

DEMYSTIFYING GOLD

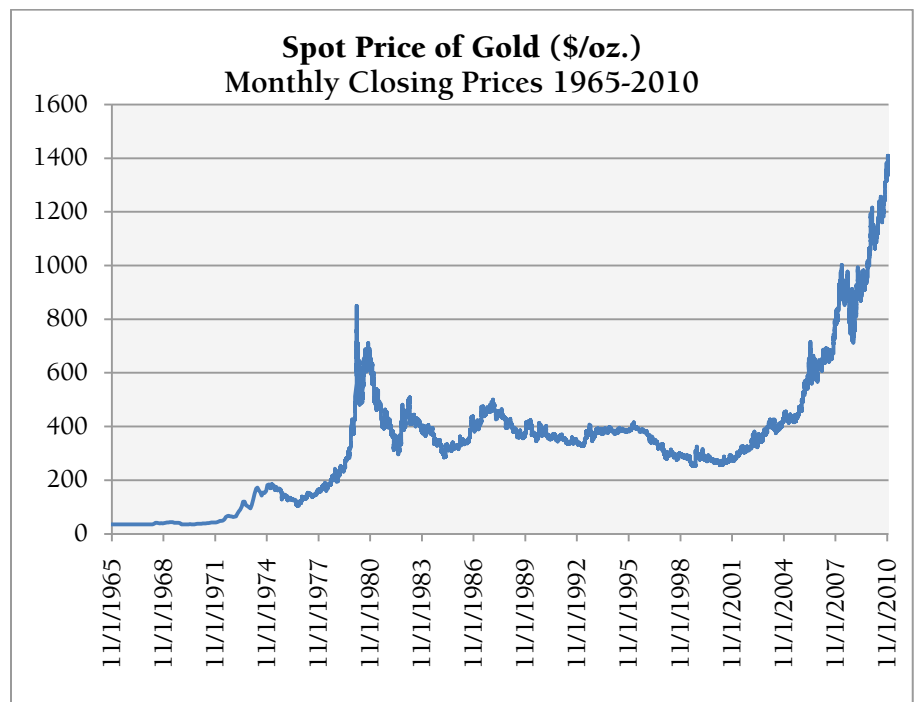
This paper briefly discusses the supply and demand fundamentals for gold as well as why we believe it is gradually becoming an accepted global asset class.

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INTRODUCTION

Gold investors suffered through 20 punishing years with the price of a troy ounce falling from the hysteria-driven peak of \$870 an ounce in 1980 down to the dot-com boredom price of about \$250 in 1999. Meanwhile, the S&P 500 chalked up 15% annual returns from 1980-2001, while gold's annual return over the same period was a loss of about 2.5%. However, since bottoming out in 2001, gold has turned in a shining performance over the past nine years, with the spot price rising more than 400% to about \$1,350 at the end of November 2010. During the same period, the S&P 500, including dividends, appreciated about 22% in total. **In aggregate, gold outperformed equities in this nine-year period by 18 times.**



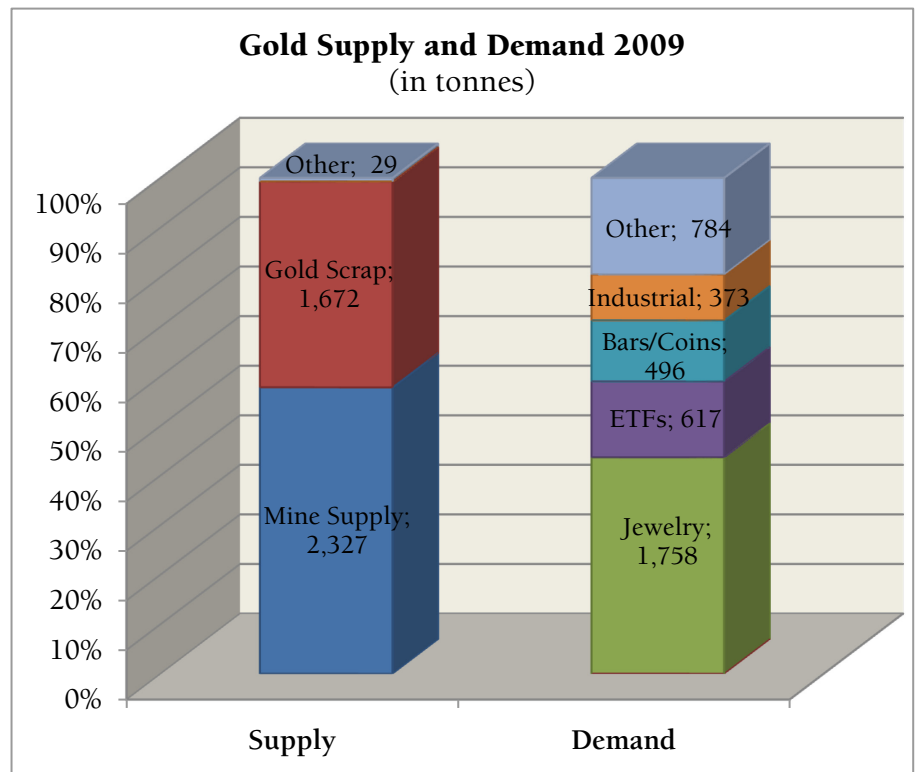
This paper briefly discusses the supply and demand fundamentals for the physical asset, gold. We argue that there is likely to be strong demand for the foreseeable future, driven by the rapid increase in demand for gold as a viable investment asset class and by the gradually

rising consumption demand in the Emerging Markets. Global production will take five to ten years to increase output materially, aside from a one-time jump in 2006. The most prominent risk to this scenario will come from the elasticity curve: higher prices could hamper consumption demand growth. We witnessed this elasticity effect on jewelry demand in India in 2006 and 2009.

In addition, should the Emerging Markets—India and China in particular—falter, demand could fall significantly. To date a much more important factor has been investment demand. **We believe that investment demand will continue to be the most important factor in the determination of gold prices in the coming years.** We expect to watch this factor closely.

SUPPLY AND DEMAND

According to the World Gold Council (WGC), global supply of gold in 2009 was 4,028 tons. What makes the supply/demand fundamentals of the gold market so interesting is the breakdown (see “Supply and Demand” charts). The largest usage, more than 50% is for jewelry. And what many investors don’t realize is that the leading jewelry consumer for gold is not the US, but India, which alone accounts for over 33% of all gold jewelry sales. Number two is China, which now accounts for more than 20% of jewelry consumption. America today only consumes 7% of the world’s gold for use as jewelry, down substantially from prior years when the US consumed more than 20%.



Of the 4,028 tons of supply, mines supplied about 2,327 tons. The amount of production has been fairly flat over the past ten years. The key here is that mine production is very difficult to increase. Most of the easy areas to mine gold have already been exhausted. The new sources of supply are in much more difficult locations (deeper mines and more remote locations) and they are accordingly much more expensive to mine. The remainder of the supply comes from the official sector—central banks selling into the market—as well as gold scrap sales.

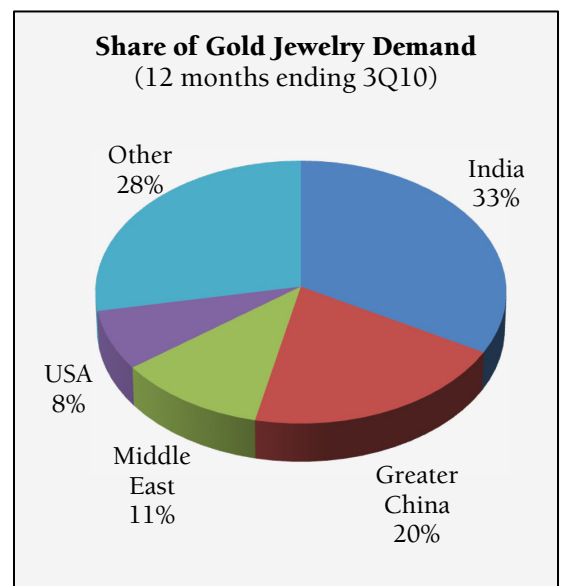
Not surprisingly, South Africa is the lynchpin of global supply: according to the US Geological Survey, the country holds 40% of the world's 90,000 tons of underground gold reserves, but is depleting them fast. Along with South Africa, China, the US, and Australia are key suppliers. However, output is slow to increase: mining is extremely labor and capital intensive, and requires significant regulatory hurdles before full-scale production can come online. In addition, low levels of capital investment over the past 15 years will limit the industry's ability to sustain a ramp-up production in the immediate future.

A CLOSER LOOK AT DEMAND:

Surging Consumption and Investment Interest

There are two major drivers of demand that we would like to highlight: growing wealth in the Emerging Markets (EM) and the “Asset Class Revival” effect.

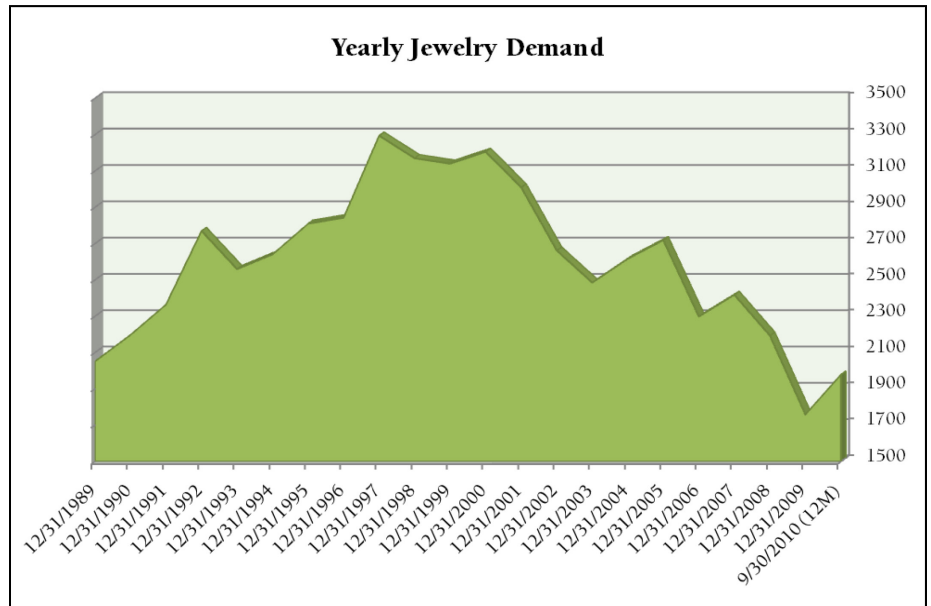
Emerging Markets' Demand: In Jeopardy? Emerging Markets' demand for jewelry over the long term should, in theory, help the global growth for gold, although in the short term the higher physical price will take a toll on tonnage demand. The “Share of Gold Jewelry Demand” pie chart illustrates the dominance of India, China, and the Middle East (where Turkey and Saudi Arabia dominate), which together consume over half the world's jewelry gold. The blistering growth rates of those countries, as well as their deep cultural affinity for gold, have rocketed these countries into the top tier of jewelry demand. *India and China alone now consume more than 53% of the world's jewelry.* This is up from only 35% percent in 2006.



In addition, the Chinese government began to liberalize its control over gold production and sales in 2003, allowing foreign companies to enter the market with Chinese partners and sell gold. The US embassy in Beijing noted in a 2003 brief that this would stimulate gold sales in the country and “ease the shortage of gold supply for jewelry in China.” Indeed, from 2002 to third quarter of 2010, jewelry consumption increased from 235 tons to 373 tons, a jump of 58%. Since that time China has continued to grow its gold production and is now the world’s largest producer of gold.

The Middle East is another area that investors need to watch carefully as a barometer of gold demand. The per capita jewelry demand in the Gulf (i.e. oil exporting) states is dramatically higher than in the West—the UAE in 2002 consumed 31 grams per capita, versus one gram per capita for the US, (Dubai’s nickname is “the City of Gold”). The region as a whole, including Turkey, accounted for 11% of global jewelry demand in 2009.

With oil prices at current levels, it is reasonable to assume that a healthy portion of an increasing mountain of “petrodollars” will find its way from “black gold” into “yellow gold.”



Of course, it should be noted that gold demand will be very sensitive to economic conditions in the emerging markets. Asian consumers responded to their collapsing markets in 1997-1998 by dramatically reducing their consumption of gold—total Southeast Asian jewelry demand fell a whopping 46% in a one-year period. Turkish demand fell 34% during its crisis in 1998-1999. During 2002, a bad monsoon season and higher gold prices in India resulted in a sharp decline in jewelry demand (gold down 20% year-on-year). In Q1 2009 consumption also dropped 24% year over year.

In addition, the price of gold itself clearly depresses – and *has* depressed – demand: jewelry demand in 2009 (1,760 tonnes) fell 23% from 2005 and was 41% lower than the comparable 2001 figure. This should not be surprising, since the dollar price of gold rose almost 300% over the 2001- 2009 time period and the laws of economics dictate some sort of demand destruction response. The gold price, which has been exacerbated by a sharply deteriorating dollar versus most foreign currencies, has risen less in most currencies than in dollar terms (only half as much in Euros as in dollars!), but marginally so in India and China, whose Yuan currency is tied to the US dollar for now.

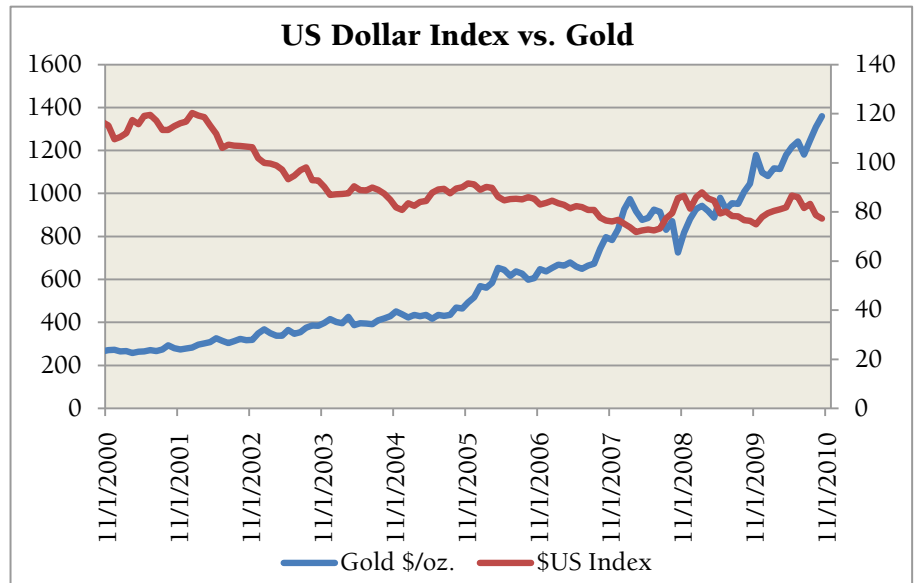
Investment Demand: Back in Business. Gold as an investment is where all the excitement is these days. As an individual asset class, gold is gaining attention but still is largely neglected by most institutional investors. Typically, major Wall Street houses lump it into either the Basic Materials sector (mining stocks) or in the “hard assets” category, which mostly favors commodities like oil and gas, and real estate. Exchange-Traded Funds are a relatively new instrument, and gold ETFs were launched in 2004.

The development of these funds allowed investors all over the globe a very easy way to invest portfolio assets in gold bullion - without the hassle of storage, high maintenance costs, and the high risk of theft. *The introduction of Gold ETFs in 2004 has revolutionized investing in gold.* SPDR Gold Trust managed by State Street Bank and Trust launched in November 2004 with \$13 million in net assets: by December 2007, the ETF reported that its assets had exceeded \$15 *billion*. As of December 2010 there is a hearty \$57 billion in the fund.

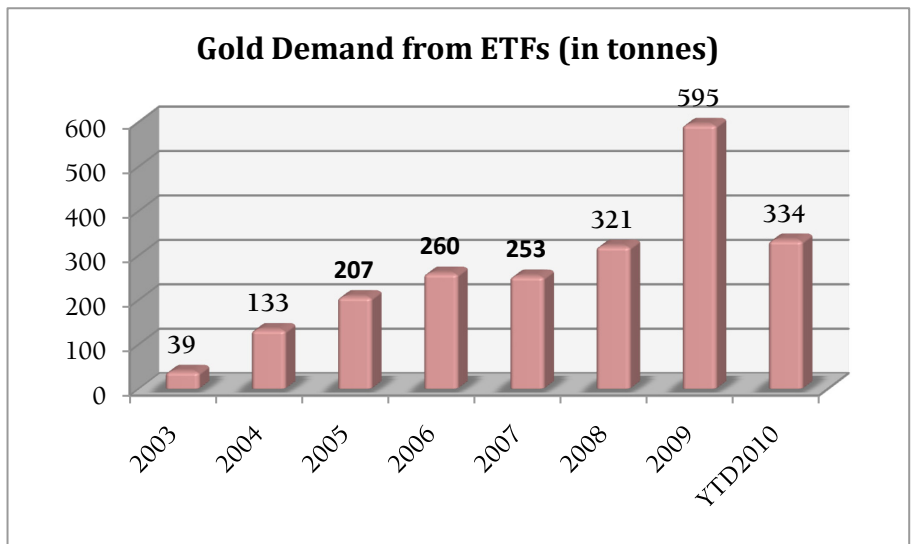
However, there is a case to be made for the inclusion of gold as a class on its own. Gold has a correlation coefficient of 0.003 to the S&P 500 from 1976-2010, indicating that there is no meaningful correlation at all between the two, and therefore providing a powerful tool for risk-reducing asset allocation within at least the two-asset-class framework. The metal also benefits from the perception that it will gain value in an environment of inflation or US dollar depreciation, or geopolitical instability. So far during this current cycle, then, it appears to be functioning according to the playbook. Given the strong performance of gold and precious metals over the past eight years, capital flows are likely to continue to enter the segment, creating a possible snowball effect, given the relatively small size of the investable gold market.

Now let's put it all together: we've got falling demand for jewelry in recent years due to the higher price of the bullion, and soaring demand from investors seeking shelter from a weak US dollar. Thus we illustrate the paradox of gold prices from a supply and demand perspective.

As the price of the bullion rises, demand for consumption is likely to be restrained, keeping overall consumption down. On the other hand, higher gold prices attract hordes of investors seeking the metal for the reasons mentioned above. The key here is demand for exchange traded fund assets is booming.

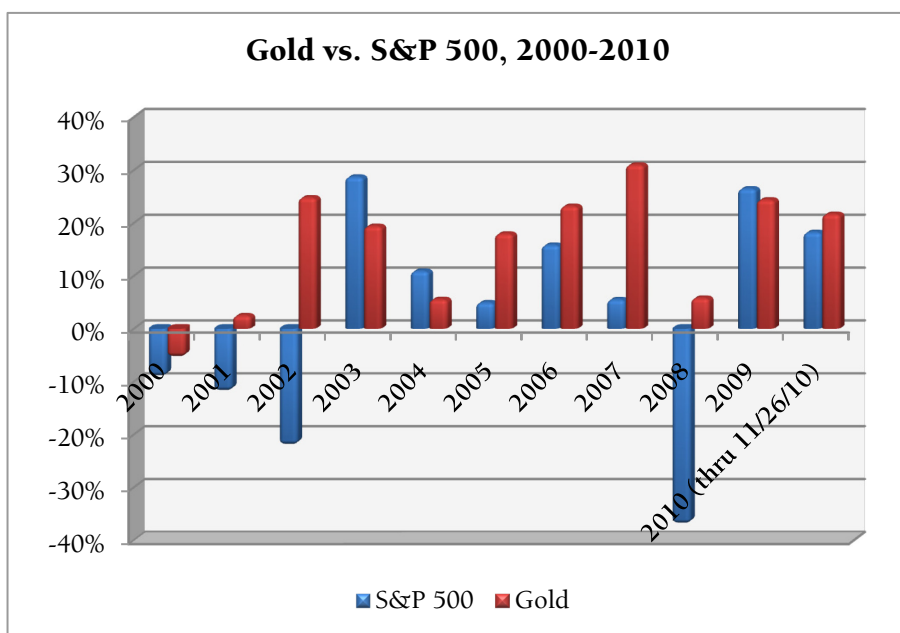


In 2009 investors put approximately 600 tonnes of gold into ETFs and similar products. This is up more than 90 percent from 2008 and is a whopping 15 times the level in 2003 of only 39 tonnes. At what level will investor demand shrink and will demand for Gold ETFs level off? No one knows for sure, however the conditions for continued high investment demand remain. This trend toward more demand for investment purposes will eventually end; however, what is interesting about the gold bull market is that all of this bullion in ETF gold assets are now removed from the supply of the market and will not return to the market until investors reverse the current trends.



For now, jewelry remains an important determinant of demand, and is likely to remain so for the foreseeable future, given that it is nearly 43% of overall demand. However, for the first time ever in 2010, ETF demand, Bar and Coin demand and other demand exceeded jewelry demand. This is a situation many thought impossible. However, the financial crisis of 2008-2009 has created many events never thought possible.

Consider the following scenario: frustrated with lackluster and increasingly volatile US equity large-cap returns, US equity holdings make a miniscule shift into gold, say 0.25% of their \$15 trillion in assets. This translates into approximately \$38 billion in additional assets scrambling to be deployed into gold. At current levels, that would represent an increase of about 22% in global investment demand for bullion. Bearing in mind that \$1 billion represents about 23 tons of gold (at \$1350/troy ounce), and that mines produce only 2,300 tons per year, the math becomes very simple: every \$5 billion in new investment demand for bullion will soak up 115 tons of gold or nearly 5% of total annual mine production, which struggles to pull more gold out of the ground in the best of times.



So, why will the demand for gold as an investment class rise? Two reasons: first, it has tacked on spectacular investment performance over the past eight years. That alone is usually sufficient to attract droves of investors who chase performance. The second reason is related, but more suitable to long term investors: as investors seek to protect their assets from government debasement in the form of printing money investment, demand for gold could continue to build. The course of action taken by governments and central bankers is now being written, however, the picture is not a pretty one.

Further, the main US equity benchmark, the S&P 500, has recouped some of the lost ground from the bear markets of the last decade, but many investors have given up on equities and seek alternatives. A sustained sideways large-cap equity market will leave investors no choice but to seek as many substitute asset classes as possible in their quest for higher returns.

What Steps Will Occur As Gold Transforms Into an *Accepted* Asset Class?

I have always believed asset classes go through three phases on the way to a bull market.

1. First, there is the **denial phase** – in this phase no one is paying any attention to the asset class and it is simply doing nothing – all have ignored it and most investors want nothing to do with it. In the case of gold – this would clearly be 1997- 2004: gold was ignored and not even considered worth discussion. In fact, most brokerage houses stopped covering gold in this period due to a 25-year bearish phase.
2. The second phase is the one we call **the acceptance phase**. In this phase, investors begin to notice that the asset class is performing and it wins over a few fans. Forward-thinking asset allocators are interested in the class and begin to start buying. The asset class in this phase moves away from being hated to starting to be noticed. Further, the fundamental reasons to believe that the asset class may be worthy of investing in grow much stronger. In the case of gold, this would be the years 2006 – 2010. During this phase, gold investors start to be noticed, hedge funds start taking large positions, and forward-thinking managers start including gold in their equity portfolios. Gold becomes an accepted investment by more investors, and it is clearly no longer hated or ignored.
3. The final phase will be **the love affair phase**. This phase is by far the most interesting and can also be incredibly profitable. In this phase, investors are fully convinced that the fundamental believe in the asset class becomes accepted by all without question. You notice people who have in no interest in investing are beginning to discover gold as an asset class. In the love affair stage, I would be expecting institutional investors to start aggressively recommending allocating a sizable portion of their portfolios to gold. Further, you will notice many new experts discussing gold and the multitude of reasons one needs gold in their portfolios. Today, we are certainly noticing lots of ads for gold coins and gold Exchange-Traded Funds.

However, we are not observing large, well-established institutional investors allocating much of their assets to gold holdings. Important investors like Harvard University, Yale, and Calpers (California Public Employees Retirement System) endowment in California and many others have not come on board the gold bandwagon yet. Will they? Yes, I believe they will eventually be drawn in by both performance and the strong argument against currencies.

I would assume these investors will start allocating a minor portion of their assets in the coming years as prices continue to rise. What will be the timing of this last phase? *We have clearly entered the acceptance phase of gold and we may be starting the love affair stage.* We have no idea how long it will take to complete this last phase. **We do believe that the last phase will be the most profitable for investors.** We also believe that at the end of this phase we will observe wild increases in volatility in the asset class.

2010 - The Year Investors Realize Their Currency Has No Real Backing – Is it a Fiat Currency?

The European currency crisis led by Ireland, Greece, Portugal, Spain and Italy has shown the spotlight very clearly in 2010 on the most glaring current day problem. Countries have spent beyond their means giving out IOUs in the form of pensions, health care benefits and lush benefits to far too many of their citizens. Many of these promises are out of reach of their financial abilities. So today we have a critical problem, given the weak status of the developed economies. Many European countries cannot push through tax hikes and they do not have the fiscal sense or the political ability to scale back spending. This results in heavy ballooning debt and larger annual budget deficits! Once a country gets to the point of debt to GDP close to 100%, this becomes problematic. The cost of carrying the country's debt becomes unmanageable and the possibility of paying back all of this debt becomes less and less likely. The bottom line is that the solution will come in the form of *large scale reforms which may include restructuring of debt for some of the weakest countries* (this is a more palatable way of saying someone will take a haircut/loss – likely the bondholders – maybe only 70 cents on a dollar/euro will be recognized under *reform*).

Today it looks like many of those European countries will not be able to return to a balanced budget status for many years. The bottom line – central bankers and government leaders have already decided what they will do – *they will print money and debase the value of the paper (fiat) currency.* What are investors to do in this situation? A critical first step is to realize that *currency-based assets may have a significant valuation risk.* So money kept in the form of cash and valued in dollars could experience a sizable loss in purchasing power in the coming years.

We need to protect against this by investing in real assets that will not be depreciated in value when currencies are debased. Which assets are best suited for this?

- *Gold and precious metals,*
- *Real estate, especially well-located land, and*
- *Equities that represent real assets in a company – like buildings, equipment and other assets that will be able to keep up with higher inflation once it starts to be priced in.*

Many believe that equities in general are a good way to protect against this currency devaluation. This is true to the extent that companies can manage their businesses to adjust to the higher levels of inflation and continue to grow real profits even in a high level of inflation. One must be careful; the proper management of after-inflation profits is not easily accomplished for all businesses. What is particularly troubling is that the United States, Great Britain, Japan and France and some other large, developed economies today have large deficits and their debt to GDP ratios are quickly approaching the 90-100% range.

So are the United States and United Kingdom very far behind these other smaller European countries? The script is still being written by governments and central bankers all over the globe. Wise investors today will keep in mind the issues raised in this paper and must consider these as critical factors when making investment decisions. For more information on how Cabot utilizes gold and precious metals to manage portfolios, please contact Mr. James Gasparello at Cabot Money Management, Inc. at (800) 888-MGMT or email us at info@ecabot.com.

GOLDMINES OF INFORMATION

For those interested in doing their own research into the gold industry, below are some useful websites.

- 1) **World Gold Council.** An industry-sponsored site that offers a wealth of information on supply and demand statistics for gold, as well as informative discussions on gold-related topics ranging from history to how a gold mine operates. www.gold.org.
- 2) **Goldsheet Links.** A good source to track the price of gold and other metals, as well as a good starting point to investigate global mining companies. www.goldsheetlinks.com.
- 3) **US Geological Survey.** (www.minerals.usgs.gov/minerals/pubs/commodity/gold) The home page of the Gold Section of the USGS. Useful statistics on gold production and a link to the monthly Gold update report (for a list of all mineral surveys, go to: www.minerals.usgs.gov/minerals/pubs/commodity/mis.html)

- 4) *The National Mining Association.* (www.nma.org/statistics/pub_gold_silver.asp) Poorly updated, but links to an interesting interactive gold price chart: www.nma.org/enumerate/gold/gold.htm
- 5) *The Gem & Jewelry Export Promotion Council.* Industry-sponsored web site with good statistics on the state of the global jewelry import/export business. www.gjepc.org/gjepc/gjepc.aspx?inclpage=Uinfo_St_Statistics§ion_id=6

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