PRECIOUS METALS INVESTING

Rethinking Asset Allocation

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Defined Benefit pension plans face tough choices.

During the bull market of the 1990s, most companies with DB plans had a free ride. Because the equities markets kept rising, many companies didn't have to make contributions to their plans and they included the surpluses in their earnings.

However, times have changed. Today, risk is increasing, the broader markets are underperforming, and pension plans are coming under increasing pressure. The Ontario Teachers' Pension Plan recently reported a $12 billion dollar shortfall. GM's pension plan is in disarray, and in the US the Pension Guaranty Corporation is stretched to the limit covering unexpected pension shortfalls. In Canada, the only pension protection offered is Ontario's Pension Benefit Guarantee Fund and it has many coverage limitations.

According to a 2006 Watson Wyatt study, more than 60 per cent of Canadian chief financial officers surveyed believe DB plans are facing severe problems. These problems will only intensify as markets continue to stagnate. The Mercer Pension Health Index, which measures the ratio of assets to liabilities, reflects the painful state of DB plans in 2008. The Mercer Pension Health Index fell to a dismal 77 per cent on March 31.

New York Times columnist Mary Walsh recently reported that some of America's biggest companies have begun to move out of stocks to shield their pension funds from market volatility. "Such a step has long been predicted by economists," she says, "but was shunned until now by the vast majority of pension investment managers."

Contrary to popular belief, stocks and bonds are positively correlated, and have been moving in similar directions for several decades.[1] While it is true that from 1926 to 1969 the correlation between annual total returns for U.S. stocks and bonds was an attractive -0.02, since that time, correlations between U.S. stocks and bonds have increased. The 10-year rolling correlations from 1970 through 2004 ranged from -0.03 to as high as 0.80. Noted economist William J. Bernstein, author of The Intelligent Asset Allocator, believes that this trend is unlikely to reverse because "as markets grow ever more integrated, asset class behavior tends to become ever more correlated."

Precious Metals Bullion: Strategic Asset Class

History shows us that equities do not perform well during inflationary periods. In light of current economic conditions, rising inflation, and the decade-long underperformance of common stocks compared precious metals (see *Figure 1*), a growing number of pension fund managers are beginning to add so-called "non-mainstream asset classes" into the mix, in particular negatively correlated precious metals bullion. Calpers, for example, has benefited immensely from its $2 billion investment in commodities, including precious metals, because their exposure to negatively correlated assets has lowered volatility and improved their risk-adjusted returns.

Figure 1: Precious Metals Correlation to Financial Assets

	US Large Cap Stocks	US Small Cap Stocks	International Equity	Spot Precious Metals Index (SPMI)	US Long-Term Government Bonds	US Intermediate-Term Bonds	Cash (US 90-Day Treasury Bills)	US Inflation
US Large Cap Stocks	1.00	0.79	0.59	-0.10	0.28	0.22	0.04	-0.22
US Small Cap Stocks	0.79	1.00	0.47	0.05	0.13	0.10	-0.01	-0.06
International Equity	0.59	0.47	1.00	0.04	0.08	-0.02	-0.1	-0.19
Spot Precious Metals Index (SPMI)	-0.10	0.05	0.04	1.00	-0.18	-0.19	-0.03	0.43
US Long-Term Government Bonds	0.28	0.13	0.08	-0.18	1.00	0.93	0.04	-0.39
US Intermediate-Term Bonds	0.22	0.10	-0.02	-0.19	0.93	1.00	0.29	-0.22
Cash (US 90-Day Treasury Bills)	0.04	-0.01	-0.10	-0.03	0.04	0.29	1.00	0.63
US Inflation	-0.22	-0.06	-0.19	0.43	-0.39	-0.22	0.63	1.00

A June 2005 study carried out by Ibbotson Associates (Portfolio Diversification with Gold, Silver and Platinum) specifically supports the assertion that risk-adjusted portfolio returns can be improved in both bull markets and bear markets by adding a component of precious metals bullion.[2] Because mining stocks do not provide direct exposure to precious metals bullion, the Ibbotson study constructed an equally weighted portfolio of gold, silver, and platinum bullion, which it named the Spot Precious Metals Index (SPMI). They used this index as a proxy for the precious metals asset class.

The results of their study demonstrated that over a 33-year period (February 1971 to December 2004), precious metals bullion was the most negatively correlated asset class to traditional financial assets. It also concluded that precious metals were the only asset class, excluding cash, with a positive correlation to inflation. Best of all, precious metals performed best when they were needed the most by providing positive returns when traditional asset classes entered bear market territory.

During the 11-year high inflation period (May 1973 to August 1984), the SPMI index was the top-performing asset class with the longest run of any of the asset classes. During the low inflation period, the SPMI had the lowest compounded annual return. During the high inflation period, the compounded annual inflation rate was 8.62 per cent and the SPMI had the highest compounded annual return of 20.83 per cent. Even throughout the long precious metals bear market of 1980 to 2002, the SPMI and precious metals outperformed both cash and inflation.

Ibbotson concluded that investors can potentially improve the risk/reward ratio in conservative, moderate, and aggressive asset allocations by including precious metals with allocations of 7.1 per cent, 12.5 per cent, and 15.7 per cent, respectively. These results suggest that including precious metals in an asset allocation may increase expected returns and reduce portfolio risk.

As most investors are only too painfully aware, the S&P 500 has been effectively range-bound since the new millennium began. Gold on the other hand, have provided excellent returns, as *Figure 2* shows. In fact, it has outperformed every major North American stock index.

Figure 2: Gold vs. S&P 500

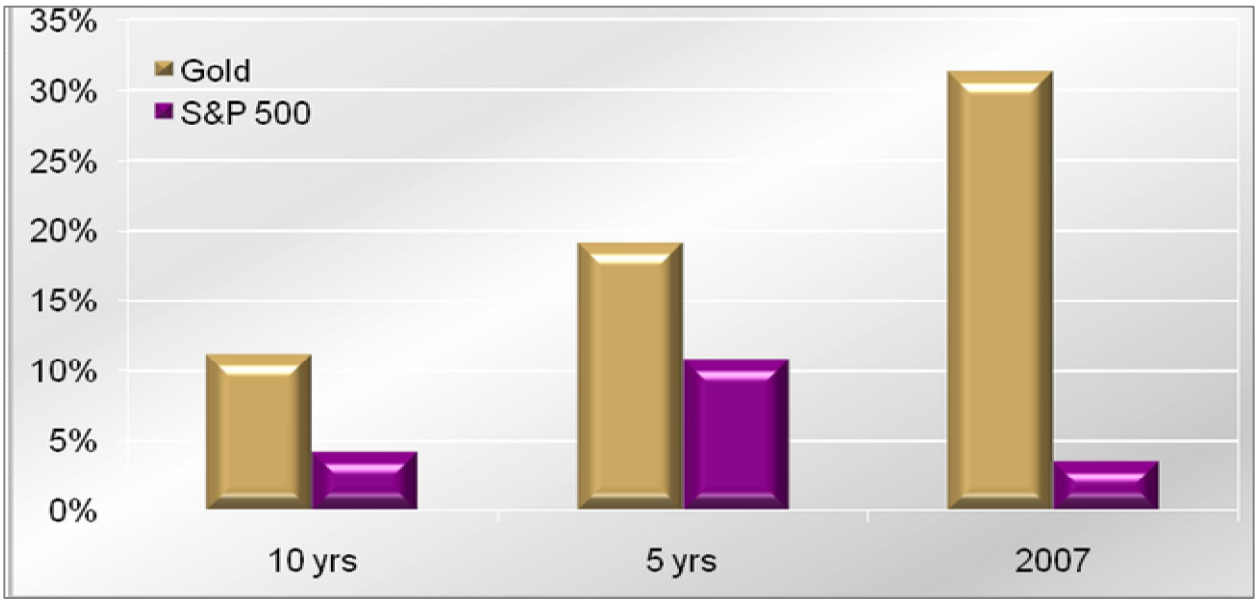
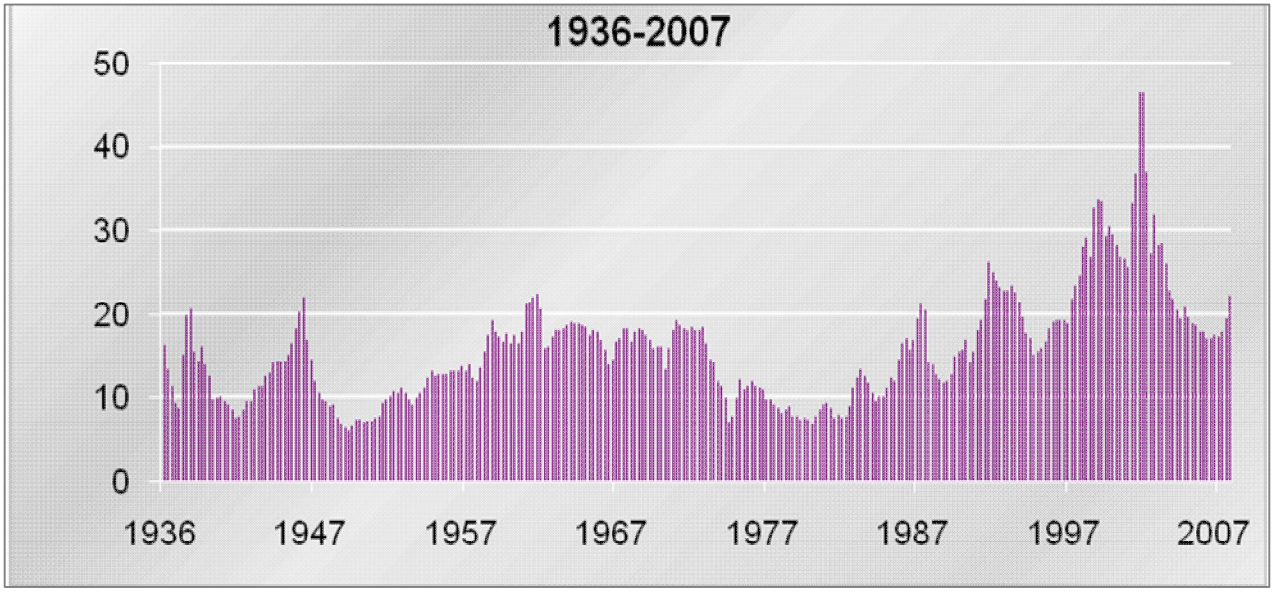


Figure 3: S&P 500 P/E Ratio



It is normal for the markets to move in cycles. During these cycles, some asset classes are strong performers and others are underperformers. The simplest proof that stock markets run in cycles is to examine historic price/earnings (PE) ratios (see *Figure 3*). As economist John Maudlin points out, markets always go from overly high valuations (PE ratios) to overly low valuations and back again.

The cycle can take decades, but long-term, the markets are always mean-reverting. According to Standard & Poor's, since 1936 the average PE ratio of the S&P 500 has been 16 times earnings. But PE ratios swing up and down from that average, moving in a range from undervalued (12 times earnings) to overvalued (20 times earnings or more) and back again. Despite the massive market correction in 2001/02, the current

PE ratio of the stock market is about 20. The bad news for stock investors is that although this number has been falling, it is nowhere near a bear market bottom.

Warren Buffett has been telling investors they need to ratchet down their stock market expectations for the medium to long term. The best we can expect from the market, he says, is low single-digit returns. And this is in an increasingly inflationary environment.

Fortunately, as we have already noted, there is a negatively correlated alternative to stocks and bonds that is also a proven hedge against inflation. Precious metals bullion is unlikely to underperform in the near future as we are in the midst of a lengthy uptrend in hard assets while financial assets are being repriced downwards. Interestingly, demand for gold, silver, and platinum is increasing not only for their commodity attributes, but also for their monetary attributes. At the same time, annual mine production is declining. In addition, the purchasing power of currencies will continue to decline as central banks accelerate increases in money supply.

Although the U.S. Federal Reserve stopped publishing M3 in March 2006, independent analysts have reconstructed this data and conclude that U.S. M3 is now growing at 16 per cent annually. *(See Figure 4)* Since the Fed stopped publishing M3, it has grown from $10.4 trillion to $13.7 trillion – an increase of 31.2 per cent in just two years.

DB plans that choose to invest in precious metals can be protected from all these negative forces and thus provide superior returns during periods of stagflation and U.S. dollar depreciation.

One of the prevailing myths about precious metals and particularly gold is that it is very risky and volatile. The data say otherwise. In fact, since January 2000, each of the individual Dow stocks has been more volatile while generating lower returns than gold, silver and platinum. *Figure 5* plots annual compounded returns against standard deviation.

Figure 4: Growth of Money Supply (M3)

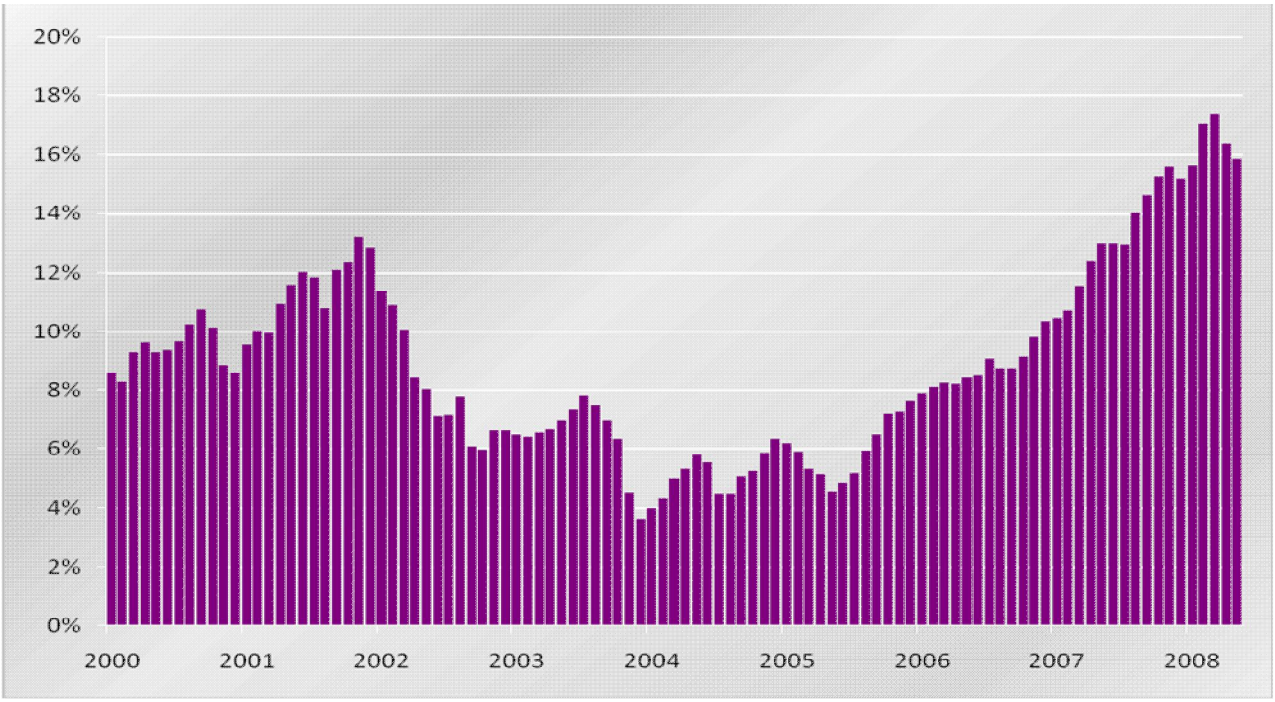
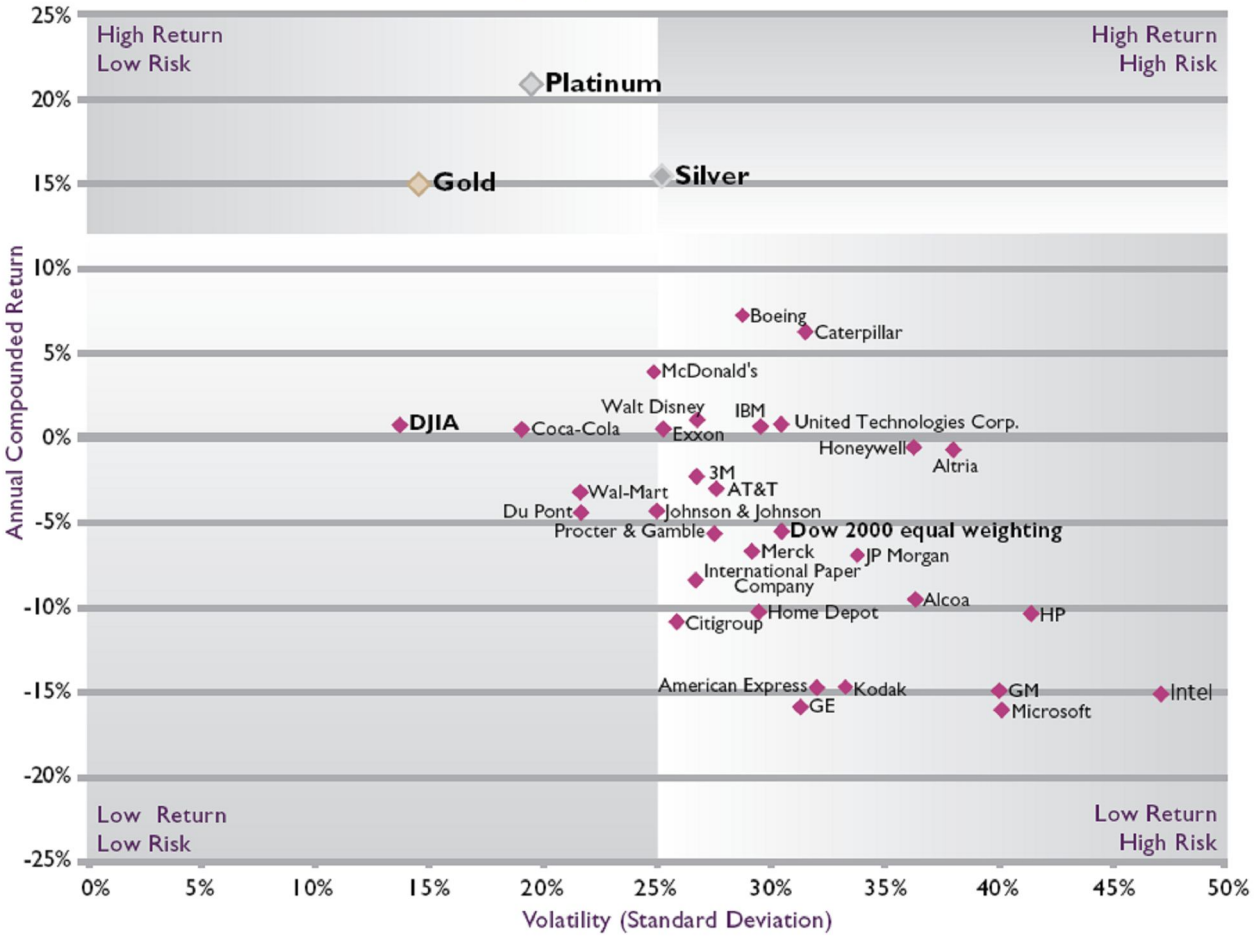


Figure 5: Volatility vs. Return
(Dow Components vs. Precious Metals)
January 2000 - March 2008



Source: Bullion Management Group Inc.© 2008

Some investment managers believe that gold is an archaic relic with no role in today's sophisticated financial system. The underlying facts refute this popular myth. Today, central banks still hold 29,000 tonnes of bullion in their currency reserves, down from 32,000 tonnes held in 1980. Both gold and silver have been a stable form of money for more than 3,000 years, platinum for more than 300 years.

Precious metals are traded on the currency desks of most major brokerages and banks and not the commodity desks. The London Bullion Marketing Association (LBMA) reports that net daily clearing turnover was $29 billion in gold and $1.5 billion in silver in May 2008. Industry experts estimate that actual trading volume is anywhere from seven to ten times the turnover rate. It is important to note these figures are only for physical bullion and exclude futures contracts. Given the magnitude of this trading volume, it is clear that they are trading as monetary assets, not simply as industrial commodities.

The total amount of aboveground gold in the world is estimated at 145,000 tonnes (approximately $1.8 trillion). However, the amount available in bullion form is less than half this total since a great deal of gold is in the form of jewelry, religious artefacts, or industrial components. Of the gold bullion, approximately 29,000 tonnes is held by central banks, leaving approximately $500

billion in private hands. Much of this bullion is held by the very wealthy for generational wealth preservation and may never come onto the market.

Platinum and silver's total aboveground stocks have been estimated to be only around $10 billion.

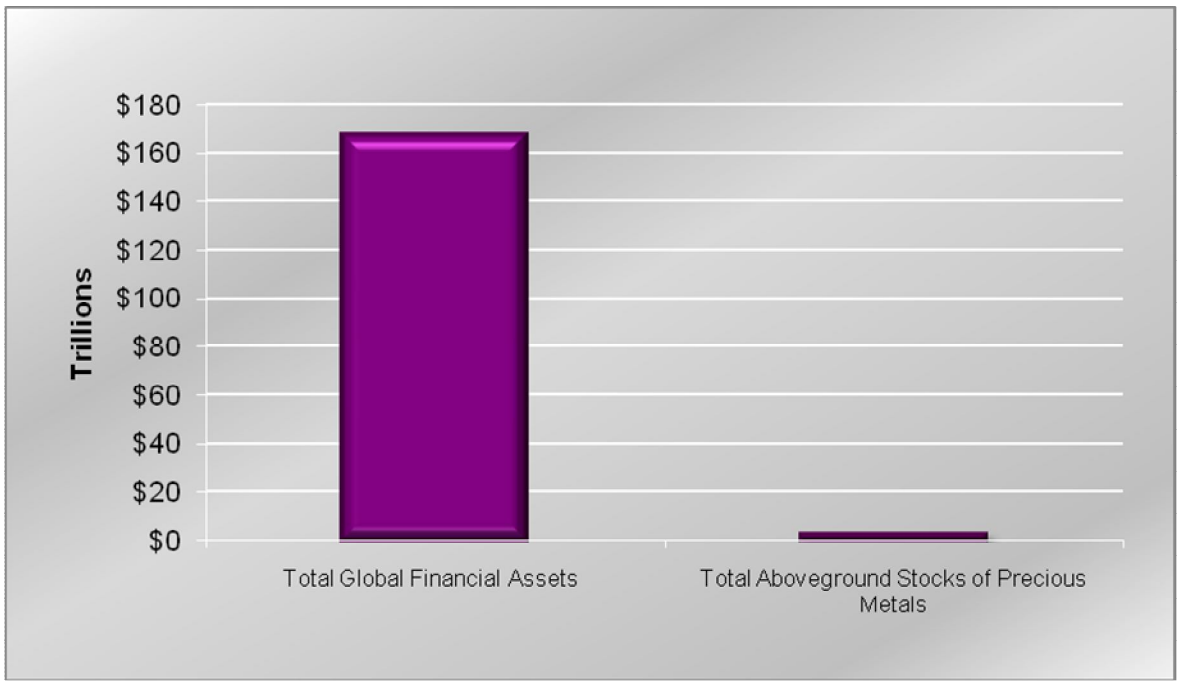
As at the end of 2006, McKinsey Global Institute estimated that global financial assets were $167 trillion. Today, the number likely exceeds $180 trillion. The limited amount of precious metals available relative to the size of the global financial assets means a small shift in investments will lead to significant price changes for the metal. *(See Figure 6)*

Precious metals bullion is *the only* asset class offering negative correlation to stocks and bonds. Because the vast majority of DB plans are not diversified into non-correlating assets, they are unnecessarily exposed to the risk of long-term capital loss. It is quite possible a secular bear market could last for a decade, wiping out bull market gains. But regardless of bull or bear, the markets are highly unlikely to produce the double-digit returns that the 1990s gave to investors. As asset mix decisions become an increasingly dominant factor in pension fund planning, company directors, pension and benefits managers, and consultants have a growing fiduciary responsibility to revisit and reassess their asset allocation strategy.

While some pension fund managers are already looking beyond stocks and bonds into alternative investments such as hedge funds and private equity, are these high-risk, unregulated investment vehicles really a good match for long-term pension investment policy?

Continued high exposure to equities and bonds without protection from negatively correlated assets will become a growing problem if the financial markets continue to underperform. As the global economy continues to be buffeted by inflation, rising oil prices, subprime credit issues, and declining earnings, precious metals bullion is poised to become a strategic diversifier – and a pension manager's best friend.

Figure 6: Are Precious Metals Overpriced?



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1. For a comprehensive analysis of the correlative relationships of the major asset classes, please visit www.bmginc.ca, go to the 'Resources' link, click 'Nick Barisheff,' then click 'Precious Metals – Critical Diversifier.' [http://www.bmsinc.ca/content/view/319/33/]
2. An executive summary of the Ibbotson study is also available at www.bmginc.ca