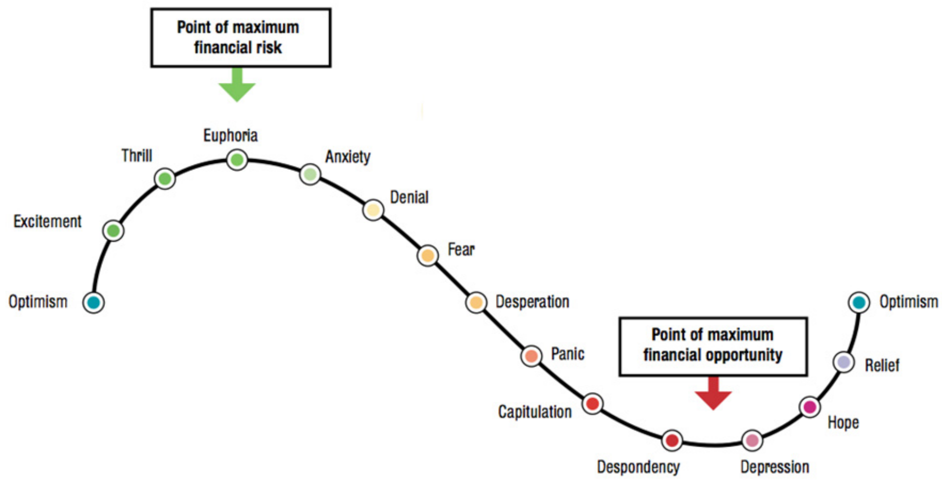
MONTHLY
INVESTMENT
COMMENTARY

February 2013: Keeping Focus

By John Goltermann, CFA, CPA

As any investor knows, price movements – whether they are to the upside or downside – can elicit emotional reactions. The cycle of emotional reactions can be illustrated as follows:



What this illustration highlights is that the observable price movements of an investment and the emotions that come with them often run counter to future performance. Moreover, short-term price moves are rarely tied to *actual* changes in long-term fundamentals. Instead, they are usually related to an aggregate change in the perception of *potential* changes. Price moves often simply represent institutional investors' position jockeying in what famed investor Seth Klarman calls "the performance derby." We have certainly seen large moves in the price of gold mining stocks of late.

The trick to disciplined investing is to keep emotions in check or, better yet, refrain from interpreting short-term price movements as a manifestation of the quality or merit of a holding. Plenty of terrible investments have inexplicably skyrocketed in price, and many great investments have tanked for no apparent reason. One need look no further than 1999 (see chart on next page), when every tech-related stock moved up significantly (many with huge multiples and/or no earnings at all), and Berkshire Hathaway performed horribly. This was not as a result of any changes in *fundamentals* – it was simply position jockeying and performance chasing. Needless to say, the price action that year was not predictive of future performance, even though many professional investors fervently believed it was! In fact this price action predicted the opposite of what many expected.

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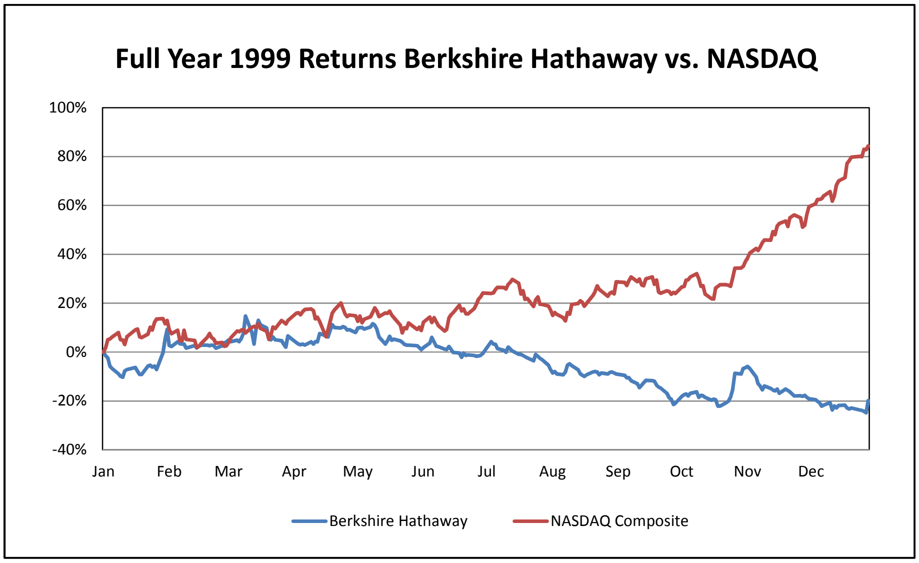

Source: Bloomberg

We have now had eight consecutive weeks where the S&P 500 hasn't closed up or down more than 2.5% from the prior day – and only five days have seen more than a 1% move. That's an extraordinarily long time to have very little market volatility. However, during this same time period, we've seen an incredible divergence between stocks, gold and gold *stocks*, where the overall stock market is up 6.3%, gold is down 6.5% and gold stocks are down 19.3% (using the GDX ETF as a proxy as of 2/20/13) since December 31st. Essentially, while people are feeling pretty excited about the stock market, there is capitulation selling in gold stocks. This begs the question as to whether the current market sentiment reflects any fundamental change in the merits of holding gold…or whether this is a time to stay the course.

We can only speculate as to what's going on in the market for gold, but there are many possible explanations. It could be hedge fund redemptions (many managers had big gold positions and poor performance last year), or a general aversion to holding more volatile assets as we approach the budget sequestration discussions, or a basic reallocation to other sectors that are ostensibly "working." Perhaps it's the end of the payroll tax holiday and rising gas prices, which squeeze discretionary income and reduce inflationary pressure as they curtail the velocity of money. Perhaps it's the selling in the yen that has caused the dollar to strengthen and reduced the available leverage of speculators (so they have to sell indiscriminately to pay back the loans). Or it could be a dearth of scary headlines at the moment.

You get the picture – it's anyone's guess as to what is impacting gold's short-term performance. But what seems clear is that the current pessimism doesn't seem to be tied to any change in *long-term* fundamentals.

Many analysts specializing in the gold mining business believe that the valuation gap between mining shares and the physical metal is the widest that it has ever been. In other words, the price of an ounce of gold would now buy more stock in gold mining companies (and claims on their gold reserves) than at any time in history. George Topping, a gold mining analyst at Stifel

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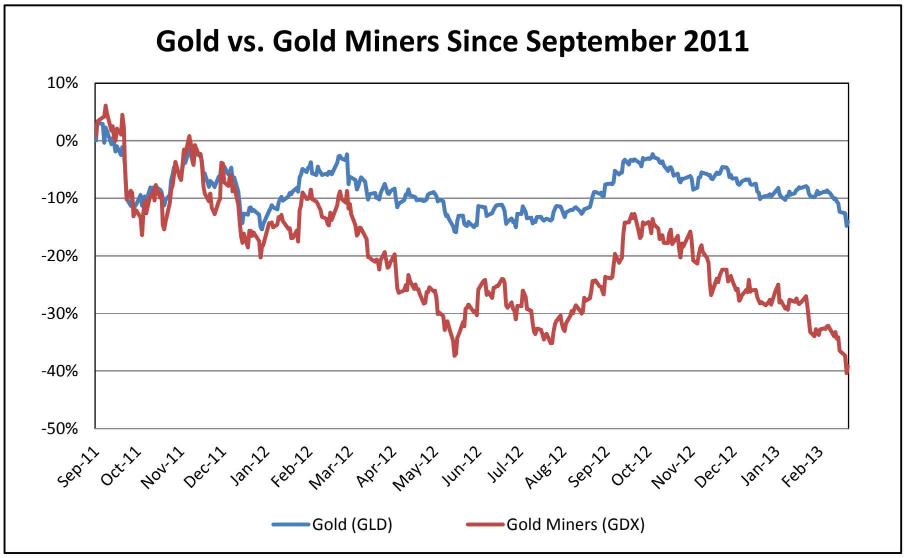
Nicolaus, says the only other time the discounts were close to this extreme was in 1999, when the gold industry was near the end of its long bear market.[1] John Hathaway, manager of the Tocqueville Gold Fund, believes that the prices of gold mining stocks only make sense if gold were $1,100 an ounce (it currently trades at about $1,600). While we don't know what will happen in the near term, there is a margin of safety in the mining shares absent a dramatic drop in the price of gold itself.



Source: Bloomberg

Whatever the reason, the underperformance of the mining shares in the last 18 months has been significant (see chart above). At this point, because of the price divergence, the valuation disparity, and general capitulating sentiment, there doesn't seem to be a case for selling mining shares. Given the valuations, we are evaluating whether it is appropriate to add to the position. The negative sentiment towards gold could continue for a time, but as economist Herbert Stein cautions, "If something cannot go on forever, it will stop." When price divergences like this occur, they usually self-correct. In the interim, there is a strong case that gold mining stocks are cheap and that much bad news is priced in.

In the complex world in which we live, we always want to stay focused on important factors and do the right thing for clients. As fiduciaries and as long-term investors, we sometimes also have to deal with short-term adverse situations when the bigger-picture fundamentals and portfolio risks remain unchanged.

We don't especially relish owning gold as it's unproductive and is the antithesis of financing great businesses and ideas. But we also accept the idea that gold is simply money, readily exchangeable globally and a store of value that cannot be debased by governments. For this reason we believe it continues to have a place in portfolios at the present time. Many view gold as simply an inflation hedge, but it can also be effective during unstable times or when the

[1] Source: *Wall Street Journal*, December 12, 2012

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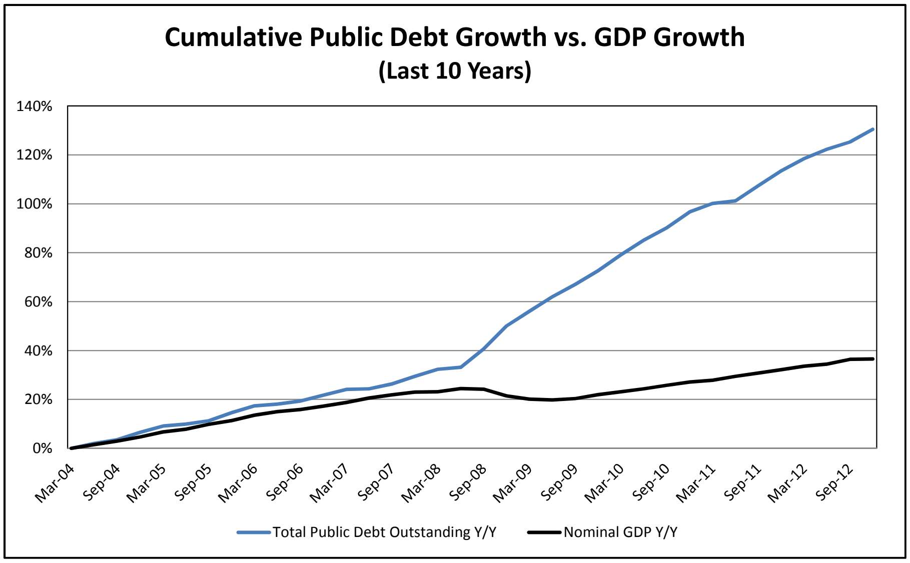
prospects for financial assets deteriorate. Admittedly, with so much tentativeness on the part of investors and consumers, high unemployment levels, and the lack of pro-growth policies in Washington, the risk of rapidly rising inflation is low *in the near term*. But with debt growth far outpacing GDP growth (see chart below), the debt will most likely have to be monetized through Federal Reserve purchases, economic growth will have to pick up significantly, or outright defaults on entitlement promises will occur. All of these scenarios could benefit the gold market. In the nearer-term, because of the current trend in debt growth, some unforeseen crisis could arise prompting capital to flow rapidly back to gold and mining stocks.



Sources: bea.gov, treasurydirect.gov

It's always hard to know the appropriate weighting of an allocation to precious metals, and in what form the allocation should be. We believe the right answer on allocation is more than zero. The precious metals market can be subject to wild price swings independent of the stock market because there are a significant number of leveraged speculators and hot-money investors involved and their behavior can't be predicted.

As we do for all portfolio holdings, we will continue to monitor the gold market for fundamental changes and will make adjustments if warranted. We also take comfort that clients have a moderate allocation to this sector; we never place all our clients' eggs in one basket. Overall sentiment and consensus views can change swiftly, particularly at about the time when everyone agrees that they've figured what the future winners and losers will be. This may be one of those times.

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