Gold's Role is to Hedge Against Inflation Risk

April 2016 Client Letter

The beginning of 2016 was a surprise to most gold investors. After falling at a 9.1% compounded annual rate for the proceeding four years, the metal was up 16% in the first quarter—the largest quarterly gain in three decades. We first purchased gold in 2005 with a position in SPDR GoldShares ETF (GLD). Since that time, despite significant volatility, gold has posted an unexpected average annual return of nearly 10%.

Gold’s Role is to Hedge Against Inflation Risk

One of gold’s basic roles in an investment portfolio is to hedge against inflation risk. Inflation is a destructive force that can decimate a lifetime’s worth of savings. Over the last 30 years, inflation has eroded the purchasing power of the dollar by nearly 56%. And this has been a period of modest inflation. When factoring in a period of high inflation, the math looks much worse. Since the 1970s, the purchasing power of the dollar is down an astonishing 84%.

These numbers may appear too long-term to worry about today, but for investors on the verge of retirement, they present a tangible risk. People are living longer and more active lives. Retirement planning is now a multi-decade affair. According to the Society of Actuaries, a 65-year-old couple faces a 45% chance that one partner will live to 90 and an 18% chance that one partner will live to 95. That’s 30 years of retirement and 30 years of income planning.

A portfolio of stocks and bonds undoubtedly helps lessen the blow of inflation, but may not be enough protection from an all-out inflation assault. When inflation accelerates meaningfully, interest rates rise, and stock and bond prices tend to decline. One of the worst 16-year periods for stocks in history was from 1965–1981, a period of elevated inflation. Gold can help smooth out returns during these inflationary episodes.

This doesn’t mean that gold will offset inflation each and every year, or that gold, like stocks, will not experience periods of poor performance. As indicated above, the four years prior to 2016 were challenging. Some investors have looked at this period as a reason not to own the precious metal.

But investors should not expect smooth returns from gold. Gold tends to bounce around more—and in different ways—than other assets.

We favor gold to guard against the risk of high inflation, market crashes, currency crises, financial and economic instability, and geopolitical upheaval. We view gold as an insurance policy of sorts. Gold helps reduce risks that are not easily diversified with a traditional portfolio of stocks and bonds.

It Could be Easy to Become Complacent

As the last financial crisis fades from memory, it could be easy to become complacent and assume the worst is behind us. In our view, such reasoning is a mistake. Many global challenges exist with untested solutions being used to address these problems.

A report last year from The McKinsey Institute paints a grim picture of the buildup in global debt. With all the talk of deleveraging and austerity, one might have logically concluded that a lot of debt has been taken out of the system since the financial crisis.

This unfortunately has not been the case. According to McKinsey, since 2007, debt has grown by $57 trillion, raising the global debt-to-GDP ratio by 17 percentage points.

Government debt has grown by $25 trillion since 2007, and it is expected to continue to rise in many countries given current economic fundamentals. For the most indebted countries, implausibly large increases in real GDP growth or extremely deep reductions in fiscal deficits would be required to start deleveraging. China has been at the forefront of global debt growth. McKinsey’s data shows that China’s debt has quadrupled since 2007, rising from $7 trillion to over $28 trillion. At 282% of GDP, China’s debt as a share of its economy is now larger than that of the U.S. or Germany.

How will overly indebted economies deleverage if faster growth or spending reductions aren't viable solutions? And what will happen to these economies during the next cyclical downturn, when incomes drop and debts rise? There may be a thread-the-needle solution that doesn't result in financial disruption, but in our view, the easiest and most probable solutions for governments will be to either: a) inflate away the debt or b) default on the debt. Gold is an asset we want to own should either of these "solutions" come to pass.

We also want to own gold as the world's central banks continue their unprecedented (some might say experimental) monetary policy interventions, which have included 600 interest rate cuts, $12 trillion of asset purchases, the imposition of negative interest rates, and talk of so-called helicopter money.

The Dangers of Helicopter Money

Negative interest rates and helicopter money are the latest from the world's central banks. Negative interest rates have been greeted with mixed results thus far, so we have started to hear more and more about helicopter money. When economists talk about "helicopter money," they're referring to money that central banks print to either hand directly to citizens or to buy government-issued bonds, which are then cancelled.

The proliferation of new and untested monetary policy tools has not yet resulted in significant financial turmoil, but monetary policy is clearly in unchartered territory here. The unintended consequences of these policy actions remain an ever-present risk, which makes gold all the more desirable in our view.

Like stocks and bonds, we view gold as a strategic asset class that should be held long-term. Based on the performance of gold over the last several years, it would have been easy to sour on the metal and sell. It is certainly advisable to sell losers if they do not have a place in a portfolio and do not fit with an overall plan; but, as I have tried to make clear, gold is part of our plan. What is not part of our plan is to sell an asset based solely on performance.

Selling an asset on the basis of performance is a strategy that can sabotage portfolio returns. Work by market research firm Dalbar has shown over and over that when investors sell in despair and buy on euphoria, they sacrifice return. The result of this emotionally charged approach to portfolio management has been dismal. Dalbar's data shows that for the 30-year period ending in 2014, the S&P 500 would have compounded investors' money at an annual rate of over 11%, but the actual return of the average equity-fund investor was only 3.8%. The same is true of bonds. Dalbar reports a 30-year return of 7.4% for the Barclay's Aggregate Bond Index, but only 0.72% for the average fixed-income fund investor.

With an asset like gold, where decisions to buy or sell can be even more emotionally driven, one can only guess how poorly the average gold investor would have fared relative to the performance of gold. (Dalbar doesn't offer data on gold returns).

We don't cite the Dalbar statistics to advocate a buy-and-hold-forever investment strategy. We favor a strategy focused on the long run, but realize the need for making portfolio adjustments. Reasons for trades may include shifting company prospects, emerging competitive threats in an industry, new or changing secular trends, vastly overstretched valuations, tax-loss harvesting, or, at the investor level, shifting risk tolerances or changing financial circumstances.

Regular, Annual, Dividend Increases

Over the last year, much equity portfolio activity was driven by our continued focus in favoring companies with a history of making regular annual-dividend increases.

The sale of Weyerhaeuser, which completed its acquisition of Plum Creek Timber earlier this year, is an example of a security we sold because it didn’t have a favorable record of regular dividend increases. With the proceeds from Weyerhaeuser, we bought General Mills, Lowe’s, Texas Instruments, or CVS.

General Mills, the maker of Cheerios and Bisquick, also owns powerhouse organic brands, including Annie’s, of mac and cheese fame, and Cascadian Farm. General Mills has recently launched a new cereal line based on its Annie’s brand of organic foods. The bunny-shaped cereals are all organic and rely on whole grains, natural colors and flavors, and fairtrade cocoa to sell units. Although not exactly health food, it's enough of an improvement over the current sugar-filled, artificially flavored and colored offerings to bridge the gap to new innovations from General Mills. General Mills has increased its dividend for 11 consecutive years.

Lowe's is the second largest home improvement chain in America. The housing market is in recovery. It is by no means in what could be considered "strong" territory yet, but improvement is obvious. Building permits, new home sales, and existing home sales have all trended up over the last 12 months. Lowe's is a major beneficiary of increased activity in the real estate market. Lowe’s has increased its dividend for 53 consecutive years.

Texas Instruments is a leader in the analog chip business. The two most important opportunities in the semiconductor industry are analog and embedded processing. Most electronic devices use embedded processing, and all of them use analog in one way or another. The customer base is highly diversified, and the product cycle for the chips’ devices is measured in years or decades, meaning stability for Texas Instruments as customers keep coming back. Texas Instruments has increased its dividend for 11 consecutive years.

CVS is America's leading pharmacy with more than 9,600 locations. It's easy to understand the impact of 9,600 retail pharmacies on CVS's business, but the largest revenue driver at CVS is actually the pharmacy services segment. The business offers a full range of services like plan design, Medicare Part D services, mail order prescriptions, clinical services, and more. This out-of-sight business generated nearly $24 billion in revenue in the first quarter alone. CVS has increased its dividend for 11 consecutive years.

When investing in companies with a history of annual-dividend increases, we are putting the odds in our favor of not only getting a pay raise each year, but also helping us keep pace with inflation. By combining the dividend increasers with the gold component, we are even further helping to offset the negative effects of inflation and hopefully reducing portfolio volatility during more problematic environments.

Have a good month. As always, please call us at (888) 456-5444 if your financial situation has changed or if you have questions about your investment portfolio.

Warm Regards,

Matthew A. Young,
President and Chief Executive Officer

P.S. The first quarter of 2016 was a bit friendlier to dividend payers than last year. The big correction in the first quarter and accompanying concerns about slowing economic growth pushed global central banks to inject more stimulus into the financial system, which helped drive down long-term interest rates. The threat of a global cyclical downturn and falling long-term rates helped act as a one-two punch for many of the defensive dividend-heavy sectors we favor, including consumer staples, utilities, and telecom. While we are pleased to see the gains, we aren't overenthusiastic, just as we weren't overly pessimistic when these same sectors lagged the more speculative sectors last year.

P.P.S. “Why is Hong Kong rich, Cuba very poor, and Puerto Rico struggling? Back in 1955, the islands of Puerto Rico, Cuba and Hong Kong had roughly the same real per capita income. They each took very different economic paths. Now, some 60 years later, Hong Kong is even richer than the United States on a per capita income basis. Cuba is an economic disaster, having gone from the richest Caribbean nation to the poorest, next to Haiti. And Puerto Rico finds itself flirting with bankruptcy, with a per capita income much higher than Cuba’s but only roughly half that of Hong Kong. Incomes

have increased approximately 22-fold in Hong Kong, 11-fold in Puerto Rico, and only fourfold at best in Cuba, in a little over a half-century.

Cuba is relatively rich in natural resources, and Puerto Rico has some, but Hong Kong has almost none. The improbable success of Hong Kong and the improbable failure of Cuba is a direct result of the economic policies each followed. Hong Kong is perhaps the best example of what can be achieved under the rule of law, with limited government and free markets. Cuba is a poster child of how rule by man rather than law, coupled with government ownership of the means of production and the destruction of the price system, results in no freedom and a great deal of poverty." –Richard Rahn, *The Washington Times*, March 28, 2016

P.P.P.S. Christopher Balding recently wrote the following in *Bloomberg* about China's economy:

First, the golden age of Chinese construction is over. There's now enormous surplus capacity in virtually every industry that requires fixed-asset investment. Companies can no longer rely on the "Beijing put" of new government stimulus to boost growth. Iron ore producers and copper miners all need to begin a painful process of downsizing and deleveraging — just as

China's bloated state-owned enterprises do. Producers around the world haven't faced up to the new normal.

Second, companies of all stripes have to put in the effort to understand China better. Expectations of double-digit growth, regardless of how poor the performance, have vanished. Luxury brands that once hoped their Beijing flagships would smooth the balance sheets at European headquarters need to recognize that different markets require different strategies, and that shops in China won't run on autopilot. They need to compete.

Third, companies and countries alike need to face up to their own irrational exuberance. Whether it’s failing to diversify, spending recklessly on the back of high prices, or taking on too much debt, fundamental mistakes can’t be blamed on China. Doing so only delays the inevitable.