



Not All That Glitters...

*"There's a lady who's sure all that glitters is gold
And she's buying a stairway to heaven."
— Led Zeppelin*

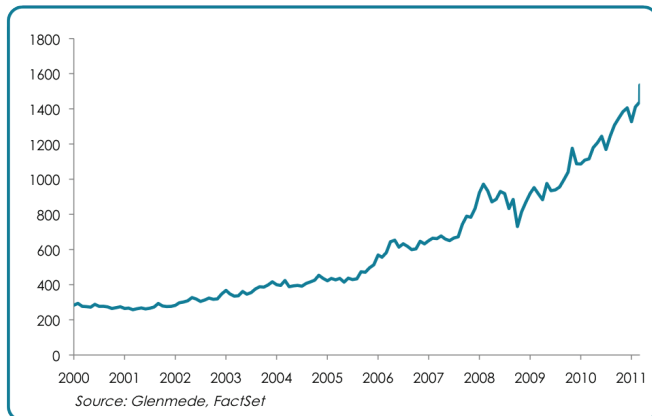
Summary

- Concerns over excess government debt and inflation have led to a rise in gold prices.
- Gold is a unique commodity that behaves more like a currency, acting as a store of value and providing no investment return beyond price fluctuation.
- Gold appears expensive when valued relative to inflation, hard assets and currencies.
- Gold's high price undermines its protective characteristics, making it more vulnerable to declines as monetary policy normalizes.

Fear of Debt and Inflation

The price of gold has seen a remarkable run since the beginning of this century, delivering an astounding five-fold increase. It is important to understand the causes of such a significant move.

Gold Price (\$/oz.)



Gold is the beneficiary of concerns over excess government debt and price inflation. As these fears have manifested, investors have sought the safety of this precious metal.

This sentiment is immortalized in Ayn Rand's *Atlas Shrugged* (1957): "If you want to know when a society is set to vanish, watch the money. Whenever destroyers appear among men, they start by destroying money, for money is men's protection and the base of moral existence. Destroyers seize gold and leave to its owner a counterfeit pile of papers."

Gold: A Unique Substance

Gold, while technically a commodity, has very different properties from most of its kin. For most commodities every ounce produced is sold and consumed, creating recurring demand. Agriculture

commodities are eaten or expire; gasoline must be replaced once depleted. Even hard commodities used for construction and manufacturing, such as aluminum and copper, are uneasily extracted once employed. Most commodities must be valued on a near-term basis in a way that accounts for the balance of production supply and consumption demand.

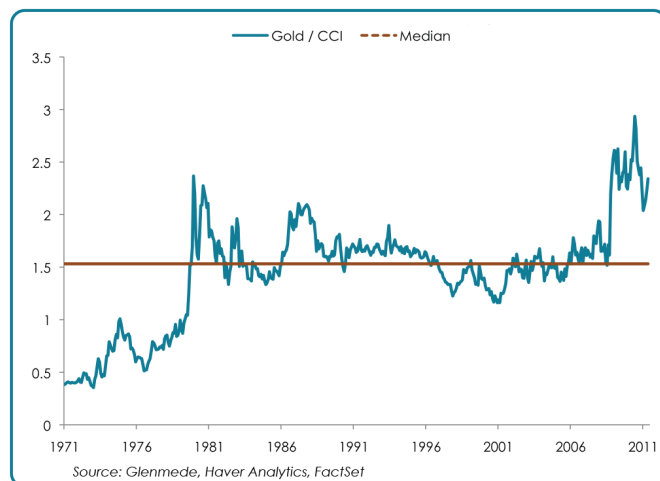
In contrast, very little gold is ever consumed. Annual production is less than two percent of the world's supply. Gold is held primarily as a store of value, either as physical bars in a vault or as jewelry in a box. In either case, the gold can be easily exchanged for cold, hard cash. TV infomercials and signs in the window of your local jewelry store remind you of this convertibility every day. It is for this reason that many financial professionals consider gold to be more of a currency than a commodity, despite its technical definition.

Central banks must have the same view as they collectively own 18 percent of the world's total gold supply. Prior to 1971, the world effectively operated on a gold standard where currencies were either directly or indirectly convertible to a certain weight of gold. While occasionally there were deviations — referred to as devaluations — there was a firm attempt to keep the money supply (within each nation) within certain bounds so that convertibility was possible for a good portion of the outstanding currency.

Valuing Gold

Unlike stocks or bonds, gold does not have an underlying yield, cash flow or earnings against which to compare its valuation. Commodities and currencies operate similarly in that neither generates investment returns beyond price fluctuations, although some economic gain can be found in the futures market. Not surprisingly, this confounds many investment professionals who view assets without an underlying return unfavorably. Yet, at the end of the day, this misses the point of value investing. All assets, independent of return generation capabilities, have a value based on their characteristics and the benefits provided.

Gold vs. CRB Continuous Commodity Index

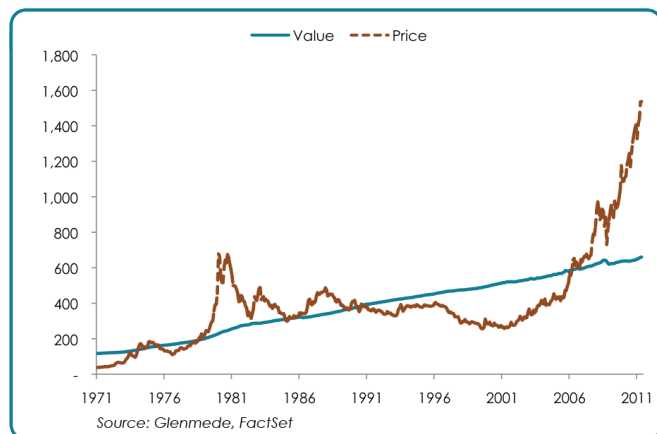


Sometimes, as is the case with any unique defensive maneuver, these benefits are less tangible and more work is required to determine the inherent value. Since gold is a commodity by definition and perhaps more like a currency in its actual utility, attempts to value the precious metal should center on these attributes.

Following this thinking, we believe there are three different ways to value gold. First, we can value gold relative to a broad basket of commodities. This is a narrow definition since it only gives an idea of relative valuation. However, it conveys

some interesting information. For comparison purposes, we chose the Commodity Research Bureau's (CRB) Continuous Commodity Index, a broad equal-weighted index of 17 commodities covering all sectors: energy, industrial metals, precious metals, livestock, grains and other soft agriculture commodities. Comparatively, gold is trading at a 60 percent premium to its relatively tight historical relationship to the CRB index. This supports the idea that investors tend to favor gold over other commodities as protection from the effects of both inflation and deflation. Yet, this preference may have gone too far.

U.S. Inflation and Gold

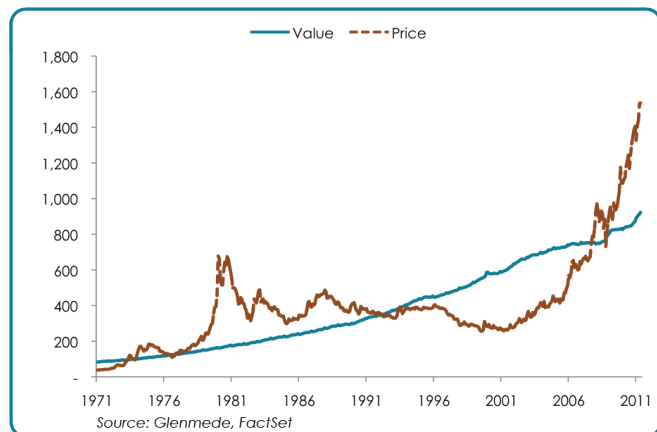


Second, we can value gold prices relative to inflation using the government consumer price index as a benchmark. By doing so, we view the purchasing power of gold in terms of a common basket of consumer goods. As a store of value, gold prices should generally rise with inflation; although extraneous factors can cause there to be rather significant deviations. With a history of wide and long-lived deviations, such analysis is arguably only beneficial at extreme valuations, such as near the peak in 1980 or the trough in 2001. Current gold prices are at the 90th percentile relative to inflation for the observed timeframe.

The last time we saw such an uptick was the 1980 peak, which subsequently saw a 50 percent decline within three years.

Lastly and perhaps more appropriately, we can compare gold to currencies. As discussed, gold's primary purpose is to act as a store of value. Throughout time gold has effectively been used as a currency for trading purposes. It is important to note that unlike fiat currencies, gold has a relatively static supply. With annual supply rising at a relatively constant rate of below two percent a year, gold is arguably a more stable store of value than a fiat currency which occasionally sees huge surges in supply.

U.S. Money Supply (M0) vs. Gold



To account for the differences in supply growth (monetary expansion vs. gold production), we calculated a theoretical value of gold based on the ratio of total money supply¹ to the total gold stock. Here, we see two significant deviations, one ending in a peak in 1980 and the other in a trough in 2001. Again, we also see the extreme valuation present in today's gold prices relative to the total U.S. money supply.

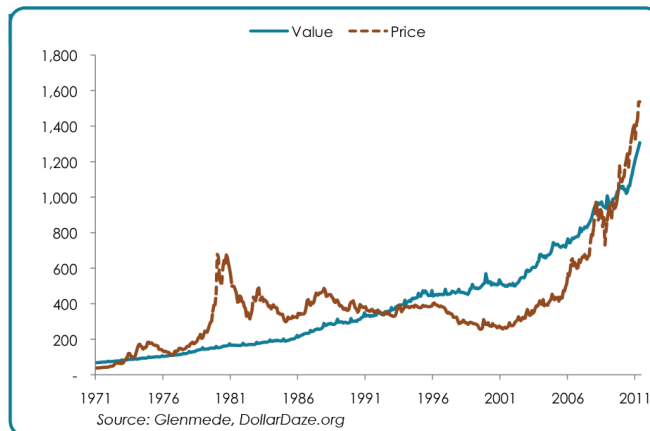
¹ Money supply (M0) is the total amount of money available in the economy at a particular point in time, typically published by the government or central bank. M0 includes all notes and coins in circulation or in bank vaults.

Too Much Glitter?

Whether listening to the lyrics to Led Zeppelin's "Stairway to Heaven" or reading Shakespeare's *Merchant of Venice* or the fables of Aesop, many have cautioned against the glitter of fool's gold. The mineral iron pyrite, with its metallic brass-yellow luster and resemblance to gold, has been the bane of many people hoping to strike it rich. Interestingly, we may face a similar situation today with the original precious metal itself. All three valuation frameworks indicate an extreme valuation for gold that is difficult to justify.

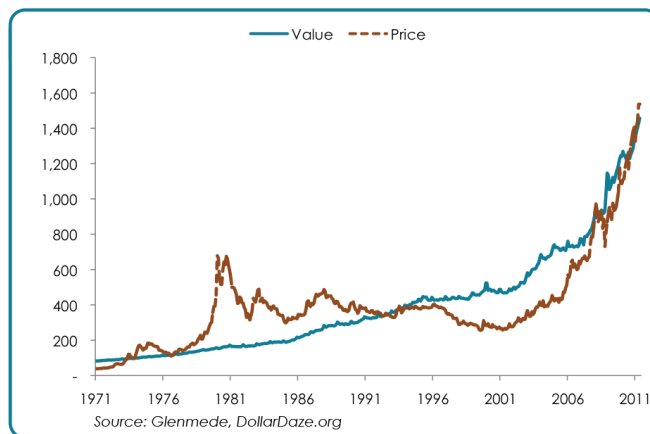
Of course, there are subtleties to these calculations that must be disclosed. First, U.S. monetary supply is not the full story. It may be worthwhile to view gold from a global perspective. Fortunately, world governments and central banks keep relatively good records of currency circulation. By compiling this data, converting each country's total into U.S. dollars and tabulating a simple sum, one can arrive at the total world monetary supply. This shows a slightly different picture from the charts we have seen so far. While gold is still overpriced relative to the historical relationship, the magnitude of this overpricing is not as pronounced.

Global Money Supply (M0) and Gold



Furthermore, money supply has multiple definitions. For the calculations we performed earlier we used the most common form and its most narrow definition, which includes notes and coins in circulation or held in bank vaults. Among the other definitions is the commonly used monetary base², which additionally includes central bank credit – both minimum required and excess reserves. This figure better captures the Central Banks' recent balance sheet expansion as it counts the reserves resulting from quantitative easing. When such reserves are included in the calculations, gold appears far closer to a fair valuation. Given the Federal Reserve and other central banks have well-communicated their intention to end quantitative easing programs and begin contracting balance sheets, we should hesitate to hang our hat on this as a reason to own a significant amount of gold. As apparent from this recent graph, the current price of gold is likely propped up by central bank actions. It can be further concluded that any true contraction of central bank balance sheets and global monetary base will likely be the trigger that precipitates the next decline in gold prices.

Global Monetary Base (MB) and Gold



² Monetary base (MB), also referred to as the total currency, includes M0 as well as Federal Reserve Bank credit (minimum and excess reserves, and is considered the most liquid measure of the money supply.

Investment Strategy: A Smarter Protection Against Inflation

The ongoing oversupply of money should have an inflationary impact, but not in all areas equally. Labor oversupply continues to stifle wage growth. Some purveyors of consumer goods and services continue having difficulty raising prices. However, commodities with relatively thin inventories and where demand is outpacing production will continue to feel upward pressure. This “bi-flation” environment, where material differences exist between upward price pressures in many commodities and downward price pressures in other parts of the economy, is likely to persist. Of course, every cycle has its limits, which are often dictated by pricing extremes. Gold appears to be at or at least near such a price extreme and arguments favoring gold are predicated upon greater fools or reliance on even more central bank stimulus to propel prices higher.

Since we do not want to fully relinquish protection from commodity inflation in a period of easy money and tight overall commodity supply, we advise investors to use a broad and active approach to commodity-oriented investments. More specifically, we recommend an approach based on investing in the scarcest commodities – those with the lowest inventories – thus better positioning investors to benefit from inflation-induced price spikes. We also continue to recommend commodity-related equities where valuations are attractive compared to owning the commodity outright. If necessary to maintain a more significant exposure to gold, gold miners should be a better long-term investment than owning the precious metal directly.

Admittedly, our sanguine attitude toward gold is not new. Having been a proponent of holding gold as both a protective investment and a portfolio diversifier as recently as 2009, we changed our tune on the precious metal in 2010 by recommending investors diversify their commodity exposure. As is often the case with valuation-based decisions, we were early in coming to this judgment. This decision has not yet had a material impact on returns; the performance of gold and a broader basket of commodities have been relatively similar through this timeframe. The SPDR Gold Trust (GLD), an ETF that holds physical gold in storage, has delivered a pre-tax total return of 40 percent since the beginning of 2010 and 28 percent over the past year, compared to 34 and 42 percent, respectively, for the CRB Continuous Commodity Index. As a result, the price of gold appears even more overvalued than previously observed, further affirming our long-term case against the metal. We continue to believe that while there are good arguments in favor of further near-term upward pressures on the price of gold, its valuation now exposes investors disproportionately to the risk of loss relative to its traditional protective properties.

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