



STRATEGY UPDATE

October 2011

Strategy Review

Our last strategy update, other than regular quarterly correspondence, was in November of 2009. While the basic ideas presented have not changed since that time, we feel it appropriate to revisit and confirm the foundations upon which our strategy and allocations are based.

In March of 2009, the world faced financial and economic Armageddon. There were two choices. One was to allow the world to collapse into another great Depression and the other was to conduct what is called “Quantitative Easing”, or QE. QE is a fancy word for the printing of money. Governments around the world committed to printing and distributing over \$20 trillion. It was the right thing to do at the time. How the money was allocated is certainly debatable by reasonable people, but printing was the only acceptable choice.

We predicted that the stimulus would create a global recovery, and it succeeded in doing so. We also believed that the printing of such an enormous sum would create both short- and long-term inflation, and it did. The magnitude and duration of the long-term inflation is still unknown, but it will be substantial if history is our guide.

Our allocations reflected these beliefs. We allocated roughly $\frac{3}{4}$ of the assets towards a global recovery and $\frac{1}{4}$ to an asset class called “Dollar Hedge”. The Dollar Hedge strategy itself was created about the time Portola Group came into being during the late ‘70s. At the time, we faced similar circumstances. The dollar was being debased due to uncontrolled printing that had begun in the mid-‘60s as well as a drastic increase in the price of oil.

The components of the Dollar Hedge strategy at the time were gold, and a few “hard money” currencies. The main hard money currencies were the Swiss Franc, the German Deutschemark and the Japanese Yen.

Our allocation to Dollar Hedge was more modest in that era as there were alternatives. A substantial portion of our client assets were also allocated to real estate and emerging markets, particularly Asia.

In the current era, the allocations to Asian equities and real estate have been very small. As we all know, real estate has been under tremendous downside pressure, and the Asian/Emerging Markets equities were the darling asset class for much of the past decade.

For this cycle, we started out with currency investments in the Australian and Canadian Dollars, the South African Rand and the Swiss Franc. The rationale for the first three was due to their heavy resource-based economies and the reason to invest in the Franc was that it has been regarded as a currency from a country that embodied fiscal and financial rectitude.

The \$20 trillion of stimulus worked. We experienced a strong global recovery. Companies that sold inputs to the recovery did very well. Among such inputs were coal, iron ore, oil, and technology to name a few. The dollar hedge portion of the portfolios also performed exceedingly well.

In the first half of 2010, however, the stimulus money was essentially spent or trapped in the banking system. The equity markets started to turn down as investors worried about a double dip in economic activity. We pared back substantially on those positions that were exposed to the economic recovery, and let stand the allocation to the Dollar Hedge asset class.

The world waited to hear from the Chairman of the Federal Reserve, Ben Bernanke. In August of 2010, Chairman Bernanke gave the world what it wanted to hear, QE2. Since the date of his speech, the equity markets and the Dollar Hedge assets soared.

Oddly enough, fixed income prices also soared in this period. As the Chairman indicated his intention to support the stock market, he also has provided tremendous support to the Treasury market. Rising fixed income prices mean that yields (rates) dropped to historic lows.

QE2 ended in June 2011. As we saw in 2010, the world has been anticipating the next move of the central bankers, particularly Mr. Bernanke. In the meantime, the safe haven that was thought to be Europe and the Euro is no more. Europe faces many aspects that we faced in the 2008 meltdown with insolvent banks plus what many people believe are insolvent countries.

The Next Phase

It is a highly interconnected world. We now stand at that same fork in the road, print more paper currency or slip into an economic decline of historic magnitude. This time, however, the \$20 trillion of the first QE is behind us as well as the money spent on QE2. The world simply has run out of real money to spend, and

we now face the printing/manufacturing of unimaginable amounts of un-backed currency/electronic money or sliding into an economic abyss.

Print they must. The two paths are unattractive, but printing is the best alternative. Nobody wants an economic meltdown. As governments struggle to retain their financial rectitude, they will eventually come to the conclusion that there is no way out of this mess other than to print.

What makes the situation particularly dramatic is that there is very little “real” money anymore. Throughout most of human history, silver and gold were the primary forms of money. As metals are difficult to transport and to hold securely, humans have experimented with various forms of derivative money such as the Federal Reserve Notes that we all currently hold. It is not really money, but in actuality a derivative, an IOU, that we collectively have agreed to use in our economic activities. In history, these paper derivatives begin with a one-to-one equivalency so that the paper denomination is exactly equal to the underlying asset such as iron, copper, silver or gold. The trouble occurs when that one-to-one equivalency is abused.

We have reviewed dozens of episodes in history involving just about every culture and era in the last 2,000 years. Every time that paper money has been tried, it ends in tragedy. What starts out as sound backing for the paper is abused by the issuer until the paper returns to its intrinsic value, zero. Among the attempts in history were Chinese, Mongols, Germans, Hungarians, French, etc. The lesson is that humans cannot be trusted with the ability to create unlimited derivatives thereby breaking the promise of one-to-one conversion. We are unaware of *any* paper money system ever surviving. All have failed. Our current system would have to be the only one in all of human history to survive. It is a very improbable scenario.

The Romans did not debase their currency with paper but through the “clipping” of coins...shaving the rims and then eventually removing precious metals from the coins and substituting base metals, the origin of the term “debasement”. Coin clipping in our time does not require debasement, nor does it even require a printing press.

Today, currencies are created out of thin air via computers in unlimited quantities and with zero manufacturing cost. Just as pouring more hot water into a coffee pot dilutes the coffee already in the pot, creating massive amounts of money has the same effect upon the existing money stock. The dilution does not become apparent until one attempts to purchase a good or service. Anyone going to the grocery store or filling up their gas tank experiences this dilution of value at an intuitive level. Indeed, since the creation of the “debt as money” system initiated with the Federal Reserve Act in 1913, the worth of a dollar has declined well over 95%. Another confirming manifestation of this is the price of a stamp. We all

know how many fewer stamps we get each year for the same dollar. In that 100-year period, it has gone from something near 30 to the dollar to just about 2. That is inflation.

Inflation is a monetary phenomenon, not a rise in prices. The rise in prices is a direct consequence of inflation, not the cause. The inflation of the '70s was born in the mid-'60s when President Johnson started printing. As mentioned in our prior strategy update, the Arabs raised the price of oil to counter the depreciation in the value of the dollar that they received for their oil.

We find it amusing that the definition of inflation was changed about 8 years ago to equate it with rising prices and not monetary debasement. When money is created/printed, the inflation is also created. It takes time to work into prices as well as the velocity of money. The velocity of money will eventually rise as it too is a response to inflation as are rising prices. Using the inflation methodology that existed in the '70s, the actual inflation rate is running over 10% (according to John Williams of Shadowstats), despite what the government publishes.

Our money has historically performed two functions, a means of transacting an economic act and as a store of wealth. What has been happening is that the two are separating. We will always need a means of making a transaction, but currencies have lost the wealth preservation function. Most of the major currencies have declined dramatically against gold and silver for the last 11 years. Gold and silver are not going up, it is the currency that is going down. The chart below from www.stockcharts.com illustrates the decline in value of the US dollar versus the price of gold.



We view the gold- and silver-related holdings as money. History has always done so. They are the only currencies that are not IOUs.

We are often asked if gold is in a bubble. We see it on the financial television programs as well as in financial publications. The only asset class that is not in a bubble are precious metals, gold and silver. The biggest bubbles are in the currencies and the Treasury market. Asset classes traditionally thought of as “safe” have now become the riskiest.

The Chairman of the Federal Reserve recently announced the most recent version of “Operation Twist”. What this means is that the Fed will sell near-dated Treasuries and buy intermediate and long-term Treasuries. In the bond market, rising prices translates into lower rates. The Fed’s policy is to force down long-term interest rates. Their stated goal is to try and stimulate the housing market by creating dramatically lower mortgage interest rates. While that might help homeowners refinance or allow new buyers to enter the market, it does so at a cost to the people and entities that rely on their fixed income such as retirees and pension funds. The net benefit to the housing sector could easily be cancelled out by the loss of income and subsequent spending for these recipients.

Conclusion

We predict that Governments will choose to print more money thereby stimulating another round of global economic growth. This growth should translate into rising corporate earnings and therefore higher stock market prices. In addition, the increasing money supplies will further depress paper currencies resulting in a rise in prices for gold and silver as well as other tangible/hard assets. A cheaper U.S. dollar also makes U.S goods and services less expensive to overseas consumers, which in turn will boost earnings of multi-national corporations. Our strategy continues to deemphasize the U.S. dollar and fixed income. We are targeting global growth themes as well as hedging against the further erosion in the value of money around the world. We continue to maintain a significant allocation to precious metals for this intention. We also see opportunities for enhancing value investing in technology. Our allocations reflect “insurance” against a collapse of the dollar but will participate nicely in the event of the happy outcome.