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summaries

SIGMA INVESTMENT COUNSELORS

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As Good As Gold

Throughout time, gold has been revered as a precious metal given its natural beauty and unique properties. Included among these properties are its brilliance, malleability, and resistance to corrosion and tarnish. For these and other reasons, gold was first utilized in fine jewelry and ornamental objects. Gold was also sought after by the wealthy as a symbol of power and strength. Some religions embraced gold not only for its ornamental use but at times, believing that the metal had special life-giving properties.

Gold also became a medium of exchange, first as a means to barter for goods and services. As civilizations evolved, gold coins became a medium of exchange. In more recent times, gold became a currency reserve, a mechanism which supported the price of a particular currency and provided a basis to determine the value of one currency versus another. In today's world, although a specific gold standard agreement no longer exists, the change in the price of gold can have an impact on the value of one currency versus another.

Other uses of gold can be found in industrial production, dentistry, coin collecting, and as a stand alone asset class. With so many current and potential uses for gold, how can one determine a fair value for the metal? Over the long term, Sigma believes the price of gold will likely be dictated by supply and demand considerations, and the incremental cost of production. The problem is each of these three variables can be impacted by a number of economic and geo-political factors, making it difficult to predict the future price of this commodity.

What we do know is that the unit cost of production of a troy ounce of gold is in the ballpark of $300 to $500 per ounce for one of the world's largest gold producers, Newmont Mining. As a public company, Newmont is expected not only to earn a profit on its current mining activities, but it is also expected to have sufficient capital to reinvest funds for future projects. Over time, the price of gold has to be in excess of its production costs in order to protect the company's long term viability and ongoing operations.

In addition, there are many other producers of gold and most, if not all, have even higher production costs. These less efficient mining companies require even higher prices to continue their operations or they will shut in production. In theory, these marginal producers determine the market clearing price where supply equals demand.

Now, it gets interesting. The price of gold is often quoted in U.S. dollars. When the U.S. dollar falls relative to other currencies, the market clearing price of gold must increase to cover the production costs of foreign producers. That is one of the reasons there is often an inverse relationship between gold prices and the value of the U.S. dollar.

Add to this the possible recent shift in the demand side of the equation. The most dramatic example of this is the purchase of 200 tons of gold bullion by the Reserve Bank of India (RBI) from the International Monetary Fund (IMF). The RBI made a strategic policy decision to invest a significant amount of its investment portfolio into gold as opposed to investing these funds in assets such as the U.S. dollar, real estate, publicly traded securities, etc. This one transaction did not change the supply and demand equation. However, should other Central Banks, including China, determine they wish to increase their holdings in gold by a like amount, this could have a potentially significant impact on future demand, driving the price of gold higher.

So, is gold a good investment? The answer is: "it depends." Gold provides a means of diversifying a portfolio as an asset class given its low correlation to U.S. stocks and fixed income securities. Gold and other hard assets often are viewed as a hedge versus fixed income securities in an inflationary environment. Gold is also often used as a hedge against a declining U.S. dollar. If someone believes that Central banks and/or sovereign wealth funds will follow India's lead and seek to hold a greater percentage of their surplus funds in hard assets, and gold in particular, the price of gold might spike as the demand for gold could easily outstrip the available supply in the short run.

On the other hand, the current price of gold is measurably above the incremental cost of its production. If and when the U.S. can demonstrate a structural change in its fiscal and monetary policies and truly get its deficit under control, it is likely that the U.S. dollar will regain its strength at which time the price of gold may trend downward.

At Sigma Investment Counselors, we do not view the threat of inflation as imminent. However, as we look out on the horizon over the next 12-18 months, we have concerns that inflation will pick up and become a significant factor for the economy and the securities markets. To address these concerns we recently purchased a gold exchange traded fund (ETF) for all portfolios where exposure to gold is appropriate. This security closely tracks the change in price of the underlying precious metal and is a far more efficient way to gain gold exposure without having to take ownership of the commodity. At the same time, we are exploring other inflation hedges, preparing for the day when inflation returns to the capital markets in a meaningful way.

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As part of our ongoing effort to broaden and improve our services, we are in the preliminary planning stages of hosting a 4 hour "financial primer" session for the children/adult children of clients. We believe that this would probably be deemed most useful for those aged 16 to 25. We would plan to cover such topics as budgeting, types of savings/investment accounts and IRA's, the basics of insurance, mortgages, credit cards, asset classes, etc. We are interested in input from you, our clients, to help us make this a worthwhile endeavor. In that regard, feedback is welcomed including whether you have children for whom you believe this would be useful, day/days and times that work best, time of year (right after college lets out in the spring, right before college starts back up in late summer), level of your youth's current financial knowledge, additional components/topics of interest, etc. Please e-mail or call Tamika Hall at thall@sigmainvestments.com or 248-223-0122.

Thank you.

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