

Rethinking Gold

3rd Quarter 2021 Letter

July 28, 2021

Until recently, gold as a portfolio asset seemed too passive to us. Perhaps it was the lack of compounding cash-flows or late-night gold television ads that gave us hives. And avoiding gold for our entire careers worked well in the age of government money printing – mid-1990s to now.

But current extremes in areas of finance, government, and human psychology have challenged our beliefs about gold. The questions we have are: Will the U.S. Federal Reserve (Fed) and the U.S. Congress (Congress) run the wheels off this long stimulus train? If so, does gold play a resiliency role in wealth preservation?

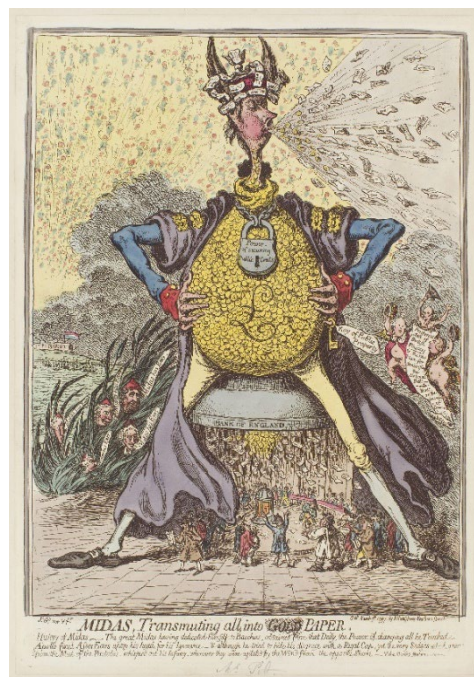
Central to understanding gold is its role as free-market money with one caveat - in the absence of politics. What we mean by "in the absence of politics" is the fact that world leaders have confiscated gold over the past 100 years to further political or policy ambitions. Specifically in the U.S., it was a felony for U.S. citizens to hold gold reserves from 1933 - 1974.

The Political History of Gold

The starting point for gold enthusiasts is often inflation. In the current inflationary environment, we believe gold can play a role that merits investigation.

Unlike money printing to support bank reserves during the Global Financial Crisis (GFC), the Fed and Congress are printing money and giving it to people **to meet their current expenses**. People, not banks, are now attempting to **consume more goods than businesses can produce**. Looking back the last six months, this has resulted in transient hyper-inflation from boats to beef.

Some families and businesses needed support in 2020. But did Tom Brady's company, TB12, really need a \$1 million PPP Loan after he won the Super Bowl? This **bank vs.**



"Midas, Transmuting all into Gold Paper"
James Gillray circa 1797

people stimulus is the distinction between money printing during the GFC and pandemic stimulus today.

On June 17, 2021, the Fed reported balance sheet assets of **\$8.064 trillion** (see Exhibit A). For reference, Fed balance sheet assets were under \$4 trillion in 2019 and at \$1 trillion before the start of the 2008 recession. The chart looks exactly like a hockey stick. With the Fed's legal authority to create U.S. dollars (US\$), they continue to **lavishly** support people and debt markets.

In 2020, fiscal and monetary support exceeded tax receipts by \$3.1 trillion, with more stimulus coming in 2021. In a world of breathtaking deficit spending that is manifesting in higher prices across the board, it is reasonable to question the backing of the US\$, a non-interest-bearing liability of the Fed.

And this brings us to the image on page one of "Midas Transmuting all into ~~Gold~~ Paper." Gold once played a prominent role in backing the US\$. In 1913, 70% of the assets on the Fed's balance sheet consisted of physical gold. The Fed's charter also allowed for 90-day or less Treasury Bills and short-term industrial and agricultural trade claims.

Over decades, gold backing of the US\$, credit quality, and maturity constraints **relaxed** to finance wars, but also to backstop Wall Street and now U.S. society.

Why was gold backing the US\$ relaxed? The Keynesian school of economics (see Exhibit D) argued that gold backing of the US\$ is too rigid and limits economic prosperity. When society hoarded gold during the Great Depression, President Roosevelt heeded Keynesian advice and issued Executive Order 6012, **making it a federal felony** for people to hold gold reserves (see Exhibit B). At that time, it was a fabulous patient trade to turn in your gold to the Fed and buy the S&P 500. Over time, politicians liked the Keynesian school of thought (think money printing) and persuaded Congress to liberate the U.S. from the Gold Standard. In the short-term, this **dampened** the peaks and troughs of the business cycle.

Skipping over the Bretton Woods system after WWII, Keynesian economists convinced President Nixon to abandon dollar convertibility to gold entirely. This action helped finance the Vietnam War and coincided with low confidence in Washington and high inflation.

In moderation, the Keynesian economic system was a plausible solution to pull the U.S. out of the Great Depression. But politicians are like children in that they struggle **mightily** with moderation and are generally prone to excesses.



Gold bars are housed in individually numbered lockers secured by three locks.

Federal Reserve Bank of New York's gold vault



Unfortunately, the Achilles heel of the Keynesian economic philosophy is that it ignores human nature: **5000 years of documented greed > fear**. History is clear that politicians will always abuse their power to print money. This wisdom was as true in 17th century France as it is in modern times.

It's fascinating that from 1970 to 1980, the **free market reasserted** itself. During that time, gold went up 35 times and the US\$ was ravaged by inflation. At \$650 per troy ounce, gold on the Fed's Balance Sheet in 1980 effectively **put the U.S. back on the Gold Standard!**

Fast-forward to the 2007-08 Global Financial Crisis. Congress and the Fed had to print dollar reserves to save the banks. Simply put, the Fed printed money to boost bank reserves, so the Banks could, in turn, lend money to businesses to construct productive assets.

The important distinction between today and the GFC is that very **little** stimulus made it to people, and that is why inflation was not a problem after that episode. Gold did well from 2007 to 2012 but as a crisis safe-haven asset.

Gold as Money

So, is it plausible, in the absence of political confiscation, for gold to function as free-market money? Carl Menger, the cited Founder of the Austrian School of Economics, developed a definition for money in his 1892 essay ***On the Origins of Money*** that has stood the test of time:

There is a phenomenon which has from of old and in a peculiar degree attracted the attention of social philosophers and practical economists, the fact of certain commodities (these being in advanced civilizations coined pieces of gold and silver, together subsequently with documents representing those coins) becoming universally acceptable media of exchange. It is obvious even to the most ordinary intelligence, that a commodity should be given up by its owner in exchange for another more useful to him. But that every economic unit in a nation should be ready to exchange his goods for little metal disks apparently useless as such, or for documents representing the latter, is a procedure so opposed to the ordinary course of things, that we cannot well wonder if even a distinguished thinker like Savigny finds it downright "mysterious."

So, two coconuts for a fish works great as money, so long as we live in beach huts. Otherwise, money needs to serve practical utility as a capital silo of wealth with a respected method of exchange and accounting.

The properties of gold are unique as free-market money.

Gold is:

- Scarce with the above-ground supply increasing only by 1 to 2% per year.
- Liquid and widely traded in large quantities with thin bid/ask spreads.
- Impervious to decay as an electrical conductor, sitting in a pyramid, or at the bottom of the ocean in a ship's hull.
- Dense and hard to replicate in a uniform stamped coin or bar.
- Recognized and accepted as valuable throughout the world.
- Beautiful to wear and used as a dowry in marriage proposals in some countries.

A word of caution - gold is a judgment call to protect against a bad outcome. As we reviewed charts and papers for this letter, we came up short in finding an "if x, then y" model for gold. There is no cash flow associated with gold, and therefore, gold is inherently speculative. These features are probably why we have avoided this sub-asset class.

But consider this fascinating observation from Verdad Capital. Testing this surprising claim, we found the academic paper from the 1990s (see Exhibit C) and believe it is a reasonable approximation:

*The famed legions of Rome were commanded by a junior officer corps of centurions, a role roughly equivalent to a captain in today's U.S. Army. In the age of Augustus, centurions earned a stipend of 3,750 denarii, roughly 38 ounces of gold. Today, in the age of Biden, the average U.S. Army captain earns a salary of about \$70K—40 ounces of gold at current prices. Over two millennia, **the same weight of gold buys a roughly equivalent amount of labor**, preserving real purchasing power despite the rise and fall of empires and wild technological change.*



World's first coins from Lydia – modern-day Turkey
Circa 630-620 BC

In the context of portfolio design, we see two resiliency purposes for gold:

- 1) Purchasing power protection against high inflation.
- 2) Diversification to manage the uncertainty of wars, political errors, market crashes, and, at the far extreme, societal revolutions.

Complicating the purpose gold plays as a resilient safe-haven asset is timing. Market timing is always hard and is prone to errors. But what we can say is that gold hates easy money, inflating credit bubbles, and prolonged periods of prosperity. Gold performs well during times of high inflation, credit busts and unexpected crises. With junk bond yields today below the rate of inflation – which has never happened – we think the timing is in our favor to add gold.

Unfortunately, which we wrote about last quarter, **we believe** a persistent shift in price inflation is coming with significant implications for portfolio design. Today, our view is that we are witnessing currency debasement with too much stimulus in the hands of people chasing too few goods.

Implementation

With that theoretical background, let's next consider implementation. What secure and cost-effective gold vehicles should investors use? We see four classes to consider:

- **Physical Gold** – We advise investors to stick with branded coins and bullion bars from identifiable mints such as American Eagle, Canadian Maple Leaf, South African Krugerrand, and Austrian Philharmonic.
- **Paper Gold** – For portfolio design purposes, we are implementing an exchange-traded mutual fund (ETF) backed 1:1 to physical gold held in a London vault. There are many ETFs available, but we believe this fund offers superior benefits:
 - 1) Twice a year independent audits – one scheduled and one surprise,
 - 2) Organized as a grantor trust with a well-recognized independent corporate trustee and respected London vault custodian,
 - 3) Management fee of 0.25%.

Unlike other ETFs, the 1:1 backing has been tested by exchanging shares for physical delivery of gold coins and bars. We have concerns with some of the larger gold ETFs that profess to allow exchanging shares for physical coins and bars.

- **Gold Mining Stocks/Fund** – Owning gold through a publicly traded gold mining company is a way to add leverage to the price of gold. This operating leverage feature can work in your favor or hurt relative to the price of gold. It should be done in a diversified way to manage the risk of an operating business exposed to the price of a single commodity. Gold mining is not an exact science. The cost of labor and production can easily affect the price of the stock. Diversification is critical.
- **Physical Collective Custody** – We are familiar with safe and sound ways of storing physical gold bars in Zurich and London vaults. This choice could manage the risk of government confiscation. If this method is of interest, please call for details.

Key Risks to Consider

There are four less common gold risks to consider – counterparty risk, fraud, theft, and government confiscation.

- **Counterparty risk** is present when there is a possibility that a fund, bank, or broker fails/defaults on its obligation. The obligation would require the entity to give a gold investor the physical metal or the 1:1 contractual value of gold, less agreed-upon expenses.
- **Fraud** risk rises with the price of gold. During our research, we had a deep conversation with a retired precious metals executive who shared interesting gold stories. "As gold prices go up, the risk of fraud goes up, too." As we know, gold plating is a common process. After the rise in price from the 70s to 80s, a Miami vault was found to have "gold" coins made of lead and gold-plated bars fashioned from wooden two-by-fours.
- **Theft** is a major risk for those who choose to store their gold safely and securely at home. One of our clients suggested that the only people who need to know about the gold's whereabouts are family members that stand to inherit the asset.
- **Gold was confiscated** in the U.S. for \$24/ounce in 1933 and then repriced to \$35/ounce so the Fed could continue printing US\$ within the limits of their charter. Gold sitting in your safety deposit box at a U.S. bank is exposed to government confiscation risk at below-market prices.

As a sidenote - bank safe deposit boxes are not risk-free storage. We strongly encourage you to read your storage agreement for bank liability limits on theft and bank errors.

Please read additional risks outlined on page 10.

Concluding Thoughts

Ending where we started, Julia and I have worked together for 20 years and have always been indifferent toward gold. We hope that we are wrong about inflation, but we can conclude that gold has been a resilient asset for thousands of years and doubt it will fail if we encounter persistent high inflation.

Bottom Line: For inflation hedging purposes, we are implementing a modest allocation to vetted gold solutions in our client and personal portfolios. Perhaps the Fed has this inflation risk under control. But, the historical evidence suggests Fed policy errors are likely, and in our view, the overwhelming stimulus on Main Street today looks like U.S. dollar debasement.



We are pleased to report that performance for Spectra's Global Equity and U.S. Value strategies at this mid-point in the calendar year is quite encouraging. Both delivered solid results thus far in 2021. Our conviction is unchanged that the global tech bubble will burst and usher in a prolonged period favoring our yield and price-sensitive investment framework.

Please call if you would like to discuss this topic or other matters. We look forward to providing you a broader portfolio update soon.

Very truly yours,

A handwritten signature in blue ink, appearing to read "Scott A. Roads".

Scott A. Roads
Founding Principal

A handwritten signature in blue ink, appearing to read "Julia E. Zaino".

Julia E. Zaino
Principal

P.S. This letter would not be complete without a mention of cryptocurrencies. Here is a quick list of issues our inner skeptic struggles to reconcile.

While there are many cryptocurrencies, Bitcoin's volatility profile resembles Tesla's stock with limited trading volume and wide bid/ask spreads. On those points, we doubt it unseats gold as an alternative currency asset. Further, it's unclear if cryptocurrencies can survive the threats they pose. They threaten the sovereignty of nations. They certainly threaten the power of banks. And after noteworthy ransomware attacks, they are attracting regulatory scrutiny. Recently, countries like El Salvador welcomed it, but China has banned cryptocurrency mining entirely. Blockchain technology has a solid use case, but the **price mania and organizers** behind several coins and exchanges - particularly Tether and Binance - raise many red flags.

If you are not a current client of Spectra, this letter is for entertainment purposes only and not intended as, nor does it constitute, an offer or solicitation in any form to buy any security or other financial instrument. Investing involves risk of loss and we encourage you to research investing with a high degree of due-diligence and skepticism.



Special Recognition

- Daniel Oliver of Myrmikan Capital. Mr. Oliver has had a diversified career in asset management and today runs a fund focused on junior gold minors. His command of financial history, credit bubbles, banking, and the U.S. Federal Reserve is very impressive. His research can be enjoyed at myrmikan.com
- Dan Rasmussen of Verdad Capital verdadcap.com
- Simon A. Milkhaiovich of The Bullion Reserve bullionreserve.com

Exhibits

A. Assets, Liabilities and Capital All Federal Reserve Banks June 16, 2021

5. Consolidated Statement of Condition of All Federal Reserve Banks		
Millions of dollars		
Assets, liabilities, and capital	Eliminations from consolidation	Wednesday Jun 16, 2021
Assets		
Gold certificate account		11,037
Special drawing rights certificate account		5,200
Coin		1,238
Securities, unamortized premiums and discounts, repurchase agreements, and loans		7,909,034
Securities held outright ¹		7,484,242
U.S. Treasury securities		5,153,771
Bills ²		326,044
Notes and bonds, nominal ²		4,427,372
Notes and bonds, inflation-indexed ²		347,259
Inflation compensation ³		53,096
Federal agency debt securities ²		2,347
Mortgage-backed securities ⁴		2,328,124
Unamortized premiums on securities held outright ⁵		351,548
Unamortized discounts on securities held outright ⁵		-13,941
Repurchase agreements ⁶		0
Loans ⁷		87,185
Net portfolio holdings of Commercial Paper Funding Facility II LLC ⁸		8,554
Net portfolio holdings of Corporate Credit Facilities LLC ⁹		25,844
Net portfolio holdings of MS Facilities LLC (Main Street Lending Program) ⁹		30,529
Net portfolio holdings of Municipal Liquidity Facility LLC ⁹		10,736
Net portfolio holdings of TLF II LLC ⁹		4,762
Items in process of collection	(0)	63
Bank premises		1,917
Central bank liquidity swaps ⁹		500
Foreign currency denominated assets ¹⁰		21,589
Other assets ¹¹		33,252
Total assets	(0)	8,064,257

Note: Components may not sum to totals because of rounding. Footnotes appear at the end of the table.

B. Executive Order of President Roosevelt [1933 Gold Executive Order 6102](https://www.presidency.ucsf.edu/documents/6102)





C. Speidel, M. (1992). Roman Army Pay Scales. *Journal of Roman Studies*, 82, 87-106.

Rank	Augustus	Domitian	Severus	Caracalla	Max. Thrax
<i>centurio cohortis</i>	3,750	5,000	10,000	15,000	30,000
<i>decurio cohortis</i>	4,500	6,000	12,000	18,000	36,000
<i>decurio alae</i>	5,250	7,000	14,000	21,000	42,000
<i>decurio equitum</i> <i>singularium Aug.</i>		(14,000)	28,000	42,000	84,000
<i>centurio legionis</i>	13,000	18,000	36,000	54,000	108,000

D. Definitions from Investopedia:

- **Keynesian** – The school of economics is based on theories articulated by John Maynard Keynes. Keynes advocated for increased government expenditures and lower taxes to stimulate demand and pull the global economy out of the depression. Subsequently, Keynesian economics was used to refer to the concept that optimal economic performance could be achieved—and economic slumps prevented—by influencing aggregate demand through activist stabilization and economic intervention policies by the government.
- **Monetarist** – A monetarist is an [economist](#) who holds the strong belief that [money supply](#)—including physical currency, deposits, and credit—is the primary factor affecting demand in an economy. Consequently, the economy's performance—its growth or contraction—can be regulated by changes in the money supply. The key driver behind this belief is the impact of [inflation](#) on an economy's growth or health and the idea that by controlling the money supply, one can [control the inflation](#) rate.
- **Austrian** school uses logic of a priori thinking to discover economic laws of universal application, whereas other mainstream schools of economics make use of data and mathematical models. The early concepts of the Austrian school contributed significantly to the theory of diminishing marginal utility.



Important Disclosures: Spectra Investment Management, LLC (SIM) is registered as an investment adviser based in Stuart, Florida and West Palm Beach, Florida. SIM is registered with the SEC and only conducts business in states where it is properly registered or is excluded from registration requirements. Registration is not an endorsement of the firm by the SEC and does not mean the adviser has achieved a specific level of skill or ability.

There is no guarantee investment strategies will be successful. Investing involves risks including possible loss of principal. All expressions of opinion are subject to change. This article is distributed for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, products, or services. Clients should under no circumstances rely upon this information as a substitute for obtaining specific legal or tax advice from their own professional legal or tax advisors. Readers other than clients should seek professional advice before investing in any security or fund.

Risks specific to gold- and silver-related investments, including gold exchange-traded funds (ETFs), are subject to risks including bullion price volatility, changes in world political developments, competitive pressures and risks associated with foreign investments. In times of stable economic growth, the value of gold, silver and other precious metals may be adversely affected. Mining companies are subject to elevated risks, which include, among others, competitive pressures, commodity, and currency price fluctuations, and adverse governmental or environmental regulations. In particular, small and mid-cap mining companies may be subject to additional risks including inability to commence production and generate material revenues, significant expenditures, and inability to secure financing, which may cause such companies to operate at a loss, greater volatility, lower trading volume and less liquidity than larger companies.

Spectra Investment Management, LLC
401 SE Osceola Street, Ste 202, Stuart, Florida 772-324-5640
501 Palm Street, Ste B-6, West Palm Beach, Florida 561-623-8305