

the Clarity July 2010 report

Mark Twain once remarked, “Apparently there is nothing that cannot happen today.” Just a few months ago, many would have shrugged off the mention that economic and fiscal crisis might threaten the glue holding together the euro currency. It was the U.S. dollar, they argued, that was in trouble: the end of last year saw record pessimism about the dollar as its price slid against the euro. Such is not the case today. For the year, the dollar is up nearly 15.0% vis-à-vis the euro and the U.S. is once again considered a safe haven, with our Treasury bonds so in vogue among global investors that yields are once again at record low levels. What a difference a few months can make.

After rising steadily for the first quarter as risk-aversion subsided and volatility waned, the second quarter brought one of the quickest quarterly declines for the broad markets in decades. The large-company Russell 3000 Index fell 11.3%, while the Russell Midcap and small-company Russell 2000 each lost 9.9%. International stocks dropped 14.0% and global real estate was off 7.8%. Exemplifying that risk aversion is back, the Russell 3000 is down 6.1% while Treasuries have gained 5.9% through the first half of the year. After numerous calls for interest rates to only head higher, yields on 10-year Treasuries are below 3.0%. Apparently, there is nothing that cannot happen today.

No ‘All-Clear’ Signals in Markets

It might surprise some to learn that the market decline this past quarter for the broad market was worse than the first quarter of 2009, a period that was particularly scary. (Of course, that quarter also saw declines in excess of 30% at one point before recovering.) Stretches of persistent market declines tend to try investors’ patience, even those following a disciplined investment strategy. Rising stocks inspire confidence; falling stocks erode it. According to the American Association of Individual Investors, 57% of investors are currently bearish, up 15% from the week before and well above the long-term average of 30%. Still, periods when stock prices decline, economic worries are pervasive and the investment world is overly pessimistic have often been better

clar’i-ty: n. The quality or state of being clear.

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times to buy than to sell.

More things can happen than will happen. That's the nature of risk. Accordingly, investors must prepare for a broad range of possibilities, not all of which are knowable. Our aim in investing client portfolios is to meet investment objectives that are often years or decades in the future. To do this, we cannot be ostrich investors by placing all of the assets in cash. Investing inherently involves considering tradeoffs. At one extreme is cash, which offers short-term peace of mind but risks erosion of purchasing power (since 1913, the dollar has lost over 95% of its value). At the other extreme are equities, which have endured much greater volatility but over the long haul have generated returns well in excess of inflation. We focus on client risk tolerance and return objectives to create an asset mix that, based on our capital market expectations, is likely to optimize return without subjecting the portfolio to undue risks.

On an ongoing basis, we evaluate the mix of assets in client portfolios. Around this time last year, we brought client portfolios into a somewhat more conservative stance overall – i.e., more funds with managers willing to hold cash should conditions warrant, as well as higher quality bonds. For the most part, these funds have performed as we would have expected but we are constantly monitoring capital markets and funds for changes to our expectations and/or investment theses.

“A disciplined investment strategy works *over time*, not all of the time.”

While stocks will be marked down from time to time, the only way to protect against permanent capital losses is to seek assets at good valuations. Buying at too high a price is a sure way to generate sub-par returns. (More on this later, with respect to gold.) A long-term orientation is crucial – there are few things as important to investment success. For example, a stock investor lacking a long-term perspective selling to cash in early March 2009 would have locked in losses more than 30% below today's prices, from which it would take a nearly 50% gain to break even.

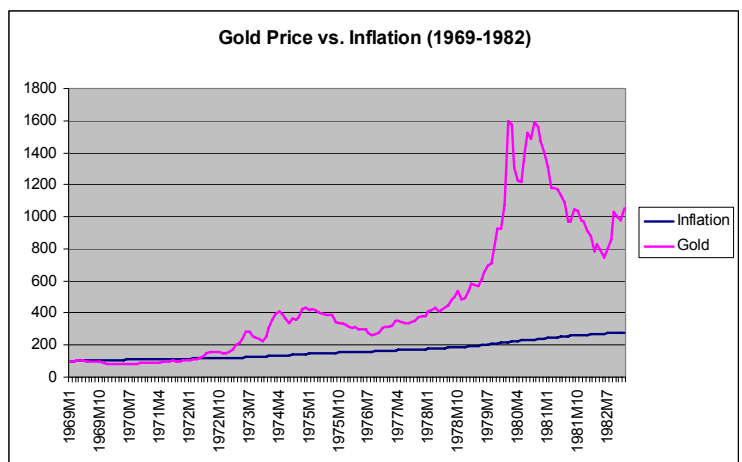
The elevated volatility of the last few months has permeated investor psyches and led many to withdraw from or avoid committing capital to equities. We caution clients not to react to short-term market swings based on emotional responses. Always keep an eye on your long-term goals and how your portfolio is positioned to achieve them over time. We advise investors to act like the new driver – keep your eyes on the road and check the rearview mirror only occasionally. A disciplined investment strategy works *over time*, not all of the time. As always, please contact us with any questions or if your financial circumstances change.

The Price of an Inflation Fighter

With the resurgence in investor's awareness of global economic turmoil, gold prices have moved higher amid shrinking volatility, climbing over 13% during the first half of the year and capturing the imagination of doomsayers and true investors alike. Two years ago (with prices at \$920), we discussed our thoughts on gold; we'd like to revisit our stance on the yellow metal and discuss its possible merits as an investment.

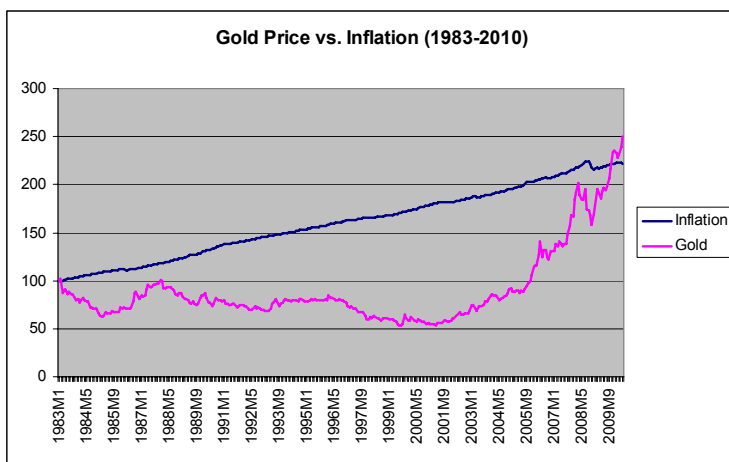
Gold has been a medium of exchange throughout history but its use in economic transactions has declined steadily since the invention of the printing press. Relative to paper, it is heavy (one of the most dense elements on the planet) and its high value makes it cumbersome to use as a form of payment – for example, a one-tenth ounce American Eagle coin, smaller than a dime, is worth about \$150. Paper currency and electronic transactions are a much cheaper and efficient way to transact business, but for many years the dollar was linked in some way to gold. In 1971, however, gold lost its last formal tether to paper currency following Nixon's closing of the gold window; since then, the metal has traded as a commodity as it does to this day.

When we wrote a couple years ago, the infatuation with gold surrounded its role as a “crisis hedge” while our country stood on the precipice of a severe economic contraction. Though today's buyers remain concerned with economic uncertainty, overwhelmingly the investment case for gold involves worries about the future inflationary consequences of current government policies. Current buyers are aiming to protect themselves against the eroding purchasing power of the U.S. dollar and other fiat currencies as central banks print money and fiscal authorities borrow and spend mostly to fund current consumption in order to prop up ailing economies. While the inflation thesis has merits – gold has held value against inflation during some periods – its validity is almost wholly dependent on the purchase price.



The last time the United States experienced significant inflation was during the 1970s. The chart above shows 1969-1982, a period during which the U.S. consumer price index rose by an average of 7.5% per annum. Over this same time, gold prices rose 18.3% annually, which more than compensated those who bought in 1969 for inflation's detrimental effects, assuming their exit was well-timed. But what about those who purchased gold at higher prices toward the later part of this period? Over the subsequent decade from 1982, the consumer price index rose close to 46% while gold prices actually *fell* almost 25%. A person buying \$1,000 in gold that year would have been left with just \$410 (1982 dollars) ten years later, a 59% *loss* of purchasing power. Gold was hardly a deadlock cinch to protect purchasing power in that period of time; over that span, the loss of purchasing power was worse than having held cash. The above serves as but one example of how buying at too high a price cost investors dearly.†

What about longer periods of time? The chart below plots the late 1982 gold buyer's subsequent longer-term experience in the battle against inflation. It took close to 25 years for him to break even with inflation and even 20 years later he was sitting on a loss of close to 50%. (Those who purchased at the 1980 peak would still be behind inflation.)†



It's hard to argue with investors who bought the metal several years ago and have seen gold's price double and triple. We are fundamental investors, not speculators, though, and accordingly we try to understand what each possible investment or asset is worth before we make a commitment. An asset's value is based on the cash it will generate now and in the future, discounted at an appropriate rate. This is a problem with gold, since it generates no income. (It actually boasts a negative yield in that there is a cost associated with storage and insurance.) Because it generates no income, it is essentially not possible for us to determine a value. The closest thing we have to a value for gold is what it costs to produce. VM Group, an industry research group, estimates the average cash costs of an ounce of gold was around \$550 at the end of the first quarter. Current prices are more than double this amount. Time will tell, but by our estimation the consumer price index

would have to double to justify current price levels – gold prices have already discounted very high future inflation that may or may not come. In other words, gold investors could be disappointed even if the much-forecast inflation arrives as predicted.

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Commodity prices are influenced by supply and demand factors. When supply outstrips demand, prices tend to fall; when more demand exists than available supply can accommodate, prices rise. Gold is not exempt from these simple market forces but seems to be defying them at present. In the past six months, about half of total gold demand has come from jewelry, industrial and dental uses. (From our perspective, jewelry, industrial and dental are “fundamental” sources in the sense that they constitute actual economic use.) The other 50% was derived from investment demand – i.e., that held in private vaults or through exchange-traded funds. This demand breakdown represents a marked shift from the five years prior to 2006, when on average over 80% of total demand was driven by fundamental factors – with just 19% coming from investment (up from 4% in 2000). Today, incremental demand comes from investors whose investment thesis is fairly uniform – i.e., “Gold is an inflation hedge” – and who lack sensitivity to price, so gold is able to increase with smaller amounts of “gravity” – price conscious, fundamental demand – to keep it in check.

“Investment demand for gold constituted half of the total in 1Q 2010, up from just 4% in 2000.”

The supply side has shifted as well. Over the past two quarters, about 60% of total supply has come from mining while about 40% has come from recycled gold. Mine production's share hasn't changed markedly since the five years prior to 2006, but recycled gold has gone from 25% of supply to 40% and central bank sales have dropped from an average of 14% to just 1% today. By not selling gold into the market, central banks (which hold about one-fifth of global gold stocks) are restricting supply, the effect of which is not very different than if they were buying gold outright. Overall, however, gold supply is more than keeping up with demand – total mine supply jumped 11% year-over-year through the end of March while recycled gold grew 28%. Overall supply rose by nearly 11%.

The aforementioned combination of greater investment demand (without price sensitivity) and lower central bank supply has acted to support the current gold price. Gold prices through the end of the first quarter were up over 20% even though aggregate demand fell by nearly 4%. Demand for jewelry fell 20% and industrial and dental by 16%. Investment demand, on the other hand, rose 24%. Normally, increasing supply and shrinking demand would lead to lower, not higher, prices. It seems reasonable to assume the reason for this

discrepancy can be found in the abnormal composition of the incremental buyers in the gold market – those buying regardless of price, for inflation protection.

Gold is up over 300%, nearly 16% per annum, since 2000, a move that is not unprecedented.[†] Similarly rapid price increases occurred in the 1970s. For the first couple years of the 1970s, gold rose to about \$200 an ounce (from the former official parity rate of \$35), then back to \$110 before surging as high as \$970 in the second half of the decade.

According to Charles Kindleberger:

“At some stage in the late 1970s the market price of gold was increasing because the market price of gold was increasing. Investors were extrapolating from the increase in the market price from Monday to Tuesday to project the market price on Friday; they purchased gold on Wednesday in anticipation that they could sell at a higher price on Friday. The ‘greater fool theory’ may have been at work, some of the buyers of gold may have realized that the increase in price was a bubble and anticipated that they would be able to sell their gold at a profit before the bubble imploded.”

In our opinion, the above could almost be written to apply to today. Gold may not yet be at bubble levels, but given recent trends it could begin to approach them soon— it may in fact have sufficient momentum for further appreciation. When the pace of buying slows or stops, though, history indicates the latest buyers – those left holding the bag – may not be pleased with the results.

[†]Calculated by Clarity Asset Management, Inc.

The performance for the Russell 3000 Index is used as a proxy for the stock market, the Barclays Capital Aggregate Bond Index for the broad bond market. The Russell 2000, Midcap, and 1000 Indices are used as a proxy for small-, mid-, and large-cap stocks. The aforementioned indices are market-value-weighted. Membership in each index is selected based on a ranking of U.S. common stocks according to total market capitalization. Numbers do not reflect fees, brokerage commissions or other expenses of investing. International stock data reflects the net total returns of the MSCI EAFE Index in U.S. dollars. Global real estate reflects the performance of the FTSE EPRA/NAREIT Global Real Estate Index. Treasury security data from Barclays Capital Indices (formerly Lehman Brothers). Gold data provided by the World Gold Council and from Manias, Panics, and Crashes by Charles Kindleberger.

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