

Abbington Investment Group, LLC
Investment and Market Commentary
The Gold Debate
June 2014

Dear Clients, Friends and Family:

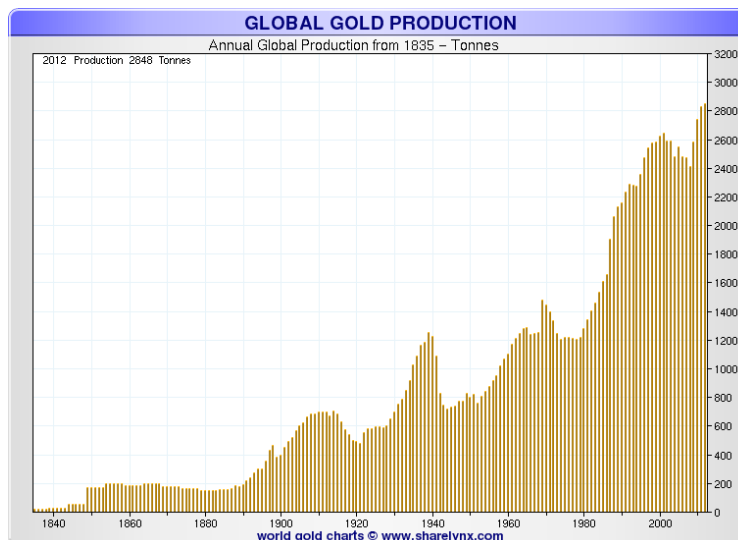
Our decision to tackle the emotive subject of gold, ahead of the other subjects on our list of pending publications, is a reflection of how important we feel the debate about gold is. The yellow metal ignites arguments among investors and the public at large. Lord Nathaniel Rothschild, at the time head of the London bank, N.M. Rothschild & Sons, said of gold, "I know of only two men who really understand the value of gold; an obscure clerk in the basement of the Banque de France and one of the directors of the Bank of England. Unfortunately, they disagree". This quote sums up the difficulty of pricing gold, even to this day.

To some, gold is the ultimate currency and a true store of value. To others, gold is a symbol of anti-establishment beliefs and an unnecessary distraction from the cut and thrust of today's modern stock markets. Over the next few pages, we will outline some facts about gold, concluding with Abbington's own view of the yellow metal.

Introduction

Gold, atomic number 79 (AU), with its characteristic color and chemically unreactive behavior, has been a source of mankind's interest for millennia. Unlike other metals on the periodic table, much of the gold ever mined remains in existence today (estimated at 163,000 tons). Gold's unreactive quality has made it an ideal tool for exchanging goods and services. Additionally, gold has the ability to maintain its distinctive color and weight, and, being a soft metal, it has a conveniently low melting point. It was no doubt these qualities, along with gold's rarity, that led to the first minting of gold coins in 640 BC, in the Kingdom of Lydia (modern day Turkey). The melting and processing of gold coins and bars continue to this day in many different mints around the world and in far greater volumes than before.

Chart 1: World Gold Production from 1835 to 2012



Source: Sharelynx

Gold as a Monetary Metal

Gold is money—it is not an investment. It does not have a yield or a return. Gold that has been fully paid for, and that is physically held, has no risk. This risk-free attribute has made gold a sought after asset in times of economic and social strife. It is for this reason that many people consider physically held gold to be a valuable risk diversifier and a form of financial insurance.

Gold cannot be consumed or converted into other compounds or materials. People buy gold for these distinctive qualities, which make it suitable as a store of value, as a return on labor, as a means of exchange and as ornamental wealth (jewelry). For almost three thousand years, gold has been *the* currency and means of exchange in many countries around the world.

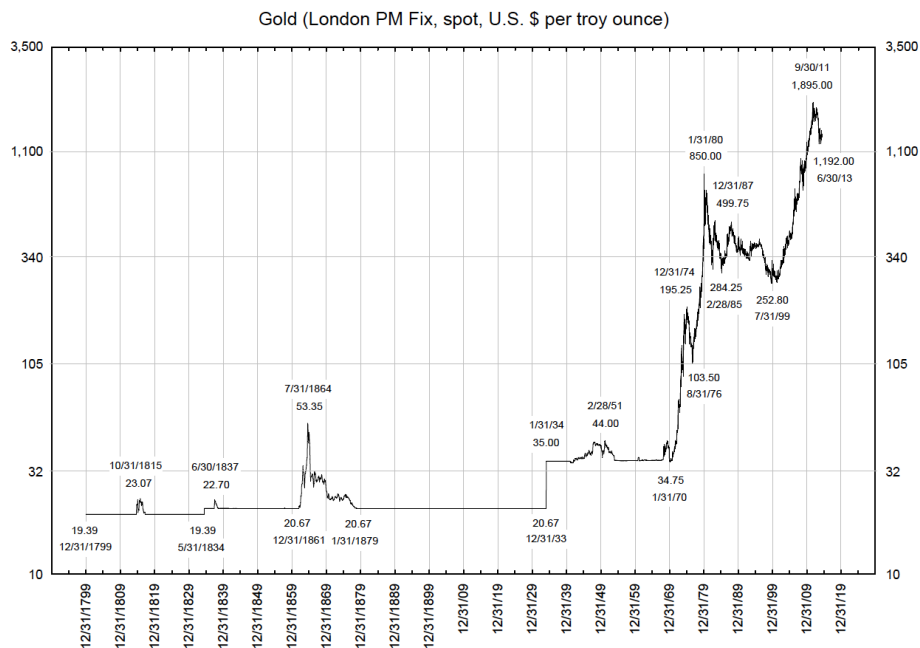
Today, gold is experiencing a surge in interest. Countries such as India and China, due to their increasing wealth, are experiencing a massive increase in gold demand from savers. In 2013, it was reported that China alone was responsible for 2,500 tons of the world’s physical gold demand. That is equivalent to one year’s entire global mine production.

Common Beliefs About Gold

Belief No. 1: Gold is too expensive. It’s a bubble.

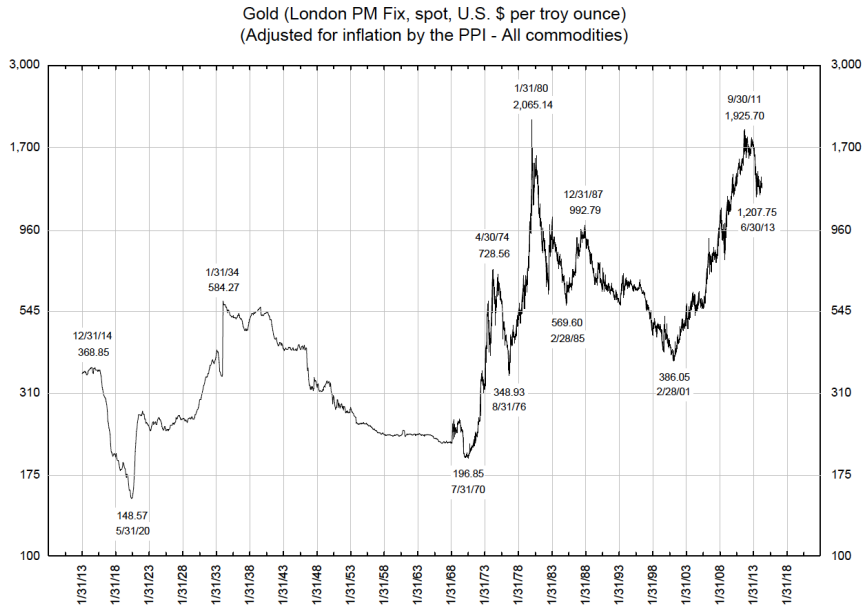
There is a commonly held belief that following the 2008 market drop, interest in gold became a mania that peaked in the fall of 2011. There is no doubt that the market had become overheated that year. However, we can see from Chart 2 (historical gold prices) and Chart 3 (historical gold prices adjusted for inflation), that gold prices did not experience the parabolic up-moves that represent a typical price bubble.

Chart 2: Historical Gold Prices



Source: Thechartstore.com

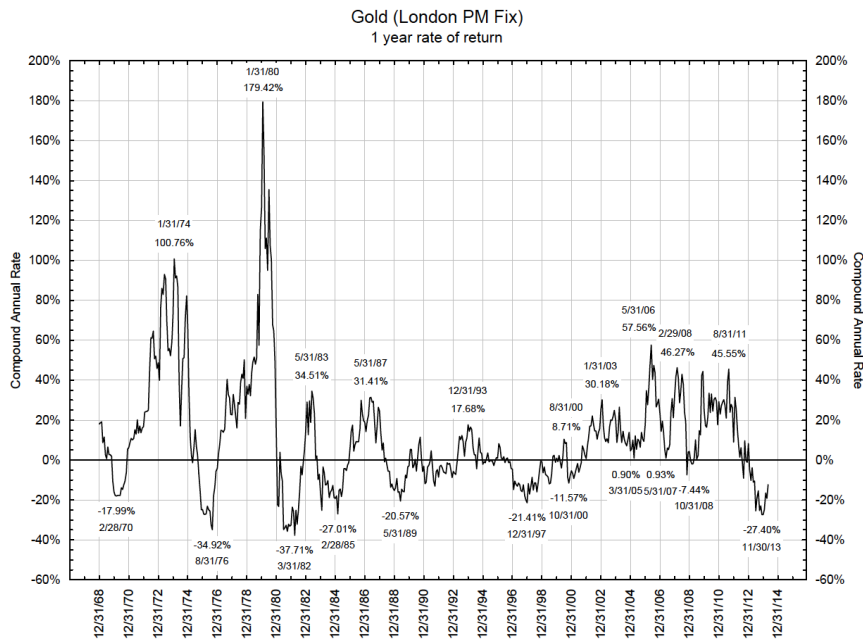
Chart 3: Historical Gold Prices Adjusted for Inflation



Source: Thechartstore.com

If the past is anything to go by—following the protracted sell-off in gold, which took place from September 2011—the 1-year rate of return level for gold today indicates a good buying opportunity (see Chart 4).

Chart 4: Gold's 1-Year Rate of Return

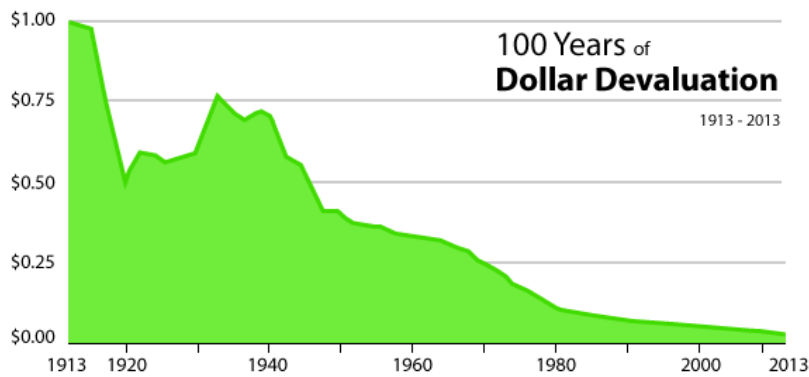


Source: Thechartstore.com

Belief No. 2: Gold has no yield or dividend.

This is true. However, as noted earlier, gold compensates for its lack of yield by offering the physical buyer of gold a risk-free store of value. As we can see from Chart 5, the USD by contrast has depreciated by over 95% since the formation of the Federal Reserve in 1913 (calculated by compounding the effect of CPI on the purchasing power of one dollar).

Chart 5: The USD Devaluation from 1913 to 2013

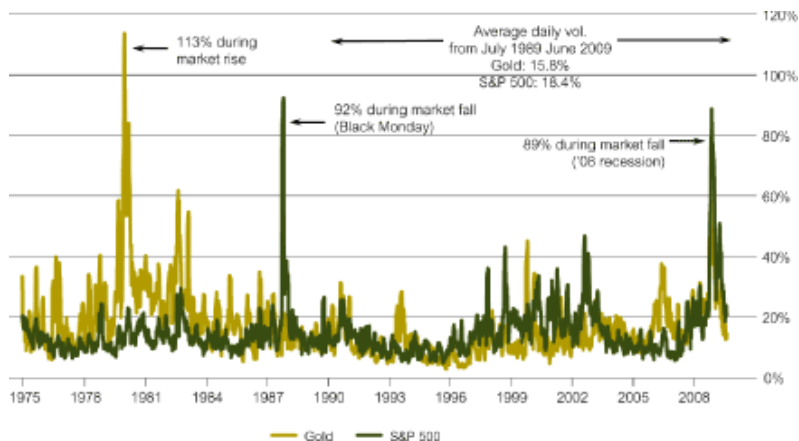


Source: Mike Shedlock

Belief No. 3: Gold is too volatile.

There is a commonly held belief that gold is too volatile for most investors. However, that opinion is countered by the many who consider gold to be an excellent portfolio diversifier. In fact, according to a Lawrence and Colin 2003 study for the World Gold Council, gold has a zero to negative correlation to all other asset classes over time, making it an important counter-balance within a diversified portfolio.

Chart 6: Gold's Recent Volatility vs. the S&P



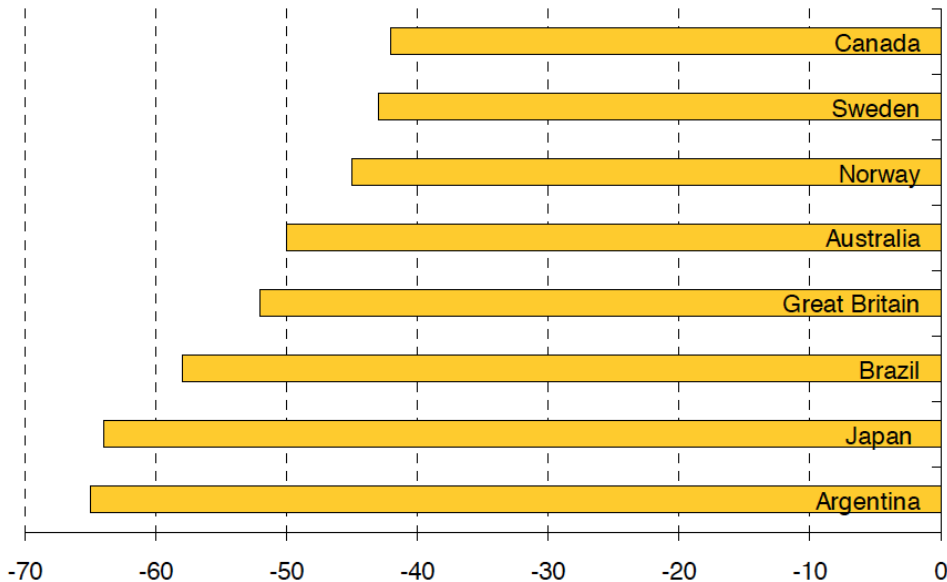
Source: ShareLynx.com

Belief No. 4: Gold is a poor investment during times of deflation.

Aside from the fact that gold should not be considered a typical investment, it is hard not to see the benefits of holding gold against the backdrop of today's massive public and private sector debt markets. Again, this time as a result of a deflationary spiral, gold offers some protection against the inevitable defaults that will occur if deflation gets a stranglehold on Western debt markets.

In an effort to reflect how gold prices would have reacted to the economic collapse of the 1930's, Ronald Stoferle at Erste Bank shows in Chart 7 how the currencies that pulled out of that period's gold standard depreciated relative to gold. Using the Canadian \$ as an example, Canadian investors in gold at that time would have maintained their spending power internationally rather than experiencing an over 40% depreciation in their own currency, had they kept their assets in gold.

Chart 7: Percentage Depreciation of Certain Currencies vs. Gold (End of March 1934 as compared to gold parities in 1929)

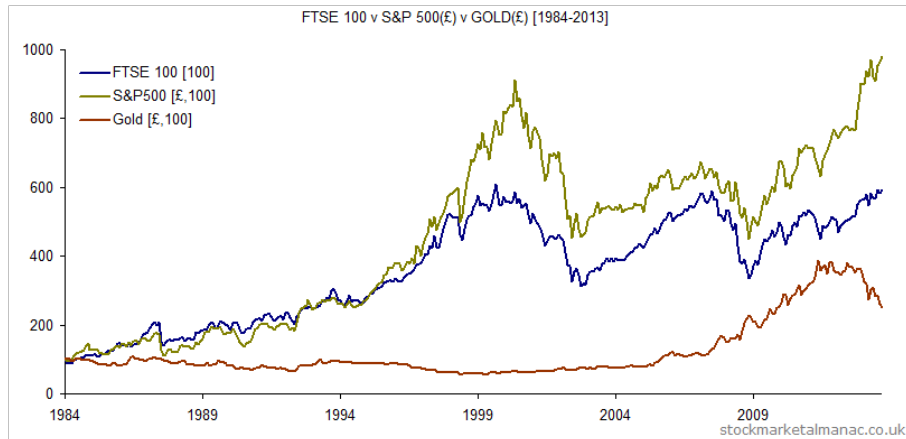


Source: Erste Group's excellent Ronald Stoferle

Belief No. 5: Gold offers solid portfolio insurance.

Gold offers price protection during certain extreme stock market price volatility. As we can see from Chart 8, gold maintained its gradual price increase throughout the last decade during and following the large stock market sell-offs that occurred then.

Chart 8: S&P, FTSE and Gold from 1984 to 2013

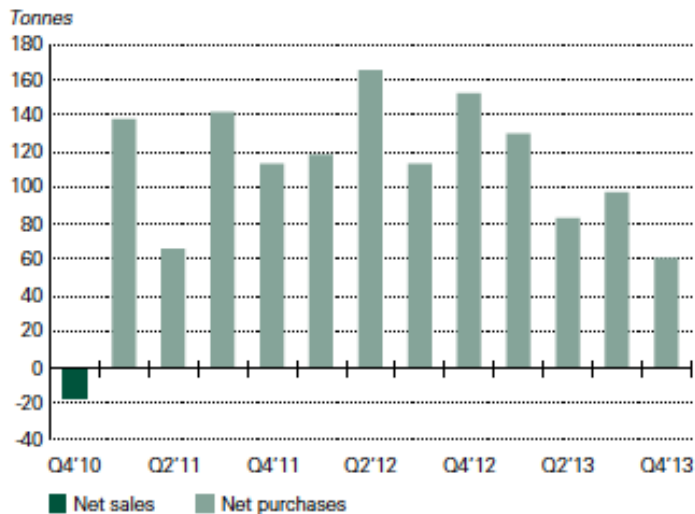


Source: Stockmarketalmanac.co.uk

Belief No. 6: Virtual currencies, such as Bitcoin, will replace gold's role

There is no doubting the competitive threat that Bitcoin and other virtual currencies create for the global foreign exchange markets and for the large banks that take exorbitant transaction fees for exchanging different currencies. However, physical gold has never played a role in the electronic market place—it is a monetary metal and as such, a real asset. Gold's monetary role has not been lost on central bankers, as we can see from Chart 9 below.

Chart 9: Global Central Banks' Recent Net Purchases of Gold



Source: The World Gold Council

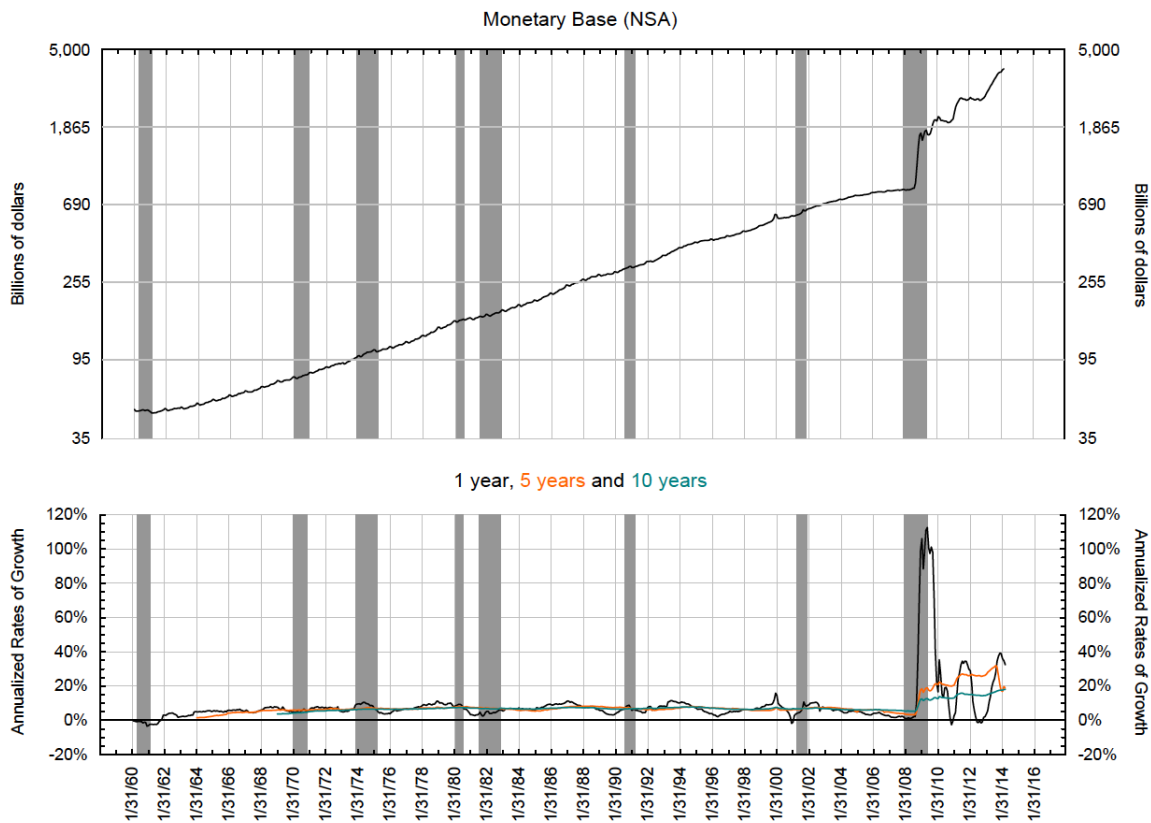
The Purist's View of Gold

Rather than looking at gold in terms of the USD, there are many advocates of gold who believe in its underlying value, attributing the price movements of gold relative to other currencies to the fluctuating value of those currencies rather than to any change in the underlying value of gold. After all, is a 5% rise in the price of gold in USD terms an increase in the value of gold or a fall in the value of the USD? If one considers gold to be *the* monetary standard, then it is the USD that has fallen in

value while the price of gold has remained constant. If it is understood by all that the gold supply and the USD supply remain constant, then it can be argued that the price at which they are exchanged should remain unchanged. However, if either the USD or gold supply permanently changes, then the exchange price will also change.

It is with this anchoring that gold standard advocates approach the QE debate. To them, money is a store of value and a return on labor; it is unquestionable that money supply should be strictly limited to the growth rate of that labor pool and the productivity of its effort. Based on this understanding of money, today's massive QE programs, as evidenced with the drastic increase in money supply since 2008 (Chart 10), have led to raging arguments between the advocates of QE and those who support a return to a gold standard.

Chart 10: The US Monetary Base and Growth Rates of Money Supply



Source: Thechartstore.com, US Federal Reserve Board

While This Argument Continues...

While advocates of QE and their gold-advocating naysayers continue with this debate, physical buyers of gold, many of whom are in Asia, are accumulating record amounts in the physical exchanges located in cities such as London, Dubai, Shanghai and Singapore. However, the price of gold continues to fall from the \$1900/oz. level seen in 2011 to today's \$1250/oz. Much of this selling pressure is coming from leveraged accounts via futures exchanges (ie. COMEX), overwhelming the physical demand from Asia and elsewhere.

Conspiracy theories abound. Is the US Federal Reserve Bank suppressing gold prices? Are the Chinese state authorities keeping prices low in an attempt to buy more physical gold? Does anyone know?

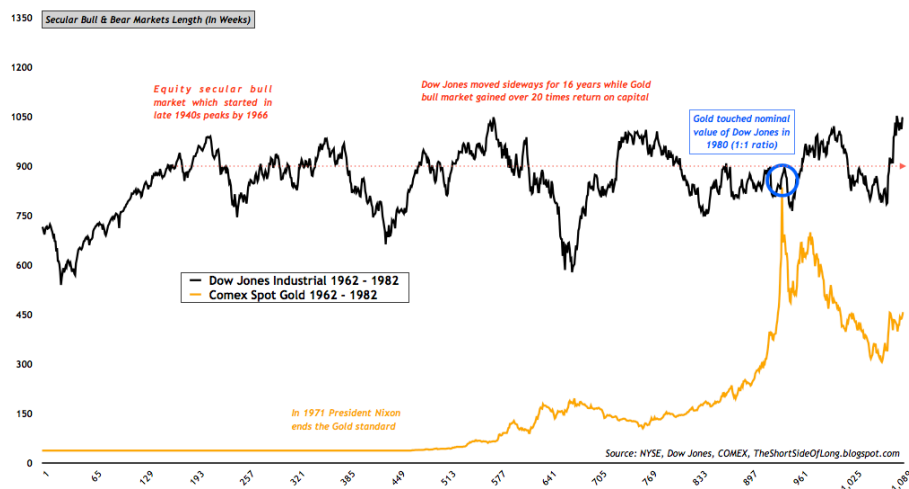
So where does Abbington Investment Group stand on gold today?

When we look again at Chart 3, it is clear that gold price movement from 2002 to 2011 did not reach a bubble phase. Prices had become overextended relative to their long-term moving averages and much of this overextension has been corrected during the last three years.

However, in contrast, as shown below in Chart 11, gold prices did experience a bubble, topping out at prices equal to the prevalent DJIA in 1980. There were a number of factors which led to that price action; the main cause being the higher inflationary environment of the 1970's.

To equate what happened in 1980 to today's market, gold would be trading at the DJIA's current 16,500 level. Now that would be a bubble!

Chart 11: Dow Jones Industrial Average (DJIA) and Spot Gold Prices 1962 to 1982 as Shown in Number of Weeks



Source: TheShortSideOfLong

We are not going to attempt to target a future return for gold. However, we believe gold has the ability to protect a typical investment book from the tail risks that are involved with global central banks' monetary policies. Whether we experience inflation or deflation, gold can help protect our clients' investments, particularly if our clients' non-gold savings are heavily committed to assets, such as bonds, which produce a yield but expose investors to inflation and default risk.

Gold can also be a useful focus for people who are underinvested in real assets such as real estate. With many younger people choosing to rent rather than buy their home, a holding in gold is a means of negating some of the inflation risk.

To conclude: Gold will remain an emotive investment topic. However, Abbington Investment Group will be monitoring its price developments, and, where appropriate, may advocate its purchase for certain client portfolios, on a case-by-case basis.



Thank you for taking the time to read this piece and we look forward to sharing our next commentary with you.

Best regards,

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