EVERY ASSET HAS A FAIR VALUE EVEN THE FORGOTTEN ONES

It never ceases to amaze me all the misinformation that exists amongst the general public when it comes to investing. In the financial community at least, Gold is one of the most misunderstood investment classes there is. Not surprising given that for the last 23 years Gold has underperformed almost every asset class. I am constantly reminded of how if you invested in Gold in 1980 you would be severely behind. The number of times I have read this in financial sections of newspapers and in financial chat rooms is mind blowing. Here's an example of what I mean from a "so called" financial guru held in high esteem by the Australian Public in a recent newspaper article:

"Gold reached $US 641 an ounce in 1980 on expectations it would rise to US$2,000 but then crashed back down again to US$350 when these expectations were not realized. By the end of 2000 it was just $272. Confusing isn't it ? That's the dilemma – gold prices seem to defy logic and do the opposite of what's predicted. A further problem for Australian investors is that Gold is priced in American dollars so you have to factor in currency risk as well."

Here's the thing. If you invest in any asset class at the peak of its cycle when rhyme and reason goes out the window, chances are you will be waiting a while to get your money back. Just look at the Technology Boom. There will be investors that will never get their money back. I am sure there will be similar scenarios to come out of the present property boom as well.

Here's another example from Benjamin Graham from his infamous book "The Intelligent Investor". In a chapter on Inflation he writes the following:

The standard policy of people all over the world who mistrust their currency has been to buy and hold gold. This has been against the law for American citizens since 1935 –Luckily for them. In the past 35 years the price of Gold in the open market has advanced from $35 to $48 in early 1972 – a rise of only 35%. But during this time the holder of gold has received no income return on his capital, and instead has incurred some annual expense for storage. Obviously, he would have done much better with his money at interest in a savings bank, in spite of the rise in the general price.

He goes on to write:

The near-complete failure of gold to protect against a loss in the purchasing power of the dollar must cast grave doubt on the ability of the ordinary investor to protect himself against inflation by putting his money in "things".

Obviously Benjamin Graham didn't have the benefit of hindsight when he wrote this as Gold over the next 8 years went on to make massive gains and outperform just about every other asset class. Common sense however suggests the Gold standard might have had something to do with Gold's poor performance, as it spent almost all of the time Graham makes reference to fixed at $35. This view of Benjamin Graham's is still common today despite the benefit of looking at the 70's and early 80's.

Paul Van Eeden is an analyst I am sure many of you are aware of. There are a number of things I have learnt from reading his columns. Probably the most important thing is that everything has a rational value including Gold. If you invest with disregard to this fact, chances are you will not be a successful investor. The most successful investors invest when the risk reward is primarily in their favor. That is when an asset is trading at a substantial discount to its fair value. Sounds simple enough doesn't it? Well it's not that easy. To invest in an environment where an asset class is out of favor is tough because every man and his dog are telling you that you are making a horrible mistake. That is when having an understanding of value is important. This is what gives you the courage of your convictions to invest when other "misinformed" investors are insisting you are wrong but can rarely give you any sound reasoning as to why.

I live in Australia but have Gold investments all over the world. As an Australian my Aussie Gold investments are affected by the Australian price of Gold which is obviously a function of the Aussie Dollar. At this point I will make reference to a column Paul Van Eeden released Paul van Eeden's Weekly Column on Kitco explaining that the fair value of Gold can be calculated in any currency by looking at the money supply increases in that particular country versus the increase in world Gold production (Since 1950 a 1.73% increase according to United Nations figures). Paul calculated that US money supply measured by M3 during this time had increased at a compound rate of 7.8%. Therefore this implies that the theoretical value of Gold should have increased at the net rate of the two, 6.07% (7.8% less 1.73%). Using a theoretical value for Gold of $51.22 as at 1959 this gave a monetary inflation adjusted price today of US$770 an ounce. I decided I would undertake a similar exercise in an attempt to calculate the monetary inflation adjusted price of Gold in Australian dollars. The results are in a table format below. I have also thrown in CPI inflation rates and Interest Rates so you can get a feel of the respective investment climates. I have separated the table into three distinct sections each representing differing inflation cycles. For those of you that prefer diagrams, this information is also represented graphically further below with the inclusion of the All Ordinaries Index (Australian Stock Market index) so you can see Gold's performance relative to the stock market.

THEORETICAL PRICE OF GOLD 1959 – 1970 (LOW INFLATION)

Dates	10 Year BB Interest Rates	Official CPI (June Qtr)	M3 Aggregate Money Supply	Rate of Australian M3 Change	Above Ground Gold Average Annual Increase (1.73%)	Australian Theoretical Gold Price	Actual Australian Gold Price	Actual as % of Theo.
Jul-1959	4.88	1.81	6.70			45.60	31.25	69.00%
Jun-1960	4.88	3.68	7.20	7.18%	1.73%	48.09	31.48	65.00%
Jun-1961	5.38	3.21	7.30	1.52%	1.73%	47.98	31.67	66.00%
Jun-1962	4.81	-0.78	7.80	7.45%	1.73%	50.73	31.43	62.00%
Jun-1963	4.37	0.67	8.50	8.57%	1.73%	54.20	31.39	58.00%
Jun-1964	4.58	1.67	9.60	12.20%	1.73%	59.87	31.49	53.00%
Jun-1965	5.15	4.04	10.30	8.17%	1.73%	63.73	31.52	49.00%
Jun-1966	5.17	3.36	10.90	5.80%	1.73%	66.32	31.54	48.00%
Jun-1967	5.03	2.95	11.80	8.11%	1.73%	70.56	31.38	44.00%
Jun-1968	5.11	2.86	12.80	8.30%	1.73%	75.19	35.42	47.00%
Jun-1969	5.35	2.88	14.00	9.13%	1.73%	80.75	37.08	46.00%
Jun-1970	6.86	3.73	14.80	6.18%	1.73%	84.34	32.28	38.00%

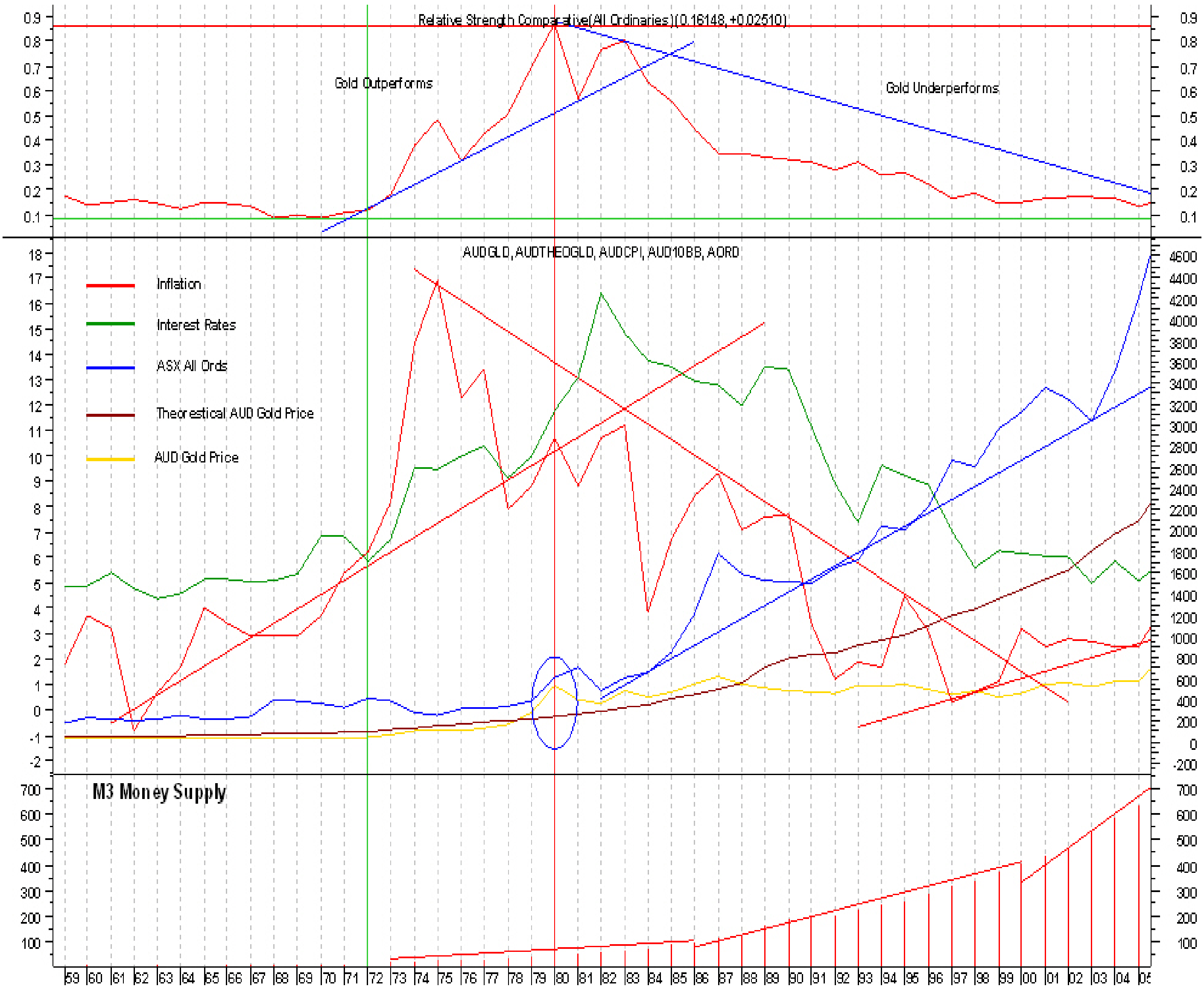
THEORETICAL PRICE OF GOLD 1971 – 1990 (HIGH INFLATION)

Dates	10 Year BB Interest Rates	Official CPI (June Qtr)	M3 Aggregate Money Supply	Rate of Australian M3 Change	Above Ground Gold Average Annual Increase (1.73%)	Australian Theoretical Gold Price	Actual Australian Gold Price	Actual as % of Theo.
Jun-1971	6.83	5.40	15.90	6.83%	1.73%	88.65	36.06	41.00%
Jun-1972	5.85	6.23	17.50	10.45%	1.73%	96.38	49.05	51.00%
Jun-1973	6.72	8.20	22.00	25.67%	1.73%	119.45	68.74	58.00%
Jun-1974	9.52	14.40	24.70	12.29%	1.73%	132.07	103.53	78.00%
Jun-1975	9.50	16.90	28.60	15.59%	1.73%	150.37	121.33	81.00%
Jun-1976	9.99	12.30	32.70	14.41%	1.73%	169.43	100.96	60.00%
Jun-1977	10.41	13.40	36.30	10.99%	1.73%	185.13	132.53	72.00%
Jun-1978	9.10	7.90	39.20	7.96%	1.73%	196.66	168.54	86.00%
Jun-1979	10.00	8.80	43.80	11.82%	1.73%	216.51	272.95	126.00%
Jun-1980	11.76	10.72	49.20	12.29%	1.73%	239.37	531.27	222.00%
Jun-1981	13.10	8.84	55.40	12.67%	1.73%	265.56	400.70	151.00%
Jun-1982	16.40	10.74	61.70	11.31%	1.73%	291.00	367.80	126.00%
Jun-1983	14.85	11.18	69.40	12.52%	1.73%	322.41	484.85	150.00%
Jun-1984	13.75	3.85	76.70	10.57%	1.73%	350.92	419.13	119.00%
Jun-1985	13.50	6.73	90.10	17.47%	1.73%	406.17	476.33	117.00%
Jun-1986	12.95	8.43	101.90	13.04%	1.73%	452.13	543.41	120.00%
Jun-1987	12.80	9.28	114.90	12.79%	1.73%	502.13	620.57	124.00%
Jun-1988	11.95	7.06	130.20	13.29%	1.73%	560.17	550.38	98.00%
Jun-1989	13.50	7.60	166.50	27.92%	1.73%	706.89	504.44	71.00%
Jun-1990	13.40	7.68	190.40	14.36%	1.73%	796.14	486.07	61.00%

THEORETICAL PRICE OF GOLD 1991 – 2005 (LOW INFLATION)

Dates	10 Year BB Interest Rates	Official CPI (June Qtr)	M3 Aggregate Money Supply	Rate of Australian M3 Change	Above Ground Gold Average Annual Increase (1.73%)	Australian Theoretical Gold Price	Actual Australian Gold Price	Actual as % of Theo.
Jun-1991	11.17	3.40	202.60	6.43%	1.73%	833.54	471.44	57.00%
Jun-1992	8.90	1.20	208.50	2.90%	1.73%	843.28	459.16	54.00%
Jun-1993	7.37	1.90	229.60	10.11%	1.73%	913.98	535.21	59.00%
Jun-1994	9.63	1.70	246.20	7.24%	1.73%	964.33	526.68	55.00%
Jun-1995	9.21	4.50	263.60	7.06%	1.73%	1015.73	542.17	53.00%
Jun-1996	8.88	3.10	290.50	10.19%	1.73%	1101.68	491.37	45.00%
Jun-1997	7.05	0.30	321.00	10.51%	1.73%	1198.40	444.00	37.00%
Jun-1998	5.58	0.70	340.90	6.19%	1.73%	1251.87	479.56	38.00%
Jun-1999	6.27	1.10	375.80	10.25%	1.73%	1358.54	422.62	31.00%
Jun-2000	6.16	3.20	406.50	8.16%	1.73%	1445.89	466.19	32.00%
Jun-2001	6.04	2.50	440.00	8.24%	1.73%	1539.99	547.59	36.00%
Jun-2002	5.99	2.80	472.40	7.35%	1.73%	1626.61	552.21	34.00%
Jun-2003	5.01	2.70	534.60	13.18%	1.73%	1812.87	518.43	29.00%
Jun-2004	5.87	2.50	588.50	10.07%	1.73%	1964.14	574.54	29.00%
Jun-2005	5.11	2.50	636.20	8.11%	1.73%	2089.48	572.35	27.00%

THEORETICAL PRICE OF GOLD 1959 – 2005



I have looked and studied this data in depth in an attempt to get a feel for how Gold performs in various investment climates. I would like to highlight four main points for you today.

GOLD AS A STORE OF WEALTH

As you can see from the data above, Gold can realize and exceed its theoretical value in times of high inflation and growing uncertainty. Taking a look at the high inflationary period of 1971 - 1990 (Inflation above 4%) we can see interest rates rose and the actual price of Gold increased very rapidly up to and beyond its theoretical value. By June1980 Gold was trading at more than twice its theoretical value. It was about this time people were "talking" about

Gold going to US$2,000 an oz and speculative frenzy took over from rational thinking. The smart money that knew Gold had vastly exceeded its fair value used this as an opportunity to exit their Gold investments and look elsewhere. It was about this time stocks in general were at bargain basement prices. If you look at the performance of the All Ordinaries index in the ten year period from 1972 to 1982 you can see the index could only manage 65 points or close to 15.5%. Take inflation into account and your investment return would have been negative. Gold in this same period put on AUD$318.75 an ounce or 649%!! The reason for this explosiveness was obvious. The Gold price had been fixed at US$35 up until the abolishment of the Gold standard in 1971. During this period it had become extremely undervalued. It had a lot of lost ground to make up and made it up relatively quickly due to the Gold favorable investment climate.

INTEREST RATE CYCLES

I am a big advocate of using interest rates to decide upon appropriate asset classes to invest in. Increasing interest rates generally implies higher inflation or inflation expectations and as we can see from the data above Gold is one of the best stores of value during these periods (Provided it can trade freely on an open market). Once higher interest rates bring inflation and the fear of inflation into check, Gold starts to fall and continues to under perform as long as these conditions prevail. Stocks are generally the best performers in times of falling interest rates and the low inflationary periods that come with them. This is again demonstrated above with the All Ordinaries putting on 3,717.30 points since 1982 (At the interest rate peak of 16.4%) or 775%. Gold during this same period only managed AUD$204 or 55%, a far cry from 775%.

WHERE ARE WE TODAY?

As I write this I firmly believe we are looking at a period where uncertainty will reign supreme again. Stocks in my opinion are heavily overvalued and the Gold price as you can see above is trading at a heavy discount to its fair value (73%. In 1970 it was 62%). I think the theoretical value is a fairly accurate number given the fact that right up to 1988 the actual price was as close as 2% to the theoretical. A void has since developed due to the change in interest rate cycles and investment climates. In Australia at the present time there is much debate about expensive fuel and a company has recently announced it is increasing the price of its milk. Apart from the airlines, this is the first company to publicly announce that an increase in costs has forced it to make such a move. I am sure more will now follow. There is also talk that skilled labor shortages are likely to force wages higher which will also impact on consumer prices. When all is said and done these are the typical things the public recognizes as inflation whilst the increase in money supply at a greater rate than increases in goods and services is the main driving force. The tide is turning in my opinion and Gold seems a pretty smart place to be. The fact that I still get many puzzled looks when I mention my investments in Gold and Gold equities also gives me heart that I am probably in the right place.

IS THIS A GOLD BULL MARKET OR A US DOLLAR BEAR?

Finally there is much debate about whether Gold is in a bull market or the US dollar is in a bear market. As you can see above the theoretical price of Australian Gold (AUD$2,089.48) is substantially higher than the US$770 an oz theoretical US Gold price. The reason for this is the Australian money supply has increased at a much greater rate (10.4%) than that of the USA (7.7%). I think if you looked at the theoretical price of Gold in most western currencies at the present time you would see a massive disconnect between actual and theoretical prices. The Australian dollar has been rising over the last few years however, and one wonders if that hasn't been just a function of our higher interest rates attracting more foreign capital. Since Greenspan's rate rising extravaganza this rate differential has been closing and Gold in Australian dollars has consequently been rising (AUD$624 an oz as I write this article). Also, despite higher commodity exports to China, Australia still runs a historically high trade deficit. One would think this does not bode well for our dollar especially if there was a worldwide economic slow down. I think Gold will ultimately rise in all currencies with many suggesting that this universal move has already begun. To suggest the US gold price will be the only one to benefit suggests the Gold price in other currencies is fairly priced. As I have demonstrated above this is clearly not the case.

CONCLUSION

I hope this article has helped you get a better perspective of Gold as an investment class. There are many fund managers and brokers that conveniently leave out the 70's when calculating stock market returns over time. They start their calculations from 1981 or 1982 and boast about the superior returns over that period (The above table demonstrates why). People buying into shares or managed funds now expecting those returns to be replicated, I dare say will be in for a rude shock. The financial landscape in my opinion is changing and we as investors need to change with it.

Troy Schwensen

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