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SPECIAL REPORT

Ten Rules for Investing In Gold

by John Hathaway

Editor's Note: No one whose writings have graced the Gilded Opinion Library has earned greater respect among our readers than has John Hathaway. Nor, for that matter, has anyone done a better job of articulating the often misunderstood, yet compelling case for owning gold. On top of a B.A. degree from Harvard College and an M.B.A. from the University of Virginia, Mr. Hathaway has 29 years of experience in the investment business.

"Gold is a controversial, anti-establishment investment. Therefore, do not rely on conventional financial media and brokerage house commentary. In this area, such commentary is even more misleading and ill informed than usual." - John Hathaway

1. An investment in gold should be based on macroeconomic considerations. If one expects or fears rising inflation, destabilizing deflation, a bear market in stocks or bonds, or financial turmoil, gold should do well and exposure is warranted.

2. Understanding the internal dynamics of the gold market can be helpful as to investment timing issues. For example, the weekly position reports of commodity trading funds or sentiment indicators offer useful clues as to entry or exit points for active trading strategies. Reports on physical demand for jewelry, industrial, and other uses compiled by various sources also provide some perspective. However, none of these considerations, non-monetary in nature, yield any insight as to the broad market trend. The same can be said for reports of central bank selling and lending activity. Central banks are bureaucratic institutions and in their judgements they are essentially market trend followers.

3. Excessive reliance on trading strategies to generate returns can be dangerous and counterproductive. Returns from a "buy and hold" strategy should be more than sufficient to compensate for the inherent volatility. Many who have tried to outsmart this market by hyperactive trading have under performed. Success is dependent in large part on the occurrence of "fat tail" events that lie outside the parameters of trading models.

4. A reasonable allocation in a conservative, diversified portfolio is 0 to 3% during a gold bear market and 5% to10% during a bull market.

5. Equities of gold mining companies offer greater leverage than direct ownership of the metal itself. Gold equities tend to appear expensive in comparison to those of conventional companies because they contain an imbedded option component for a possible rise in the gold price. The share price sensitivity to a hypothetical rise in metal price is related to the cash flow from current production as well as the valuation impact on proven and probable reserves.

6. The carnage of the last twenty years has simplified the task of individual stock selection because so few have survived the gold bear market. Although a rising tide may lift most boats, financial statements should be reviewed with special attention to hedging arrangements that could undermine participation in higher gold prices or even jeopardize financial stability. Individual stock selection is less important than identification of the primary trend.

7. Even though gold itself is a conservative investment, "gold fever" attracts a crowd of speculators, promoters, and charlatans who only want to separate investors from their money. Avoid offbeat "exploration" companies with little or no current production and gargantuan appetites for new money.

8. Bullion or coins are a more conservative way to invest in gold than through the equities. In addition, there is greater liquidity for large pools of capital. Investing in the physical metal requires scrutinizing the custodial arrangements and the creditworthiness of the financial institution. Do not mistake the promise of a financial institution to settle based on the gold price, for example, a "gold certificate" or a "structured note", (i.e. derivative), for the actual physical possession of the metal. Insist on possession in a segregated vault, subject to unscheduled audits, and inaccessible to the trading arrangements or financial interest of the financial institution.

9. Gold is a controversial, anti establishment investment. Therefore, do not rely on conventional financial media and brokerage house commentary. In this area, such commentary is even more misleading and ill-informed than usual.

10. Don't settle for too little. Should outlier events now deemed unimaginable by consensus thinking actually occur, the price target for gold would be several multiples of its current depressed price. Gold represents insurance against some sort of financial catastrophe. The magnitude of the upside is a function of the amount of paper assets that would be converted to gold irrespective of price.

by John Hathaway, CFA
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