Gold   October 2010

*'Gold is unusual in that it is both a commodity and a monetary asset'. (*The Gold Council)

Key Recommendation – All but the most aggressive traders should adopt a cautious stance as prices erupt to a speculative frenzy. Gold's volatility should feature only modestly in an overall inflation busting portfolio.

Key issues - Investors should consider the collapse in physical demand for jewellery over the past decade as prices have raced higher. Together with incremental supply increases, this should eventually balance financial speculative demand.

Introduction

Investment fashions, like hem lines, are quick to change. From the mid-1990s central banks' sales of gold cemented what seemed like a secure bear market in the precious metal. Or at least the lack of interest paid appeared to favour coupon bearing securities. However, as various economic crises reared up over the first decade of the 21st century the safe haven status of gold once again found support. As the bull market developed, and fears over fiat currency multiplied, prices soared to new levels. Investors have been encouraged to diversify portfolios towards commodities, including the yellow metal.

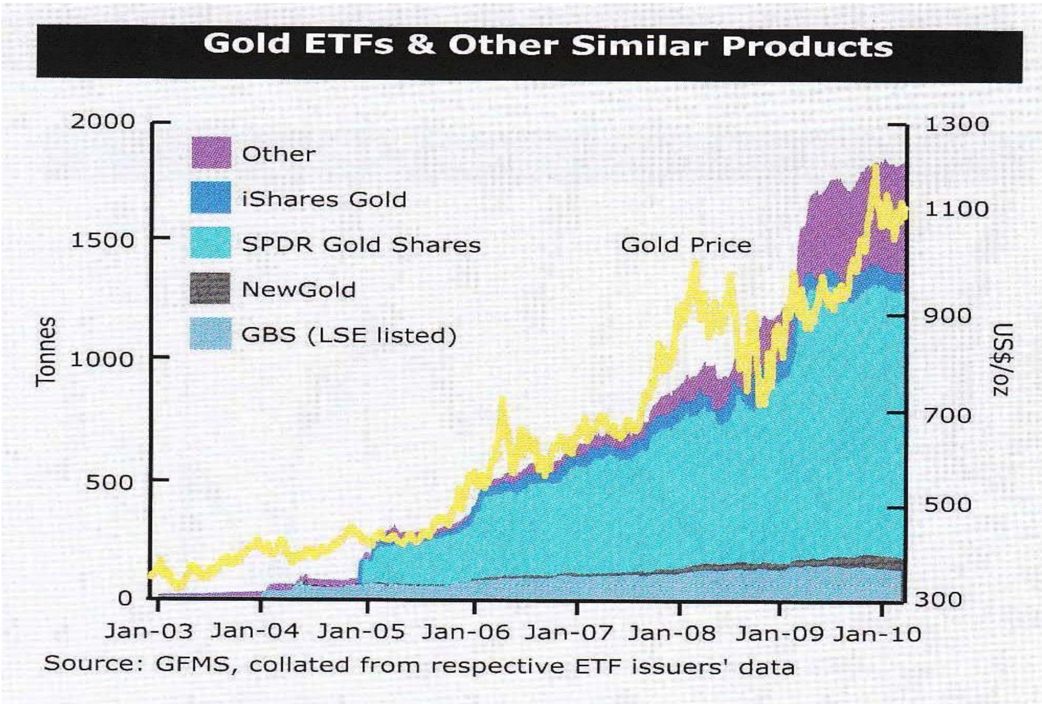
Higher prices may have led to more financial investors, but these same issues saw a sharp reduction in jewellery demand. Together these trends have balanced overall demand. While the continued unprecedented monetary stimulation, coupled with strong growth in emerging markets, may well forecast inflation there are other products that can also act as a protection against rising prices. **The Short View FT 15th October; 'with little fundamental demand, keeping the price up depends on attracting more hoarders (or investors).'**

Demand --- Financial Investors

Where shall we start? Inflation, the Federal Reserve's ballooning balance sheet, competitive devaluations, QE, sovereign default risks, record low interests in government bonds and at the same time hugely increased deficits…. 'Gold is not just an inflation hedge any more it's a systemic risk hedge' wrote Van Nieuwenhuijzen, ING's head of Fixed Income wrote on CNNFN's website on 24 September this year.

Since the bursting of the Internet bubble in 2000, and the corresponding end of the last equity bull market, investors have been searching for a price resilient asset. Gold has seemed to do the trick. It is tangible, limited in absolute supply and beyond the control of any government.

Since 2003 a plethora of new instruments have sprung up to cater for demand.



Are these fears justified? There are always going to be issues for investors to fret about. In previous eras we had the millennium bug, or the existential threat of the Cold War, to name but two. It is unclear whether today's problems are greater. For veteran industry players who had lived through the 1970s inflation, South American and Russian debt defaults, or the 1987 equity market crash, today's volatility is nothing new. Maybe the advent of 24 hour rolling news, and the Internet skewers a more measured and reflective perspective on changing events. This is not to decry worrying trends, especially in the developed world of high unemployment, ultra loose monetary policy, fiscal and trade imbalances. But it may be the interpretation, and the perception of gold as a one size fits all answer is something new.

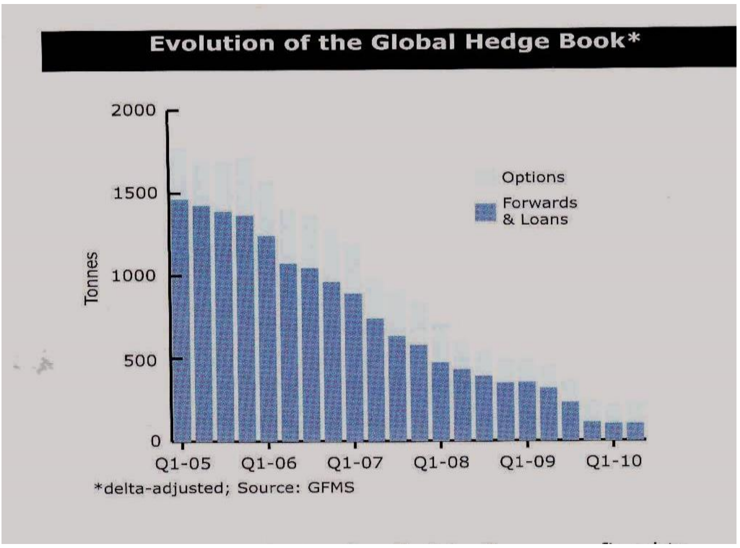
Low interest rates and hence cost of carry. This is new. Since the 2008 crisis and the slashing of G7 rates to near zero the penalty of holding all commodities has lost its opportunity cost. It is now cheap to hold and speculate with products like gold that bear no coupon or dividend. Undoubtedly this has spurred demand and leverage.

Physical demand

As gold is not just a 'currency', we need to look carefully at other aspects of its use.

Since the dawn of time, jewellery has long been a major and constant part of the demand for the yellow metal. From the turn of the millennium this need has diminished. In western markets it is clear that higher prices have weighed on demand, however this may have also masked longer term trends in fashion. As GFMS, a leading gold consultant, explained in their 2009 survey, there has been a 'swing from the simple, heavy, unbranded and plain to higher design, light weight branded gemset.' All of this has cut sharply into the demand for product. In the less developed world, as GFMS goes on to say, '**absolute prices have now reached such high levels that they have begun to severely constrain jewellery budgets.'**

Hedging has been sharply reduced over the past three years. Producing companies have been canvassed by their own shareholders to see **gold mining as an access to the spot metal price**, and not to sell forward the production. The message has been acted on as companies like Barrick Gold and Ashanti have ended their hedging programmes. In the process they were required to buy back over 160 tonnes. This unwinding process has given a short term boost to demand.



Industrial and dental demand has held steady throughout the last decade. A summary of overall demand over the past ten years shows a surprising little change in tonnage. Of course in currency terms there has been an increase. But it is an interesting fact that demand is dependent on financial flows as more traditional end users step aside.

Table 1a - End-Use Gold Consumption (tonnes) © Copyright GFMS Limited	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Jewellery Consumption	**3,205**	**3,009**	**2,662**	**2,484**	**2,616**	**2,718**	**2,298**	**2,417**	**2,193**	**1,759**
Industrial & Dental	**451**	**363**	**358**	**382**	**414**	**433**	**462**	**465**	**439**	**373**
Electronics	283	197	206	233	262	282	308	311	293	246
Other Industrial & Decorative	99	97	83	82	85	89	93	96	91	74
Dentistry	69	69	69	67	68	62	61	58	56	53
Identifiable Investment	**166**	**357**	**344**	**341**	**482**	**601**	**676**	**686**	**1,177**	**1,319**
Bar Hoarding	242	261	264	180	257	264	235	236	386	187
Official Coin	77	83	97	107	115	111	129	135	187	229
Medals & Imitation Coin	29	29	26	26	26	37	59	73	70	57
Other Identified Retail Investment*	-181	-15	-47	-11	-49	-18	-8	-11	213	230
Investment in Exchange Traded Funds and Related Products**	-	-	3	39	133	208	260	253	321	617
Total	**3,822**	**3,729**	**3,363**	**3,207**	**3,512**	**3,753**	**3,435**	**3,568**	**3,809**	**3,451**

Source: GFMS

Gold supply – Central Banks, scrap sales and mining

Patricia Hewitt, former UK Trade minister, announced in Parliament on 7/5/99, 'Today we are announcing a restructuring of the UK's reserve holdings to achieve a better balance in the portfolio. This will involve a programme of auction of gold.'(The Times)

The so called 'Brown bottom' and the instigation of serious central bank sales of gold is obviously not confined to one country. Consensus forecasts for the long term performance of precious metals in the 1990s seem a little short sighted in light of recent forces, but nevertheless they were acted on. The total programme averaged around 500t pa throughout the 2000's, representing approx 20% of overall supply.

However, this policy has undergone a dramatic change since 2008. As GFMS put it, '**central banks seem now more willing to accept the virtues of gold reserve** asset and, therefore, reluctant to reduce bullion reserves.'(GFMS) The folly of selling at historic lows, and the political fallout from that policy are likely to remove one large dynamic supply from forward calculations. In fact emerging market central banks with burgeoning coffers have already shown an interest in bolstering their reserves. Russia and the Philippines both added to their holdings in 2010.

But can this new trend make any real impact? As the FT Analysis column put in on 27th September, 'Central banker's joke that gold is similar to what the Norwegian Krone is in the foreign exchange market: too small for diversification.'

Mining – static

Some small increases in production have occurred over the past seven years. For the first half of 2010 total mine production has increased by 2.4%, hitting an annualised figure of over 2,600t - (GFMS). However, in the overall context of the industry this is of minor interest. Furthermore, with production costs increasing fast (by 17% in 1st H 2010) it would appear that this 5000 year old industry has little major finds to come. Higher prices have helped start-ups and M&A activity, but are unlikely to unlock any substantial supply.

Scrap --- coming from a big stock

The overall estimate for total stocks worldwide is **approx 165,600t** - (Gold Council). We should bear in mind one of the metal's enduring qualities is capacity for indefinite storage. Gold does not rust, degrade, or reduce in quality - it can only be lost. So all that metal is out there, and it has already notched up increasing sales from scrap. Redeemed sales have more than doubled over the past five years to over 1,670 t in 2009 - (GFMS). Higher prices, and tough economic times have spurred liquidations. These **sales represent only barely 1% of the total stock**, so a great deal more inventory could yet hit the market.

Conclusion --- a sense of perspective

Readers of this newsletter will know that we most fear inflation. The increasingly desperate attempts of the Federal Reserve, and other central banks, to use asset purchases to solve the longer term problems of unemployment represent a real risk to re-ignite inflation.

We are not bearish on gold --- but

For investors who share our fears, gold has been a major beneficiary of this rerating of inflationary risk. However, the supply/demand matrix should factor a more cautious approach and avoid putting too many eggs in one glittering basket. Physical jewellery demand has faltered, even in emerging economies like India. At the same time, the vast overhang of existing stocks represents a real potential supply issue that bulls will have to wade through.

Other commodities have had overshoots in the past few years, as speculators responded to inflationary concerns. **Do you remember peak oil** and those arguments that drove crude oil to a super cycle high at $150 a barrel as recently as mid-2008? This is a paradigm example of how excesses speculations can develop. The subsequent collapse in that bubble is a salutary lesson. While gold has a role in a modern portfolio, there may be substantially better entry points in years to come.

As even a gold bull like Paul Tustain of BullionVault explains (even if one subscribes to the inflation argument) 'some will exit to land, some will exit to equities, some will exit to real estate, some will exit to commodities, and some will exit to gold. They each have their merits, and their risks. **In fact there's a lot to be said for a balanced approach involving them all.**'

At the bottom of this piece we have plotted gold vs oil, US TIPS and real estate over the past 10 years.

P.S. US real estate – it is perhaps now time to revisit this unloved asset.

Model Portfolio

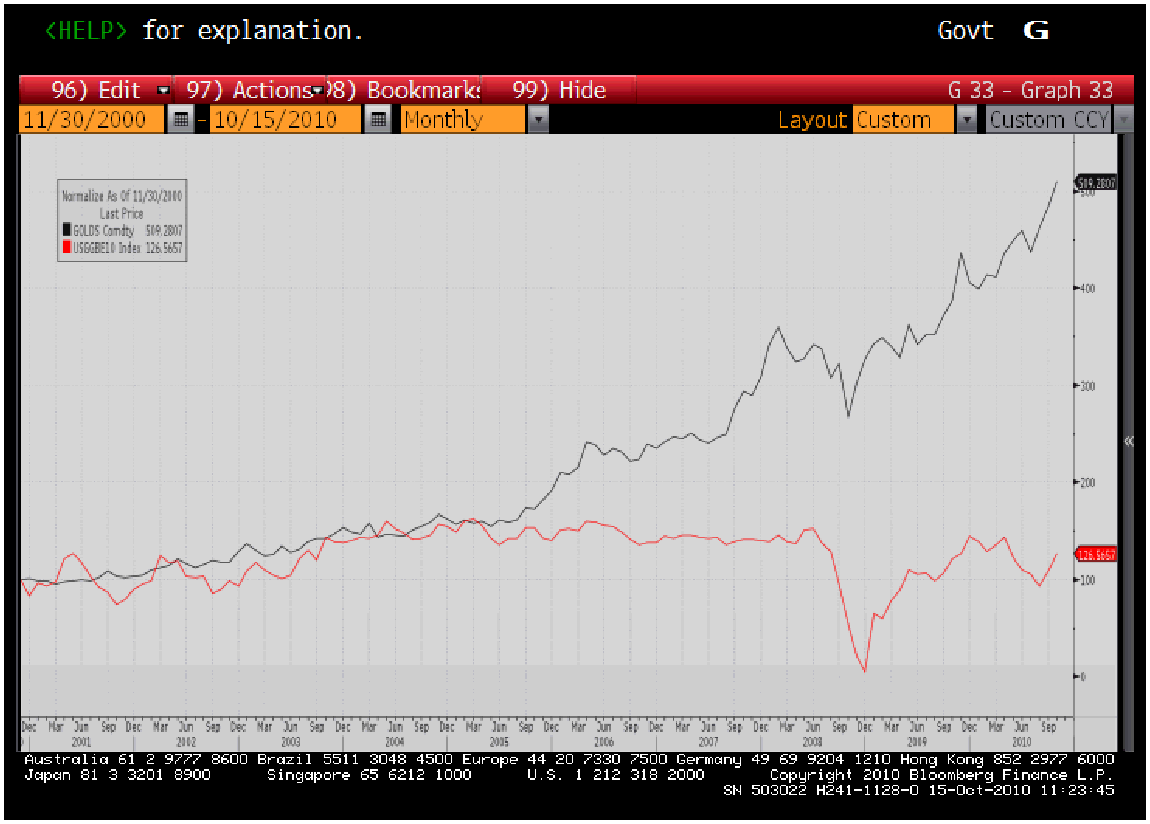
August was another good month for the implied portfolio, with a total return of 3.03%. Bearing in mind our objective is absolute return, we are satisfied with this performance.

However, the blazing bull market in risk assets that has now entered its third month must provoke a response to our patience first approach. The well flagged aggressive moves by the Federal Reserve accentuate the imperative of embracing a higher weighting of inflationary assets and a corresponding conservative stance towards bonds.

Accordingly, we will reduce further our bond portfolio by 5% and invest the proceeds in equities. This will maintain a higher weighted average in cash, allowing further flexibility.

We also note with interest the sharpening of the dollar bear market. While this is not reflected in our model portfolio for ease of analysis, investors should continue to weight portfolios away from the US$.

Source: Bloomberg



Source: Bloomberg

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ACM Model Portfolio
September 2010

Asset class	SAA	TAA	Over/under	Contribution SAA	Contribution TAA
Cash	5.0%	15.0%	10.0%	0.00%	0.01%
Fixed income	25.0%	25.0%	0.0%		
Government bonds			0.0%		
	25.0%	25.0%		-0.08%	-0.05%
Corporate bonds					
Equities	40.0%	30.0%	-10.0%		
US	18.0%	16.5%	-1.5%	1.58%	1.44%
Europe	12.0%	9.0%	-3.0%	0.41%	0.30%
Japan	4.0%	0.0%	-4.0%	0.25%	0.00%
Asia ex-Japan	4.0%	3.0%	-1.0%	0.46%	0.35%
Emerging market	2.0%	1.5%	-0.5%	0.22%	0.16%
Hedge Funds	20.0%	25.0%	5.0%	0.49%	0.61%
Eq hedge	5.0%		-5.0%		
Conv Arb	3.0%		-3.0%		
ED	3.0%		-3.0%		
Fixed income	3.0%		-3.0%		
Macro	3.0%		-3.0%		
CTA	3.0%		-3.0%		
Real Estate	5.0%	5.0%	0.0%	0.20%	0.20%
Commodities	5.0%	0.0%	-5.0%	0.47%	0.00%
Total	100.0%	100.0%	0.0%	3.99%	3.03%

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