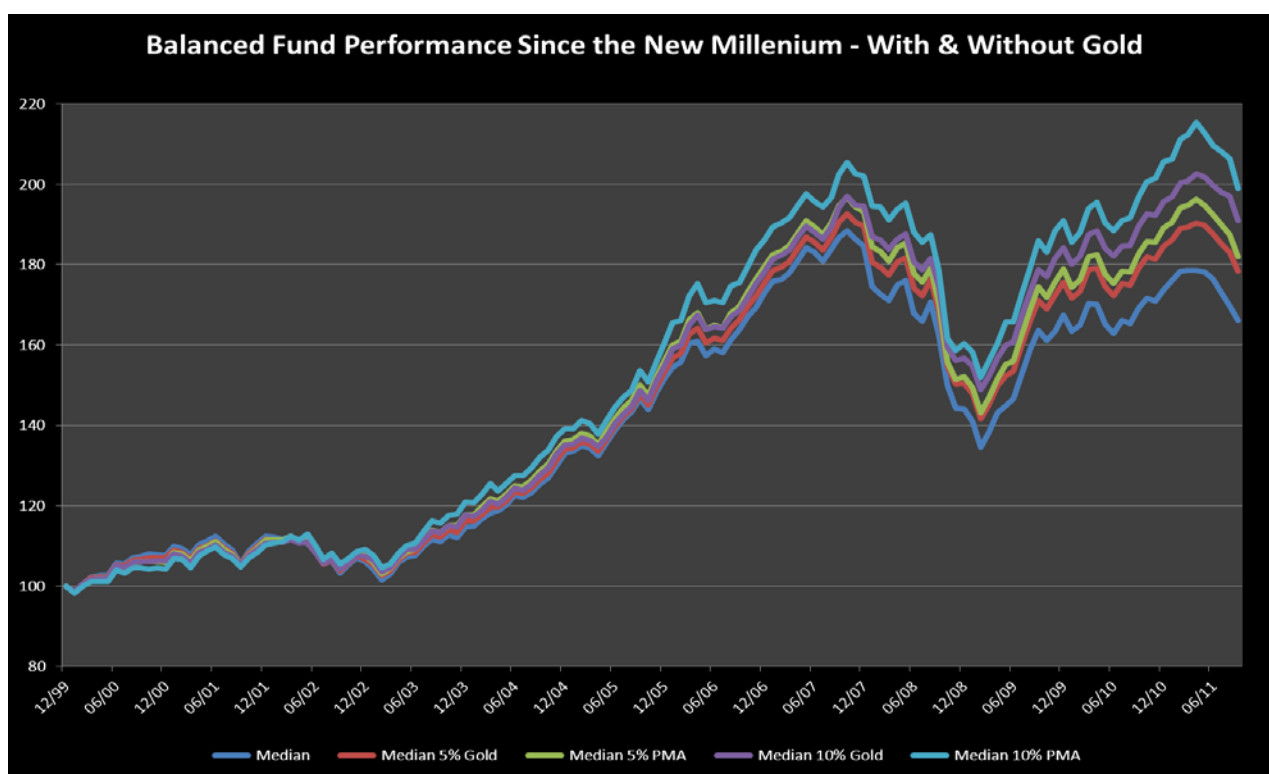
The numbers above highlighted in green signify instances where the incorporation of Gold or PMA's into a portfolio would have seen the median return exceed the upper quartile return.

As you can see, with the exception of the 1yr return for a 5% Gold Allocation, and the 'Since 99' returns for 5% Gold and 5% PMA, incorporating even a 5% Allocation to Gold alone would have moved the median manager into the upper quartile on every other occasion. This is an important point for asset managers, who are constantly compared to their peers, to consider.

Over the entire period, allocating 10% of investor money to PMA's would have added 1.80% pa to investor returns. Over the last 3 years (a period including the GFC and the recent market scares due to Euro Zone Sovereign Debt) a 5% Gold Allocation would have added 1.24% to returns, and a 10% PMA allocation would have added over 3% pa to overall portfolio returns, significantly helping to preserve capital (and outperform inflation) in this volatile period.

The chart below, which shows the cumulative fund performance of the median balanced growth fund (and the 4 portfolios which include an allocation to Gold or PMA's), further brings to light the added returns investors with an allocation to Gold would have received. Returns for all the portfolios have been rebased to 100 as at December 1999.

Cumulative Fund Performance since the Turn of the Century



This chart brings a couple of very interesting points to light. Firstly, having a precious metal allocation would have added significantly to fund performance leading into the GFC. Median Funds returned roughly 88% (cumulative) leading into October 07, compared to 96% for a portfolio with a 5% allocation to precious metals, or 115% for a portfolio with a 10% PMA allocation. This data strongly refutes the oft-heard argument that Gold is only a useful investment in periods of market stress, as equity markets were up circa 80% from 2003 to 2007, yet Gold outperformed strongly.

Post GFC Markets bottomed in February 2009, by which point Median portfolios had lost some 28% of their value. Despite the supposedly higher risk nature of gold, silver and gold stocks, the losses on the 4 portfolios that incorporated a precious metal exposure ranged from 24 to 27%. Clearly, incorporating precious metals exposure would have helped limit losses through that period of unprecedented market stress.

Since February 2009, whilst median portfolios have recovered somewhat, they still sit some 12% below their highs achieved in October 07. Had Asset Managers allocated 10% of their portfolios to Gold, or to precious metals, their portfolios would have recorded new highs in April of 2011. One imagines this would have been quite a useful selling point and marketing tool for those that had managed to recover their GFC induced losses.

Whilst even the funds with exposure to Gold have pulled back since April, this is hardly the fault of the portfolio's Gold component. Despite the falls from its August high near \$1900, since April Gold is up 4%, comparing very favourably to the circa 16% drop in various equity markets, which has led to a 7% loss for median balanced funds over that period.

Despite the supposedly high risk nature of precious metal investments, Gold's annual volatility (14% since Dec 99) is markedly lower than Equity (18% for the ASX300) and REIT (27%) markets. This fact, coupled with Gold's generally negative to low correlation to equity markets has meant that for a diversified investor, incorporating Gold into their portfolio would have reduced overall volatility.

Over the period, median balanced growth portfolios have had an annual volatility of 10.35%. Incorporating a 10% Allocation to Gold would have reduced this number to 9.71%, highlighting the smoother returns an investor with an allocation to Gold would have received. Even a portfolio with a 10% allocation to PMA's (which includes higher volatility silver and gold stocks) would have had a lower annual volatility than a median portfolio (10.28%).

The net result of all this is that an investor who placed \$100,000 into a balanced fund with 10% of its investments in precious metals in December 1999 would be some \$30k better off by now (\$179.6k vs. \$151.47k) and would achieved this result with lower volatility across the period and suffered a smaller drawdown during the GFC.

Portfolio Managers, who due to the nature of the industry they work in are extremely competitor sensitive, can also rest easy. The Opportunity Cost of Gold, on a calendar quarter basis, is negligible. When balanced growth portfolios are rallying, they only outperform gold just over 50% of the time, and when they do, the average outperformance is only 0.20% over the quarter. As such, a portfolio with a 10% Gold allocation would have suffered a loss, all other things being equal, of 0.02% vs. its non-Gold holding competitors. This number is so small as to be effectively meaningless, especially when one considers the standard deviation of calendar quarter median returns since December 1999 has been 4.28%.

Comparatively, when balanced growth portfolios fall, their average underperformance over the quarter compared to Gold is 8.90%. All other things being equal, a Portfolio manager with a 10% Gold allocation would outperform their competitors by 90bps during these periods.

To give some context to this number, consider the following. Since December of 1999 the average calendar quarter performance differential between upper quartile and median balanced growth portfolios has been 0.63%. However, when asset markets and balanced growth portfolios fall in value, this differential blows out to 0.89%, highlighting that markets tend to be more volatile to the downside.

Therefore, diversified managers with a 10% Gold Allocation in their portfolios will almost certainly be top quartile fund managers when markets fall, based on this one asset allocation decision alone, whilst otherwise lower quartile portfolio managers would see their returns outperform those of the median manager.

It is worth pointing out that over the entire period, a 10% allocation to Gold would have proved 5 times more effective than the bond market in protecting and growing client capital.

Considering the Debt and Demographic challenges the developed world faces today, leading to a hugely uncertain economic and political environment, market volatility is likely to be with us for some time. As a result, an allocation to Gold will likely continue to be a very useful diversifier for asset managers and their clients in the period ahead.

The tables below, which show the 5 best and worst calendar quarters for median balanced growth portfolios since December 1999, illustrate this in more detail

5 Best Quarters for Balanced Funds since the Turn of the Century

Period	Balanced Growth Return	Gold Return	Excess Return (Fund vs Gold)	Fund Return with 10% Gold	Excess Return (10% Gold vs Non Gold Portfolio)
Q3 09	11.56	8.83	2.72	11.28	-0.27
Q4 01	6.42	-5.61	12.03	5.22	-1.20
Q4 04	6.08	4.81	1.27	5.95	-0.13
Q2 09	6.01	0.26	5.75	5.43	-0.57
Q1 06	5.77	13.85	-8.08	6.58	0.81

Holding a Gold weighting of 10% in a portfolio during the 5 best calendar quarters for Balanced Funds would have cost you just 0.27% per quarter on average. In fact, in early 2006, when the median balanced growth fund returned nearly 6%, Gold went up nearly 14%, adding 0.81% to the returns of any investor with a 10% allocation to the metal.

5 Worst Quarters for Balanced Funds since the Turn of the Century

Period	Balanced Growth Return	Gold Return	Excess Return (Fund vs Gold)	Fund Return with 10% Gold	Excess Return (10% Gold vs Non Gold Portfolio)
Q4 08	-11.21	-1.75	-9.45	-10.26	0.95
Q1 08	-7.39	11.51	-18.91	-5.50	1.89
Q3 01	-5.99	8.13	-14.12	-4.58	1.41
Q3 11	-5.81	7.95	-13.76	-4.43	1.38
Q3 02	-4.50	1.84	-6.34	-3.87	0.63

As you can see, during periods of market stress, of which there have been many of late, Gold's ability to protect capital comes to the fore. The average return of balanced funds in these periods has been -6.98%, whereas Gold has had an average rise of over 5.50%. Any investor with a 10% allocation to the metal would have outperformed their non-gold counterparts by an average of 1.25% over these periods.

Section 1 Conclusions

- Gold and other precious metal investments have provided far greater price appreciation than traditional assets since the turn of the century
- Precious metals have strongly outperformed the global equity market in particular, as well as debt markets both in Australia and internationally
- Incorporating an allocation to Gold and PMA's into portfolios would have dramatically enhanced the returns investors would have received over this period
- Investors with a 10% Allocation to Gold and / or Precious Metals would have recouped all of their GFC induced losses, with their portfolios hitting new heights in early 2011
- These superior results would have been achieved whilst reducing volatility across the entire period and minimising drawdowns suffered throughout the GFC
- Despite these results, Asset Managers are still yet to embrace Gold as part of their strategic asset mix, and hold on average, less than 0.25% of client money in the best performing asset of the new millennium
- Had Asset Managers incorporated Gold into their portfolios, they would not have suffered from a competitor performance perspective in periods where balanced growth portfolios are rising
- Median Asset Managers would have almost definitely been top quartile performers in periods of market uncertainty and stress where balanced portfolios are falling just by allocating 10% of their portfolios to Gold, and otherwise lower quartile managers would have outperformed their sector median
- Despite record low yields – Gold has been a far stronger portfolio diversifier and protector of wealth than the bond market throughout this period
- Considering the outlook for the global economy, Gold is likely to continue to provide a very useful diversification benefit, and wealth preserver, for asset managers and their clients in the period ahead

Section 2: Understanding Gold



Understanding the Physical Gold Market

- **Production this Decade**
- **Stock to Flow**
- **2000 vs. 2010 – The Changing Landscape**
- **Gold Market Liquidity**
- **The Size of the 'Investable Gold' Market**
- **Why Gold is 'Not Just a Commodity'**

SECTION 2: UNDERSTANDING GOLD – A LOOK AT THE GOLD MARKET

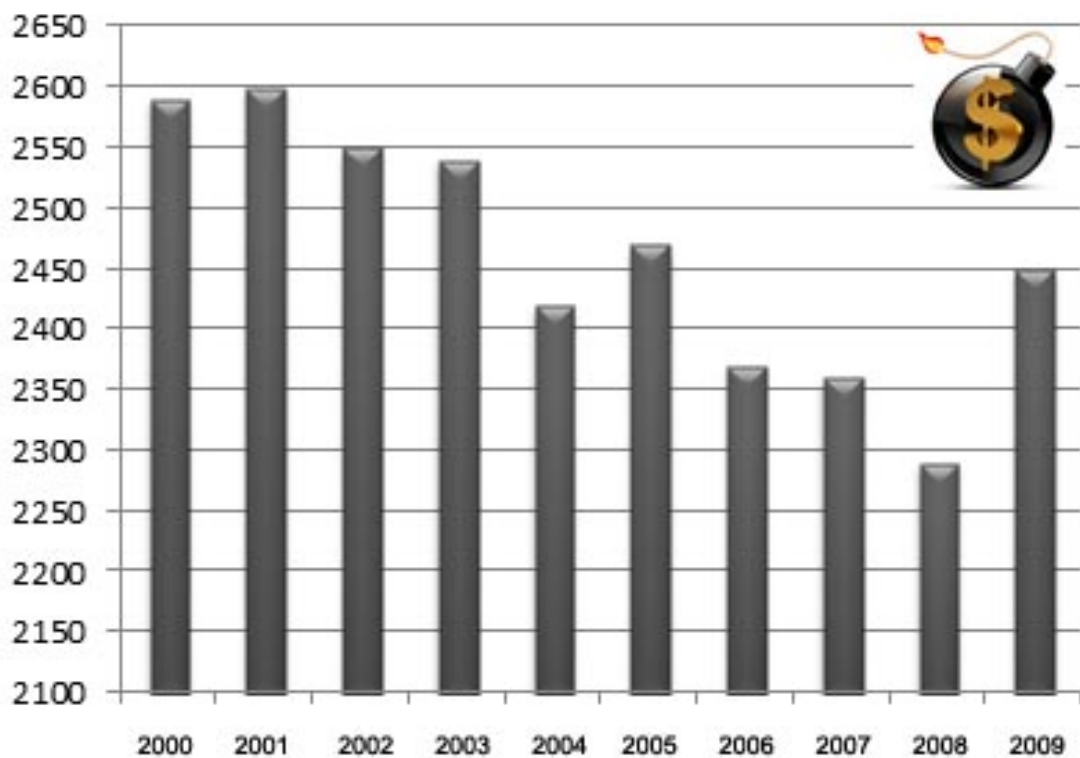
In this section, we'll look at some key components of the Physical Gold Market, to help gain a greater understanding about the metal itself. We'll investigate

- **Production This Decade**
- **The Stock to Flow Ratio of Gold**
- **2000 vs. 2010 – the Changing Landscape for Physical Gold**
- **Gold Market Liquidity**
- **The Size of the 'Investable Gold' Market**
- **Why Gold is 'Not Just a Commodity'**

Production This Decade

When something goes up in price by more than six times in a decade, basic logic would suggest that the market would have responded on the supply side, and that production would have increased dramatically, as a natural response to higher prices. The chart below highlights that this is clearly not the case for Gold.

ANNUAL WORLD GOLD PRODUCTION (IN METRIC TONNES)



Source: US Geological Survey Historical Data

As you can see, for the first 8 years of the Gold Bull Market, Production actually fell from its prior peak in the 2001. Globally, Gold Miners have found it near impossible to increase their supply in response to higher prices. This has been due to a multitude of factors which include the following:

- **Much higher mining costs**

At the start of the Bull Market in Gold – companies were pulling Gold out of the ground for roughly \$150 per ounce. By 2009, this had risen to well over \$500 per ounce, according to research by VM Group and Halliburton, due to increased energy and labour costs, as well as declining ore grades. South Africa (until recently the largest supplier globally) is by far the costliest Gold Mining jurisdiction, with production costs in 2010 coming in at just under \$800 per ounce

- **Declining ore grades**

A century ago, you could find 20 grams of gold per tonne in Australia, Brazil, Canada and South Africa. Entering the new millennium, ore grades had declined to one-tenth of that figure, approximately 2 grams per tonne. In the 11 year bull market for Gold, this number has halved again, such that many mines are only producing 1 gram of gold per tonne of ore mined. Since 1995, total Gold Ore processed has gone from circa 900 to over 1,800 million tonnes per annum, with essentially no increase in actual Gold production as we saw above.

- **A decline in identifying deposits of substantial size**

Despite the increase in the price of Gold, precious few large deposits have been found this decade. Whilst this leads to plenty of M&A activity within the sector, it doesn't add even 1 ounce to the supply of Gold. According to Newcrest, in 1998, some 15 deposits, totalling circa 150m ounces (5000 tonnes) were discovered. Since then, discovery rates have dropped dramatically. Throughout the entirety of this Gold Bull Market, there has not been even 1 year when 100m ounces (3,110 tonnes of Gold) were discovered.

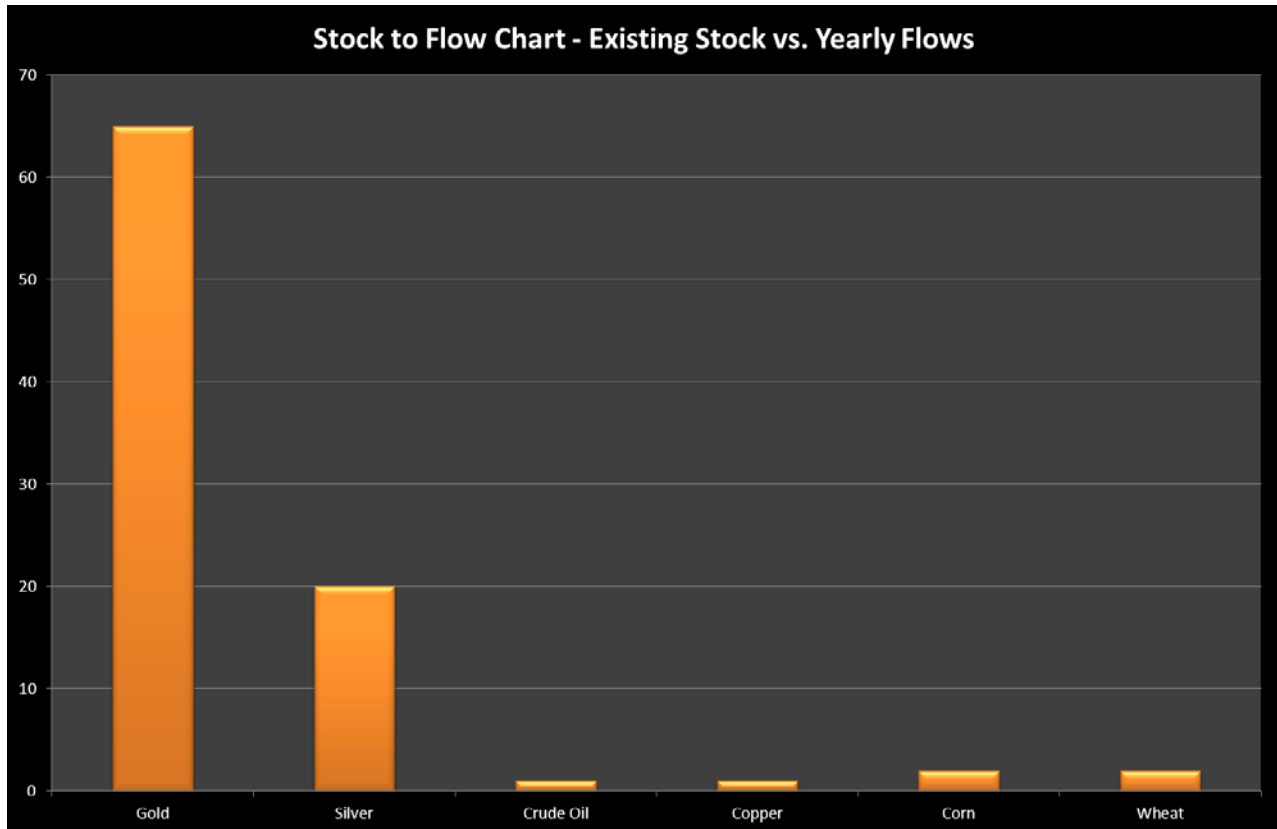
- **The underinvestment in the sector due to a double decade bear market**

Whilst spending on Gold exploration has increased, it's still only running at around \$5bn per annum, according to the Metals Economic Group. To put that into perspective, that's approximately equal to 1 day of US Federal Government Borrowing. In section 3, we'll highlight how the lack of money raised by Gold Miners is further evidence that we are not yet near the 'bubble' phase for Gold

World Gold Council data highlighted that it took until 2010, fully 10 years into the Gold Bull Market, for production to exceed its 2001 peak, coming in at roughly 2700 tonnes. Due to all the aforementioned factors, the expectations of the World Gold Council are that total Gold production will not increase in any meaningful way from the current levels for many years to come.

Stock to Flow

Stock to flow is a measurement calculated simply by dividing the total above ground supply of a commodity by the annual production of that commodity. The slide below highlights an often ignored fact about the Gold market – namely that its stock to flow, at 65 years, dwarves that of any other commodity.



With annual production coming in at around 2,700 tonnes per annum – and roughly 168,000 tonnes in above ground supply – Gold has an exceptionally high stock to flow ratio, compared to energy, base metal and agricultural commodities, which are essentially consumed almost as soon as they are produced. This is another reason why Gold is 'not just a commodity' – a subject we'll visit shortly.

Another way of looking at the Stock to Flow ratio is this; Annual production represents only 1.55% of existing supply. Even if production doubled to nearly 5,500 tonnes annually (and there are no reasonable predictions of anything remotely like this occurring) – it would still only translate to a 3% increase in above ground supplies.

The stability of Gold supply compares quite favourably to the growth in paper money, which has been running at over 10% p.a. for the better part of 3 decades. This should help illustrate Gold's inherent stability and its attractiveness as a monetary asset.

2000 vs. 2010 – the Changing Landscape for Physical Gold

Whilst still an investment that is largely ‘off the radar’ for large institutional money managers and retail investors, the landscape for physical Gold (with the exception of production, which as we know has barely increased) has changed dramatically in the last decade.

The table on the right highlights some of the key changes that have occurred in the physical market, to help illustrate the point.

Gold Market (per annum stats)		
Measure	2000	2010
Production (t)	2620	2689
Central Banks (t)	-400	400
Coin Sales (oz)	290k	2,355k
ETFs (t)	0	2300
China (t)	200	700
India (t)	535	918

Consider the major changes. Central banks are now net buyers of the metal, a huge change from the year 2000 when, as per the Washington Agreement, they sold roughly 400 tonnes of Gold. Year on Year Central Bank Gold Demand increased over 550% in Q3 2011.

Coin sales (from the US and Canadian Mints) have risen by a factor of 8, requiring an additional 65 tonnes of the metal per annum, & ETF holdings account for circa 230 tonnes annually, compared to zero at the turn of the century.

Finally, China and India, the worlds most populous nations, who have always had an affinity for precious metals, are now collectively demanding approximately over 1600 tonnes annually, an increase of nearly 1000 tonnes per annum from what their demand was in 2000.

Together, the changes highlighted above represent an increase in physical demand of some 2000 tonnes each year, in a market that is capable of only producing 2,700 tonnes.

In the last year alone, physical demand (for bars and coins) has risen by nearly 130% in China, and by over 100% in both Germany and Switzerland. Less you think these increases represent bubble like numbers, China’s Gold Holdings (circa 1050 tonnes) still represent less than 2% of their total Foreign exchange reserves. This number is insignificant when compared to countries like the US, Germany, France and Italy – all of whom hold between 65 – 75% of their Foreign exchange reserves in gold bullion. Considering China has over \$3Tn in Foreign Exchange Reserves, a move to increase their bullion holdings to 50% of total reserves would imply demand of \$1.5Tn – equivalent to 10 years of total gold production at today’s prices!

With such stable supply characteristics, it is clear that a continued increase in the demand for physical Gold will be impossible to satisfy at existing prices.

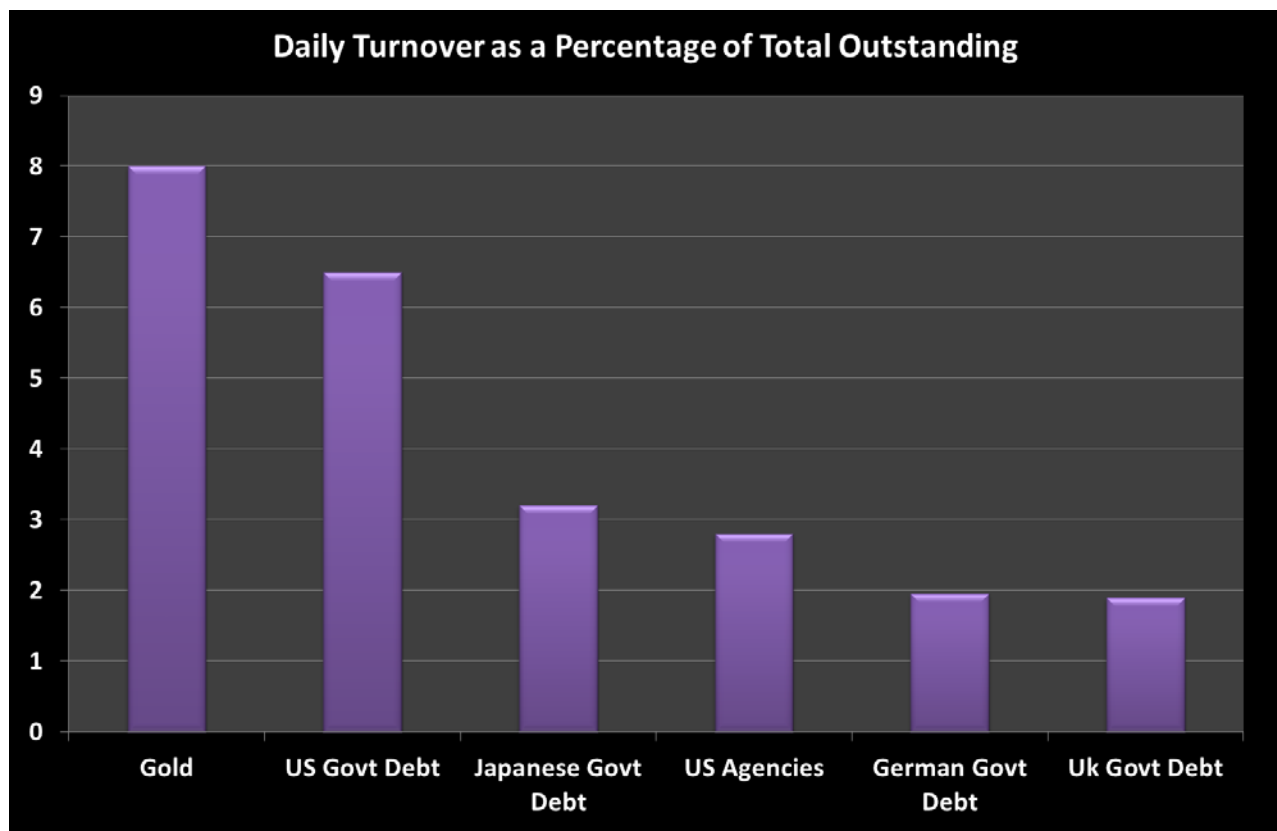
Gold Market Liquidity

One of the popular misconceptions surrounding Gold as an investment is that it is an illiquid asset. The image of a Gold bar locked in a vault collecting dust comes to mind, and people falsely assume it is not an easy asset to trade. This is not the case.

Data released by the London Bullion Market Association (LBMA) indicates that on a daily basis, roughly US \$21bn of bullion a day is **transferred** between accounts. This figure doesn't include the amounts the bullion dealers net off with each other. In the March quarter of 2011, an LBMA conducted survey into Gold turnover showed that total the total value of bullion traded per day was up to US \$240bn. This amount is far larger than any sovereign debt market with the exception of the US Treasury market.

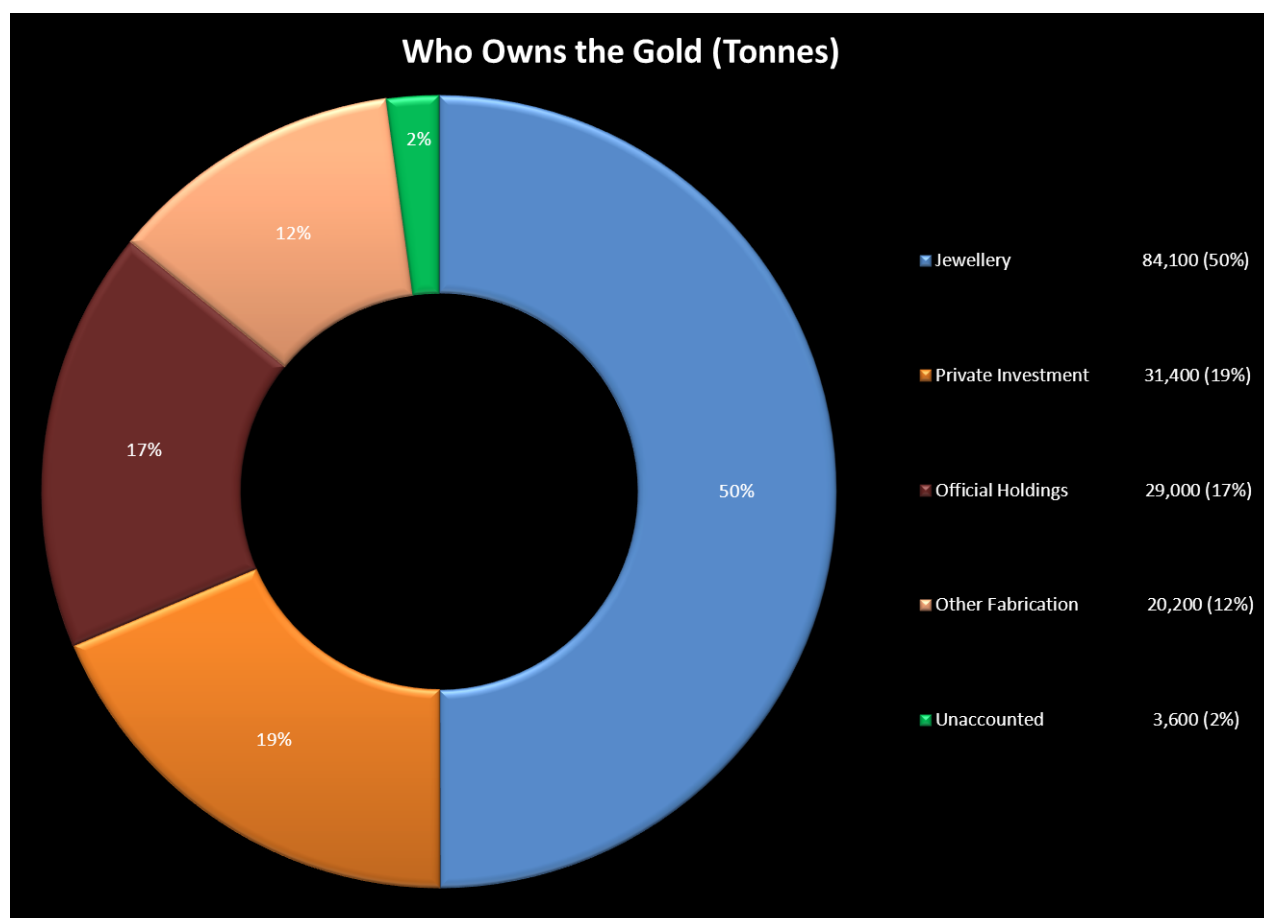
Furthermore, as highlighted in the graph below, the average daily turnover of Gold, as a percentage of total outstanding value (based on private and central bank holdings) is roughly 8%. This number is far higher than the markets for US Treasury bonds, as well as the sovereign debt markets for Japan, Germany and the UK.

What the data demonstrates is that Gold is in fact a highly liquid asset.



The size of the 'Investable Gold' Market

The chart below, based on GFMS and World Gold Council Data, highlights who owns the roughly 168,000 tonnes of Gold believed to be in existence as at the end of 2010.



Jewellery accounts for approximately 84,000 tonnes of Gold, 50% of the total above ground supply, whilst Fabrication accounts for a further 12%.

Private Investment (You and I) & Official Holdings (Central Banks) account for 60,400 tonnes, roughly 36% of total above ground supply. This is an important point to consider as it is only Central Bank and Private Investor holdings that are commonly thought of as 'near marketable' Gold (even if pawn shops are doing a roaring trade these days)

Based on the end September 2011 price of \$1622.00 – the current value of the 'near marketable' gold is roughly \$3.15 Trillion.

This figure is some \$400 to \$500 billion greater than the US Agency Market (\$2.7T) and any of the European Sovereign Debt Markets.

Unlike those, Gold is no one's liability.

Why Gold is Not 'Just' a Commodity

The final part of this section of the paper deals with why gold is 'not just a commodity'. To help communicate this message, we'll analyse the following

- The breakdown (allocation wise) of various commodity indices
- The volatility and drawdown of various commodities and of Gold
- The correlation of commodities vs. the correlation of Gold to broader equity markets
- The performance of Gold (and commodities) in periods of market stress

Before looking at those statistics, to help understand why Gold is not 'just a commodity' it pays to briefly consider why commodities have value at all. Unlike a financial asset, they do not throw off cash-flow or engage in business activity, so it's impossible to value them based on the criteria one might use to value the equity market for example.

Commodities have value in that they are needed for consumption. Oil is used to make petrol to fuel automobiles, or in the manufacture of plastics, rubbers, synthetics etc. Corn is used to feed livestock, feed humans, to produce sweetener, and recently, it has also been used to produce ethanol.

Gold is different. Apart from the small percentage of Gold that is used for fabrication, Gold is produced purely so that it can be stored – as a measure of value and maintainer of wealth. This is true even for jewellery. Historically and even today, jewellery in essence represents wealth. There is a reason we don't wear earrings and necklaces made of tin.

Acknowledging this, it is easy to understand why the stock to flow ratio (which we looked at earlier) is so low for most commodities, yet so high for Gold. Unlike Gold, commodities are produced purely for the purpose of consumption, and most production is consumed within 12 months.

From an investment perspective, any investor or asset manager who assumes they are getting a reasonable de facto Gold exposure by investing into a commodity index or a fund which tracks a commodity index will actually find they are getting minimal Gold exposure, as you will see from the breakdown of three of the major commodity indices highlighted on the next page.

You will also see that an investor with a 10% allocation to Gold will have a very different portfolio to the investor with a 10% allocation to commodities, from a return, drawdown and volatility perspective.

Construction of Major Commodity Indices – and the Weighting to Gold

Commodity Index	Gold Weight	Construction
Goldman Sachs Commodity Index	3.00%	Production weighted - contains 20 physical commodities. Nearly Two thirds is energy (oil/coal/gas)
Goldman Sachs Light Energy Index	7.00%	Production weighted - contains 20 physical commodities, but Energy Weights divided by a factor of four and other commodities increased proportionally
Dow Jones UBS Commodities Index	6.50%	Broad based exposure. Rebalanced yearly. Weights determined by liquidity, diversification, economic significance and continuity

Assuming an investor simply thought of Gold as another commodity, and wanted 10% of their portfolio exposed to this space. If so, their effective Gold exposure would most certainly be less than 1% of their total assets, based on the breakdowns of the above indexes.

Volatility and Drawdown

When compared to other commodities, not only is Gold is far less volatile, but it is also far less likely to suffer precipitous falls in value in periods of market stress. This is due to a number of factors including;

- Gold's Exceptionally High Stock to Flow Ratio
- Gold's diverse geographical production breakdown (no single country contributes more than 14% of supply), which is higher than most commodities (over 80% of Platinum comes from South Africa alone for example)
- Gold is less exposed to the business cycle
- Gold is not subject to adverse weather conditions (crop yields etc.)
- Recycled Gold makes up 40% of total annual supply at present, a figure much higher value than say copper (15%). This allows the market to absorb production shocks more effectively.
- Historical role as a monetary asset comes to the fore in periods of uncertainty

The table on the following page, which highlights the return volatility from 1991 to 2010, as well as the performance of Gold and other commodities during 2008, illustrates the lower volatility and 'minimal drawdown' characteristics that Gold, but not commodities, offers to investors.

Commodity Characteristics – 2008 Drawdown and Return Volatility

Asset Characteristics	2008 Performance	Volatility of Return (91-10)
Gold	4.3	15.6
Broad Commodities		
GS Commodity Index	-51.2	21.7
GS Light Energy	-43.0	15.3
Energy		
Energy Index	-58.2	31.2
Crude Oil	-62.3	34.4
Metals		
Copper	-56.8	25.3
Industrial Metals	-52.5	20.6
Platinum	-41.8	21.1
Food		
Agriculture	-30.2	18.6
Grains	-30.6	22.3
Livestock	-27.9	13.7

As you can see, Energy prices were the biggest losers throughout 2008, followed by base metals and agriculture etc.

Not surprisingly, the volatility characteristics mirror the 2008 drawdowns in that Energy prices display the highest levels of volatility, followed base by metals and finally the Food sector (agriculture, grains, livestock) of the commodities universe.

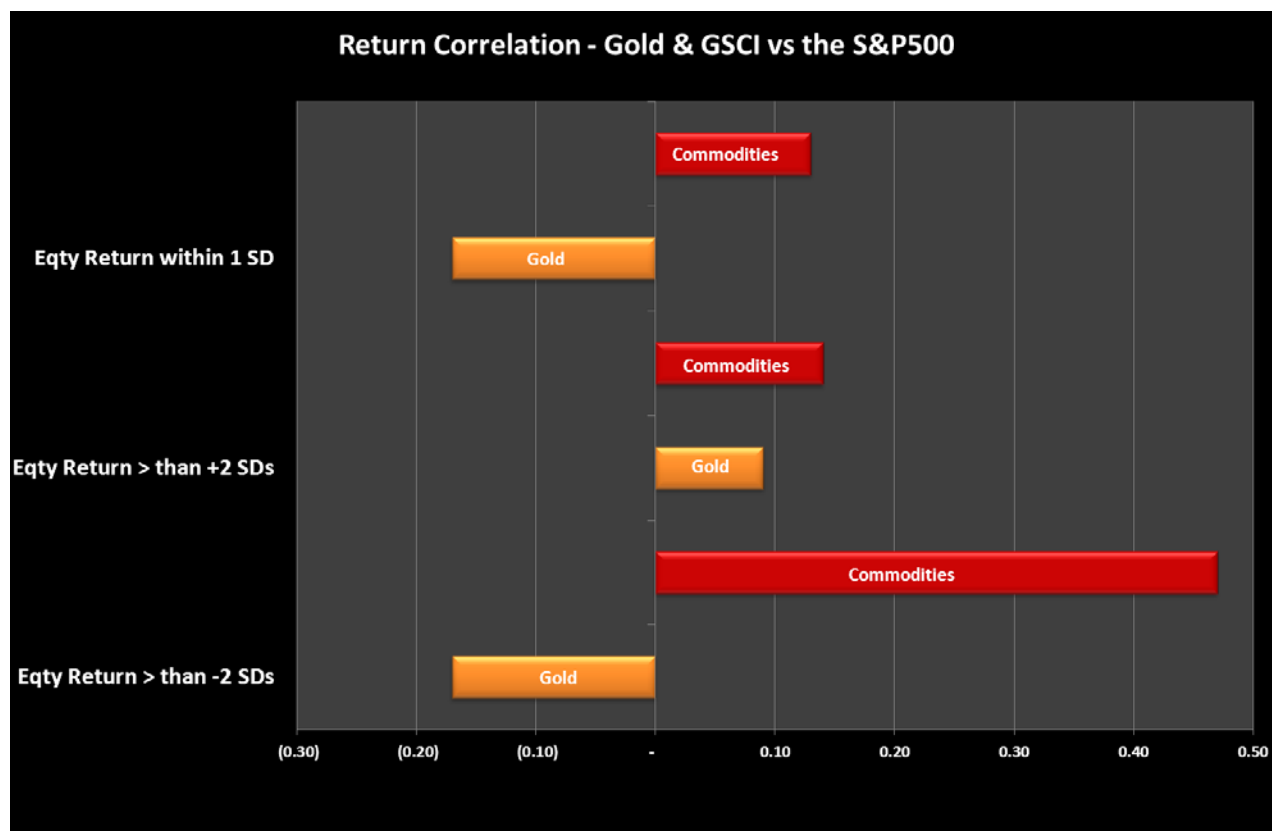
Investors in even a broad commodity index or commodity portfolio would have suffered a loss of at least 40% during 2008 on that component of their portfolio, compared to a 4% gain for Gold. This would have translated to a +4.5% return differential for a balanced investor with a 10% allocation to Gold.

This data provides conclusive evidence that Gold provides enhanced capital protection compared to commodities in general, and with significantly lower volatility than the majority of individual commodities, especially base metals and energy.

Gold's ability to better protect capital compared to a broader commodity exposure will become more clear in the section below, where we study the correlations of Gold and of commodities to the equity market.

Correlation

The chart below, which shows the correlation of both Gold and commodities to the equity market (using data going back to the 80s), highlights very clearly the difference between the returns an investor in commodities will receive, versus an investor with an allocation to Gold alone.



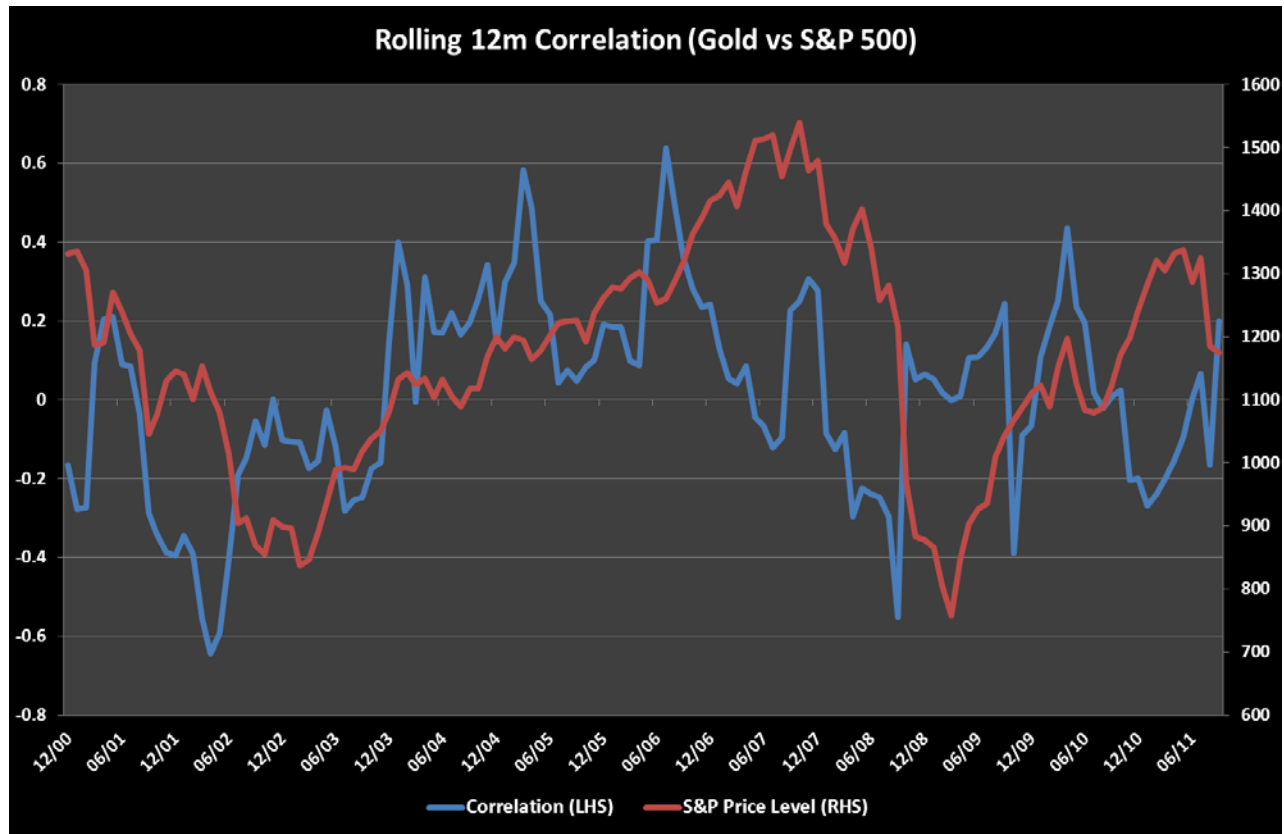
When market returns are stable (within 1 standard deviation of the mean), Gold is negatively correlated to risk assets. However, when markets rally strongly (more than 2 standard deviations) – Gold's correlation tends to turn positive, benefiting from the rise in all asset prices, whilst commodity correlations remain more or less stagnant (albeit higher than that of Gold).

On the other hand, in strong 'risk off' environments (more than 2 standard deviations) Gold really comes into its own as a portfolio diversifier and protector of capital. In these extreme periods of market stress, Gold reverts to being the traditional, negatively correlated asset that it is, preserving investor wealth.

Unfortunately for the commodity investor, in these periods, commodities tend to display much higher than normal correlations to the equity market, failing to help a diversified portfolio protect capital.

As mentioned earlier, this was clearly evident throughout 2008 when Commodities dropped some 40% over the year. Despite a 3m period where Gold also fell, in 2008 Gold was up 4%.

The chart below, highlighting the rolling 12m correlation of the gold price to the equity market, brings the correlation of Gold to 'Risk Assets' out in more detail, providing further evidence that, over the last decade, correlations have risen when risk assets rally, but turn negative when risk assets are falling. This helps explain why a portfolio manager with an allocation to Gold will tend not suffer from a relative performance perspective versus his competitors without Gold, even when markets are rallying.



The diversification benefit that Gold offers versus commodities in general is extended to the broader 'alternative investment' universe. Hedge Funds typically display correlations above 0.50 to listed equities (and running toward 0.80 at end Sep 11), as do Private Equity Investments.

A longer term analysis of major market shocks (LTCM, Gulf War I, 9/11 & 2002 recession, the GFC and the early stages of the European debt crisis) highlights that again, an investor would be better holding Gold, rather than a basket of commodities or 'alternatives' for downside protection.

In all of these periods, the Gold price rose. Not only did 'risk assets' fall in these periods (between 10-30%) but all other 'Alternative' Investments fell in value as well (with the exception of oil, which spiked during the 2002 recession and Gulf War I).

Section 2 Conclusions

The information about the Gold market contained in this section has demonstrated several key attributes that should help investors understand why Gold is not just another commodity, and why investing in Gold can and should be part of a sound diversified investment strategy

As we have seen, the Gold market is

- Limited and Most importantly, Stable in Supply
- Unlikely to see huge increases in production
- Subject to increased demand
- Highly Liquid
- Larger than any of the European Sovereign Debt Markets

Section 3: Gold – Where We Are Now?

Is Gold Overvalued?



A look at the price of Gold in the context of:

- Gold vs. Inflation: CPI Adjusted
- Gold vs. Equities: The Dow/Gold Ratio
- Gold as Percentage of Total Financial Assets
- Gold Stocks vs. the Broader Share Market
- Gold vs. Gold: Current Bull Market vs. the 1970's
- Gold vs. Cash: Gold vs. US Base Money Supply

SECTION 3: GOLD – WHERE WE ARE NOW

Section 1 highlighted the positive performance gold investors have received from December 1999 through to September 2011 as well as the benefit an allocation to Precious Metals would have had on diversified balanced growth portfolios over the corresponding period.

The purpose of this section is to answer the next logical question we must consider which is,

IS GOLD OVERVALUED AND IN A BUBBLE?

Before we answer that, let's quick take a look the beginning of the Present Bull Market in Precious Metals

Present Bull Market Beginning

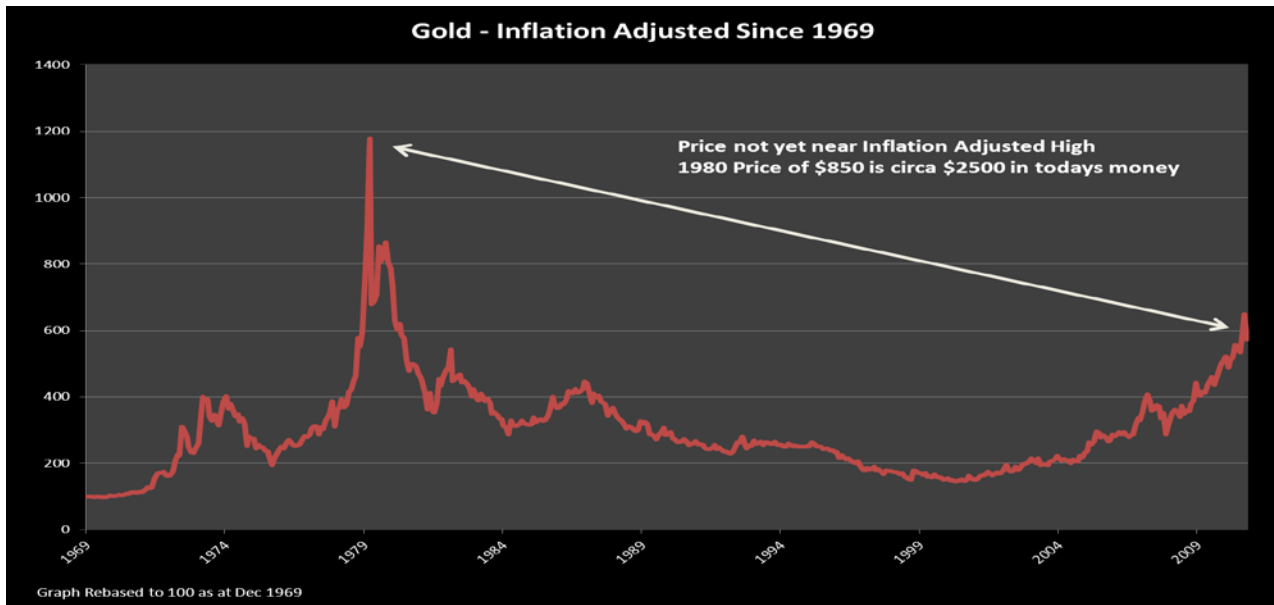
- The 20 year bear market in Gold that began in February 1980 reached its nadir around August 1999, right around the time Gordon Brown, then Chancellor of the Exchequer, made the decision to offload Britain's Gold Reserves
- Brown sold 400 tons for prices between \$256 and \$296 an ounce, a decision which in a decade alone cost the taxpayer over \$13 billion dollars
- Since then, Gold has gone up almost every year, averaging a return of circa 15% pa, as was illustrated in Section 1

The measures we'll look at over the next several pages will put the Gold price, currently around \$1620 per ounce, in a historical context, and will **demonstrate conclusively that Gold is still inexpensive**, and most certainly is not in a bubble.

Furthermore, by looking at Gold Shares as well as the timing of price movements between the bull markets, we'll see what proportion of Global Assets we can expect Gold (and Gold Shares) to reach, and the rapid price appreciation we can expect to see before this bull market is finished.

Gold vs. Inflation

Comparing Gold to its official Inflation Adjusted high (indexed to start at 100), demonstrates clearly that the current Gold price is not 'a bubble.'



Key Insights from the above chart:

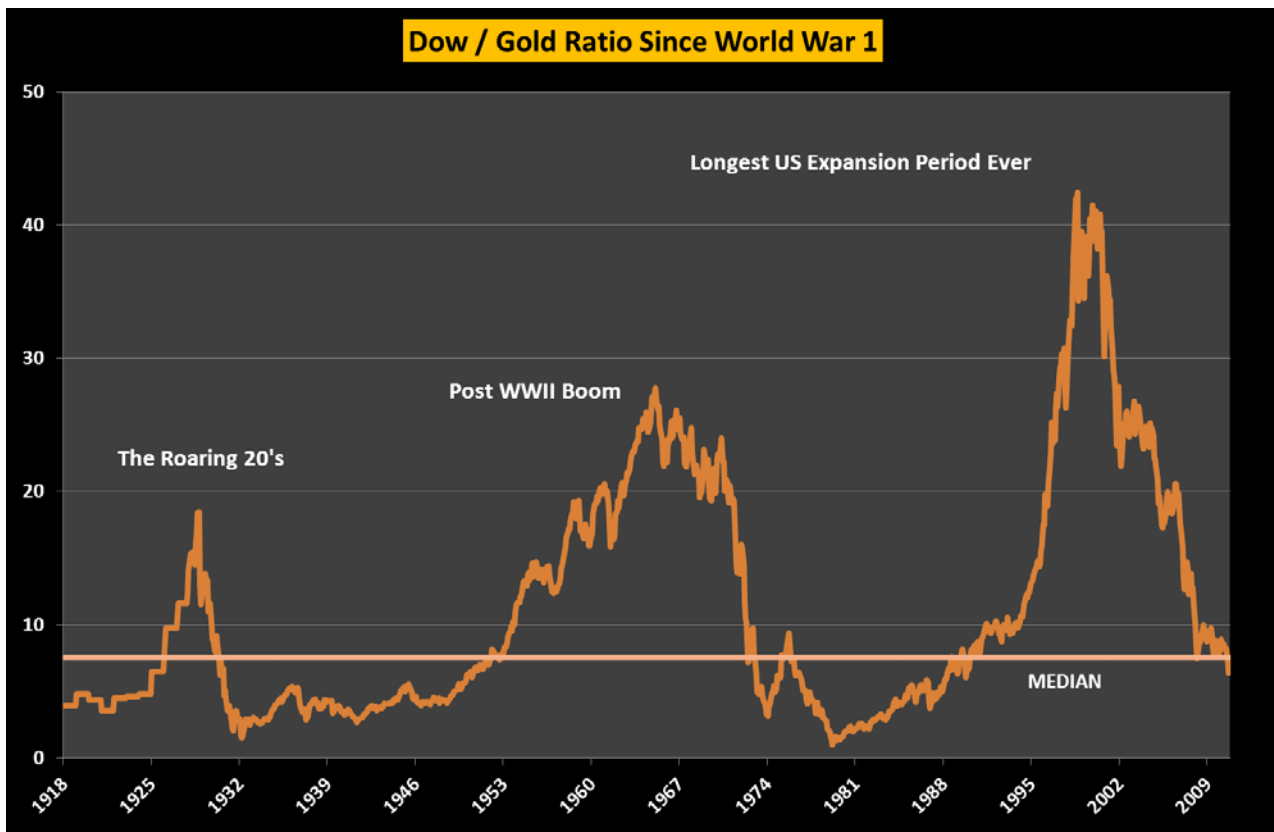
- Gold is nowhere near its Inflation adjusted High from the 1970's
- Gold would need to be near **\$2500** to have kept pace with inflation*
- In the previous bull market, the Gold price went up by a factor of 24
- In this bull market, its only gone up by a factor of 6.5

*NOTE: This paper uses the US Governments Official Inflation figure (calculated by the BLS) in the above calculation. CPI calculation methodology has changed drastically in the last 30 years, to include 'product substitutions', as well as 'hedonic adjustments'. There have been over 30 of these adjustments, **each one of them lowering the CPI rate**. If the CPI rate was calculated the same way as it was back in 1980, it would be significantly higher than has been officially documented. **The inflation adjusted Gold price today, when calculated using the same CPI methodology as existed in 1980, is over \$7000.00**

Some Examples of BLS Adjustments to CPI through time:

- When a certain food price rises, the BLS substitute the product. In 2007-2008, the 'Food' component of the CPI rose just 4%. This compared to over 11% as per the Farm Bureau, who calculate price changes annually based on the same basket of food items.
- In 2003-04, 27 inch TV retail prices were unchanged at \$330. Logic suggests an inflation rate of zero. The BLS, making an assumption that the quality of the TV screens had improved, used a price of \$195 in the 2004 CPI calculation, a drop of 29%.
- Geometric weightings to decrease the percentage of certain sections of the economy. For example, Health Care, which has seen price rises far in excess of CPI, only accounts for 6% of the overall CPI calculation, despite accounting for roughly 15% the average Americans spending

The Dow/Gold Ratio

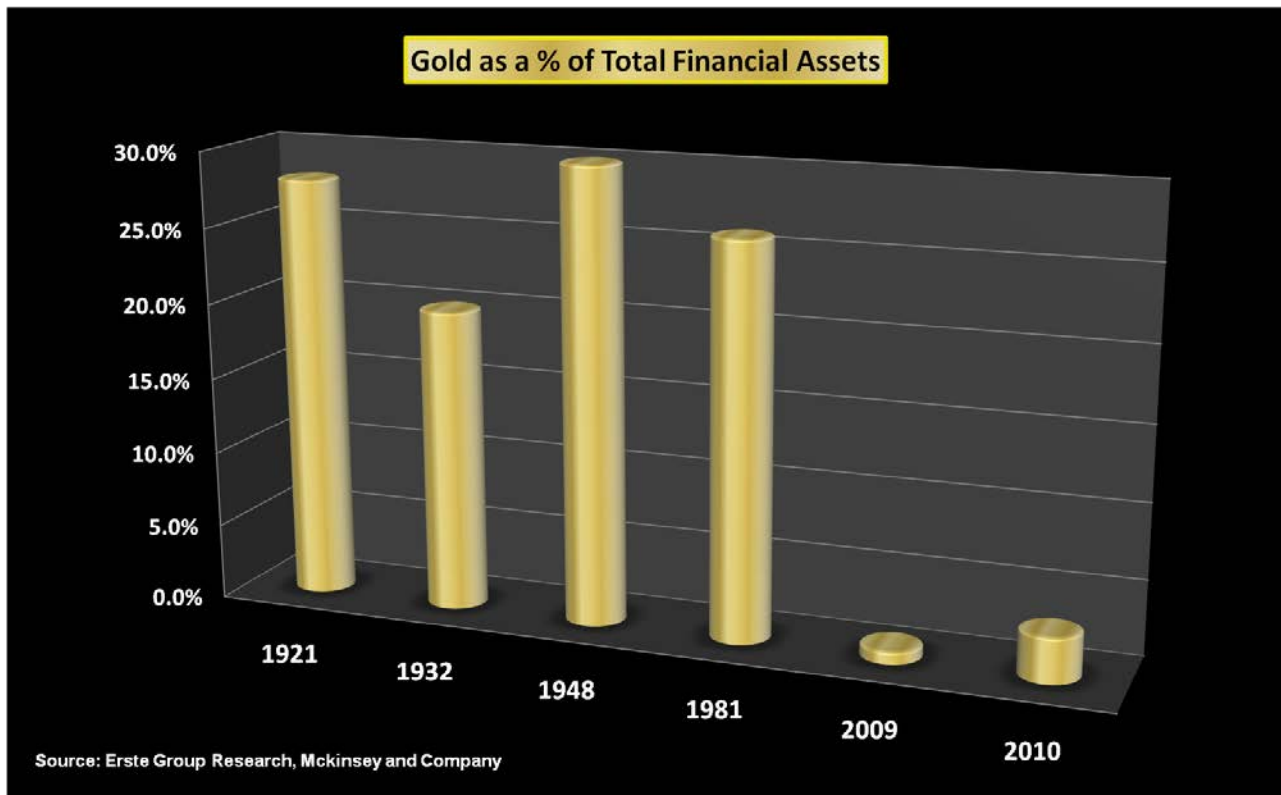


Key Insights from the above chart:

- In every market cycle, the Dow/Gold ratio has troughed around 1
- **Peak 1:** The 'Roaring 20's' with new technologies like radio, automobiles and moving picture. Irving Fisher says "*Stocks have reached what looks like a permanently high plateau.*" Period ends in the Wall Street Crash and the Great Depression
- **Peak 2:** Post WW11 boom lasted until the end of the 1960's. By this time, the Inflationary effects of the Vietnam War, LBJ's Great Society and Nixon closing the Gold Window set the scene for Stagflationary 70's and the last Gold Bull Market
- **Peak 3:** The Longest period of US economic expansion ever, fuelled in no small part by 20+ years of easy money. New media, the Internet, Off-shoring. Then came the NASDAQ crash, September 11, nearly 10 years of foreign wars and ultra-low lending policies, which triggered the housing bubble and ultimately led to the GFC
- **The Dow/Gold ratio is currently just under 7, therefore assuming no move in the price of the DOW, the Gold price will head to over \$10,000 per ounce**
- During the Depression, it took 42 months for the Dow/Gold ratio to trough just above 1
- During the 60's it took nearly 15 years (from January 1966 to February 1980)
- The difference between the Depression and the 1970's Bull Market is that post 1971, the Dollar was no longer linked to Gold. As a result, like today, authorities embarked on aggressive stimulus plans to prevent an economic contraction, but which ultimately only served to delay the forces of correction and sparked a boom in the Gold price.
- In the current cycle, **the Dow/Gold ratio peaked in August 99** – a repeat of the previous 15 year cycle would indicate that Gold should peak relative to Equities in late 2014, at prices (and relative values) significantly higher than they are today

Gold and Gold Stocks As A Percentage of Total Financial Assets

The chart below highlights how large a portion Gold and Gold shares make up of Global Financial Assets at the end of a bull market in Gold

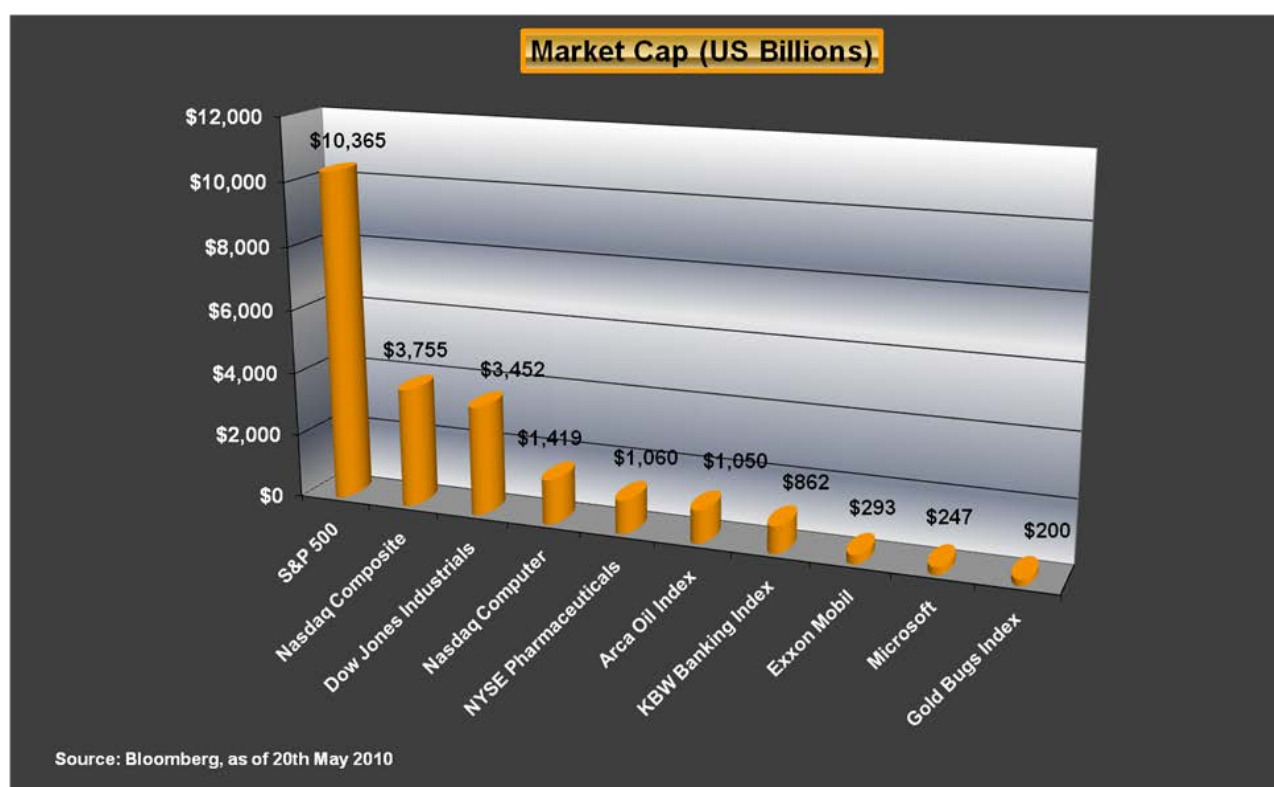


Key Insights from the above chart:

- After World War 1 Gold and Gold stocks were circa 28% of Total Financial Assets
- During the Depression this number reached approximately 20%
- After World War 2, circa 30% of Total Financial Assets were in Gold and Gold shares
- After the Stagflationary 70's, which was the last major bull market in Gold, the ratio was approximately 26%
- At a minimum, based on historical precedent, we should expect Gold and Gold shares to comprise some 20% of Total Financial Assets at the end of a Bull Market
- **Currently the ratio stands at somewhere between 3 and 4%**

The circa 3-4% that Gold and Gold Mining companies makes up of Total Financial Assets is despite Gold having risen six-fold this decade to a nominal price above \$1620/oz. This helps highlight just how much money has been created in the last 30 years since the Dollar went off the Gold Standard and how large the total pool of global financial assets has become.

Large Cap Gold Stocks vs. Other Equity Valuations



Key Insights from the above chart:

- The total market capitalisation of the Gold Bugs Index is tiny in relation to the size of the S&P 500
- The HUI Gold Bugs Index, made up of the 15 largest public Gold Mining companies (Barrick, Goldcorp, Newmont etc), has a market capitalisation less than individual companies like Exxon Mobil, Microsoft and Apple
- There is enormous potential price appreciation in Gold stocks (especially mid cap and juniors) if even a small percentage of retail investors and the asset management community decided to allocate a portion of their capital to this market

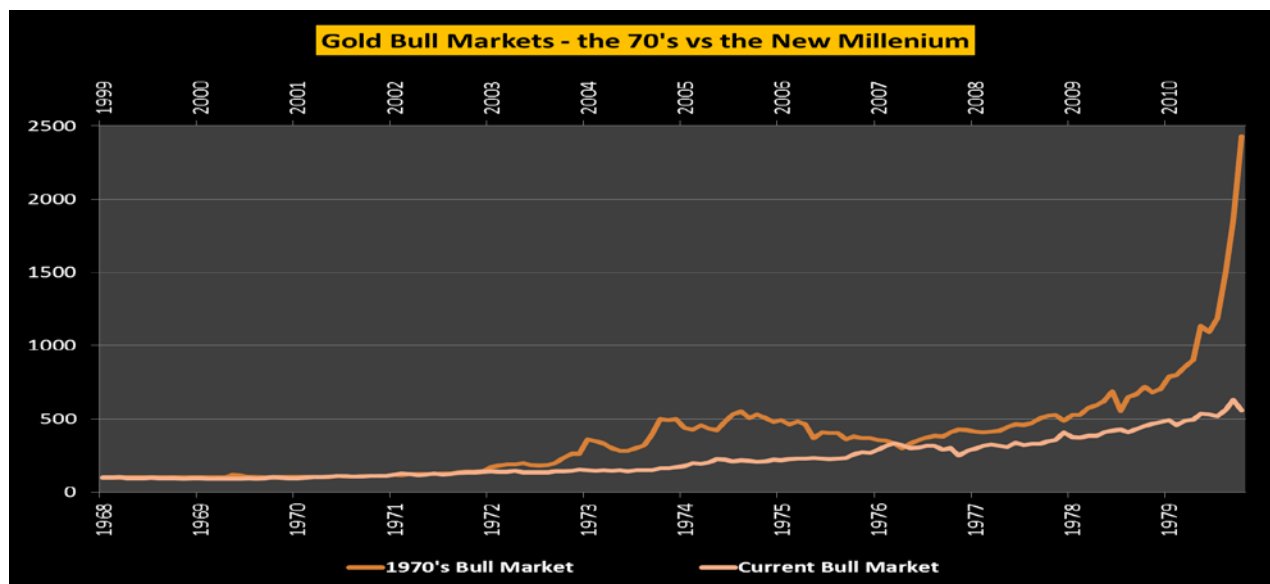
As a final comparison vs. the Equity Market, consider the following. In the year 2000 alone, at the height of the NASDAQ 'Tech Boom' – some **\$223Bn** was raised by 'Technology Stocks'. In 2010, a decade into the Gold Bull Market, Gold Mining companies raised just **\$12Bn**.

Over the entire 11 year Gold Bull Market, estimates suggest only **\$80Bn** has been raised by Gold Mining companies, **essentially one-third of 1 years capital raising by 'high tech'** during the NASDAQ boom.

It is difficult to give much credence to the 'Gold Bubble' story when, per annum, companies in the Gold Mining sector are raising only 5% of the capital that private investors contributed to 'Technology stocks' over a decade ago.

Gold v Gold – The 1970s's Bull Market vs. the New Millennium

The chart below (indexed to 100) was calculated using monthly movements in the Gold price across two time periods, the 70's Bull Market from May 1968 (\$35) to February 1980 (\$850), and the current bull market, from December 1999 (\$291) to September 2011 (\$1622)



Key Insights from the above chart:

- Despite the fact that the Gold price has moved from under \$300 to circa \$1620/oz., we have not seen the type of price movements one typically expects at the end of a bull market
- Whilst the easy money has been made, this bull market is still more or less in 'stealth mode'
- There is still room for significant price appreciation based on the metrics we have observed in other parts of this section of the paper
- A repeat of the 70's would foreshadow explosive returns ahead of us in Gold
- We are most definitively not in a Gold bubble, but when it does come, we will see a 'mania' stage, where the Gold price goes 'off the charts'

Gold vs. the US Base Money Supply

To calculate what the price of Gold might need to rise to in order to back the US Monetary Base, we simply need to take the current US Money Supply (Base Money) and divide this by the 8,133 tonnes of Gold purported to be held by the US Treasury.

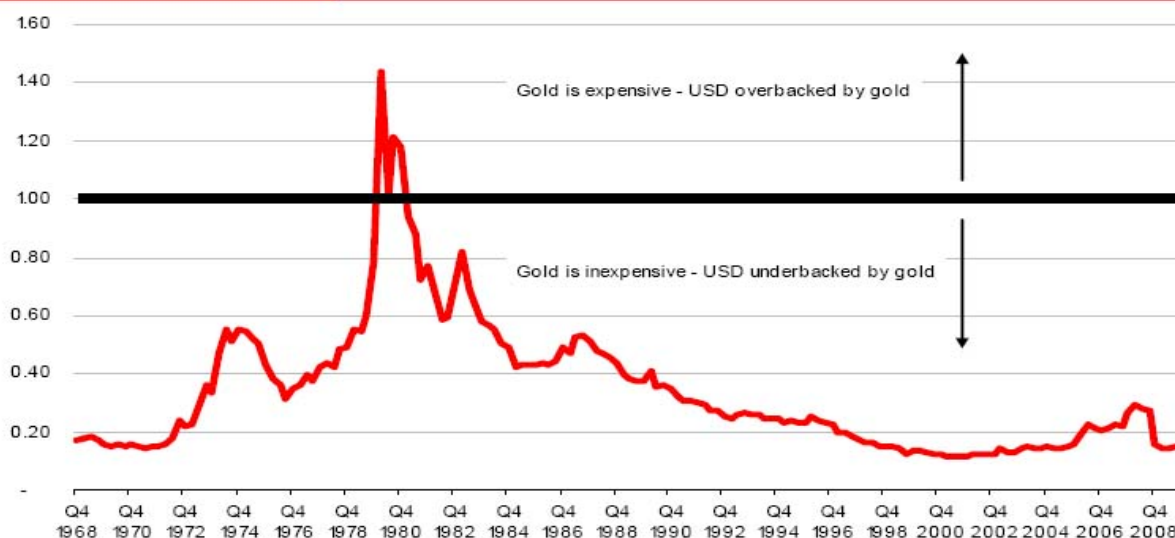
Performing this calculation is not merely a theoretical mind game, but in fact recreates the Bretton Woods agreement in terms of how the value of the USD was measured. Note that the Federal Reserve Act specified that the Coverage Ratio of the USD to Gold should be 40%.

The table below, calculated by taking the Money Base at various points in time since Nixon closed the Gold window, and dividing it by Treasury Gold holdings (unchanged since 1971), highlights clearly that if the USD is to be backed by Gold (in accordance with either Bretton Woods or Fed policy), then the Gold price has a lot of catching up to do.

Year	Money Base (\$US Bill)	US Gold Holdings (millions of oz)	Gold Price (100% Backed)	Gold Price (40% Backed)
1971	\$66.00	261.5	\$252.39	\$100.96
1980	\$133.00	261.5	\$508.60	\$203.44
2000	\$636.00	261.5	\$2,432.12	\$972.85
2008	\$850.00	261.5	\$3,250.48	\$1,300.19
Today	\$ 2,600.00	261.5	\$ 9,942.64	\$ 3,977.06

For those who think that \$10,000 Gold is an implausible number, consider that in 1980, at the height of the last Gold Bubble, the Gold Price actually overshot 100% backing of the US Money Base. At the time, US Treasury Gold holdings were worth approx. 1.3-1.4 times their 'fair value' based on this metric. The chart below highlights this quite clearly. **To recreate the 1980 'bubble' – the Gold price would have to hit approximately \$13,000 today. This number assumes no further money printing, or "quantitative easing."**

Gold is very cheap - at current prices, the USD is only 15% gold backed



Source: SG Cross Asset Research

Section 3 Conclusions

- There is no doubt we are in a Gold Bull market, however the Gold price is still inexpensive and it has not yet come close to delivering the price appreciation and returns that Gold bull markets have historically delivered
- There is no reason to assume this Bull market is any different from the rest and therefore we should expect continued price appreciation
- Gold is still undervalued vs. all of the following metrics
- Nominal price adjusted for Inflation, and especially unadjusted for 'Real' Inflation
- The Equity Market
- As a percentage of total financial assets
- Compared to its last bull market
- As a backer of the Money Supply
- We can expect Gold to continue to outperform equities and can expect it to be a much larger percentage of Total Financial Assets by the time this market is through.
- We'll know that we haven't reached a top in this cycle until we have a 'mania stage', where price appreciation goes 'off the charts'.

Section 4: Traditional Asset Classes

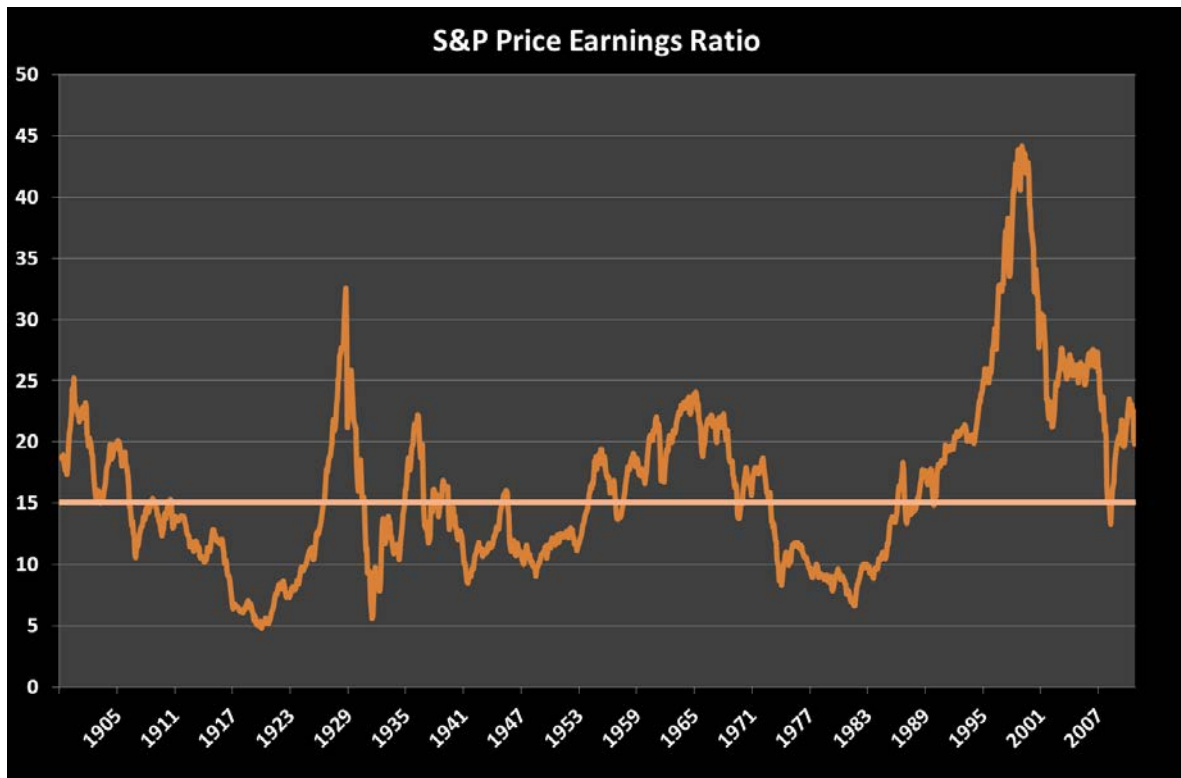


A Look at the Current Valuation Levels
in the Equity, Property and
Bond Markets

SECTION 4: TRADITIONAL ASSEST CLASSES

Equities

To help analyse whether or not the equity market is attractive at current levels, consider the graph below, highlighting the cyclically adjusted P/E ratio of the S&P 500 since 1900.



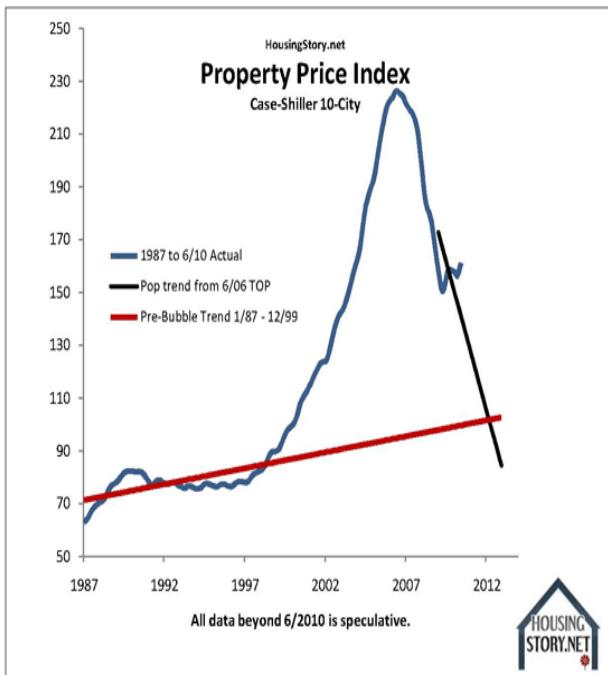
Key Insights from S&P 500 P/E Ratio Chart:

- **A P/E ratio of 20 highlights clearly that equities are not cheap at current levels**
- The median P/E ratio over the last 110 years has been just over 15
- Typically, at the end of a bear market in stocks, investors won't pay more than 5 to 6 times earnings, and **every Equity bear market** has ended with a P/E ratio well below 10, indicating that equity prices could halve from here.
- A look at the Dividend Yield ratio of the same index paints the same picture, with a current reading well below the median, indicating that equities are expensive
- Stocks enjoyed a bounce from early 2009 to early 2011 due to the unprecedented and unsustainable levels of fiscal and monetary stimulus governments deployed.
- This is not dissimilar to the last major equity bear market began in the mid 1960's, which saw a brief bounce in the late 60's. This bounce didn't last, and the equity bear market continued on into the early 1980s, with the P/E ratio ultimately dropping to about 6.5
- In an environment of increased political dysfunction, rising savings rate, greater macro-economic volatility, high unemployment, unprecedented levels of personal and public debt, building inflationary concerns and with pressure sure to come on sovereign borrowing costs (think Europe), there is significant risk in equity valuations at current levels
- As a result, unless this time it's different, we can expect this ratio to drop over the next decade

Property

Despite the huge fall in residential property prices in the US and parts of Europe, prices are still subject to further downside pressure due to all the factors mentioned above, indicating that the bubble may still have more 'bursting' to do. Government and Central Bank measures to 'protect homeowners' have only served to delay the full unwinding of the excessive speculation that took place in the residential property market

The graphs below highlight what could happen to house prices should they merely revert to their longer term medians

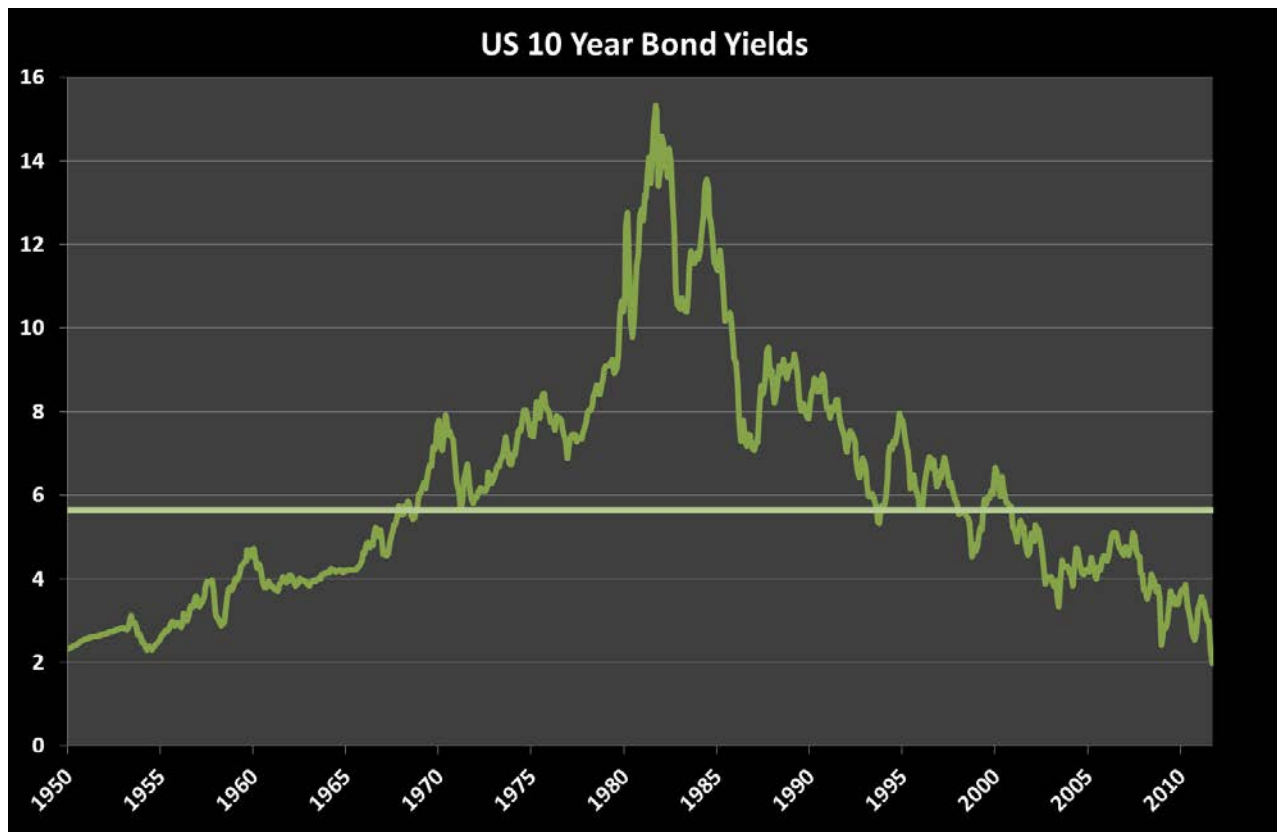


Key Insights from the Property Price Index Charts:

- Based on the Case-Shiller 10 City Property Index, Housing Prices would need to fall circa 50% to reach their longer term median
- Based on the FHFA's data they would need to fall an additional 20%
- Household Mortgage and Consumer Debt is still near all-time highs (around 110% Debt to Income Ratio) according to Federal Reserve Data, in an economy with high unemployment and rising levels of home repossession
- The data indicates the outlook for property is fragile at best
- There will be severe ramifications and risk for any financial institutions still significantly exposed to the Housing Market
- The US taxpayer is significantly exposed via their ownership of Freddie Mac / Fannie Mae
- Whilst 'Foreclosure Gate' was more of a 2010 story, the problem has not gone away, and there remain millions of homeowners 'underwater' on their property who can no longer service their mortgages.
- The strain on homeowners, coupled with the mortgage banks unwillingness to crystallise losses (by forcing people out of their homes and selling them) indicate that the natural bottom in the housing market valuations is likely still some way off in the future.

Bonds

As the chart below of the US 10 Year Bond Yield shows, despite some short term corrections along the way, US Treasuries have been in a bull market for over 30 years. Current yields are sub 2% pa in nominal terms. This represents an all-time low in bond yields, at a time when the public finances of the US (and most of the developed world) have never been so precariously placed.



Important Considerations about the US Debt Situation and the US Bond Market:

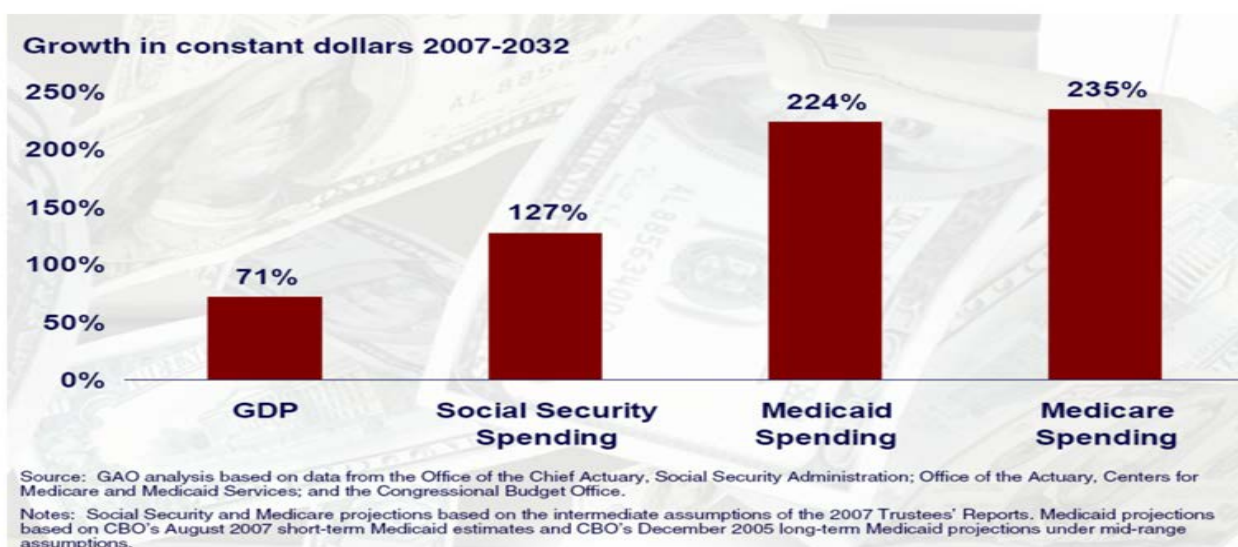
- Real Yields on 10 Year US Debt are approximately minus 2% after official inflation but before taxes, meaning that investors are practically guaranteeing a loss on their money with any dollar they lend to the US Government today
- The US Government currently borrows \$6 billion per day – a number that translates to \$20k per taxpaying American annually
- Annual Budget Deficits are running at or near 10% of GDP
- The deficit – equal to roughly \$1.5T per annum, accounts for 37% of Total Federal Spending
- National (Federal) Debt is over \$15T, or 1 full year of GDP, a number which translates to over \$100,000 per US household.
- Total debt in the economy is circa \$55T (before accounting for unfunded future liabilities like Medicare and Social Security)
- Since 1961, the US Government has never repaid even \$1 of debt – total debt outstanding has never gone down
- It took the US Government 191 years (1791-1982) to run up its first \$1T in Debt

- In the last 3 years alone, nearly \$4.5T of Public Debt has been accumulated
- To spur the recovery, and keep Federal borrowing costs down, The Federal Reserve has provided unprecedented levels of monetary stimulus, aiming for higher levels of inflation, **with the intention** of further reducing the purchasing power of the income stream and capital to be repaid for lending to the US Government
- David Walker (Comptroller of the CBO) predicts that to return to surplus by 2040, **Federal Spending would need to be cut by 60% or taxes would need to be doubled**
- Mandatory spending already exceeds tax revenue in the USA. With social security and Medicare/Medicaid spending set to increase at substantially faster rates than GDP going forward (see chart below), due largely to retirement of America's baby boom generation **(10,000 retirees per day for the next 18 years)** the borrowing requirements of US Federal Government are only going to get larger from here, absent an enormous change to their social welfare model
- Any attempt at genuine fiscal austerity in the United States to control costs and the Federal debt blowout we are witnessing can only come at the cost of a severe economic contraction, considering the \$1.5T in debt growth per annum vs. only a \$300bn increase in GDP
- Short of continuing to monetise debt (which brings inflationary concerns), unless there is no longer an interest rate cycle, US debt is a bubble and yields will move decisively higher in the coming decade

The United States Government, along with the US public, is in an incredibly perilous financial position. It begs an obvious question,

"Why would anyone lend this institution money for 10 years for less than 2% (before taxes and inflation)?"

Projected Growth in Mandatory Spending vs. GDP




Source: GAO-U.S. Financial Condition and Fiscal Future Briefing; January 2008.

Section 4 Conclusions

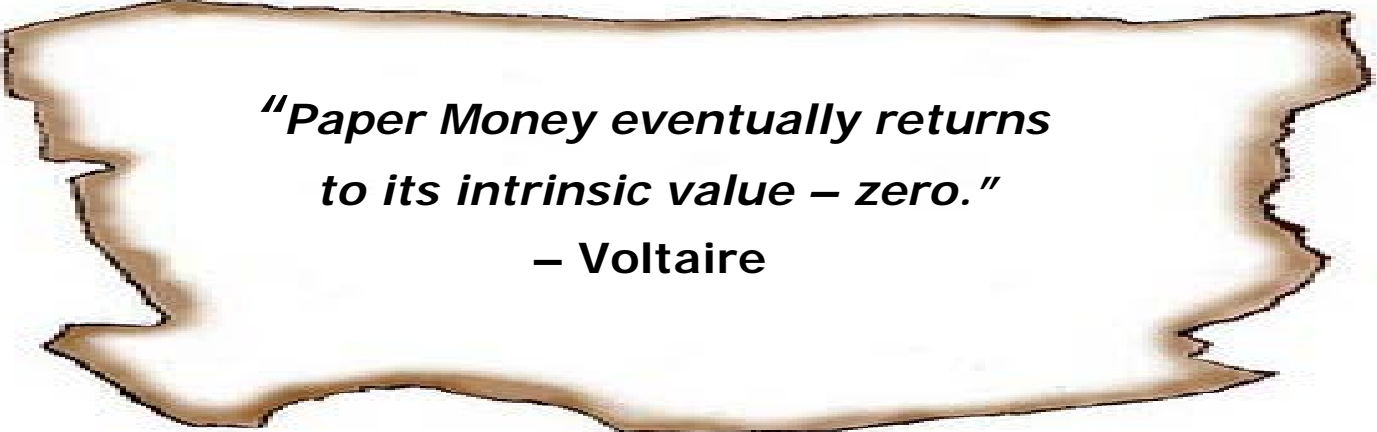
- Valuations in the broader asset markets are still well above median levels and significantly above the levels we would see at the bottom of bear markets
- Whilst not as overvalued as they were before the GFC, both Equities and Property are still expensive and would need to drop much further just to reach their long term medians
- The Bond market is at all-time highs, despite record deficits, record government spending, high unemployment, foreign wars and a Federal Reserve that is actively printing money
- The majority of these characteristics are evident all across the developed world, with the US providing an appropriate proxy to highlight the risks that are evident in financial markets across the globe
- These asset classes comprise some 90% of Traditional Balanced Growth Investment Portfolios
- **Prudent investors would be wise to reduce their allocations to all of these asset markets over the following decade**

Section 5: The History of Money



***"The great merit of gold
is precisely that it is scarce; that its
quantity is limited by nature; that it is costly
to discover, to mine, and to process; and that
it cannot be created by political fiat or
caprice."
– Henry Hazlitt***

A Look at Gold and FIAT Currency as a Store of Value through Time



***"Paper Money eventually returns
to its intrinsic value – zero."
– Voltaire***

SECTION 5: GOLD VS. FIAT MONEY

The purpose of this section is to look at the performance of Gold and Fiat Money as stores of value through time.

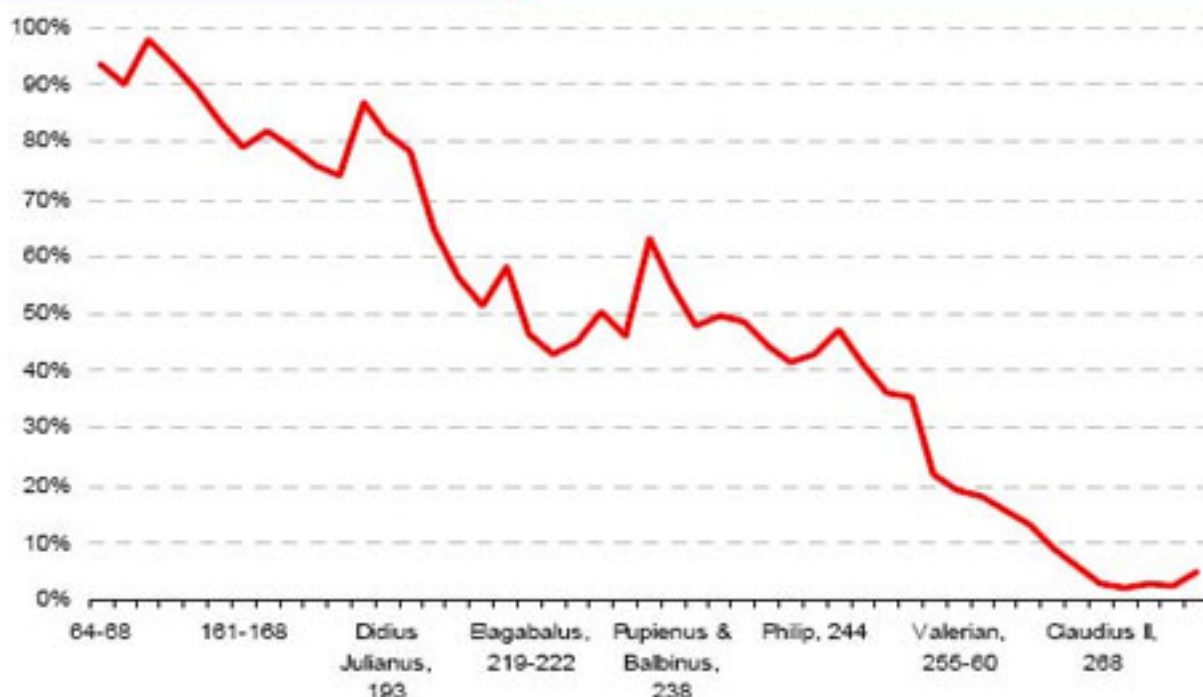
- Gold has been used and accepted as a store of value for over 6000 years. The first recorded use of Gold as what we know today as money was in roughly 700BC, when Lydian (modern day Turkey) merchants produced the first coins
- This was followed by The Athenians who, learning from their Lydian predecessors, also used Gold and Silver as Money, which they called Athenian Owls - in around 407 BC
- Throughout history, not only has Gold always been accepted as money, but it has always been the free markets preferred choice of money. The reason for this is simple in that Gold best satisfies all the prerequisites of sound money, namely that it is:
 - A Medium of Exchange
 - A Unit of Account
 - Durable
 - Divisible
 - Portable
 - Fungible
 - **A STORE OF VALUE**
- Gold's scarcity, and most importantly, the stability of its supply, is what has allowed Gold, and Gold alone, to maintain its value, and to protect capital, through time
- Conversely, the **history of FIAT currency is lamentable.**
- Since the Athenians in 407BC, over 3500 FIAT currency systems have been created. Each and every FIAT currency that was ever invented was ultimately devalued and eventually collapsed, or is currently in the process of devaluation
- From the Assignat to the German Mark, from French paper francs to the US Continental dollar, even the Roman denarius, all FIAT currency ended up on the scrapheap of monetary history as a result of excessive creation, ultimately leading to excessive inflation and the eventual, inevitable loss of faith in the paper
- Like Modern day America, Europe and Japan – all these currencies were backed by powerful governments who promised they would act with integrity to protect the value of the currency they issued. History has demonstrated with absolute clarity that it is not prudent to have faith in this promise, as FIAT currency has a 100% Track Record of Failure

As General De Gaulle once said ***"Betting against Gold is the same as betting on governments. He who bets on governments and government money bets against 6,000 years of recorded human history."***

As such, the chart on the next page, which highlights the timeline of 'coin clipping' on the Roman Denarius, is instructional as to how Money not backed by Gold or Silver loses its value through time.

A Currency Crisis More than 200 Years in the Making

Silver content of a Roman denarius



Source: <http://www.tulane.edu/~august/handouts/601cprin.htm>

Key Insights from the Silver Content of a Roman Denarius Chart:

- At the start of the first century AD – during the reign of Augustus, the denarius was made up of nearly 100% pure silver
- Under Nero's rule (circa AD 64), the silver content of the denarius was reduced to 94%
- By AD 100 the denarius had been reduced to only 85% silver, and by AD 218 the denarius was more base than precious metal, with a silver content of only 43%
- By circa AD 260, the end of Valerian's reign, the denarius was barely 1% silver
- Records from the time of Diocletian show that, over the space of 4 centuries, from the time of Augustus's rule, the denarius had been devalued by a factor of **30,000,000:1**
- this point, due to the inflationary impact of 'coin clipping' most Roman citizens in the empire realised the denarius was most definitely NOT a store of value, and unsurprisingly, refused to accept it as a medium of exchange

It's important to ask why Emperors from Nero to Valerian felt the need to clip the coins so as to increase the money supply. It was primarily done to finance wars of 'pacification' in foreign lands, and to provide for social services (panum et circums, or bread and circuses) at home.

This state of affairs aptly describes the situation in America and the majority of the developed world today, none of whom can honour the massive debts they have incurred as a result of the creation and constant expansion of the social welfare state.

From the Denarius to the Dollar - The Not so Mighty Greenback

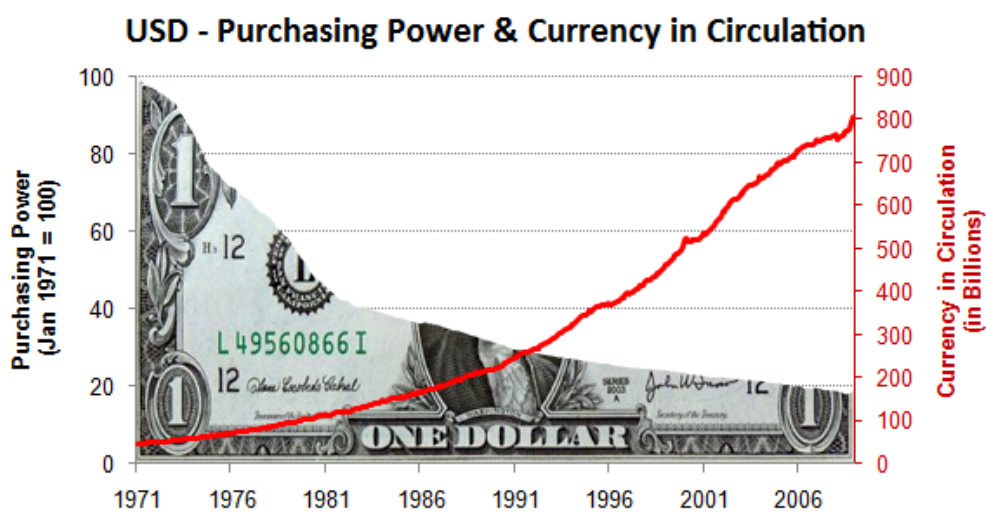


Two conclusions stand out when analysing the above chart, dating from 1775-2000:

- Between 1775 and 1913, despite the fluctuation in the value of dollar (depreciating periods tie in with the War of Independence and the Civil War), the dollar actually maintained its value over a period of 130 years, as it was typically backed by Gold
- Since around 1913 (the year the Federal Reserve was created – ironically with a mandate to protect the value of the dollar), the Dollar's value has fallen almost without interruption, comprehensively failing to protect purchasing power
- It has lost well over 95% of its value in just under 100 years

This extreme reduction in purchasing power isn't surprising considering the money creation we've seen this century, especially since 1971, the year Nixon 'temporarily' closed the Gold Window.

Money Supply since the Gold Window Closed



Important Considerations:

- In 1862, the first one dollar bill was issued as a legal tender note
- In around 1973, the 1 Trillionth dollar came into existence
- It took over **100 years to create those first 1 Trillion dollars**
- The **most recent Trillion** was created in **roughly 14 months**
- The Money (M2) stock of the US is now close to **10 Trillion dollars**

Perhaps the simplest way to illustrate the extreme reduction in purchasing power that occurs if one maintains their assets purely in paper money is to consider the following table, which converts a \$1000 cash investment into Gold Bullion at various points across the last 100 years.

<u>Investment</u>	<u>Year</u>	<u>Gold Price</u>	<u>Ounces</u>	<u>% Change</u>
\$1,000	1911	20	50	-99%
\$1,000	1971	35	28	-98%
\$1,000	1999	250	4	-86%
\$1,000	2002	300	3	-83%
\$1,000	2011	1622	0.62	-

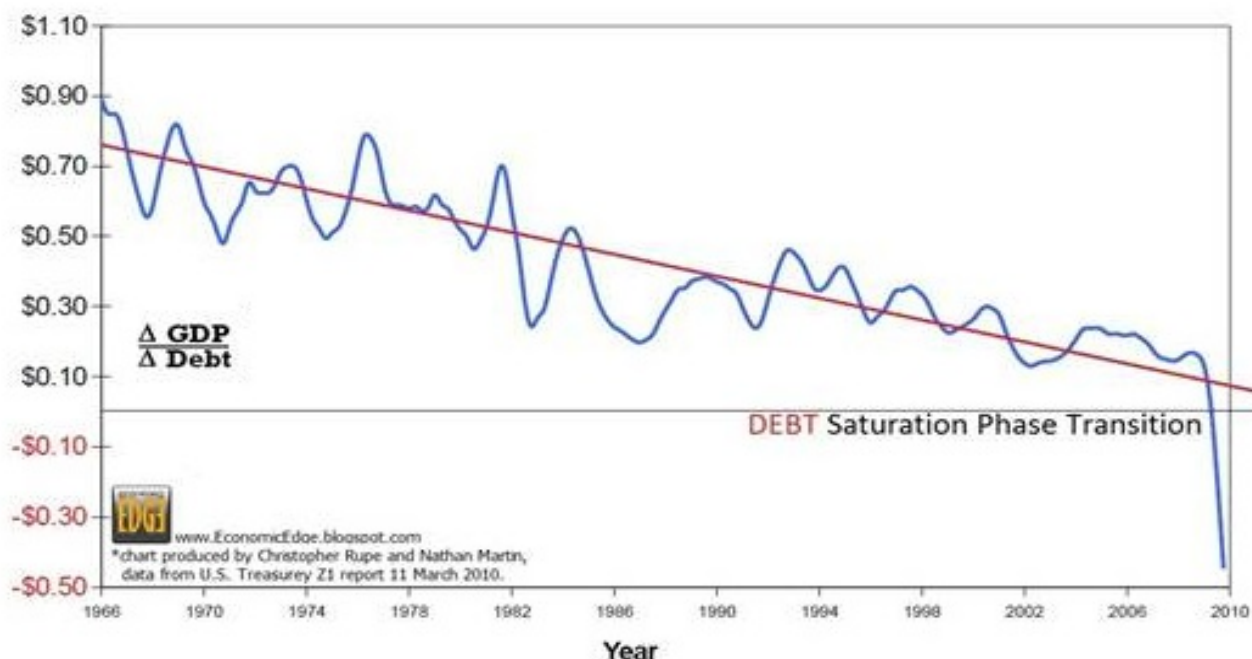
As you can see, 100 years ago you could buy 50 ounces of Gold with your \$1000. Today you would barely get one half of one ounce of Gold with \$1000.

Whilst the economic outlook is undeniably poor, and it's understandable politicians and central bankers have unleashed unprecedented fiscal stimulus spending and monetary inflation in an attempt to kick-start desperately needed growth, the following table illustrates that not only is debt growth not translating to meaningful GDP growth, but that each layer of new debt is becoming less effective in stimulating GDP.

<u>Year</u>	<u>GDP (\$T)</u>	<u>Debt (\$T)</u>	<u>Ratio</u>
1985	4.2	7.4	57%
1990	5.8	11.8	49%
1995	7.4	16.4	45%
2000	9.8	24.6	40%
2005	12.6	36.5	35%
2006	13.2	44.8	29%
2011* (est)	15.1	54.4	28%

This decrease in the efficiency of Debt in terms of its ability to generate GDP is also shown clearly in chart form on the next page, built using data from the US Treasury.

Diminishing Marginal Productivity of Debt in the US Economy (in Dollars)



The above table and chart includes government, corporate and individual debt. The Govt's share of this debt is now north of \$15 Trillion, or 100% of GDP. The data does not include the additional unfunded liabilities of the US Federal Govt (Social Security/Medicare etc), which would otherwise push the total debt of the USA well north of \$100 Trillion, or some 700% of GDP

Key Insights from the Debt/GDP Table & Chart:

- Since the early 1980's, the amount of debt in the system has been increasing at significantly higher levels than GDP growth
- In 1985, there was roughly \$1.75 in Debt for every \$1 of GDP generated
- In 2009, the US economy required \$3.43 in Debt to generate that same \$1 of GDP, a reduction in efficiency of nearly 50%
- Consider that in 2010 GDP Growth of 2% represents a nominal increase in wealth of approximately \$300Bn. Considering Federal Debt alone grew by nearly \$1.5Bn last year, it's now taking roughly \$5 of Debt for to generate \$1 of GDP.
- As the chart above says, Developed Economies have reached the Debt Saturation Phase.
- Monetary and fiscal stimulus, and the accruing of ever larger debts is not working, and based on past precedent, will not work. This phenomenon is not new, as the quote below, from Henry Morgenthau, when describing the lack of success of FDR's 'New Deal' in stimulating a genuine economic recovery, helps to illustrate

"We have tried spending money. We are spending more than we have ever spent before and it does not work....We have never made good on our promises.....I say after 8 years of the Administration we have just as much unemployment as when we started, and an enormous debt to boot" – **Henry Morgenthau (Treasury Secretary, 1939)**

Section 5 Conclusions:

- Gold always has and always will be a store of value
- The scarcity of Gold, coupled with the stability of supply is the reason it has been trusted for thousands of years as the most perfect form of money and ultimate store of value
- Gold has always been accepted as money
- By comparison, FIAT currencies are backed by nothing more than political decree. Throughout history, every FIAT currency that was ever created has always been inflated to the point that it is worthless, with the public eventually refusing to accept the money as payment for goods and services
- FIAT Money has a 100% track record of failure
- Increasing the supply of money, especially way beyond the growth in goods and services produced by an economy acts only to reduce the value of the money itself and does nothing to generate prosperity
- The unprecedented increase in total debt in the US economy (indeed the entire developed world) is not, and most likely will not stimulate sustainable GDP growth
- Printing money (as is being done today) is the only way the United States can nominally meet its financial obligations
- The impact of printing this money will be to further erode the value of the USD, causing an increase in prices for all goods denominated in dollars
- The problems the United States face are shared by all Developed nations – which will ultimately lead to a continuation of the global race to devalue all FIAT currencies
- Gold and Silver are the only protection against the continuing abuse of paper money that authorities are engaging in

Central Bankers and Politicians the world over are gambling that they can add trillions of dollars of currency units to the money supply without causing a catastrophe. Each and every time in history society has attempted this, it has ended in a financial disaster and typically, the return of some sort of commodity backed currency, usually Gold.

Maybe this time it's different, and the powers that be can solve all the problems of the global economy simply by printing money, but it's never been done before.

As such, prudent investors and asset managers should prepare for the worst. Gold, Real Value Preserving Money across the millennia, is the best asset to own in these uncertain times.

Section 6: What Could Stop Gold and How High Could it Go!



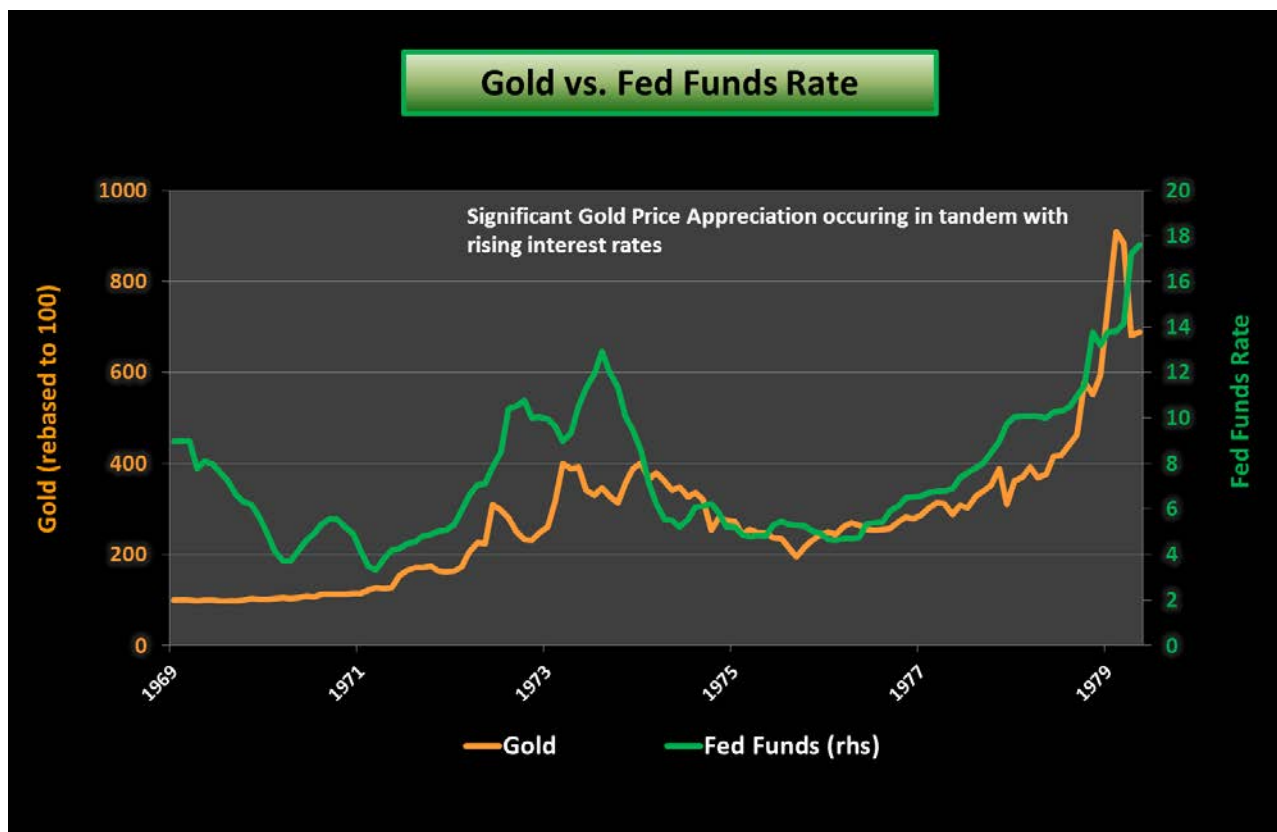
What would need to happen to stop the current Gold bull market and how high it could go in the current environment

SECTION 6: WHAT COULD DERAIL GOLD

In looking at what might bring an end to the unfolding Gold Bull Market, it is worth noting that Gold's weakest quality as an investment is that, typically, it pays no yield (although Gold can be leased). As a result, the more attractive yields are on either debt, cash deposits, property or stocks, the less attractive gold becomes as an investment option.

As we covered in section three, by historical standards, none of the traditional asset classes are providing attractive yields at this moment in time. The lack of yield in traditional assets, along with the negative real rate environment we are in, the inflationary threat from further monetary printing, and the threat of sovereign default currently haunting Europe (and indeed the developed world) will continue to provide further impetus for Gold price appreciation.

Furthermore, perhaps somewhat counter-intuitively, history tells us not to expect a falling Gold price in the face of rising cash rates, at least not for several years into the rate cycle, as the following graph shows



Key Insights from Gold vs. Fed Funds Rate Chart:

- In the early 70's the Gold price appreciated as a result of Nixon 'temporarily' closing the Gold window (August 15th 1971), and as the Fed Brought the Discount Rate below 4%
- Despite hiking rates in the early 70's, which did temporarily depress the Gold price, the closing of the Gold window, coupled with the easy money policies of the mid 70's (where rates were slashed by over 6%) sparked a Gold price boom which didn't end until February of 1980, when the Gold price hit \$850

- The Federal Reserve ultimately had to raise rates for over 5 straight years, to a high just shy of 20%, to kill off inflation and ultimately bring an end to the Gold Bull Market

Unless there is no longer an interest rate cycle, at some point this decade, we can expect rates to move decisively higher, most likely in response to the inflation we are beginning to see and will eventually see even more clearly as a result of the unprecedented monetary stimulus central banks are engaging in. History indicates we can expect the Gold price to rise throughout this period of rate tightening.

If the Federal Reserve (as well as the ECB, BOJ, BOE etc) continue to monetise debt (QE3 and beyond), and keeps rates below zero in real terms for an extended period, this will only further undermine the quality of their currencies, fuel inflationary expectations and as per the above, continue to boost Gold prices

The following table illustrates how high the rates that the Fed might be paying, as well as how attractive the yields on financial assets may need to be before the current bull market in Gold is over.

How A Gold Bull Market is Stopped!

Statistic	Previous Peak	Where It Ended	Current Level
Federal Funds Rate	14.13	19.08 (Jan 81)	0.00
10 Year Bond Yield	12.41	14.32 (Sep 81)	1.98
S&P P/E ratio	9.05	6.64 (Aug 82)	19.84
S&P dividend yield	4.99	6.24 (Aug 82)	2.12

Notes on the above Gold Bull Market Statistics Chart:

- The 'Previous Peak Level' refers to the Rates/Ratios in February 1980, which was the month the Gold price peaked (\$850 per oz.) in the last precious metal bull market
- 'Where it Ended' refers to what date, and at what level did the peak in the these Rates/Ratios occur during that particular cycle
- The 'Current Level' is where these Rates/Ratios are as at the 30th September 2011

As you can see, from a yield, or opportunity cost perspective, none of the necessary conditions are in place to put an end to the current Bull Market in Gold.

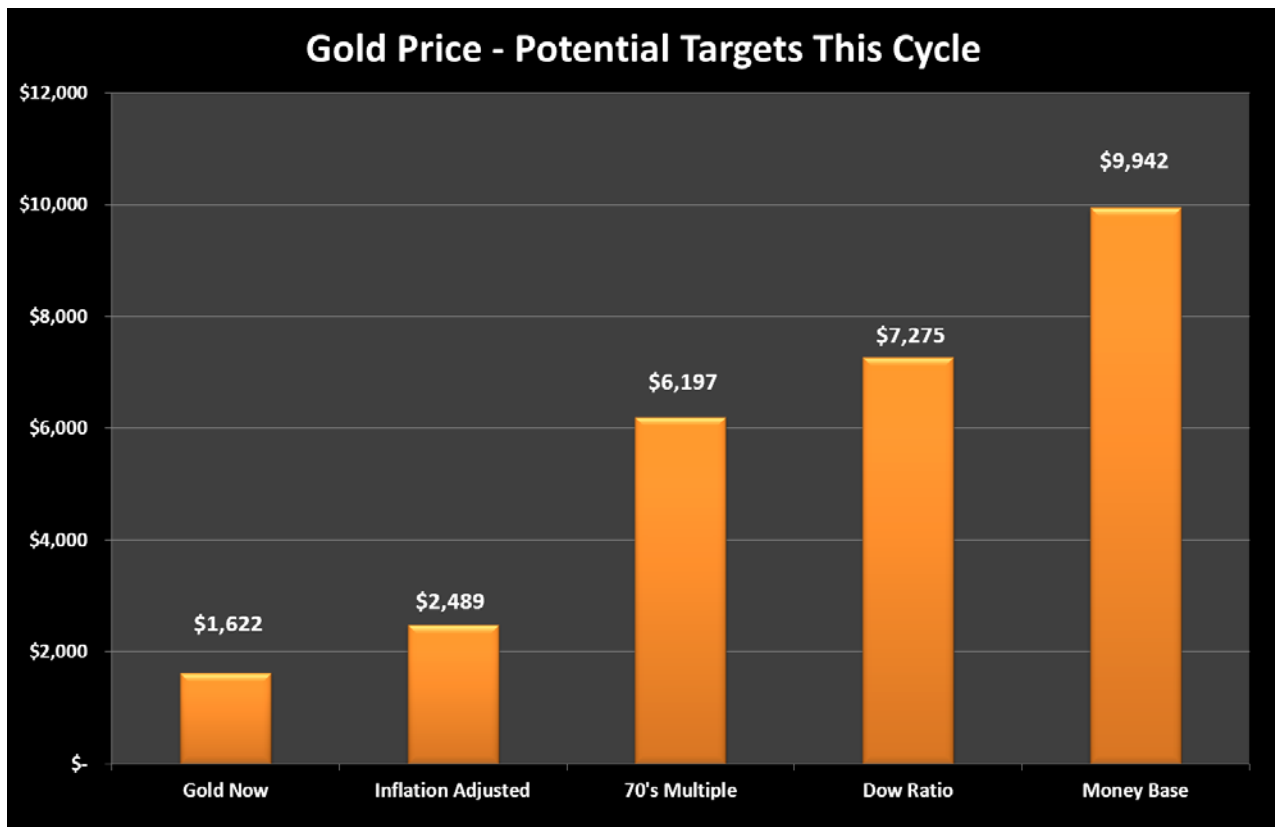
If the Gold price does not continue to significantly outperform financial assets in the period ahead, it will mean that current bull market in Gold is exceptionally anaemic by historical standards.

Gold Price Prediction:

In making the price predictions featured in the graph below, one must remember the following key points:

- Currently, not one currency is linked to Gold or even a tangible commodity
- Every major currency in use today is entirely FIAT
- As Gold is and has always been money, ultimately its price will be determined by just how much 'monetary stimulation' central bankers and politicians are willing to throw at the markets (Gold went to approximately 100 Trillion German Marks in 1923 per ounce, and as per the brief section on Rome, Gold went to 30 Million denarius during Diocletian's reign)
- The US, the Japanese, the Europeans, the English, the Swiss and the Chinese are all actively devaluing their currencies in an effort to boost exports and domestic economic activity
- Over time these actions will prove to be highly inflationary and will lead to further and significant Gold price appreciation

The graph below provides an indication as to how high one might expect gold prices to reach based purely on comparisons with the past. Until it reaches **at least** these levels, it will be premature to think of Gold as being expensive and in 'bubble territory'.



Notes on the Figures in the Price Prediction Chart

- The Inflation Adjusted price is calculated using \$850 Feb 1980 Gold as a base and adjusting for official monthly US CPI figures since then.
- If one uses the Shadow Stats CPI calculation, which is an apples with apples comparison with the 70's, **the Inflation adjusted Gold Price is closer to \$7000**
- The 70's Multiple price is based on how many times the Gold price went up in the last cycle, using \$35 as a base, and using the same multiple (24x) on a starting Gold value in this cycle of \$255 (Aug 99 nadir)
- Dow Ratio price assumes a Dow price of 10,913 (Sep 30th 2011) and a Ratio of 1.5:1 with the Gold Price (ie this Gold Bull Market isn't quite as exceptional as the last)
- The Money Base reflects what was covered in section 3, simply backing the US Money base with the Gold the US Treasury purports to hold
- An average of these estimates would suggest a Gold just shy of **\$6000**

Key Insights from the Price Prediction Chart:

- Based on the returns observed in the 70's, we can expect the Gold Price to be considerably higher by the time this bull market is over
- Considering the economic and political climate of today, as well as using the past bull market as a guide, logic would suggest the Gold price will reach a **minimum of \$5500.00** and probably well north of that in this cycle
- This figure is conservative if anything, as the economic situation today for the US and the developed world is far more perilous than in the previous bull market – this time around there have been far larger increases in the money supply globally, and the debt and demographic challenges the world face would appear to be insurmountable without continued monetisation
- Considering gold is still only circa \$1620/oz, its **clear potential to more than triple in value** from here provides a compelling investment argument for individual investors and diversified asset managers

Section 6 Conclusions:

- Yields on cash, fixed income and the equity market are low by historical standards and would need to move much higher for Gold to become a less attractive investment
- History tells us it will take several years of rising rates to end the Gold Bull Market
- Based on the returns seen historically, the current Gold Bull Market has only just gotten underway in terms of price appreciation
- Looking at any metric other than nominal price, the current Gold Price is still low when compared to the previous cycle
- Based on a variety of measurements, the Gold price should at a minimum triple from here in value, just to match the returns seen in the last bull market
- In all likelihood, the price may go much higher than that, especially if central banks continue to provide monetary stimulus, further debasing the value of the currency they issue

Section 7: What to Do Now

***“Predicting Rain Doesn’t Count –
Building the Ark does!”***

–Warren Buffet



A preliminary look at how individuals
and diversified asset managers could
Better construct a portfolio of assets to
benefit from an exposure to Gold

SECTION 7: WHAT TO DO NOW

What to do Now

The likelihood of significant Gold price appreciation in the decade ahead, the beneficial role Gold can play as a portfolio diversifier, and the risks inherent in the Equity, Property and especially Bond Markets are abundantly clear.

The last question to answer therefore is – *“How do investors best structure a balanced portfolio to capture the upside from Precious Metal related investments, whilst minimising exposure and risk to other asset classes?”*

From the perspective of a professional asset management house, there are three points which they should consider

- 1) Asset managers should develop the investment capability (or find a viable outsourced alternative) to offer exposure to the 2 most important components of the Precious Metals Investment Market
 - a. Physical Gold and Silver
 - b. Large Cap Mining Companies as well as Mid-Tier producers & Juniors (explorers)
- 2) All Diversified Balanced Growth Funds – from Conservative Options to Higher Growth Portfolios - should allocate the same percentage of their investments to Precious Metals or Precious Metals Mining companies
- 3) Exposure within these funds, whilst consistent at an aggregate level, should differ at component level, e.g. a Conservative Growth Fund (or investor) would have a higher allocation to physical metals and a lower exposure to Precious Metal Stocks

Individual investors may wish simply to limit their exposure to physical bullion, preferably purchasing physical metal from a reputable dealer, although they may find it easier to simply use ETF vehicles (not the personal preference of the author as ETF's still carry counterparty risk and are not necessarily backed by physical Gold). Investing in Gold Mining companies will provide leveraged upside to the rising Gold price, but one must wear the additional risks of investing in specific companies, and be aware of the fact that Gold Mining stocks are still highly correlated to the overall equity market.

The key takeaway for individual investors is that they need Gold to preserve wealth in this environment, and ultimately, there is no substitute for physical metal

The subsequent questions that must be asked and answered are the following:

- 1) How much should the total exposure be?
- 2) From which assets should the exposure get re-allocated from?

Total Exposure & Reallocation– How Much and Where From?

In part 1 of this paper we saw the impact that allocating 10% of portfolio assets to Gold would have had to Balanced Growth Portfolio Returns since the turn of the century. As a result, allocating 10% of investment capital to precious metal related investments would be an appropriate starting point for diversified portfolio managers and for individual investors,

In the decade ahead, the potential divergence in returns between Precious Metals Investments and Traditional Assets will likely be even more pronounced than it has been since December 1999. Accordingly, allocating 10% of investor capital to Gold should significantly help individuals and clients to protect capital through the turbulent period we are facing, and should allow portfolio managers to outperform the majority of their competitors.

Exposure Re allocation – Where Should it Come From?

Paying attention to the 70's and early 80's and using market movements from that period as a guide to what one can expect to see unfold helps understand where to reallocate capital from. Ignoring Gold for the moment, we can see that the following occurred to traditional asset classes:

- **Equity Prices:** Though down 5% in real terms from Dec 69 through Dec 79, they **were up 95% in nominal terms**
- **Bond Yields:** Rose from **5.7%** in March 71 to over **15.30%** by late 81. Capital losses far outweighed interest payments, even before allowing for the inflationary effect on the income received and capital returned. There's a reason why bonds were known as 'certificates of confiscation' throughout this period
- **Cash:** Inflation, which started to rear its ugly head by 1973, **averaged 8.76%** over the following decade. Essentially, by the end of 1982 one would have needed \$100 to buy \$36 worth of 1972 Goods and Services. Whilst one does earn interest on cash holdings, currently rates are zero or near zero globally, and you must pay tax on any income generated. Whilst providing tactical flexibility, Cash in the bank is not likely to preserve capital and purchasing power in the decade ahead.

What is clear from a quick look at the above is that whilst equity returns were negative in real terms, they outperformed Bonds and Cash.

From the perspective of an Australian diversified portfolio manager, they might wish to adjust their asset exposure accordingly (note that the current weights in the table over the page are based on Intech's Sept 2011 Asset Exposure for Balanced Growth Funds)

Proposed Allocation Table for Balanced Growth Diversified Managers

Asset Class	Current Allocation	Potential Allocation
Australian Shares	33.5	32.3
International Shares	25.0	23.0
Australian Property	2.5	1.5
International Property	2.0	2.0
Direct Property	4.0	2.5
Australian Bonds	11.2	9.0
International Bonds	6.5	4.5
Cash	5.4	5.2
Alternatives / Direct Investments	10.0	10.0
Gold / Precious Metals	0.0	10.0
Total	100.0	100.0

The one key message from this paper and from this reallocation exercise is that, **at an absolute minimum**, investors and asset managers should consider deploying at least 10% of their capital into Gold and Precious Metal Investments.

The new allocation would reduce equity and property holdings by circa 5.5% in total. The remaining 4.5% would come from bonds and cash. Based on existing weights, proportionally this represents a much larger reduction in the weighting to fixed income investments.

While it's likely Equities and Property will struggle to grow 'real wealth' in the upcoming decade, the potential for sovereign debt default as well as the threat of ever higher levels of inflation and currency debasement is likely to be particularly deleterious to fixed income investments.

Individual investors should obviously consider their own circumstances regarding risk tolerance, cash flow requirements etc., but the above template would be a useful starting point for looking at where they may wish to shift their capital allocations from.

For those investors with a greater focus on wealth preservation, they would be advised to hold an even larger component of their wealth in precious metals going forward.

Final Thoughts & Conclusions

Everything has its limit –
iron ore cannot be educated into gold.”



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Mark Twain

SUMMARY

Legendary investor John Templeton once famously said that the four most dangerous words in investing are 'This Time it's Different'.

It is my hope that this paper, which has detailed the reasons both individual investors as well as professional asset managers should invest in precious metals this decade, has succinctly and comprehensively demonstrated its most important points.

Unless this time it really is different.

- Gold, whilst having appreciated significantly in the last decade, is still inexpensive and nowhere near bubble territory
- Gold is still substantially undervalued by any number of historical metrics
- Including Gold in investor portfolios will help reduce portfolio volatility and significantly help asset managers outperform their competitors in periods of market stress
- That the supply of physical Gold is stable, and as an investment it highly accessible and highly liquid
- That if the current Gold Bull Market was to reach levels seen in every other cycle, a Gold price well north of \$5000 is to be expected at a minimum, and prices of over \$10,000 would not be unexpected
- That yields on cash, stocks and bonds would need to be significantly higher than current levels to end the current Gold bull market
- That there remains significant risk in the more traditional asset classes of equities, property and especially fixed income and cash
- That these traditional asset classes are expensive when looked at compared to their long term medians, especially when one considers the fragile outlook for the global economy
- That Gold will always be accepted as money and will always will be a better long term store of value than FIAT money
- That excessive money creation will eventually lead to extremely high levels of inflation
- It will be during this upcoming period of monetary uncertainty and higher inflation that the Gold price really takes off, as the wider investment community learns again to appreciate Gold's monetary role and the appeal of precious metal investments
- Finally, and most importantly, at a minimum investors and asset managers should consider allocating at least 10% of their wealth to Gold and Precious Metals, as they are likely to be the best investments to preserve wealth in the turbulent period ahead.

Regards

Jordan Eliseo

December 2011