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VIEWPOINTS

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Gold and Money

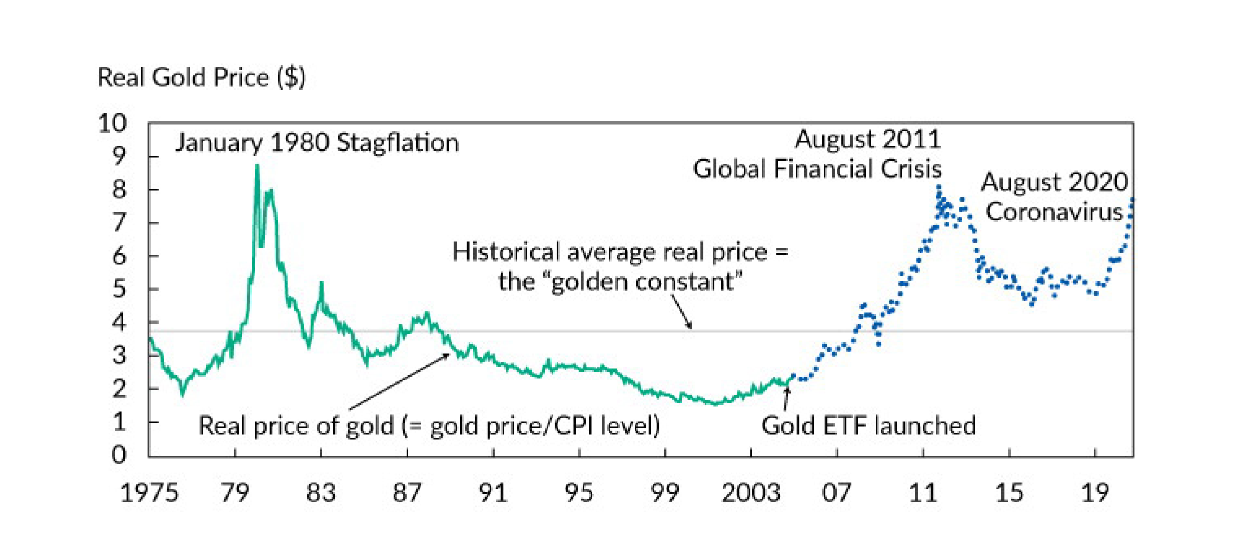
At Houston Trust Company, we frequently handle physical gold in our estate and investment agency practices. Traditionally, however, gold has not been an appropriate investment asset for trusts, as trustees generally have a duty to make assets "productive of income," which gold is not. After this recent period of extraordinarily low, indeed even negative, interest rates, however, we thought it wise to review our thinking on this venerable asset class and share our thoughts in this issue of Viewpoints. Below is a discussion of our view of the current monetary situation, as well as the various ways to gain investment exposure to gold, if desired.

Introduction

Most people know "The Wonderful Wizard of Oz" as a children's story. However, hidden behind the playful plot lies a deep political and financial commentary on monetary policy and precious metals. The author, L. Frank Baum, illustrates his thoughts on money throughout a symbolic storyline. Instead of the ruby slippers made famous by the film, in the original novel Dorothy wore silver slippers to symbolize the pro-silver ("easy money") movement of the late 19th century. She is guided on her journey by the yellow brick road ("the gold standard") and arrives at the Emerald City ("green dollars," or paper printed by the government) which Dorothy soon discovers to be an illusion.

While much has changed in the financial landscape since Baum published the story in 1900, the interest in monetary policy and the role of gold and other precious metals continues. With the growth of money supply higher than ever before, many contemporary investors are curious about gold's potential as a store of value and hedge against inflation, especially given today's historically low global interest rate environment.

Gold is one of the most ancient investment vehicles and forms of currency. Throughout human history, gold has been used as a medium of exchange, yet fundamentally it serves as a store of value due to its scarcity. Before the gold standard ended in 1971, the value of a dollar was tied to an ounce of gold at a fixed exchange rate, or "gold standard," set by central banks. Gold's limited supply helped to make it more stable than a fiat currency, in which the value of a dollar is both decreed and potentially distorted by the actions (i.e. "money printing") of central banks. Today, many investors favor gold as an asset when inflation, or fears of inflation, begin to rise. For instance, the late 1970s saw very high levels of inflation in the U.S. By 1980, inflation as measured by the CPI (consumer price index) reached 14% and the Federal Reserve ("the Fed"), led at the time by Paul Volcker, took



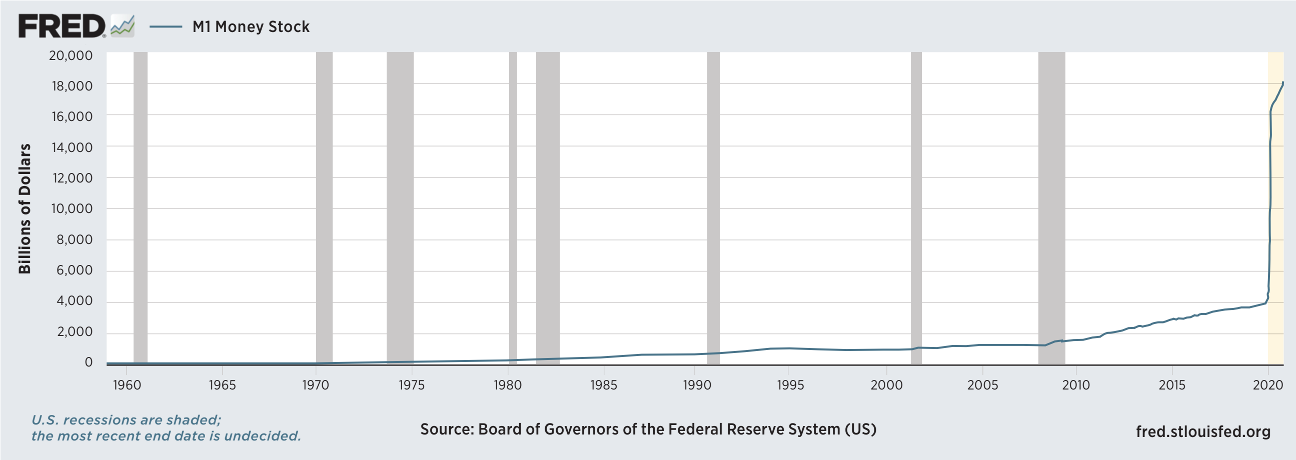
Source: Bloomberg data (tickers: GC1 Comdty, CPI INDX).[1]

steps to dramatically increase interest rates in order to contract the money supply and thereby control the level of inflation. As we can observe in the chart above, the real, or inflation adjusted, value of gold increased dramatically over this same period due to fears of runaway inflation. After the global financial crisis, from 2008 to 2009, the real price of gold peaked in August of 2011 due to fears of runaway inflation resulting from quantitative easing. Thus, investors tend to view gold as a "store of value."

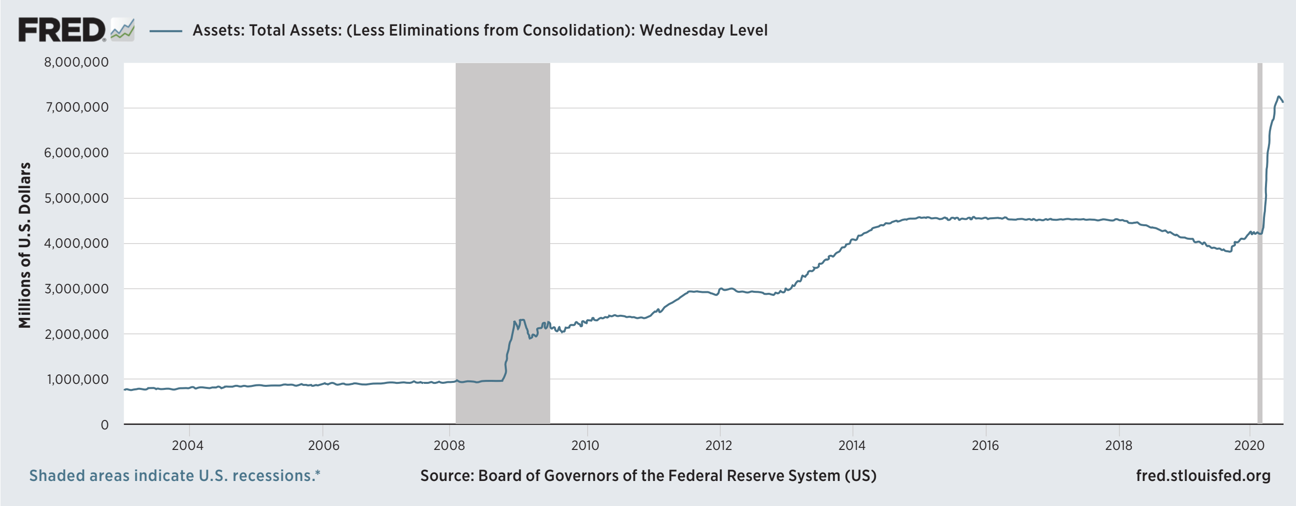
Gold also tends to be less correlated to other risk assets, such as stocks, during times of extreme market volatility. As a result, gold has performed well when investors are fearful and a resulting "flight to quality" trade occurs. For instance, during the Great Financial Crisis of 2008 when the S&P 500 was down roughly -44%, the price of gold increased by approximately +10%. Similarly, during the brief but volatile bear market of 2020, the S&P 500 closed out the first quarter down -20%, while the price of gold rose +6% during the same timeframe.

[1] Erb, Claude. "Gold, the Golden Constant, and Déjà Vu." Taylor & Francis, 6 Oct. 2020, www.tandfonline.com/doi/full/10.1080/0015198X.2020.1817698?scroll=top&needAccess=true.

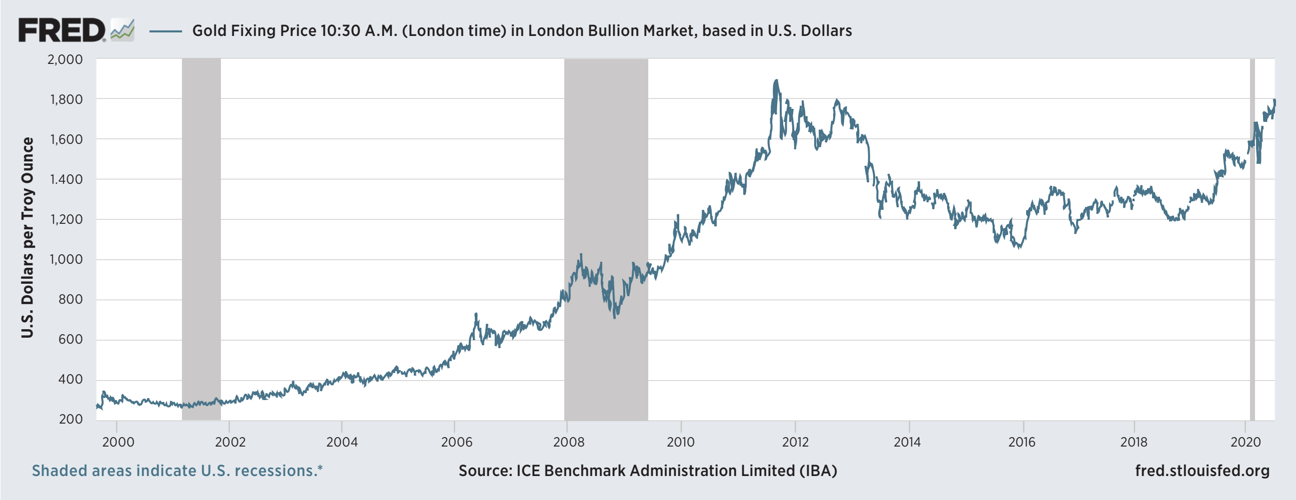
Currently, the Fed's "easy" monetary policy has similarly led to investor fears of potential runaway inflation down the road due to the unprecedented amount of "money printing." Below is a graph of the money supply in the U.S. dating back to 1960, illustrating the net effect of money printing after the Great Financial Crisis of 2008 and in 2020 with the onset of the COVID-19 pandemic:



Beginning in 2008, the Fed took some of this newly created money and bought U.S. Treasuries and other fixed income securities, placing these assets on the Federal Reserve's balance sheet ("quantitative easing"). The chart below is a snapshot of the Fed's balance sheet, which illustrates the magnitude of the Fed's securities purchases during 2008, and even more significantly, during 2020. By engaging in quantitative easing, the Fed is effectively using its large (and arguably, somewhat "unlimited") balance sheet to reduce yields in the Treasury market by "bidding up" the price on Treasuries, which in turn, equates to lower yields. Since the level of interest rates offered on most forms of credit (ranging from risky corporate bonds to home mortgages) are effectively priced off of the Treasury market, reducing yields in the Treasury market through quantitative easing has a significant impact on the value of most financial assets.

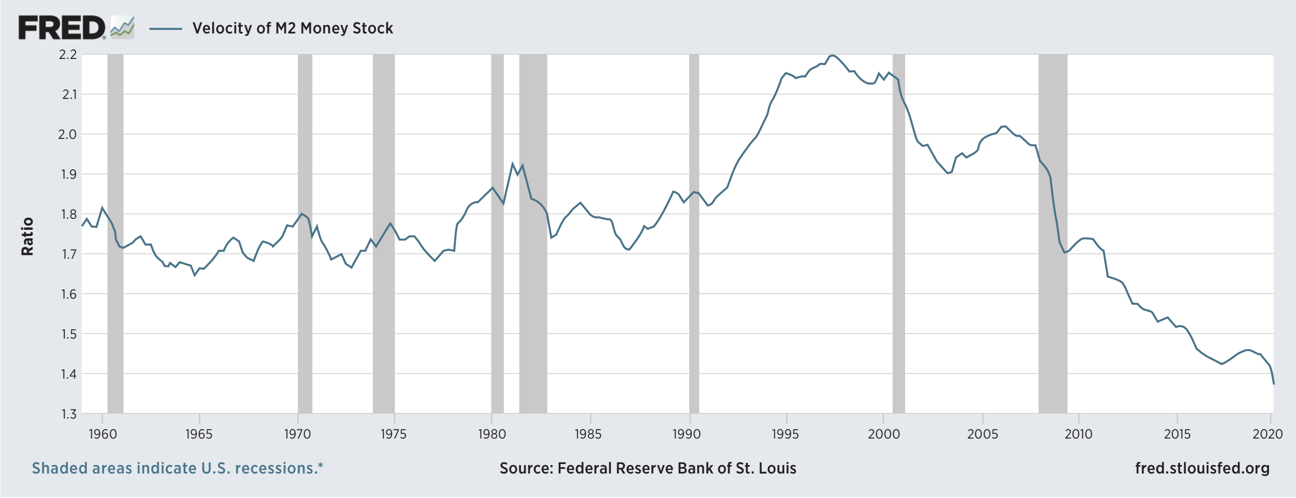


Considering these unprecedented purchases by the Fed, it is no surprise that the price of gold has been bid up again due to increasing inflation worries. Notice the new cycle illustrated in the chart below. As the underlying health of the economy wanes (the shaded areas indicate U.S. recessions), the Fed steps in by printing money in order to stimulate economic growth, and in turn, driving up investor demand for gold. Conversely, as the economy begins to recover and find its footing without support from the Fed, the rate of money creation begins to slow, reducing investor demand for gold (holding all else equal).



Despite this monetary expansion, why has inflation not materialized after the Great Financial Crisis? Until now, the velocity of money, or the rate in which money is "turned over" in the economy, has decreased since the Fed reacted to the "Tech Wreck" in 2000, and the 2009 and 2020 quantitative easing programs have continued that decline in velocity. While the Fed has printed money, that money has not been put into circulation, but instead ended up as an asset on the central bank's balance sheet, stalling inflation.

Below is a snapshot of the Fed's measure of the velocity of money. If this measure increases, so does the likelihood of inflation, along with the potential for a longer bull market for assets such as gold.



Gold is unique in that it can be both pro-cyclical and counter-cyclical due to a diverse set of demand and supply drivers. In times of economic contraction and uncertainty, investment-driven purchases tend to increase. During the COVID-19 global pandemic in 2020, gold reacted with prices reaching an all-time high. Conversely, in times of economic expansion, consumption-related purchases, like fine jewelry and art, tend to drive the increase in gold demand. While the economy experienced recovery and strong growth in 2013, annual gold demand for jewelry and technology made up almost 60% of total demand while investment demand was only about 35%, with central bank purchases filling in the rest.[2]

Historically, one of the largest downsides to gold as an investment has been the lack of yield. However, in a world where yields on government bonds are decreasing to zero or even negative, gold becomes more attractive. We saw this early in 2021 as gold demand surged. Gold is also an asset with active and deep markets, so liquidity is an advantage gold has over many other "real" (inflation-protected) assets, such as real estate, art, and jewelry.

Gold as an Investment

For the typical investor, investment in gold can be accomplished in various ways: physical gold (such as bullion and coins), exchange-traded funds ("ETFs") and mutual funds, gold trusts, gold mining rights, and stocks of public gold mining companies.

A collection of gold bars and South African gold Krugerrand coins are seen at London bullion dealers Gold Investments Ltd. Photographer: Simon Dawson/Bloomberg via Getty Images

Physical Gold

Physical gold, for investment purposes, is most often held in the form of gold bars or official coins, like the Canadian Maple Leaf or South African Kruggerand. Aside from the inability to earn interest or dividend income from such holdings, there are often costs associated with holding physical gold and ensuring its safekeeping, such as carrying insurance or paying someone to securely hold the gold in a vault. The largest advantage to holding physical gold is that it is outside of the financial system and is unaffected by market distress.

Gold coins may serve as a safe-haven asset in extreme situations due to their relative value and ease with which they can be transported – or even hidden. During the Holocaust, individuals fleeing countries under Nazi influence would hide both gold and silver coins in an attempt to preserve their wealth in harrowing and unpredictable circumstances.

Yet the relatively high value of coins may prove problematic when purchasing everyday goods. In the 1700s, when colonists ran out of English coins but were not allowed to mint money of their own, they used any available coinage. At the time, Spanish coins were preferred over other currencies because they had a patterned edge. This unique quality prevented traders from secretly shaving off the edge of the coins, ensuring they were cut into even eighths. These "pieces of eight," or "peso de ocho," were often referred to as a "peso," and allowed consumers to use coins with relatively high value to purchase daily goods priced less than a full coin.[3]

Historically, in times of distress, the US government will step in to ease investors' worries by limiting the sale methods of gold and the quantity that may be traded. While the trading of physical gold is harder to restrict, it is not immune to government restrictions. In 1933, an executive order banned "the hoarding of gold coin, gold bullion, and gold certificates." All gold was to be sold to the Federal Reserve, effectively taking

[2] Street, Louise, et al. World Gold Council, 2014, *Gold Demand Trends Full Year 2013.*

[3] The Mexican Peso derives its name from the "Pieces of Eight" in Spanish/Mexican history.

away many of the advantages of owning investment grade physical gold.

Mining Company Stocks

One can also invest directly in the stocks of gold mining companies which correlate with the price of gold. However, as with any stock, long term performance is dependent on future earnings and profitability of the company. When investing in mining company stocks, there are many factors to consider. Unlike gold itself, investing in mining stocks is a way to gain exposure to both the price of gold and a yield as many mining stocks pay a dividend. However, there are the added risks of the firm's financial health, its ability to operate at a profit, and management risk. In many cases, political risk is significant as many of the world's primary gold mines are in developing countries with state-owned enterprises maintaining significant influence.

Some public mining companies are not yet in the production stage, so investors must speculate on the success of projects in development. Exploration, on average, can take 10 to 20 years before a gold mine is ready to produce material that can be refined into a final product.[4] Furthermore, the cost of development will vary country to country. Historically, South Africa has been a popular area for gold mining, but due to recently increasing labor costs and regulations, South African production has declined. In 2018, China and Russia individually produced close to double the gold that South Africa produced that same year.[5]

Jackson, Wm. A. (William A.), Mudge, Theodore A, Lambert & Lane. Retrieved from the Digital Public Library of America <https://ark.digitalcommonwealth.org/ark:/50959/4m90fc37g>.

	Pros	Cons
Physical Gold	• Physical asset held outside of the financial system • Hard to restrict trading • Store of purchasing power	• Cost of physical safekeeping and storage • No income • More challenging to trade promptly and efficiently • Transaction, holding, and appraisal costs
ETFs	• Fast and easy to trade • Efficient pricing • The logistics of safekeeping and storage are handled by a third party	• Wide variety of structures with less transparency in ownership • Often uninsured • No direct ownership of gold
Mining Companies	• Fast and easy to trade • Some mining stocks are income producing	• Business and operating risks • Potential for global political risk depending on the mine's location

[4] "Gold Mine Development: 1 - 5 Years." *World Gold Council*, 14 Dec. 2017, www.gold.org/about-gold/gold-supply/how-gold-is-mined/development.

[5] "Gold Production by Country: Gold Production: Goldhub." *World Gold Council*, 30 June 1970, www.gold.org/goldhub/data/historical-mine-production.

One way to mitigate some business risk while maintaining exposure to gold mining stocks is to invest in a gold royalty trust. Investors benefit from increased gold prices without the risk of shrinking margins if operating costs increase. Another investment option would be in companies like Sprott that specialize in investment banking for gold and gold mining. Gold-focused investment banks allow investors to profit in times when there are significant gold transactions and gold prices increase. With both gold royalty trusts and gold-focused investment banks, there is relatively greater business and operating risk in comparison to physical gold or gold ETFs. However, there is less mining operating risk than investing directly in gold mining company shares.

Exchange Traded Funds and Mutual Funds

Publicly traded gold ETFs allow investors to gain exposure to gold in a fast and easy way without the costs associated with the storage and safekeeping of physical gold. It is important to note that owning a gold ETF does not directly translate into owning physical gold; rather, it simply allows investors to gain economic exposure to the price of gold. In the event that financial markets freeze, or the economy collapses, this could present counterparty issues. Similarly, one can use mutual funds as a vehicle for gold exposure. They are not as popular as many ETFs and tend to be smaller. It is not uncommon for a mutual fund to buy a gold ETF, but it should be noted that this creates an unnecessary layer of additional fees.

Investing in gold ETFs and mutual funds requires some research as there are a wide variety of these. Primarily, people invest in physical-backed gold ETFs, like SPDR Gold Shares (GLD). One share of GLD typically represents one-tenth of an ounce of gold. In the case of GLD, physical gold is secured by HSBC in their London vault, but this physical gold backing for GLD is not required to be insured for loss, damage, theft, or fraud. Alternatively, there are ETFs that assume a long position in futures contracts while holding U.S. Treasury securities as collateral that provide income. Gold futures ETFs allow investors to leverage positions so that small swings in gold prices can lead to large profits or losses. There are other ETFs, like GLX, that gain indirect exposure to price movements by investing in precious metal mining companies.

Conclusion

Given the recent growth of money supply, many investors are considering expanding their exposure to gold as a hedge against future inflation given the low opportunity cost resulting from low interest rates. As we have seen, there are various ways to invest in gold, among them are: physical holdings, ETFs and mutual funds, mining company stocks, and gold trusts. Each class of gold investment has its own benefits and risks, should an investor desire exposure to the yellow metal.

Gold at Houston Trust Company

At Houston Trust Company, we offer the holding of physical gold for clients with proper appraisal and storage. When holding physical gold there are costs associated with safekeeping and insurance, which can be significant. For example, the Texas Bullion Depository's annual storage cost for about $2.5 million USD of gold is about $12,500 or 50 basis points.[6]

As a trust asset, gold is at most a small allocation because of the lack of income and volatile prices. Gold's story is generally one of supply and demand, with a set amount of gold in the world, prices are determined by investors desiring to sell or buy gold due to a change in economic forecasts. At Houston Trust Company, we manage portfolios in accordance with the needs of our clients keeping a close eye on the economic cycles. Houston Trust Company and our investment managers focus on long-term returns and stability of our client's assets. We see this in large cap companies that are market makers, not price-takers. If gold were a company, we would view it as a price taker subject to supply and demand of other investors. Gold cannot create value on its own, and in today's environment appears to be a costly, unpredictable, and in some cases, illiquid cash alternative, despite its inflation-beating characteristics.

[6] "Texas Bullion Depository® Schedule of Fees as of April 1, 2018." Texas Bullion Depository, www.texasbulliondepository.gov/pricing.

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Lauren graduated from Washington University in St. Louis with a Bachelor of Business Administration in Finance from the Olin Business School, and a minor in Computer Science. While earning her degree, she worked at numerous family offices and was part of the Olin Venture Consulting Program in Budapest.

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Matt Caire joined Houston Trust Company in 2014. As Senior Vice President of Investments, he is responsible for managing the firm's fixed income investments, performing equity manager due diligence, and constructing the asset allocations for client accounts. Matt previously was a Portfolio Manager with Patriot Wealth Management, where he managed approximately $500 million in fixed income investments. Prior to that, he was a Research Associate and Bond Trader with Linscomb & Williams.

Matt holds a Bachelor of Business Administration in Marketing, Cum Laude, from Texas State University and a Masters of Finance from the Tulane University Freeman School of Business. He is also a Chartered Financial Analyst (CFA®) charterholder, a CERTIFIED FINANCIAL PLANNER™ (CFP®) professional, and a Chartered Market Technician (CMT). Matt serves as an Arbitrator for the Financial Industry Regulatory Authority (FINRA), and he also teaches as an investments instructor for the CFP® Program at Rice University's Glasscock School of Continuing Studies.

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Taylor currently serves on the Board of the Bush School of Government and Public Service at Texas A&M University in College Station, Texas. He is also a member of the CFA Institute and the CFA Society of Houston.