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## **Gold, Stocks and the Siren's Song**

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Happy New Year! I have been working from the middle of last week until today organizing my thoughts on the investment frontier, and, most challenging of all, trying to give you a written piece that is not a novel, and that, hopefully, is easy to understand and hits on several important issues. In general, I believe the US Stock Market will perform fairly well in 2012. Gold continues to look attractive in the longer term, as I will explain below, and the bond market, generally, has some very unattractive characteristics.

The Siren's Song is a literary allusion to the mythical beauties who lured sailors to their doom by concealing hazards with their tempting attributes. I refer to this myth in the title of this letter because I think that investors in most government bond investments, particularly intermediate and long term US Treasury Bonds, hold the same fate as the sailors who were lured by the sirens' song. While government bonds have performed well over the last several years, particularly when compared to stocks, much of that performance has been the function of government intervention in printing enormous amounts of paper money, issuing new bonds, and then buying their own bonds back, which has artificially increased bond prices by lowering their yields. Today, a US Bond Investor may purchase a 10 year bond that yields 1.9% per year. In theory, when governments print money, they devalue the purchasing power of their paper money and ultimately create inflation.

Since the credit crisis of 2008, the US Federal Reserve balance sheet has grown from \$800 billion to roughly \$2.8 trillion dollars today. In fact, if we look at the central bank balance sheets of the four largest G4 countries, their combined central bank balance sheets have grown from \$3 trillion in 2008 to \$8 trillion today. That is \$5 trillion of newly printed paper money floating somewhere out there.

On the other end of the monetary spectrum lies gold. Gold, which has been recognized as a global currency for centuries, typically appreciates in value when paper money currencies devalue. I have been asked by many clients why gold represents a "hard" currency. Gold is simply a shiny metal that is mined from the ground. It pays no dividend and creates no consumable product. It is an inert metal with no real industrial use. So why own gold? Why not use oil or potatoes or tomatoes as a currency? Gold is abundant enough to be held by many but is scarce enough so that it is not easily obtained. Gold is easily stored in large quantities in a relatively small area and is not subject to expiration like potatoes or tomatoes. Can you imagine buying a loaf of bread with a zip lock bag full of oil? The expansion of the existing supply of gold in the world is limited and is at the mercy of mining capabilities, as opposed to the roll of a printing press holding endless supplies of paper.

So how does this make gold valuable, and why do we own it? There are many opinions on this question, and I will give you the viewpoint that I have reached. I do believe that within the next five years or so, governments around the world will need to begin to address their **monetary** (excessive paper money printing) policies. These governments really need to address their **fiscal**-spending problems but that is another subject for another day. They will likely need to support (prove the paper is worth more than paper) the supply of existing printed paper money with a hard currency which is notably gold. They will likely add significant gold supplies to their central bank vaults to back up their paper currency value. That should make the price of gold go up, or, in reality the value of the paper money that people are holding will go down against the gold value. Thus, it is my belief that inside of five years, gold's price in US Dollar and Euro terms will be quite a bit higher than it is today. That does not mean that gold's price will go straight up; it may even decline for some time, but the longer term trend appears to me to be upwards. My final point with gold is that we don't own it to speculate on its price. We own it as an insurance policy to help protect the purchasing power of your assets.

I do believe that certain stocks will perform better than gold over a longer time horizon. However, gold, as measured by the GLD exchange traded fund, turned in a 9.6% rate of return for 2011, outpacing stock returns and performing very closely to the returns from intermediate term US Treasury Bonds.

On the bond front, I want to be clear that not all bonds look expensive even though US government and European government bonds look overpriced. I have a generally negative outlook for municipal tax free bonds, also, as I do not believe that many local and state governments have the willpower to address their fiscal problems, and we will likely see more bond defaults from local and state governments. That may present an investing opportunity in time. However, corporate, high yield, some developed country and some emerging market country bonds do look attractive. We entrust mostly active bond managers like Loomis Sayles (Dan Fuss), DoubleLine (Jeff Gundlach), Pimco, and Lord Abbett to navigate our bond investments.

On the stock front, I am relatively optimistic about the US stock market. In 2011, the S&P 500 proved lackluster, ending the year gaining 2.11%. International stocks, as measured by the MSCI EAFE index, turned in a negative (-12.14%) return and Emerging Market stocks, as measured by the MSCI BRIC, lost (-22.67)%. However, while governments around the world have been printing money, many companies have been making money. Profits at many public companies have been record breaking. Many publicly traded companies have been buying back their own stock by issuing debt at record low borrowing costs. The theory behind such a move is that the business can earn a far greater return for its shareholders from company operations than it pays in borrowing costs. We have begun to cautiously add to our stock allocations, favoring dividend paying companies that, in many cases, are paying yields greater than US Treasury Bonds.

I also continue to maintain a strong conviction in holding our largest individual stock position in Warren Buffet's Berkshire Hathaway. The market performance of Berkshire for 2011 was negative (-4.75%), but I remain convinced that the market does not understand the value of this company and discounts its value based on Mr. Buffet's age. The underlying companies owned by Berkshire are significant insurance company operations such as Geico, other non-insurance holdings include Burlington Northern

Railroad, Acme Brick, Mid America Energy, Jordan's Furniture, See's Candies, and Benjamin Moore Paints, to name a few. Additionally, there are significant public holdings such as Coca Cola, American Express, IBM and Wells Fargo, to name a few more. Combined, these diversified holdings provide large cash operating profits each year to the company. I contend that the value of each share of the company is worth significantly more than the price the market currently credits it for. Warren Buffet has built Berkshire into what is effectively a diversified conglomerate. His genius is in knowing what businesses to buy using the pile of cash generated from the company profits. I contend that even if Warren no longer continues in this role and the company is unable to fill his shoes, then the company will simply become a cash machine that will be forced to turn over its healthy profits to its shareholders in the form of a dividend. Patience will likely pay us handsomely on this holding.

I do see opportunities presenting themselves in the stocks of emerging market countries. We have stayed relatively unexposed in this area and are happy about that, given the awful performance these equities turned in for 2011. China still has me concerned, and we will continue to shy away from taking any significant positions there. Brazil, however, is a different story. This is a commodity rich nation with very little debt compared to the US and the developed European countries. Brazil looks quite attractive, and we will start allocating a small part of assets there through an exchange traded fund.

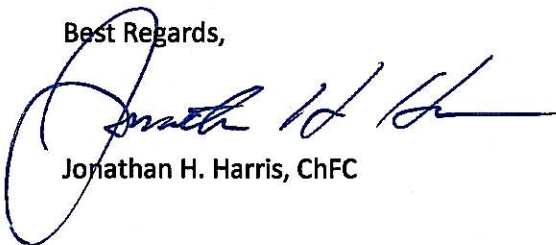
Europe, on the other hand, is in tough shape. The experiment in having one common currency, the Euro, is showing a great deal of stress. Portugal, Italy, Greece and Spain are the weak heavily indebted nations of the Euro, affectionately referred to with the acronym PIGS. I think the jury is still out as to whether the currency will survive. I predict odds of 50/50 that the Euro is still a currency in the next 36 months. I think Europe may find itself in an extended recession, and these countries will be spending a few years clawing out from what has been bad fiscal governance. This will likely cause some gyrations in US markets from time to time until there is a clear, actionable plan to fix the European problems. I do think that many of the problems in Europe have been priced into stock market valuations.

In summary, I believe, the US Stock Market is looking quite attractive, particularly the large cap dividend paying stocks. Gold is currently moving around a bit in price, but in the longer term I remain bullish. Government bonds appear overpriced, but opportunities exist with other types of fixed income investments. Opportunity appears to exist in Latin America, while Europe remains an area of concern.

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We will be contacting you soon to schedule a review meeting. Should you have any questions, please call me any time at 401-683-7392.

Best Regards,



Jonathan H. Harris, ChFC

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