A SOUND MIND INVESTING
SPECIAL REPORT

Gold as an Investment: Will Precious Metals Continue to Shine?

BY AUSTIN PRYOR

Introduction

At the tender age of 25, as I was becoming interested in the topic of investing, one of the books that captured my attention was a 1970 best-seller by an investment adviser named Harry Browne. It had the rather alarming title *How You Can Profit from the Coming Devaluation*.

Browne took the unconventional view that America's tax and monetary policies would lead to the devaluation of the U.S. dollar—and soon! He recommended that investors diversify into gold, silver, and foreign currencies like the Swiss franc. Given that the United States had the world's strongest economy, and was the world's leading creditor nation as well, Browne's concern about devalution seemed, well, preposterous. So I ignored his diversification advice, and continued on my merry way investing in U.S. common stocks.

Then, a year later in 1971, President Richard Nixon stunned the world financial community by "closing the gold window." You may have no idea what that means, so let me offer some background that will help you understand its significance.

As World War II drew to a close, economists from the leading industrial nations met in Bretton Woods, New Hampshire, to hammer out a new international monetary system on which to base post-war recovery and growth. Under the "Bretton Woods" system, the U.S. dollar was established as the central international trading currency. All other currencies would be valued in terms of how many dollars they could be exchanged for. These "exchange rates" with the dollar were set at specific levels appropriate to each country's economic strength at the time, and a mechanism was put in place to keep them there.

In turn, the dollar's value was anchored to U.S. holdings of gold. The U.S. obligated itself to exchange one ounce of its gold for every $35 turned in by foreign governments. The "gold window" was the place where these dollar redemptions took place. Therefore, under Bretton Woods, all currencies were convertible into dollars at a fixed rate, and all dollars were convertible into gold at a fixed rate. In effect, and this is the important thing to understand, *international commerce was based on a gold standard*.

This provided a degree of economic discipline. Nations couldn't unduly expand their money supplies (i.e., they could not irresponsibly turn on their money-printing presses) because doing so would undermine the exchange rate of their currencies against the dollar—rates they had committed to maintain and support. For similar reasons, the U.S. couldn't print more dollars than it could redeem with gold. The intended result was that each nation's money supply would grow at the same rate as that nation's supply of labor, goods, and services. In this way, prices would be kept stable.

This system worked fairly well for over two decades. Commodity prices were generally stable. In the U.S., inflation was typically less than 2% a year. Interest rates rarely ex-

ceeded 4%, and long-term fixed-rate mortgages were commonly available at rates around 5%. This economic stability led to a period of exceptional growth. Once the post-war recovery got started in earnest in 1948, the U.S. economy grew at an average annual rate, after inflation, of 6.6% for the next 20 years.

The ever-accelerating decline of the dollar

In the 1960s, however, the U.S. federal government increasingly burdened itself with substantial and rising costs, notably from the space program, the Great Society social welfare programs, and the war in Vietnam—in addition to ongoing cost of serving as the primary military defender of the West. America couldn't afford it all. So to fund its spending, our government either borrowed or printed what it needed. The result was that we betrayed our post-WWII Bretton Woods commitments by sending billions of dollars overseas *for which we had no gold.*

Thanks largely to our lack of monetary self-discipline, Bretton Woods began to collapse in 1968. At that time, the world's central banks gave up on their attempts to link the exchange rates of their respective currencies to the U.S. dollar and the price of gold. They announced a "two-tier" approach to pricing gold—the "official" price at which they would transact business with one another, and the free-market price at which gold changed hands in the financial markets. To the attentive observer, this was a hint that the days of Bretton Woods were numbered.

By 1971, foreigners held more than 45 billion in U.S. dollars, but the U.S. had only 10 billion dollars in gold reserves to back them up. In other words, the dollar was greatly overvalued in relation to its gold backing. In August of that year, Nixon made it official. He announced that he was closing the gold window—the U.S. would no longer deliver gold to foreign central banks in exchange for dollars.

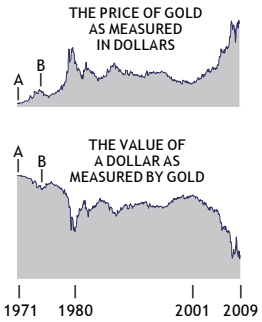
By closing the gold window, what was left of the Bretton Woods system was destroyed. A brief monetary crisis ensued and the world's credit markets were thrown into chaos. Within a week, the value of the U.S. dollar decreased by more than 17% against the world's other major currencies.

In his fascinating book *The Death of Money*, economist Joel Kurtzman gave this assessment of our "solution" to this problem: "On August 15, 1971, money—in the old sense, the traditional sense—was repealed. Nixon transformed it into something totally new, a currency without any underlying value whatsoever and without any limitations on the government's ability to create it. Nixon turned money—traditionally a symbol of real, tangible wealth—into a twisted abstraction."

We had entered a brave new economic world where the dollar was no longer backed by gold. Going forward, the U.S. dollar was "money" only because the U.S. government

said it was money. And the new system would work only as long as everyone in the world *believed* the dollar was money and *accepted it* as money. Many were skeptical and moved out of dollars and into gold. Over the next three years, the exchange rate for gold climbed from $43/ounce (Point A in Figure 1) to $195/ounce (Point B).

FIGURE 1



In our dollar-bound vision of the world, we look at these numbers and conclude the price of gold had gone up. But actually, this change reflected that the value of the dollar had shrunk sharply. By late 1974, it took almost five times as many dollars to buy an ounce of gold as it did in 1971. In other words, in relation to gold, the dollar had effectively been "devalued" by about 78%. Harry Browne, it turned out, was right. And this was just the beginning. By the dawn of 2011, it took 32 times as many dollars to buy an ounce of gold as it did when Nixon closed the gold window.

Here's the major point I want you to take away from this bit of economic history: *the economic reality of a crumbling dollar has never stopped our leaders in Washington from printing as many dollars as they wish in order to satisfy their spending desires.*

They do this even if it means renouncing previous commitments (such as the initial backing of Federal Reserve notes by gold, which ended in 1933), international agreements (such as Bretton Woods) or campaign promises ("What I've done throughout this campaign is to propose a net spending cut."—Barack Obama, Oct. 16, 2008).

Since 1933, government leaders have consistently moved away from any standard or commitment that hinders their ability to print currency and "produce money out of thin air." And it's this propensity to run the printing presses that has resulted in the shrinkage in the purchasing power of the dollar (i.e., inflation).

FIGURE 2

THE DECLINE AND FALL OF THE AMERICAN DOLLAR

DATA SOURCE: THE MYTHS OF INFLATION AND INVESTING BY STEVEN LEUTHOLD

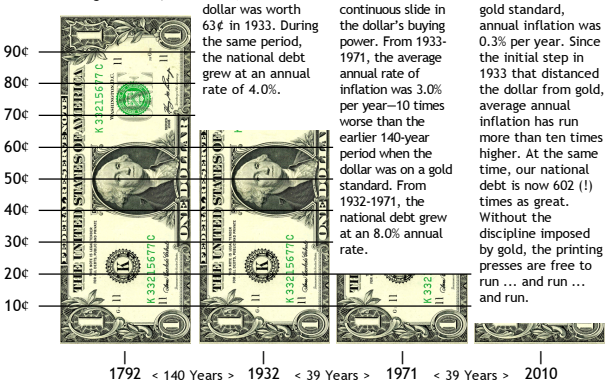
Dates	Role of Gold	National Debt	Value of Dollar
1792-1932	Gold Standard	Grew 4.0% Annually	Fell 0.3% Annually
1932-1971	Moving Away from Gold	Grew 8.0% Annually	Fell 3.0% Annually
1971-2010	Officially Decoupled	Grew 9.5% Annually	Fell 4.1% Annually

The U.S. dollar was created by the Coinage Act of 1792. It was backed by gold or silver (in varying weights). The dollar continued to be convertible into gold until 1933 (except during war time).

To freely increase government spending, FDR took America off the gold standard in 1933. Up to this point, from 1792-1932, the average annual rate of inflation was just 0.3% per year. As a result, a 1792 dollar was worth 63¢ in 1933. During the same period, the national debt grew at an annual rate of 4.0%.

By 1971, a 1792 dollar was worth just 20¢. The continuing inflation of the post-WWII period was primarily the result of the government printing too much money (to pay for its spending). The result was a continuous slide in the dollar's buying power. From 1933-1971, the average annual rate of inflation was 3.0% per year—10 times worse than the earlier 140-year period when the dollar was on a gold standard. From 1932-1971, the national debt grew at an 8.0% annual rate.

At the end of 2010, the dollar was worth about 4% of its original 1792 value. From 1972-2010, the average annual rate of inflation was 4.1% per year and the national debt grew 9.1% annually. In summary, when America was on a gold standard, annual inflation was 0.3% per year. Since the initial step in 1933 that distanced the dollar from gold, average annual inflation has run more than ten times higher. At the same time, our national debt is now 602 (!) times as great. Without the discipline imposed by gold, the printing presses are free to run ... and run ... and run.



Currently $43,600 per person in debt ... and growing

Consider the data in the table at the top of Figure 2 (page 4). You will note a relationship between the speed at which our national debt has grown (a measure of our spendthrift ways) and the resultant rate of inflation. The gold standard obviously imposed a much-needed discipline that restrained policymakers in Washington from borrowing and printing money to extremes.

Follow along with me as I explain Figure 3 on the right. In 1800, the national debt was about $79 million, or a mere $15 for every man, woman, and child in America. By 1840, it was essentially zero, just $3 million. The Civil War caused a rise past $1 billion for the first time, nevertheless by 1910 the debt per person was still only $28. (The graph doesn't accurately reflect all of these numbers because they were too small to even appear on the page, so I had to increase them enough to be visible.)

In 1913, a constitutional amendment was ratified that made the federal income tax legal. (Some tax protesters dispute that the 16th Amendment was properly ratified. Legal cases based on that view have repeatedly failed in the courts.) Despite the additional income flowing into the U.S. Treasury, the costs associated with World War I boosted the national debt per person to $137 by 1920.

By 1940, before we even entered World War II and the associated financial burden, Franklin D. Roosevelt's "New Deal" spending had raised the per capita national debt to $281.

Now here's an interesting thing. Following WWII, the U.S. was the richest and strongest nation on earth. We owned approximately 60% of the world's gold reserves. Our economy was booming. One would have thought that by 1950, we would have begun paying down the national debt. And yet, at that time, the debt had climbed to $1,657 per person.

This is roughly where it stayed until the 1970s and the closing of the gold window described above. By 1980, with the government printing and spending freely, the per capita debt had approximately doubled, rising to $3,396. You can see the obvious jump in Figure 3, and there's been no looking back since. The projection for 2020 is based on 2011 data from the nonpartisan Congressional Budget Office based on President Obama's 2012 budget proposal. The population projections are from the U.S. Census Bureau.

And take note: that staggering number of $68,400

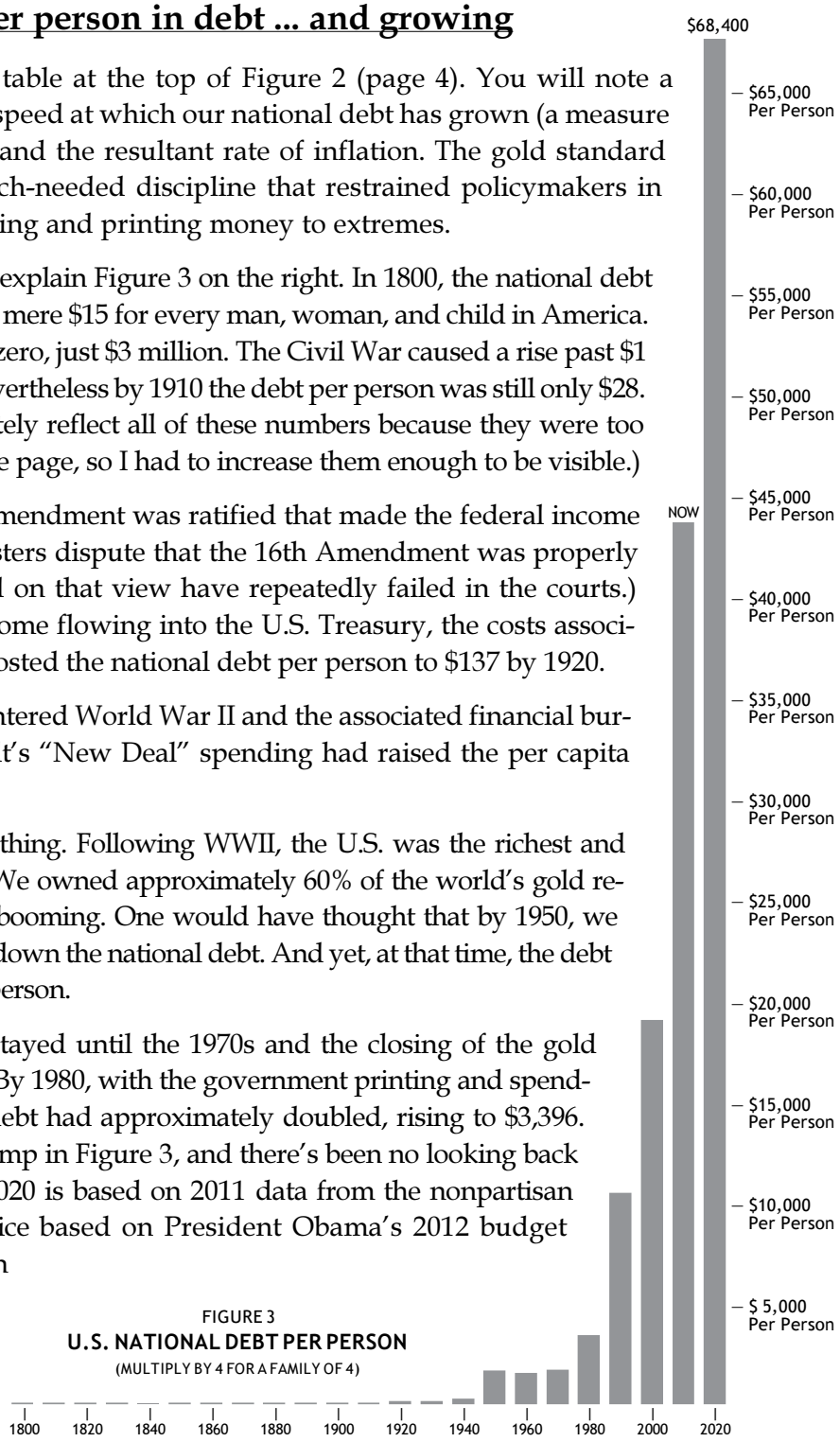


FIGURE 3
U.S. NATIONAL DEBT PER PERSON
(MULTIPLY BY 4 FOR A FAMILY OF 4)

per person doesn't include any of the needed fixes to Social Security and Medicare which are generally agreed to be financial catastrophes waiting to happen.

Unfortunately, with only a few exceptions, the political leadership in Washington has shown little inclination to restrain federal spending. No matter how heavy the burden on future generations, or how grim the prognosis regarding what will happen if we don't return to living within our means, spending has continued with abandon. This has been accomplished, essentially, by printing the money as needed. And this propensity never ends well. Eventually, unless a government reforms its ways, the piper must be paid. His name is hyperinflation.

When a currency becomes worthless

Hyperinflation, as the name implies, is inflation that is exceedingly high. Sometimes it is referred to as "runaway inflation." A Wikipedia article on hyperinflation notes that it is "a condition in which prices increase rapidly as a currency loses its value. Definitions used by the media vary from a cumulative inflation rate over three years approaching 100% to 'inflation exceeding 50% a month.' ... Although there is a great deal of debate about the root causes of hyperinflation, it becomes visible when there is an unchecked increase in the money supply (or drastic debasement of coinage) usually accompanied by a widespread unwillingness to hold the money for more than the time needed to trade it for something tangible to avoid further loss."

Wikipedia.com lists more than 30 countries that have experienced hyperinflation since World War I. Among them: Argentina, Austria, Brazil, Chile, China, Germany, Greece, Hungary, Israel, Japan, Poland, Soviet Russia, Taiwan, and Turkey. It's a sobering read, but a recommended one if you are to get a grasp of the worst-case scenario.

I should probably pause here and emphasize that I'm not saying hyperinflation in the U.S. is inevitable. *The point of what I have shared this far is not to say hyperinflation is necessarily coming, but rather to alert you to the possibility.* And so the question arises, "How does one prepare for such a possibility?"

Increasing your emphasis on tangible assets

From an investment perspective, here's the "big picture" to keep in view: during times of high inflation, assets that have value *due to their physical attributes* will hold their value best. This includes asset groups such as houses and productive farmland, needed commodities like oil, and precious metals such as gold and silver. These are called "tangible" assets. Common stocks in companies that *own* tangible assets (real estate, factories, machinery) and provide essential services can also do well.

Among the variety of tangible-asset options, gold is of particular interest to many people because it has a centuries-long history of serving as money. This is due to several factors—it is durable, scarce, divisible into smaller units, easily transported, and readily hidden or stored. And so we turn now to a discussion of several approaches to investing in gold.

Which kind of gold investor will you be?

It's one thing to make the initial choice to invest in gold. From there, it gets a little more complicated. There are many ways you can invest in gold, each with its own set of advantages and drawbacks. To simplify the task of selecting one or more vehicles from your menu of options, you need to first determine which of two kinds of gold investors you intend to be.

- **Opportunistic trader.** If one looks at a price chart of gold (such as the top chart in Figure 1 on page 4), it becomes obvious that while there have been periods of rapid ascent in the price of gold (e.g., 1971-1980, 2001-2009), there have also been long periods when gold moved sideways or down (1981-2000).

  One response to this would be to look at gold as you would any other commodity and attempt to capitalize on the uptrends and sidestep the downtrends. Based on trend analysis or other indicators, you would buy gold only when an attractive opportunity seemed to present itself and sell when the uptrend appeared to have ended. Your focus would be on the short- to intermediate-term.

- **Long-term accumulator.** This kind of investor doesn't regard gold as primarily a commodity to trade, but rather as a valuable asset to be acquired and held—possibly for decades.

  The basic motivation here is not merely capital appreciation, which is also possible through other investment strategies. Rather, the primary, over-arching goal is to protect one's wealth against the debasement of the U.S. dollar. Accumulators want to own the actual metal, not a trading vehicle.

What portion of your assets should you allocate to gold?

The answer to the question of "how much gold?" largely depends on which kind of gold investor you intend to be. "Traders" might do well to keep the amount relatively small, say in the 5%-10% range. They would reduce the equity portion (in SMI lingo, the "invest-by-owning" types of investments) of their portfolio by a corresponding amount. After all, trading a volatile commodity like gold is a high-reward, high-risk undertaking.

For "accumulators," on the other hand, 5%-10% seems like a relatively small amount given their questions about the long-term viability of the U.S. dollar. They might feel comfortable going as high as 20% (or even more, depending on the strength of their concerns).

In this connection, it's worth considering if the allocation should come from the fixed-income portion of their portfolio ("invest-by-lending" investments, such as savings accounts, T-bills, bonds, and annuities). The rationale for such a suggestion is that, for this kind of investor, the gold is being accumulated as a money substitute in case the dollar begins losing value rapidly during a period of runaway inflation. So rather than holding *paper money* (dollars) via savings accounts, etc., which they expect to drop in purchasing power, they would think of it in terms of holding *gold money* instead.

Whether to take the money for the gold allocation from the equity portion or the fixed-income portion of the portfolio is a decision each gold accumulator has to think through for themselves.

FIGURE 4
HYPOTHETICAL ALLOCATIONS

	Trader		Accumulator	
	Before	After	Before	After
Stocks	80%	70%	80%	80%
Gold	0%	10%	0%	10%
Fixed Income	20%	20%	20%	10%

Figure 4 illustrates possible portfolio changes for both kinds of investors who presently have an 80/20 portfolio allocation.

Once the above decisions have been made, the accumulator also has a timing decision to make. Let's say he or she has $10,000 to invest. Should it be invested immediately, all at once? If gold moves up quickly from present levels, this would be the most profitable. But also, from a timing point of view, the most risky.

The accumulator might prefer to "diversify the timing risk" by dollar-cost-averaging, investing $1,000 a month for the next 10 months. Or, he or she might choose a combination, such as $4,000 now and $1,000 a month for the next six months. Because we can't know the future price behavior of gold, there's no "correct" way to approach this. The decision will be based on one's personal risk tolerance and assessment of gold at current levels.

Specific investments for the long-term accumulator: Gold coins

If you want to own physical gold, one approach that fits the wallet of most investors is to purchase gold coins—not collectible coins with numismatic value, but legal-tender bullion coins issued primarily for their gold content.

Gold coins have been around for thousands of years, of course, but the kind of bullion coins popular today date only to 1967 when South Africa introduced the Krugerrand (named after former South African leader Paul Kruger, whose image is on the coin). The goal of the South African gold mining industry was to boost demand for its prod-

uct by making available a convenient and trustworthy form of gold that could be easily bought and sold at a relatively low premium over the prevailing international price of bullion. In 1970, the Krugerrand began to be mass produced and overseas sales began.

Each Krugerrand contains one "troy ounce" of gold (precious metals are usually measured in troy ounces; a troy ounce weighs about 10% more than a regular ounce). However, the coin actually weighs *more* than one troy ounce due to the addition of a small amount of copper to add durability. As a result, the coin is only 91.667% pure gold (22 karats). Don't let that confuse you—it still contains a full troy ounce of gold.

Eventually, fractional versions of the Krugerrand came on the market: a half-ounce coin, a quarter-ounce coin, and even a one-tenth ounce coin. This put gold ownership within the reach of millions of buyers who couldn't afford to purchase a one-ounce Krugerrand. Today, with nearly 55 million coins in circulation, the Krugerrand is the most widely-held gold-bullion coin in the world. (NOTE: If you're using gold coins for an IRA investment, be aware that U.S. law requires non-U.S. gold coins used for IRAs to have a fineness of at least .995. That means Krugerrands don't qualify.)

A significant shift occurred in the gold-coin market in 1979 when Canada introduced a *pure* gold coin. The one-ounce Maple Leaf is 99.99% fine (24 karats). As a practical matter, a pure-gold formulation isn't durable enough for such coins to be used in general circulation. But for purposes of investment, where coins are stored rather than circulated, this isn't a consideration.

After the Maple Leaf came on the market, many investors preferred Maple Leafs over Krugerrands because of the intangible value associated with holding a "pure gold" coin, even though the amount of gold in a Krugerrand and a Maple Leaf is almost exactly the same (Maple Leafs weigh slightly less than Krugerrands because there is no base metal added).

The U.S.A. was late in coming to the gold-coin party. It wasn't until 1985 that Congress authorized the U.S. mint to produce legal-tender gold coins. The first American Gold Eagle coin appeared the following year. The U.S. followed the South African model of using a formulation of 91.667% fine gold, choosing to alloy the gold with both copper *and* silver. This gives the Eagle a slightly different color than either the Krugerrand or Maple Leaf. In addition to producing a one-ounce Eagle, the mint eventually added half-ounce, quarter-ounce, and tenth-ounce sizes as well.

Given the growing popularity of *pure*-gold coins (not only Maple Leafs but also coins introduced to the market by China, Australia, and Austria), the U.S. ultimately entered the pure-gold market with the introduction of the American Gold Buffalo in 2006. Based on the design of the old Buffalo nickel, American Buffalo coins come in one-ounce, half-ounce, quarter-ounce, and one-tenth ounce varieties.

The most popular gold-bullion coins are those shown in the table below. Three levels of gold content are shown for each coin. Notice that the "premium over spot price" *increases* as the degree of gold content *decreases*. (The spot price, which can change minute-by-minute, is the current market price of the actual physical commodity as it is being traded in the spot market where goods are sold for cash and delivered immediately. The terms spot price and cash price are used interchangeably.)

UNDERSTANDING THE DIFFERENCES

The Three Most Popular Gold Coins >	American Gold Eagle	Canadian Maple Leaf	South Africa Krugerrand
Face Value	$50 U.S.	$50 Canada	None
Total Weight (In Grams)	33.930	31.1030	33.930
Fineness (Percent Pure Gold)	91.667%	99.99%	91.667%
Gold Content (In Grams)	31.103	31.100	31.103
◆ Gold Content (In Troy Oz.)	1 oz	1 oz	1 oz
Premium Over Spot Price[1]	4%-5%	4%-5%	3%-4%
Face Value	$25 U.S.	$20 Canada	None
Total Weight (In Grams)	16.965	15.5515	16.965
Fineness (Percent Pure Gold)	91.667%	99.99%	91.667%
Gold Content (In Grams)	15.552	15.551	15.552
◆ Gold Content (In Troy Oz.)	½ oz	½ oz	½ oz
Premium Over Spot Price[1]	8%-10%	**	**
Face Value	$10 U.S.	$10 Canada	None
Total Weight (In Grams)	8.483	7.777	8.483
Fineness (Percent Pure Gold)	91.667%	99.99%	91.667%
Gold Content (In Grams)	7.776	7.776	7.776
◆ Gold Content (In Troy Oz.)	¼ oz	¼ oz	¼ oz
Premium Over Spot Price[1]	12%-18%	**	**

Notes: [1]Range of best prices found in Web surveys during July and August 2009. ** Not included in surveys.

The premium is the difference between the spot price and the price dealers typically charge—in other words, their markup. Because the smaller coins aren't as profitable for the dealers, they charge a higher premium to compensate. Here's how that works. Let's say that on the day you buy your coin(s), the spot price of gold is $1,360. A dealer who charges a 5% premium for a one-ounce Gold Eagle will be selling them that day for $1,428. Also be aware that dealers often charge a different premium based on the coin being purchased. Premiums for both Krugerrands and Maple Leafs are generally less than premiums for American Gold Eagles.

Another thing to keep in mind when coin shopping is that premiums quoted may reflect a dealer's "best price" based on a volume discount. In other words, to buy at that lowest level of premium may require a minimum purchase (usually at least five or 10 coins). So be sure to verify the actual price and premium before ordering.

You need to know at least three other important things about the market for gold-bullion coins:

- **Gold coins can be sold by anyone**. Dealers are not regulated and there are no licensing requirements. So it's "buyer beware" all the way.
- **Gold coin prices aren't standardized.** This means it's not uncommon for inexperienced investors to overpay. It is up to you to make sure the price you pay is competitive (i.e., shop around!).
- **Gold coin prices fluctuate throughout the day along with the spot price of gold.** On a volatile day, this can make it difficult to compare dealer prices for the

same coin. You should focus instead on a dealer's premium, which doesn't change as frequently.

To find a gold-coins seller, check the dealer list published online by the U.S. Mint at www.usmint.gov/bullionretailer, but remember that dealers aren't regulated or licensed, so inclusion in the Mint's list is not an endorsement.

When buying, always insist on undamaged/unmarked coins. Gold bullion coins with edge nicks and heavy bagmarks or gouges are worth less when dealers buy them back.

Finally, find out if the dealer has an exchange policy that guarantees satisfaction. In other words, if you're unhappy with the condition of the coins you receive, can you exchange them? You may want to call the dealer and clarify exactly how the exchange policy works and find out if there are any exceptions or limitations.

Some dealers promise to buy back your coins when you're ready to sell, but that's not much of a promise since the dealer isn't guaranteeing he will buy them back at a specific price. Indeed, when you do sell—whether back to the dealer or to someone else—expect to receive roughly the current spot price (perhaps within a percent more or less depending on the market trend). This, of course, is why you don't want to pay too high a premium when you purchase your coins.

Another thing to think about is protecting your coins from theft. If you store gold at home, put it in personal safe and be sure the safe is securely attached to the floor (so a thief can't put it on a hand truck and roll off with it!). A better option, depending on how many coins you have, is to store your gold coins in a bank safe deposit box.

Most standard homeowner's policies have very limited coverage for gold kept in a house. Generally, polices cover only up to $200 for gold bullion—far less than the value of a single 1-ounce coin. Special riders may available, however, so consult your agent.

Another option for the long-term accumulator: Gold bars

Gold bars tend to be more complicated to buy and harder to resell than gold coins, so I don't consider them as attractive as coins. An exception would be if you intend to make a very substantial purchase. Gold bars do sell at a smaller premium (i.e., markup) than coins do, so there's an opportunity for some savings when making a sizable investment.

Gold bars can be purchased in many sizes, from the 1-gram wafers to the hefty brick-like bars—the type held by governments and central banks—that weigh 400 troy ounces each (more than 27 pounds) and come with a hefty price tag to match (more than $600,000 apiece at today's prices!).

For average investors, the standard unit for gold bars is 10 troy ounces. For those for whom that's still out of reach, 1-ounce bars are quite popular. (If you buy less than an ounce, you can expect the premium to rise significantly.)

Worldwide, there are about 100 internationally accredited makers of gold bars. Some of the more well-known are Credit Suisse, Engelhard, Johnson Matthey, Metalor Technologies, Produits Artistiques Métaux Précieux (PAMP), and the Perth Mint.

According to the World Gold Council, most gold bars are classified into two types. "Cast" bars are made by pouring molten gold into a mold of specified dimensions. Markings are then applied manually or by a press. These are often referred to as "ingots." Bars made from gold blanks and stamped out to various dimensions are called "minted" bars or "biscuits." This process gives the bars a more lustrous finish, similar to gold coins. Markings are then applied by minting presses.

Most gold bars made today have a fineness (purity) of 99.99% pure gold, but that varies somewhat by manufacturer. Some bars have a fineness of 99.50%. When you buy a gold bar, you should receive an "assay certificate" that documents the bar's purity, refiner, and serial number.

As noted above, bars usually sell at a smaller premium than coins. In today's market, expect to pay about 2.5% to 4% above gold's spot price. As with coins, prices for gold bars fluctuate in relation to the spot price, which can change minute-by-minute when gold markets are open. Although some dealers post their gold-bar prices on the Web, many require you to call to get their current prices so they can check the latest spot price before making a firm quote.

When shopping, start by deciding which size bars you'll be buying. The advantages of the 1-ounce size are that they are more affordable and cheaper to ship. The drawback is they carry higher premiums. The 10-ounce bars, if you can afford them, have lower premiums, giving you more gold for your money.

To find dealers, check the website of the World Gold Council at www.gold.org for a list of companies. Again, these are just listings, not recommendations.

After researching companies online, call a few dealers and double check the information you found on the Web: Where was the gold refined? What is the purity level? How will the gold bar(s) be delivered? Do you guarantee quality? What options do I have if I'm not satisfied with my purchase?

In addition to your purchase price, buying gold means you will incur costs for storage, whether that involves buying a home safe or paying a dealer or independent depository to hold the gold for you. If you store bars at home, you'll need to add a rider to homeowner's policy (as noted previously, most homeowner's policies will cover only

up to $200 for gold bullion—that's not much!). Check with your agent to see how much additional coverage is available.

You can find out about dealer-storage options from dealer websites (or by calling). Some dealers have arrangements with third-party depositories to hold their customers' gold purchases in specially-secured vaults. Nevertheless, there is always a degree of counterparty risk when you rely on dealers to store your bars—many scams have arisen from such arrangements.

Because gold is valuable and not easily traceable, there is great incentive for theft and fraud. You must be on your guard. Remember, sellers of gold bullion aren't licensed or regulated. It's up to you to perform due diligence to make sure you're dealing with a reputable firm. Never buy bars from a dealer that doesn't have a strong—and long —reputation.

A newer option for the long-term accumulator: Digital gold

Digital gold currency, or DGC, is an electronic form of money valued in terms of gold rather than a currency. It takes the form of a savings-like account through which you can buy, store, and sell your gold via the Internet in any quantity at anytime from anywhere. You make a deposit that is converted into gold and credited to your account. Your statements refer to how many grams or ounces of gold you own. DGC is convenient, and the buy/sell commissions and storage costs are low.

There are several players in this market, but the leader is GoldMoney, a firm launched in 2001 by James Turk, an internationally-recognized expert on the precious metals markets. The company's main offices are in Jersey, one of the Channel Islands of the British Isles.

The main features of interest to prospective clients are:

- **Ownership rights.** The gold in your account is legally your gold held in your name.
- **No counterparty risk.** Your direct ownership rights mean you are not dependent on GoldMoney's financial solvency for protection. If for any reason the company failed, your gold would be delivered to you.
- **No minimum purchases.** You can buy and store in amounts that fit your particular strategy (whether little or much). This ability to make "fractional" purchases frees you from the common denominations found with gold coins/bars, and makes the accounts ideal for dollar-cost-averaging.
- **Low commissions.** When converting your dollars into gold, the premium is

only 2.5% (and less for larger purchases) over the spot price. There is *no charge* for selling your gold.

• **Fully insured.** All metals holdings are insured 100% against theft by a policy underwritten by Lloyd's of London.

• **Low storage fees.** The gold is stored in London and Zurich at the VIA MAT vaults, a division of one of Europe's largest armored transport and storage firms. The fee for this is less than two-tenths of 1 percent of the value of your gold holdings per year. This includes the cost of the insurance.

• **Regular, mandated audits.** Quarterly reports from the vault operators and database auditor (companies independent from GoldMoney) verify that the amount of gold shown on your statement is, indeed, in the vaults. Further, a "Big Four" accounting firm provides an annual audit and report.

• **Option of taking physical possession.** At any time of your choosing, you have the option of having your gold delivered to you in 100-gram units (a little over three troy ounces). There is a 4% redemption fee for this service (less for 1000-gram bars).

For these reasons, this service has a lot of appeal. I opened my personal account there and have had a good experience to date. However, you should carry out your own careful investigation of GoldMoney (or any of the other DGC companies) to gain a satisfactory comfort level. Information is available at www.goldmoney.com. To learn more about companies in the digital-gold market, go to www.dgcmagazine.com.

An option for the opportunistic trader: Exchange-traded funds

Now we turn to two kinds of investments suited to those with a shorter-term outlook, the first being commodity-based exchange-traded funds (ETFs). These securities, which trade like stocks on the New York Stock Exchange, were designed to give investors easy exposure to the various commodity markets. The dominant ETF with an emphasis on gold is SPDR Gold Shares (GLD), launched in 2004.

This stock-mutual fund hybrid buys gold, and its market price rises and falls in sympathy with changes in the gold price. Like all other ETFs and stocks, GLD can be purchased through your broker. Its shares trade continuously throughout the day and can be bought/sold at generally low commission costs.

The difference between owning GLD and actual gold is that the ETF is a security that serves as a paper proxy for owning actual gold. In theory, it is "backed" by gold, but *that is not the same as direct ownership of physical gold*. The GLD website explains: "SPDR Gold Shares represent fractional, undivided beneficial ownership interests *in the Trust*,

the sole assets of which are gold bullion, and, from time to time, cash [emphasis added]."

GLD offers a convenient way to gain exposure to changes in the price of gold, which is great for traders. However, GLD has drawbacks that make it a questionable choice for those interested in the long-term accumulation of gold: (1) holdings are neither inspected nor audited, (2) holdings are not insured, and (3) it's not clear if its holdings may include gold certificates and other "paper" gold vehicles as substitutes for gold bullion. In other words, there is counterparty risk (i.e., where the value and safety of your investment relies on others to honor their obligations or remain in business.)

This may be suitable for traders, but it doesn't seem well-suited for those wishing to build a long-term position guaranteed to be absolutely secure.

Also for the opportunistic trader: Gold-mining companies

A second indirect way to invest in gold is to buy shares in gold-mining companies. These are companies that specialize in locating and developing gold-rich properties. They may or may not actually mine the gold once they have discovered and gained ownership of the mineral rights. Some such are giant-sized dominant players, others are relatively small in size. Also, they vary widely in their geographical emphasis in terms of where they explore and operate their mining properties. Some focus on North America, others have a global reach.

Analyzing the prospects of such companies is a complicated task best left to experts. That's where mutual funds can help, namely those that specialize in following the gold mining industry and the companies therein, both large and small. Managers of these funds can sort through the issues and provide a convenient way to gain exposure to the price of gold.

When you invest in mining companies with proven reserves, you obtain leverage with respect to the price of gold. Let's say you bought gold at $900 an ounce. When the price later rose to $1,200, you made $300 an ounce, or about 33%, on your investment. Compare that with a mining company which, with gold selling at $900, was making, let's say, a profit of $100 an ounce on its gold production. When gold's price rose by $300, the company's profit margin (assuming no change in production cost) would have jumped from $100 to $400 an ounce. In other words, its profits would have grown by 300%. The company's shares would have climbed dramatically in price, certainly far more than the 33% you made by holding the metal. Obviously, this leverage makes the price of their shares extremely volatile, much more so than the price of gold itself.

The successful use of mutual funds as a substitute for directly owning gold depends on quite a few things. We're looking for solid companies with proven reserves, not specu-

lative exploration companies. We're assuming the companies have good management, and operate in politically stable countries. We're assuming the company isn't hedging its production in the futures market. We're assuming that geopolitical events that can trigger a rise in gold don't at the same time devastate the company's operations or disrupt normal channels of commerce. We're assuming the company doesn't use too many of its resources on precious metals other than gold. And we're assuming the mutual fund we own has picked these kinds of companies! As you can see, there's plenty of room for this approach to go astray.

COMPARING RISK AND RETURNS

Year	Gold Bullion	Gold Funds	Upgrade Funds
1991	-10.1%	-3.7%	4.4%
1992	-5.8%	-16.3%	-3.8%
1993	17.7%	79.8%	75.4%
1994	-2.2%	-10.8%	-10.9%
1995	1.0%	4.7%	1.1%
1996	-4.6%	9.5%	32.1%
1997	-21.4%	-41.6%	-44.7%
1998	-0.8%	-11.0%	0.4%
1999	0.9%	5.9%	13.8%
2000	-5.4%	-16.7%	-10.7%
2001	0.8%	19.0%	19.2%
2002	25.6%	63.1%	70.0%
2003	19.9%	56.0%	53.7%
2004	4.7%	-8.4%	-10.0%
2005	17.8%	30.8%	31.6%
2006	23.2%	31.6%	35.8%
2007	31.9%	23.5%	23.3%
2008	4.3%	-30.1%	-26.7%
2009	25.0%	53.0%	53.2%
2010	29.2%	41.8%	39.9%
Avg Annualized	6.6%	9.4%	13.0%
Volatility	4.3	9.4	9.8
Best 3 Months	25.8%	50.9%	54.5%
Worst 3 Months	-20.4%	-51.6%	-53.7%

If you're considering gold-oriented mutual funds, you should obtain prospectuses and annual reports from the ones that interest you. Risk varies depending on a variety of factors, as suggested above. These factors also include a fund's investment philosophy, regional exposure (how much invested in developed countries versus the Third World), degree of ownership of gold bullion in addition to mining shares, and the degree of diversification into non-gold areas.

Since 1991, the price (in dollars) for gold bullion has risen at a 6.6% annual rate (see table at left). During the same period, the average precious-metals mutual fund in the Morningstar database returned 9.4% annually, but with more than twice the standard deviation—volatility—and a wide range of results within the group. In other words, investing in the mining companies rather than gold bullion offered better returns but at a much higher level of risk. Consider the "worst 3 months" line in the table. Not many investors can accept watching their investment drop 50% in value in what seems like the blink of an eye.

If you are familiar SMI's Upgrading strategy, you may be wondering how an Upgrading approach—which involves regularly selling funds that are lagging in performance and replacing them with better performers—would work with gold funds. I tested such an approach by selecting eight no-load gold funds that were among the lowest in volatility (which is not saying much in this sector), and upgraded monthly following a modified version of SMI's momentum formula.

The results from this Upgrading test are shown in the table as well. There was significant improvement in the long-term results, with the average annual return coming in at about twice that of owning gold itself. The risk is still much higher than owning physical gold, but more aggressive investors might find this acceptable given that the return

is roughly twice as high as well. I suspect few investors have the stomach to stay the course with a gold-fund Upgrading strategy during down periods (see the "worst 3 months" results); however, for the courageous few, the gold fund recommendations needed to follow the strategy are published each month in the SMI newsletter on the "Optional Inflation Hedges" page.

Another option: Silver

To this point, our discussion of precious metals has focused exclusively on gold due to its popularity as a currency backstop. But this doesn't mean that other metals, in particular silver, aren't also worthy of consideration.

Silver has the highest electrical conductivity of all metals, which, when combined with its far lower price, means industrial demand for silver dwarfs that for gold. By one estimate, about 95% of the silver mined each year is used by business and industry, leaving a relatively small amount to add to stockpiles. Due to its industrial applications, silver tends to be significantly more volatile than gold.

Gold and silver prices are not fixed relative to each other. For example, in 2010 silver was up 83% while gold gained "only" 28%. Generally speaking, when precious metals do well (as in 2010), silver will typically outperform gold. In contrast, when metals are in retreat, gold tends to hold up better.

For those interested in not merely investing in precious metals but actually having some in their possession, silver's lower price makes it more readily available to the masses. One of the most popular ways to own physical silver is via "junk silver bags." Prior to 1965, U.S. dimes, quarters, and half dollars each contained 90% silver. These common, circulated coins are what is included in these junk bags. A "full bag" contains $1,000 face value of these coins—it doesn't matter whether the bag contains dimes, quarters, half dollars, or a mixture of the three, as the total silver content will be the same based on the face value of the coins (though half dollars do carry a small premium with some sellers). Given that a full bag costs roughly $26,000 at today's silver prices, a half bag ($500 face value) or even quarter bag ($250 face) will be more attainable for some investors.

Junk bags have one other significant benefit—the premium charged over the spot price of silver for a junk bag is typically among the lowest premiums charged for any type of precious metals purchase. Having a small amount of physical metals on hand seems to provide many with the same sort of peace of mind that comes with having a well-funded emergency fund.

For those who merely want to benefit from any price appreciation in silver, there are affordable silver-oriented ETFs which track the metal very closely. Two popular ones are the iShares Silver Trust (SLV) and ETFS Physical Silver Shares (SIVR).

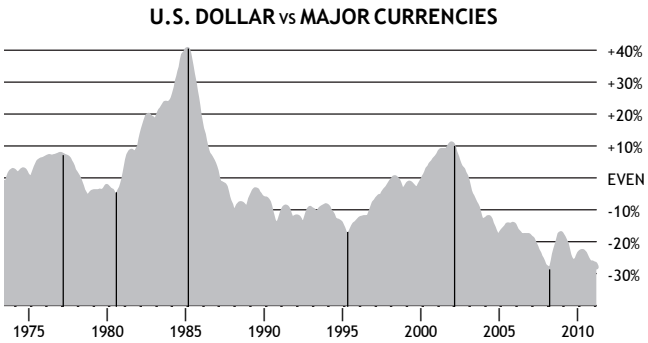
Looking ahead

The rise in gold and silver prices in recent years has been meteoric. But when something can't go on forever, it doesn't. So it's only natural to wonder if this is a bubble about to burst.

As long-time SMI readers know, we don't attempt to make forecasts. But we can provide a round-up of the pros and cons as we see them so you can make an informed decision as to what's best in your situation. Let's start with the factors that appear to favor further gold/silver gains (or at least seem to defend against a major selloff):

• **The weak-dollar argument.** This continues to be Exhibit #1 in the case for gold. A fairly strong long-term correlation exists between weakness in the dollar and a rising gold price. The chart below shows the relative strength of the dollar since 1973, which is when the Federal Reserve first began tracking its value in relation to a basket of other major currencies.

In broad terms, the chart divides the almost 40-year period into those years when the dollar was rising versus those times when it was falling. The accompanying table shows the change in the price of gold during each period. Clearly, there's a strong tendency for the dollar and gold, over time, to move in opposite directions.



Dollar Movement	Trend Begins		Trend Ends	Dollar	Gold
Dollar rising, gold falls	1/1973	-	12/1976	+9%	-24%
Dollar falling, gold rises	12/1976	-	7/1980	-14%	+358%
Dollar rising, gold falls	7/1980	-	3/1985	+55%	-47%
Dollar falling, gold rises	3/1985	-	4/1995	-44%	+18%
Dollar rising, gold falls	4/1995	-	2/2002	+40%	-24%
Dollar falling, gold rises	2/2002	-	3/2008	-37%	+214%
Dollar flat, gold rises	3/2008	-	2/2011	+2%	+51%

That's not surprising. The more the U.S. government debases the dollar by running the printing presses, the more it threatens to undermine its value. Under such circumstances, a flight out of the dollar and into gold, a historically popular form of money, is understandable.

A weak currency is primarily a reflection on government policies. Which bring us to the next point which favors a rising gold price—the current scene in Washington.

• **The political gridlock argument.** It is projected that the United States government will overspend by $1,600 billion in 2011—the largest deficit since World War II when measured against the size of the U.S. economy. Looking further ahead, the non-partisan Congressional Budget Office has said that the Obama administration's latest bud-

get proposal will likely generate at least $9,500 billion in deficits over the next decade.

Republicans won the House in the 2010 midterm elections with promises of spending reforms, but with Democrats still holding the Senate and the White House, major spending reductions seem unlikely.

Unless the 10-year plan proposed by Rep. Paul Ryan, chairman of the House Budget Committee, gains traction with the American people, there is no political solution to the massive projected deficits currently on the horizon. (Ryan's plan would reduce currently projected spending by more than $6 trillion over the next decade.) Without movement toward a solution, the dollar is expected to continue drifting lower and, accordingly, it's reasonable to think gold may continue moving higher.

• **The global instability argument.** Gold has traditionally been the most trusted of "safe havens" during times of crisis. The European debt crunch, uprisings in the Middle East and North Africa, saber-rattling by North Korea, and early 2011's massive Japanese earthquake and tsunami have created the kind of economic uncertainty on the world stage that, in the past, has heightened the demand for gold.

• **The inflation-adjusted gold price argument.** In response to those who say gold has run up too far and is in a bubble of its own, fans of the yellow metal point out that the critics are not taking the impact of inflation into account. In January 1980, gold hit a then-record $873 an ounce. In today's dollars, that would be $2,345, according to the U.S. Labor Department's inflation calculator (i.e., it takes $2,345 today to buy what $873 would buy in 1980). By that reckoning, gold would need to climb more than 60% from present levels to merely equal its previous high (when measured in constant dollars). That's a lot of head room.

Of course, not all the experts believe gold is necessarily going higher. Here are some commonly heard rebuttals:

• **The "it's just a commodity" argument.** Like copper, lumber, and other commodities, the price of gold is the result of demand/supply factors. Unlike the others, however, gold has relatively little practical value. Only about one-sixth of each year's mining supply goes into industry and jewelry.

Furthermore, efficiencies in mining combined with the enticement of higher gold prices has led to more gold being mined than in the past. According to the World Gold Council, gold's supply has been rising gradually since 2007. What will happen if/when supply finally exceeds demand? As with any commodity, the price will fall.

• **The indeterminate worth argument.** The value of an investment is typically calculated based on the income it will potentially generate. Whether you're looking at stocks, bonds, rental properties, oil and gas wells, whatever, the investor always has the

same question—how much income can I reasonably expect to receive in coming years if I make this investment? Based on the answer, along with interest rate assumptions and a present-value analysis, one can determine the "value" of that investment. Gold, however, generates no dividend or interest. To the contrary, it generates negative cash flow in the form of storage and insurance charges.

How, then, can it be objectively valued? It can't. This means any claim concerning the worth of gold is completely subjective.

• **The poor inflation-hedge argument.** Despite its reputation as a good way to protect against inflation, there have been long periods of time when it failed to do so. Indeed, the "inflation-adjusted gold price argument" put forth by the bulls (p. 19) proves the point. If, after adjusting for inflation, gold needs to climb another 60% or so from present levels to get back to its 1980 high in real terms, it clearly has failed as an inflation hedge for the past 30+ years.

And one need not look only to the recent past for more examples. One very long-term study, based on the official British price of gold dating back to 1265, showed there was a 500-year period running from the mid-1400s to the mid-1900s during which gold moved erratically lower in real terms, eventually bottoming out 90% below its starting value after adjusting for inflation.

So while gold has stayed even with inflation for some periods, there have been other periods in which it has failed in spectacular fashion to do so.

Investment implications

After looking at the arguments of the gold bulls and gold bears, we're back where we started—with no clear view into gold's future direction. But of all the points made by both sides, the ones that make the most sense to me are the "weak dollar" and "political gridlock" arguments made by the bulls.

The dim outlook for the dollar is primarily caused by the federal government's spending. It's a political problem that requires a political solution, but in the current environment one doesn't appear to be forthcoming. In buying gold, an investor is making a bet against Ben Benanke and Congress taking the right course.

Investors are understandably nervous about the current direction of our economic policies. If there is indeed a bubble in gold, it's been driven by that anxiety, and will only burst when people stop being nervous about federal spending, budget deficits, and the health of the economy.

Conclusion

The odds seem to favor a period of sustained inflationary pressure in the U.S., due primarily to our past and present governmental choices. Given that, it seems prudent to own some inflationary hedges, such as gold or silver.

But keep in mind that precious metals aren't guaranteed to continue rising, so you don't want to overdo your exposure.

In general, for those wishing to add a gold component to their portfolios, I suggest an accumulation strategy that involves directly owning gold bullion. For those planning to add a small amount (say under $10,000), buying gold coins and taking possession seems to be the easiest approach.

For those investing more than $10,000, there are two safe options. If you're not intimidated by the prospect of wiring money overseas, I recommend a savings account at GoldMoney.com. Their website is user friendly, and your transactions costs will be lowest with this approach. Alternately, gold coins are an option, again being sure to take possession of your coins (and being sure to store them securely!).

I have no specific recommendations when it comes to the indirect ownership strategies such as with mutual funds—other than be aware of the risks. All I can say is that owning such funds is not for the faint of heart. When it comes to gold funds, it's likely to be a wild ride any way you look at it.