Avoid a Catastrophic Loss; How Gold is Like Insurance for Your Portfolio

August 7, 2015 By Nick Barisheff

If you looked out your window and saw a hurricane coming, would you cancel your house insurance? Of course not; that would be foolish. We are content to pay for house insurance for most of our lives, yet very few of us have actually experienced a fire or a major disaster where we had to use the insurance. We are comfortable with paying the premiums every year in order to avoid a catastrophic loss.

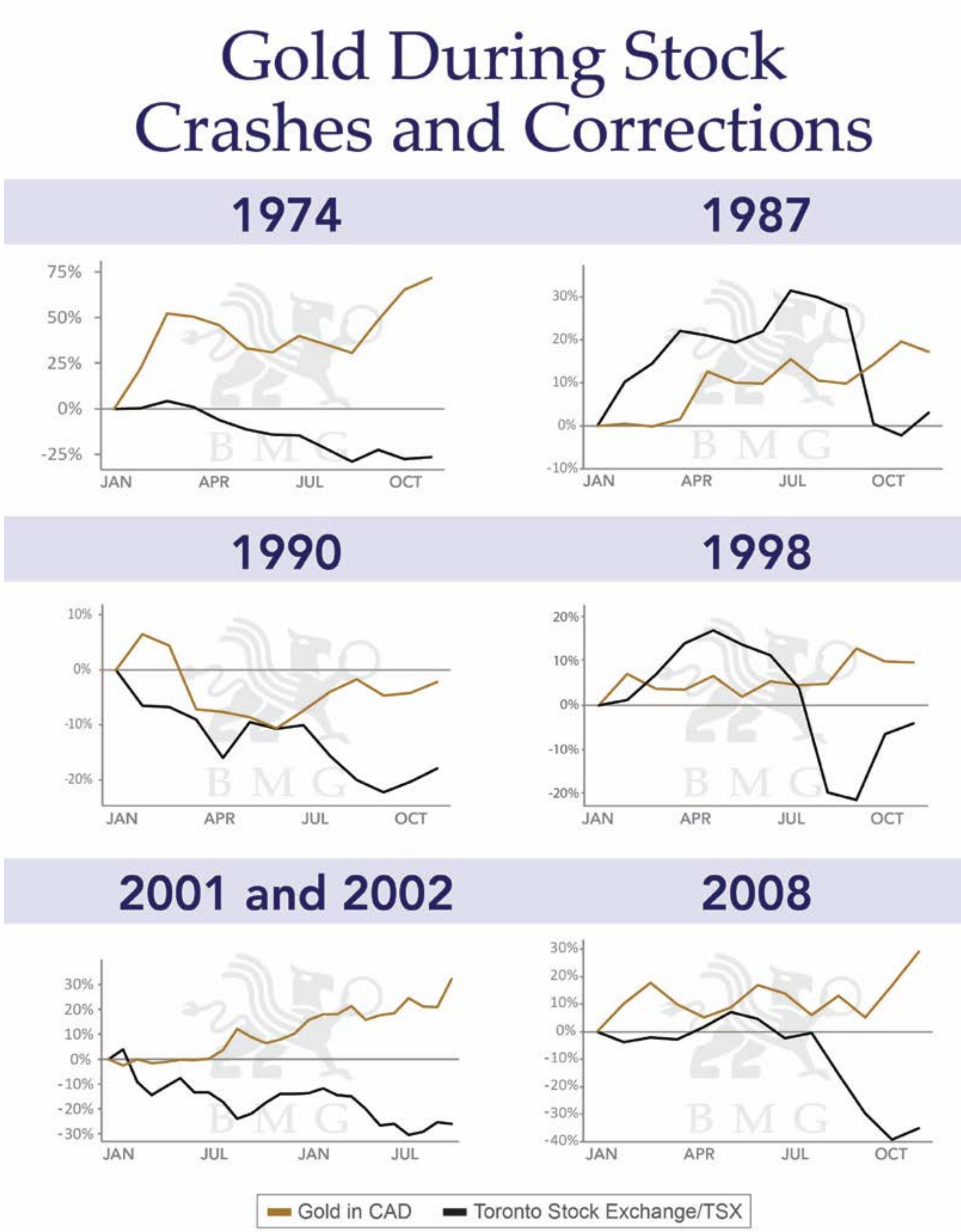
Owning gold is tantamount to owning an insurance policy on your investment portfolio. Depending on how you hold it, you may not have to pay premiums and unlike cash, in the long term it increases in purchasing power. The capital appreciation is many times greater than the minimal storage costs. It is like an insurance policy that allows you to put the premiums in your own pocket. Most insurance policies are expenses, and unlike precious metals, are dependent on the insurance company staying in business. How much of your money has been spent in premiums for your car and house insurance over your lifetime? And what is there to show for it if you've never made a claim? Gold is like a portfolio insurance policy with no premiums to pay.

The reason gold acts like insurance in a portfolio is that, historically, it is the least correlated asset to traditional financial assets like stocks and bonds. This means that it tends to move in the opposite direction to stocks and bonds. While gold has an excellent record as portfolio insurance, it is not 100% guaranteed to protect against short-term equity downturns. It is, however, ideal as long-term (three years or more) protection.

How to Avoid Trading away Your Wealth

Gold is complex and has many attributes. It is a coveted precious metal, because it is scarce, and difficult and expensive to mine. Chemically, it is stable, portable and easily divisible. The fact that it is scarce, collectable and easy to split into various denominations means that it makes sense to consider it as money, rather than a commodity. It has been used as money for 5,000 years, with the first gold coins being struck around 550 BC. Some see gold as an industrial commodity, and trade it, and others know that it is money and is meant to be held, not traded. Central banks understand this, and South East Asia certainly sees the value of holding gold. According to the World Gold Council, "while global consumer demand for gold has increased nearly 50% over the last decade or so, demand for gold in South East Asia has increased by over 250% during the same period." China is driving most of that growth in demand.

While some people believe gold is no longer money but an archaic relic, they fail to comprehend that: central banks list it on their balance sheets as a monetary asset; it is traded on the currency desks of all the major banks and brokerage houses, not on their commodity desks; and it is referred



to as honest money throughout the bible and in most religions.

For 12 years I've been watching those who like to buy and sell gold on the markets, and I don't believe they can trade it effectively. If you are going to trade in gold, then trade paper gold (derivatives, puts and calls), and hold your physical bullion. In fact, now is not the time to sell gold, even if you wanted to use it for trading on the markets. Gold has been in a correction for the past three years against stocks and bonds, but that trend is poised to reverse.

Seeing Beyond the Bubbles

The stock market is dangerously overvalued, policy-driven low interest rates are coming to a close, the Eurozone, the UK, Japan and even China are struggling, and any of a number of black swan events could change the global economic landscape at any moment. Artificially low interest rates have kept bond yields (and junk bond risk) high, but with no further room for interest rate reductions, the bond bull market is coming to an end. While the Fed has been busy inflating the latest bubble, investors have been blindly following mainstream momentum, and borrowing record levels of margin debt into the overvalued stock market.

What will you do when a massive correction occurs? When that correction happens, gold will go up as financial assets come down. If you hold physical bullion in your portfolio, even just 10% to 20%, you can reduce your risk significantly and improve returns. This is the time to rebalance your portfolio by reducing equity holdings and fixed income holdings, and increasing gold holdings.

We should always remember that success in investing is to "buy low and sell high."

Evidence of stock market overvaluation is clearly illustrated using The Buffet Indicator shown above. By looking at the total market values relative to US GDP, one can see that stocks are well over the 80%, or fully priced, mark. During the dot-com bubble, the Market Cap to GDP ratio spiked to almost 160%, during the 2008 market collapse it spiked to almost 120%, and today it sits at around 132%.

"The S&P 500, and many other key stock indices, are overpriced when measured by all major historical stock market valuation tools. That includes aggressive share buybacks, weak corporate earnings, and high stock market valuations," said economist Michael Lombardi in a recent release from Lombardi Publishing. "What's actually driving the S&P 500 higher? Investors don't seem to care about fundamentals anymore; it's the Federal Reserve that's driving the stock market higher…A stock market that rises on the anticipation of the Fed coming to its rescue is not a healthy market, nor a real one."

The bond market is also highly overvalued. Central banks have pressed investors into the high-risk bond market with low to negative interest rates on more stable, long-term bonds. According to a recent article by Investment Research Dynamics, "The retail investor is always the last one in when chasing an investment bubble and always gets hurt the most when the bubble collapses. Currently there's a massive bubble being blown in the junk bond market."

The investor who gambles in this market is ignoring liquidity risk, and the risks associated with unsecured debt. The bond bubble has already begun to burst, with investors all trying to sell at once, triggering a drastic fall in bond prices as yield rise. And while long-term bonds have been in a bull market for the past 30 years, the overvaluation of the bond market was so severe that, according to the *Washington Post*, "80 percent of fund managers think bonds have become badly overvalued." Trillions of dollars (up to 25%) of European bonds have negative interest rates right now, ultimately charging investors interest to hold the bonds. This strategy makes no sense for the investor, and surely cannot last. Robert Wenzel of the *Economic Policy Journal*, commenting on the impending fall of the bond market, stated, "Anyone who holds the view that the Fed will not soon raise interest rates, and soon, fails to understand the nature of the developing crisis. It will be led by a collapse of the bond market." That collapse has already begun.

The Chinese Understand the Value of Gold as Money

With interest rates near zero, it no longer makes sense to hold traditionally high allocations of equities and bonds. At this point in time it makes more sense to increase your gold allocation by rebalancing your portfolio. With US debt over $18 trillion, and whispers in the news about China's renminbi joining the International Monetary Fund's Special Drawing Rights (SDR) basket of key currencies in an effort to dethrone the US dollar as the world's reserve currency, why risk your hard-earned money by keeping it in pieces of paper that devalue over time? China recently ended years of speculation about its gold reserves by revealing an almost 60% jump in gold holdings since 2009. The PBOC said gold reserves were 1,658 tonnes as at the end of June, 2015. In April 2009, reserves were 1,054 tonnes. The Chinese government has been petitioning the IMF to include the renminbi in the SDR basket, and as I discussed in detail in my recent Inside the Vault Video, An In-Dept Look at China's Gold Holdings, substantial gold holdings will bolster their case with the IMF. For the next several years, China's energy needs are going to be met by Russia. The New Silk Road, with its many free-trade zones, would be well served by a gold-backed currency. "Asians have a tradition of collecting gold," said Song Yuqin, deputy general manager of the Shanghai Gold Exchange. "The gold trade is expected to become a significant component of transactions by 'Belt and Road' countries."

The Bottom Line

The goal for including gold in your portfolio is long-term wealth preservation and diversification. Physical bullion is negatively correlated to stocks and bonds, and paper currencies have lost purchasing power against gold over time.

Nick Barisheff is the founder, president and CEO of BMG Group Inc., a company dedicated to providing investors with a secure, cost-effective, transparent way to purchase and hold physical bullion. BMG is an Associate Member of the London Bullion Market Association (LBMA) and an Associate Member of the Responsible Investment Association (RIA) as well signatory to the Six Principles of Responsible Investments (United Nations endorsed Principles for Responsible Investment – PRI).

Widely recognized as international bullion expert, Nick has written numerous articles on bullion and current market trends that have been published on various news and business websites. Nick has appeared on BNN, CBC, CNBC and Sun Media, and has been interviewed for countless articles by leading business publications across North America, Europe and Asia. His first book, $10,000 Gold: Why Gold's Inevitable Rise Is the Investor's Safe Haven, was published in the spring of 2013. Every investor who seeks the safety of sound money will benefit from Nick's insights into the portfolio-preserving power of gold. www.bmgbullion.com