Memo to: Oaktree Clients

From: Howard Marks

Re: All That Glitters

In 1952, Noah S. "Soggy" Sweat, Jr., a member of the Mississippi House of Representatives, was asked about his position on whiskey. Here's how he answered:

> If you mean whiskey, the devil's brew, the poison scourge, the bloody monster that defiles innocence, dethrones reason, destroys the home, creates misery and poverty, yea, literally takes the bread from the mouths of little children; if you mean that evil drink that topples Christian men and women from the pinnacles of righteous and gracious living into the bottomless pit of degradation, shame, despair, helplessness, and hopelessness, then, my friend, I am opposed to it with every fiber of my being.
>
> However, if by whiskey you mean the oil of conversation, the philosophic wine, the elixir of life, the ale that is consumed when good fellows get together, that puts a song in their hearts and the warm glow of contentment in their eyes; if you mean Christmas cheer, the stimulating sip that puts a little spring in the step of an elderly gentleman on a frosty morning; if you mean that drink that enables man to magnify his joy, and to forget life's great tragedies and heartbreaks and sorrow; if you mean that drink the sale of which pours into our treasuries untold millions of dollars each year, that provides tender care for our little crippled children, our blind, our deaf, our dumb, our pitifully aged and infirm, to build the finest highways, hospitals, universities, and community colleges in this nation, then my friend, I am absolutely, unequivocally in favor of it.
>
> This is my position, and as always, I refuse to compromise on matters of principle.

Sweat's response shows, depending on how you look at it, either how views can diverge on a given subject or how differently a tale can be spun. Thus it serves well to introduce the topic of this memo: gold.

Before the global financial crisis, most participants in the world of finance felt they understood how things worked, and that in addition to the underlying processes, they could rely on institutions and currencies.

Then the crisis occurred and a lot changed. Things happened during the crisis that were described as "five-standard-deviation occurrences" (or three or eight). In other words, things happened that had never happened before and had been considered capable of happening only once in several generations or centuries. But they happened, and sometimes a few in a single week.

These were negative "black swan" developments, and they had a number of ramifications. First, they imposed substantial losses. Second, they called into question the predictability and understandability of the financial world and introduced new levels of uncertainty. And third, they set off a search for things that would provide certainty and safety in the newly uncertain world. This search led many to look to gold.

On the Merits of Gold

I have no doubt: gold is the ideal investment. It serves as a reliable store of value, especially in challenging and uncertain times. It's a hedge against inflation, since its price rises in sympathy with the general level of prices. It exists without the involvement of man-made constructs such as governments. And it's desired and accepted all around the world (and always has been).

The supply of gold is finite. It can't be created out of thin air. Thus it's not subject to dilution or debasement, as is paper currency when governments decide to print more. In comparison, currency can be similarly reliable only if backed by gold.

Finally, gold is tangible, meaning you can take delivery and store it. Most other investment media exist only in the form of figures on a computer screen. But gold is something you can actually hold and know you own. Thus it's one of the few things you can depend on in an uncertain world. Gold is perfect.

Except, of course, gold is nothing but a shiny metal. Since its real-world applications are limited to jewelry and electronics, very little of its value comes from actual usefulness. Further, the amount put to those uses each year is small compared to the total amount in existence, so its value for those purposes is at the margin and can't be of much help in putting a price on the world's gold reserves.

There's little intrinsic to gold that enables it to serve as a store of value and a hedge against inflation. Gold serves those purposes only because people impute to it the ability to do so. It's self-deception, nothing but the object of mass hysteria like that exhibited in "The Emperor's New Clothes." **Gold has no financial value other than that which people accord it, and thus it should have no role in a serious investment program. Of this I'm certain.**

A Never-Ending Argument

The foregoing aren't my views, of course. Rather, they're my effort to summarize the prevailing – and obviously polar – points of view regarding gold. I think gold engenders attitudes that are the furthest apart of those regarding any potential investment. The "gold bugs" think it's ideal and dependable, and the naysayers think it's unanalyzable and anachronistic.

Due to the trauma and uncertainty introduced by the financial crisis, the subject of gold has attracted increased attention and the debate has heated up. It has doubled in price over roughly the last two years. And I've been asked about gold more in those two years than in all the rest put together.

I didn't think about gold very much during my first 39 years in the money management business. First I was an equity guy, and then I became a bond guy. I never had a client who held gold (as far as I knew) and no one asked for my views on it. In a world in which people thought they knew how things worked and everything went smoothly most of the time, gold was considered largely irrelevant.

For the last few years, I've advised a Swiss charitable foundation that, as is customary in its home country, holds substantial amounts of precious metals. Thus I've had to think about gold – which I never had to do before – and come to a conclusion.

My view is simple and starts with the observation that gold is a lot like religion. No one can prove that God exists . . . or that God doesn't exist. The believer can't convince the atheist, and the atheist can't convince the believer. It's incredibly simple: either you believe in God or you don't. **Well, that's exactly the way I think it is with gold. Either you're a believer or you're not.**

My View

In the past, the only thing I considered certain about gold was that I didn't have to consider it. But in the last few years, I did think (and write) on a subject very germane to gold: the valuation of non-income-producing assets.

Show me a company, security or property that produces a stream of cash, and I think I can value it reasonably accurately. P/E ratios, yields and capitalization rates give us a framework for valuing these things, and by comparing them to prevailing interest rates, to historic valuation parameters and to each other, we can assess whether an asset is dear or cheap.

But there's no analytical way, in my opinion, to value an asset that doesn't produce cash flow . . . and especially one that doesn't at least have the prospect of doing so. (What I mean by the latter is that it's more challenging to value an empty building than a rented one; or an empty lot compared to one with an office building on it; or a young company relative to an established, profitable one. But at least you can attempt to value the former asset in each case on the basis of its potential to produce cash flow.) How do you put a value on an asset that will never throw off cash?

Take oil, for example. As I wrote in "There They Go Again" (May 6, 2005), you can say the supply of oil is finite; that we're using it up faster than we're finding it; and that much of it is in the hands of nations we can't depend on. But what does that make it worth? You could have said those things in December 2008, when oil was $35 a barrel, and if you'd bought you'd be up 150% today. But they were equally true in July 2007, when oil was at $147, and if you bought you would have lost three-quarters of your money in six months. Qualitative statements like those simply cannot be converted into a price.

And how do you value a home? The appraisals that were relied on by mortgage lenders in 2002-07 obviously did more harm than good. All the appraisers did is compare each home to the last similar one that sold, and their work-product literally turned out not to be worth the paper it was printed on. You might value a home based on what it could be rented for, but today's vacancies show that you can find tenants for some houses but not all of them. No, the value of a home at a given point in time ultimately is just what a buyer will pay for it.

In fact, that's true of all non-income-producing assets: they're only worth what buyers will pay for them. You might say that about income-producing assets as well, given how their prices fluctuate, but that's completely true only in the short run and mostly when markets function poorly. If assets produce cash flow, that gives them value, and it's reasonable to believe that eventually their prices will move in the direction of that value. They aren't required to do so in any particular time frame, but that expectation provides the most solid basis there is for investing. **Everything else is mere conjecture by comparison, and that goes for gold.**

At What Price?

In "Hemlines" in September, I said investors were pursuing safety – simplistically, as they usually do the flavor of the day – but ignoring the price they were paying for it. I titled that section "At What Price?"

I'm reusing that heading here, because that's really the key question in investing. We all would prefer to have growth, quality, income and safety in our investments. But how much will we pay for them? **I've said it many times: no asset can be considered a good idea (or a bad idea) without reference to its price.** How can we evaluate whether the price of gold is right?

As with oil, you can list gold's attractions as enumerated on page two. But how do you turn them into a price? And don't you have to be able to turn them into a price in order to invest intelligently? Consider this conversation:

Howard: How do you feel about gold here at $1,400 an ounce?

Gold bug: Great. I'm sure it will hold its value from here and keep up with inflation.

Howard: Would you be equally sure if it were $2,000?

Gold bug: A little less, but yes.

Howard: At $5,000?

Gold bug: That's a tough one.

Howard: And at $10,000?

Gold bug: No; there it would be ahead of itself.

Howard: So the price of gold matters?

Gold bug: Sure.

Howard: Then how can you be sure it's fairly priced at $1,400?

Gold bug: Hmm . . . . .

The point is, in investing, price has to matter. Nothing can be a good buy solely on the basis of its attributes alone, without considering the value they give rise to and the relationship of price to that value. And there's no quantifiable value against which to compare price in the case of gold. There; that's it. Either you agree with those statements or you don't.

The gold bug's usual recourse to the difficulty in pricing gold is to point to a past price for the metal and how little it has appreciated since then. For example, gold hit a high of $850 in 1980 and has gained only 2% per year since then. The Leuthold Group is often quoted (e.g., *Reuters*, November 29) as observing that it would have to be at $2,400 today to merely equal the 1980 price in inflation-adjusted terms.

But those making a claim for gold's cheapness on the basis of comparisons against historic prices typically point to hand-selected observations, as in Leuthold's case. What about the fact that gold was $250 in mid-1999 (*Financial Times*, November 13), meaning it's been up 16% a year for the last decade-plus? And even if the snail-like appreciation from $850 in 1980 seems persuasive, how do we know gold was priced reasonably in 1980, and thus that the fact that it's low relative to 1980 makes it reasonable today? If gold was overpriced in the past, then even having failed to show much appreciation in the interim, it could still be overpriced today.

In Gold We Trust

In the 1970s I came across a book called *Money Is Love* by Richard Condon. I bought it because I had enjoyed *The Manchurian Candidate,* a 1962 movie based on another

Condon book. All I remember about *Money Is Love* is that it was set in a period when people were crazy about collectable plates and amassed them as a store of value. One person had so many that their weight made his apartment collapse into the one beneath it.

In the book, collectable plates had value for the simple reason that people felt they did. That sounds silly. But is gold any different? Are there better reasons for it to have value?

My point here is the one I've held longest on this topic: that gold works as a store of value solely because people agree it will. For years I've felt that there's nothing special about gold that makes it right for this role. It just happens to be the metal people began to lust after a few millennia ago. It could have been iron, but iron is too common and thus not special enough: it doesn't shine, and it rusts. It could have been platinum, but people couldn't find it, or enough of it for it to be popular. Perhaps the fact that gold got the job is just a coincidence.

But what about the other hand? (For thoughtful people, I think there's always another hand.) **Let's say we disrespect gold given that it has value only because people agree it does. What about the U.S. dollar?** Why do we accord the dollar value, or any other paper currency for that matter? It has value because the government says it does, and we go along. Sound familiar?

Forty years ago, you could turn in paper money and get an ounce of gold for each $35. Then President Nixon ended the convertibility of gold in 1971 and that was no longer possible. Now there's nothing behind the dollar but people's belief in it.

As an aside, when I was working on Wall Street for the first time in the summer of 1967, the government announced that it was going to terminate the convertibility of banknotes labeled "silver certificates." So I found a dozen or so in my wallet and took them to the Federal Assay Office on a nearby street called Old Slip. The clerk counted them, put the equivalent weights on one side of a huge balance scale, poured granulated silver onto the other side from a bag, and handed the silver to me in an envelope. I'm very glad that I still have it today, plus a few silver certificates that I didn't convert . . . plus the rest of my memories of those early days.

Wikipedia defines "fiat currency" as "state-issued money which is neither legally convertible to any other thing, nor fixed in value in terms of any objective standard." Today the non-convertible dollar (like most other currencies) is a fiat currency. Wikipedia goes on to say fiat currencies "lack intrinsic value."

So if I complain that gold lacks intrinsic value, perhaps my wariness should also make me question dollars (and euros, pound sterling and yen). If gold has the limitations I describe in this regard, what can we say about currencies? (Bruce Karsh goes on to raise a further conundrum: we may prefer income-producing assets, with their intrinsic value, to fiat currency. But the income they produce is reckoned in currency, and thus their value is as well. So, is the value of those assets any more "real" than currency? What does have real value? Maybe just things with actual usefulness and not just monetary value, like farms. It certainly does get complicated.)

We can talk about the fact that gold's value isn't intrinsic or quantifiable. But the question really comes down to whether people's faith in gold will increase or erode. Relevant here is a profound observation regarding markets from John Maynard Keynes.

In Keynes's time, a London newspaper ran photos of a large number of young women, with a prize going to the reader whose list of the five prettiest most closely paralleled the votes of all readers. The winning strategy wouldn't be to try to pick the prettiest contestants, but rather the ones most voters will say are the prettiest. In other words, one's contest submission shouldn't be based on intrinsic merit, but on guesses regarding the other participants' views of intrinsic merit. The same is true for investments, including gold. Thus it's not whether gold has value, but whether people will impute value to it.

But it goes further. Especially in the short run, the superior investor may not be the one who's right about the merit of something, or even the one who's right about the consensus view of merit. Rather, the superior investor may be the one who's right about the judgments other people will make about the consensus view of merit.

> It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees. (*General Theory of Employment Interest and Money*, 1936).

Will people continue to impute value to gold? Or will they bet that others will continue to impute value to gold? Those are the key questions. It's hard to predict change in these things, but it's the change that makes and eliminates fortunes.

<u>Gold in Times of Uncertainty</u>

In the last six weeks, in addition to North America, I have visited with clients and contacts in Europe, Asia, Australia and South America. **Perhaps the greatest common thread I detected was a sense that the world is more uncertain, and the range of possible outcomes wider, than ever before.** People who before the crisis felt they understood how economies and governments work – and thus what could be expected in the future – now feel very differently.

Today we're faced with uncertainty regarding a vast list of issues including:

- the outlook for economic growth,

- the ramifications of high debt levels and the necessary austerity measures,
- the economic future of the developed world,
- the impact of China and other emerging nations,
- the likelihood of deflation versus hyperinflation, and
- the soundness of currencies and sovereign debt.

Thus it shouldn't come as a surprise that people are groping for something they can depend on. **Since gold acts as a barometer of expectations regarding inflation and concern about economies and currencies, its popularity has risen as sentiment regarding these things has declined.**

Being away from home tends to alter one's perspective. While traveling, I was shocked to hear someone (okay, a gold producer possibly "talking his book") describe the U.S. as having a corrupt political system in the grip of special interests and being committed to the debasement of the dollar. While I know the stimulative actions being undertaken may well cause the dollar to weaken, I like to think the part about corruption isn't true.

But I have to admit that I'm not all that happy with what's going on in the U.S., and especially in Washington, D.C. (see "What Worries Me," August 2008 and "I'd Rather Be Wrong," March 2010). While other nations are enacting austerity measures to trim their deficits and debt, I don't see much coming from Washington. So if not corrupt, then perhaps just weak-kneed.

- The recent compromise tax "solution" is a good example (merits of the provisions aside): "I'll agree to continue the tax cuts and reduce estate tax rates for the wealthy (exacerbating the deficit) if you'll vote to extend unemployment benefits, cut payroll taxes and increase tax credits (exacerbating the deficit)." There's something for everyone in this bill, with its estimated cost of $858 billion over ten years. The only element missing from both sides' agendas is fiscal discipline.

- And what about the vote on the proposals from the President's commission on the deficit? While the appointed members of the commission generally backed them, they failed to get the needed supermajority because six of the ten elected officials who care about reelection voted no. These are tough issues, and by definition every possible solution will raise taxes or reduce government services. The fact is that most elected legislators seem unable to take any actions that might cost them votes.

Questions about the dollar are being raised worldwide. Thus an interesting result of being abroad is that **what looks like an increase in the dollar price of gold becomes easier to view as a decrease in the amount of gold a dollar will buy. So perhaps we should think about the dollar's weakness rather than gold's strength.** Here's a post from a Reuters blogger:

> If you look at the price of gold in a currency other than U.S. dollars, for instance Australian dollars, it hasn't gone up at all over the last few years. Gold isn't booming at the moment. The U.S. dollar is crashing. You

> think [gold is] worth a lot of U.S. dollars now? Just wait until QE4 or QE5.

This may or may not be from a qualified observer, but it's indicative of current sentiment. It's interesting in this connection that *The Wall Street Journal* reported as follows on December 3:

> Data cited Thursday by China's state-run Xinhua news agency showed that China imported 209.7 metric tons of gold in the first 10 months of the year, a fivefold increase compared with the same period last year.
>
> That surpassed purchases made by ETFs and surprised analysts, who until now had no clear insight into the size of China's buying. . . .
>
> "Everybody in the gold market knew there was a surge in investment demand, but they didn't know it was China," said Jeff Christian, managing director at CPM Group. . . .
>
> [This news] comes as the government loosens its restrictions on gold purchases by financial institutions and individual investors.

Money has to go someplace, and in these uncertain times, gold seems to be a destination of choice. Further, some of the objections to gold have eased:

- It used to be difficult and costly to transact in, especially in small amounts. But the creation of easily tradable ETFs has eased that concern.
- In the past, people would complain about the fact that gold doesn't throw off current income. But with interest rates ultra-low thanks to central banks, not much else does, either.

Removing impediments like these has the effect of increasing demand relative to supply. The short-run impact on price is clear.

<u>The Usefulness of Gold as a Reserve Currency</u>

In many ways, the rise in the popularity of gold may be largely the result of a process of elimination. Here's a helpful analysis from "Gold's Allure Grows Amid Instability," by James Saft writing in the *International Herald Tribune* (November 10):

> Real assets are the place to be when the solvency of the banking system is threatened and the authorities refuse to deal directly with it.
>
> With trillions in bank collateral that is worth less than its stated value on paper and with a U.S. economy mired in a balance sheet recession, the temptation to take care of these issues by creating more backed-by-nothing

> money is too great. This is exactly what the Federal Reserve is doing in its latest $600 billion round of quantitative easing.
>
> This in turn is an invitation to the rest of the world to print money right back. There is no brake on this system other than the ability of nations to cooperate, and right now cooperation is not in everyone's individual interest. . . .
>
> You could argue that where we are now was a likely outcome of the current system. A global reserve currency in a fiat system creates tremendous incentives to take on too much debt.

In other words, **when (a) your income is inadequate to cover your spending, (b) you can borrow from abroad to cover the shortfall, (c) you can print the world's reserve currency with which to repay debt and (d) that currency isn't required to be backed by something tangible such as gold, printing money seems like the easy way out.** But as the world is learning about many things, that won't work without limitation.

The *Financial Times* reported as follows on November 13:

> Some policymakers think it is dangerous to rely on a single reserve currency, the dollar, from an economy that needs to borrow heavily from abroad. Amid Friday's failure of the Group of 20 industrial and emerging nations to reach any meaningful accord on global imbalances, France has promised as part of its G20 presidency next year to start a debate about the world's future monetary arrangements.

The world needs a reserve currency (or more than one). What candidates are there? The U.S. dollar, euro, sterling, yen, renminbi and gold.

The dollar has problems these days, and the world's opinion of it as a reserve currency is on the decline. If it hasn't fallen much in recent years relative to the euro and sterling – and in fact it's up strongly since late 2007 – that's mainly because the other two have bigger problems. Only the yen has strengthened relative to the dollar, due to belief in Japan's conservatism and solidity (although its massive national debt suggests otherwise).

Here's how World Bank president Robert Zoellick put it a month ago in arguing for a limited role for gold in the world monetary system:

> Gold has become a reference point because holders of money see weak or uncertain growth prospects in all currencies other than the renminbi, and the renminbi is not free for exchange.

That leads by default to gold. It's unlikely to take over from the others, but it may see further increases in demand, especially if nations conclude that the gold component of their reserves is too small relative to currency holdings. On the other hand, the role for gold appears likely to be limited because the small amount of gold that trades – and the swings in sentiment (and thus supply and demand) – render it awfully volatile for a serious component of the world monetary system. Further, the finiteness of the gold supply would limit potential economic growth in a gold-backed monetary system.

Most things in the international arena seem to argue against the dollar, and that can be viewed as implicitly arguing for an increased role for gold relative to the dollar. **But remember that because it can't be assessed quantitatively, no one can say definitively that the current price for gold doesn't already recognize and reflect all of the dollar's problems (and all of gold's merits).**

<u>The Bottom Line</u>

It was about two years ago that I first noted the similarity between gold and religion. Before that, I had always been a non-believer in gold (not strongly anti, just indifferent). But I concluded at the time – just as any wary agnostic might about God – that whereas I didn't believe in gold, I couldn't be 100% certain that was the right position. (It's like someone who considers himself non-superstitious but still favors lucky numbers and daily rituals "just in case.") So I stopped arguing against gold with any vehemence.

More importantly, I also concluded that since gold has "worked" for hundreds of years, it probably will keep on doing so. It might not do so forever, but what's the probability this will be the year it stops? So I wouldn't bet against it, and I might recommend a position "just in case." Not because I view gold affirmatively as a moneymaker, but rather as a useful contributor to safety through diversification. Surely the uncertain world situation seems to call for all the protection against the unknown that we can amass.

Still, the other hand brings me back to price. Yes, gold is probably more likely to continue serving as a store of value than to quit. And yes, maybe one should have a position. But is this the right price at which to start . . . ?

December 17, 2010

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