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Golden Boy

Warren Buffett deserves the public's respect. His great success and apparent modesty, kindness and reason in a field replete with promoters and chest thumpers have allowed him to stand out in our society. He is to most an honest broker among charlatans, uniquely capable of separating truth from fiction, the way it is and will always be versus cockeyed theories touted by ignorant newbies. He has been the most successful and most charitable financier of the last hundred years, and his proclamations become, ipso facto, the common perception of truth.

Buffett may be a sage, a wizard, and an oracle when it comes to nominal relative value pricing of financial assets, but it is well worth noting that Buffett's proclamations are not necessarily worthy of being considered "fact" in matters unrelated to *finance*, just as the legendary Joe Paterno's judgment seems to have been sorely lacking when it came to sorting out matters unrelated to a winning football program.

That has not seemed to stop Mr. Buffett from expressing wide ranging views from tax policy to the value of gold. In fact, over the last two weeks -- in a Forbes interview, in Berkshire Hathaway's annual report and this morning on CNBC -- Buffett chose to comment on gold even though he does not have a publicly disclosed position in it. We must assume his aggressive gold comments have been meant to force the price of gold lower. (We do not know why he is so interested in doing so though we do have a reasonable theory, for another time). We strongly disagree with Mr. Buffett's views and we thought it would be best to explore his comments and provide our counter-arguments.

Productive Assets vs. True Savings

The crux of Buffett's argument is that he prefers productive assets (procreative, he calls them) and that gold is not one. This implies correctly that gold is a form of savings. Regrettably, the rest of his argument relies on confusing the two, which leads him to two-dimensional logic that clearly fails in practical terms.

We would share Buffett's preference for productive assets in a Utopian world where money was scarce and credit was funded exclusively with organic savings. In such a world simply depositing our savings in a bank would pass-on our capital to productive businesses that would in turn earn the productive return, all while we (the saver) would retain the risk. That would be a great deal for the bank and the producer but a lousy deal for the saver.

Such a warning to savers (gold holders) is a ridiculous position to take, however, in the context of our modern global monetary system characterized by over-levered currency and unreserved bank credit. Though Buffett is correct that saving in the form of incessantly inflating fiat currency is a fool's game today, he is dangerously wrong in not seeing that exchanging fiat currency for financial assets and businesses with egregiously inflated enterprise values, (via the egregiously inflated and inflating currencies in which they are denominated), is not equally foolish.

Warren Buffett's argument against gold falls woefully short of the mark because he does not acknowledge that there is always a role for robust savings wherein the saver neither suffers the dilutionary pain of fiat currency devaluation nor the deflationary pain of acquiring over-levered assets. The medium that allows the true saver to escape both trap doors is gold. It is simply a form of savings that cannot be diluted and the nominal prices of all things leveraged (including financial assets) will revolve around it and other scarce, unlevered items.

Within this context, we re-print and rebut Mr. Buffett's specific observations related to gold from Berkshire's annual report, below:

Buffet: "…the second major category of investments involves assets that will never produce anything, but that are purchased in the buyer's hope that someone else – who also knows that the assets will be forever unproductive – will pay more for them in the future. Tulips, of all things, briefly became a favorite of such buyers in the 17th century.

This type of investment requires an expanding pool of buyers, who, in turn, are enticed because they believe the buying pool will expand still further. Owners are not inspired by what the asset itself can produce – it will remain lifeless forever – but rather by the belief that others will desire it even more avidly in the future.

The major asset in this category is gold, currently a huge favorite of investors who fear almost all other assets, especially paper money (of whose value, as noted, they are right to be fearful). Gold, however, has two significant shortcomings, being neither of much use nor procreative. True, gold has some industrial and decorative utility, but the demand for these purposes is both limited and incapable of soaking up new production. Meanwhile, if you own one ounce of gold for an eternity, you will still own one ounce at its end."

QB: Gold is not an asset and is not meant to be procreative. Above all else it is a currency, like US dollars, and its daily spot pricing reflects its exchange rates with currencies currently being issued by global central banks on behalf of their host governments and used as media of exchange. Gold is not currently a medium of exchange (although to some people it remains a store of purchasing power vis-à-vis other currencies currently in use as exchange media). Thus, in today's fiat monetary system gold is simply *potential money* and its spot price indicates the degree to which global wealth holders are willing to handicap the possibility that the future purchasing power of central bank-issued currency will be diluted against it.

Gold is no more or less "lifeless" than Dollars, Euros or Yen. One needs to lend each in order to have a return on them. (We argue one would be foolish to lend gold and receive interest denominated in other currencies when gold is relatively scarce -- and getting scarcer -- to them.) As for being "not of much use", yes gold is pretty useless…until it isn't.

Mr. Buffet is wrong when he implies gold is a bubble (like Tulips). In fact, in spite of all the noise there is very little sponsorship of gold today relative to financial assets. As indicators, the value of the world's largest gold ETF is one-fifth the market capitalization of Apple, and total precious metal exposure represents just 0.15% of global pension assets.

Mr. Buffet is again wrong in arguing gold needs more avid buyers to keep the bubble inflating. It does not, and in fact we think it is unlikely there will be many buyers relative to financial asset holders as time goes on. Rather, we believe the price of gold will increase in fiat terms with or without widespread secondary market endorsement precisely because central banks must increase their monetary bases to de-lever their banking systems, which in turn de-values the currencies in which leverage is denominated.

Paper claims on gold, such as futures, swaps and dubiously-backed ETFs, will fluctuate with the changing sentiment of financial asset investors until, one day, for some reason that cannot be predicted, claim holders begin to demand physical bullion. All it will take to trigger "a run" will be more demand for physical bullion than the amount available on-hand for delivery. When this happens there will not be a "reasonable" price at which an exchange can be made. Spot pricing will cease to exist and all paper claims on gold will settle in brokerage accounts at the price of the last spot trade. We think very few committed financial asset investors will own gold in any size at the precise moment they will need it most.

Those that do hold physical gold (or shares in gold miners) would be able to then set the exchange rate to fiat currencies (gold price) at which they would part with their bullion. Any externalities, such as government intervention or price controls that would serve to try to set the exchange rate at a lower-than-market rate, would likely be met with indifference among bullion holders and miner shareholders. So yes, Mr. Buffet may be correct that an ounce of gold will always be only an ounce of gold, but he does not seem to be considering its exchange rate.

Buffet: ""What motivates most gold purchasers is their belief that the ranks of the fearful will grow. During the past decade that belief has proved correct. Beyond that, the rising price has on its own generated additional buying enthusiasm, attracting purchasers who see the rise as validating an investment thesis.

As "bandwagon" investors join any party, they create their own truth – for a while. Over the past 15 years, both Internet stocks and houses have demonstrated the extraordinary excesses that can be created by combining an initially sensible thesis with well-publicized rising prices. In these bubbles, an army of originally skeptical investors succumbed to the "proof" delivered by the market, and the pool of buyers – for a time – expanded sufficiently to keep the bandwagon rolling. But bubbles blown large enough inevitably pop. And then the old proverb is confirmed once again: "What the wise man does in the beginning, the fool does in the end.""

QB: The great bubble from 1981 to 2006 was in unreserved global credit distribution, which explains the funding behind Mr. Buffett's market psychology discussion. The current bubble is in global base money printing, which has risen over 200% just since 2008 and must increase five times more from current levels to cover unreserved bank assets. Financial assets are the direct beneficiary of credit expansion and real assets are the direct beneficiary of base money expansion. Gold is simply responding to the bubble policy makers are administering. We believe gold is the most under-valued and most optimal risk-adjusted hedge against the current bubble.

Buffett: "Today the world's gold stock is about 170,000 metric tons. If all of this gold were melded together, it would form a cube of about 68 feet per side. (Picture it fitting comfortably within a baseball infield.) At $1,750 per ounce – gold's price as I write this – its value would be $9.6 trillion. Call this cube pile A. Let's now create a pile B costing an equal amount. For that, we could buy all U.S. cropland (400 million acres with output of about $200 billion annually), plus 16 Exxon Mobils (the world's most profitable company, one earning more than $40 billion annually). After these purchases, we would have about $1 trillion left over for walking-around money (no sense feeling strapped after this buying binge).

Can you imagine an investor with $9.6 trillion selecting pile A over pile B? Beyond the staggering valuation given the existing stock of gold, current prices make today's annual production of gold command about $160 billion. Buyers – whether jewelry and industrial users, frightened individuals, or speculators – must continually absorb this additional supply to merely maintain an equilibrium at present prices.

A century from now the 400 million acres of farmland will have produced staggering amounts of corn, wheat, cotton, and other crops – and will continue to produce that valuable bounty, whatever the currency may be. Exxon Mobil will probably have delivered trillions of dollars in dividends to its owners and will also hold assets worth many more trillions (and, remember, you get 16 Exxons). The 170,000 tons of gold will be unchanged in size and still incapable of producing anything. You can fondle the cube, but it will not respond.

Admittedly, when people a century from now are fearful, it's likely many will still rush to gold. I'm confident, however, that the $9.6 trillion current valuation of pile A will compound over the century at a rate far inferior to that achieved by pile B."

QB: As we've written in the past, our preferred piles (we call them "buckets") are these: Bucket A is the stock of money and Bucket B is the value of all things not money. At any given point of measurement the value of Bucket A must equal the value of Bucket B. Thus, the debate reduces to "what is money?" If one presumes that fiat currencies and unreserved bank credit have no marginal cost of production (electronic ones and zeros), then their terminal value in exchange must be zero. This leaves gold in the money bucket to assume the value of all things not money. Mr. Buffet again misidentified gold as an asset, not as money.

Summary

We think it is imprudent to advise legitimate savers to invest in levered financial assets. The extraordinary relative wealth one may have amassed over the last forty years in the financial markets was most likely legitimized by nominal scale that cannot be sustained in real terms. Such beneficiaries of leverage and inflation typically built very little sustainable capital and innovated nothing. The largest beneficiaries of leverage and inflation had a near infinite funding advantage, either near zero-rate short-term fiat currency funding or very low term funding. Insurers like Berkshire could effectively divert wages from their country's factors of production (by charging insurance premiums) and reinvest those wages by providing financing to businesses that would maintain their pricing power (through strong branding or demand inelasticity). That great funding advantage is now gone and Mr. Buffett does not seem too happy about it.

The narrow gap separating wage growth and asset price growth had to widen following the demise of Bretton Woods. Mr. Buffett may have known about this opportunity earlier and better than almost anyone else because his father, (Howard Buffett, US Congressman from Nebraska), was outspoken in aggressively supporting gold and a fixed exchange currency system. It would be counterproductive and beyond our area of study to try to understand what psychological impulse might compel Mr. Buffett to pursue and achieve lifelong financial success in a manner directly contrary to his father's views on the value of gold and paper currencies. So we can only guess whether his astounding success in consistently positioning a leveraged inflation portfolio has been the result of a sound pre-meditated strategy passed down from his father or has merely been very ironic.

Mr. Buffett's motivations are not important. He is rich and we think he will always be rich in relative terms because most wealth holders will remain committed to financial assets. Nevertheless, we suspect Mr. Buffet is aware that his wealth is about to be greatly devalued in real terms, just as he correctly foresaw the fate of dot-com billionaires who held their outlets for unreserved credit too long (in the form of corporate shares). Further, we think Mr. Buffett must be aware that the procreative assets he touts are currently priced at multiples of their future nominal cash flows and discounted for almost 0% interest rates, ensuring their future purchasing power will be destroyed in an inflationary environment no matter how much revenue growth they produce.

We believe true savers across the world not beholden to Western financial assets understand or will soon understand the difference between relative nominal returns and absolute real returns. They do (or will) not care about the views of very successful leveraged money changers. Yes, an inert rock today will be an inert rock tomorrow. But it will be an even scarcer inert rock tomorrow relative to the fiat currency in which it is priced (same for fine art). Levered productive assets will lose their value against both unlevered scarce inert rocks and unlevered inelastic commodities. The only things they will outperform in a period of great monetary inflation are bonds and cash (both also levered).

Mr. Buffett is no doubt brilliant but we respectfully disagree with his sense of real value. We find inspiration in the good sense and graciousness of Sir John Templeton who became fabulously wealthy investing in capital building enterprises and always seemed to maintain an objective and flexible investment perspective.

Kind regards,

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