WEBB ASSET MANAGEMENT

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Monthly Commentary

SYSTEMATIC, PROVEN & RELIABLE

Commentary

The Luster of Gold

We have been bullish on gold since the financial crisis of 2008. The reason for our bullishness, are the profligate ways of the developed nations. The developed nations with the exception of Canada are structurally bankrupt. The politicians of these countries have granted entitlements to their constituents that their nation's finances can not afford.

These entitlements will shackle these nations financially and the prospects of future generations. The results are: massive government debts, massive government deficits, and quantitative easing (printing money). Little has been done to address the cause and reduce the entitlements. Nobody has been willing to take the hard medicine.

Remember that currencies are fiat money. They are backed by nothing of tangible value. People use fiat money based on the belief that central banks will defend that value and not abuse the currency. Given the massive structural deficits and quantitative easing, central banks are currently not defending the value of their currencies. The 'entitlement problem' just keeps getting kicked down the road.

Most people say they do not understand gold. They say it has no use like oil and/or can not produce a return like a bank deposit.

Gold is a currency no different than any other fiat currency. However, gold's main difference vs. fiat money is that the supply is basically fixed. Gold is very hard to mine economically. This is one reason it is the longest surviving currency in the world. When fiat money supply is managed prudently gold's luster as a store of value is low. When fiat money is not judiciously managed, gold shines.

Also, when real interest rates are low, gold's value increases as there is little incentive to hold fiat money. When real interest rates are high, you are paid an adequate return to keep your money in debt instruments or the bank. Though official inflation rates are low, governments have a vested interest in understating inflation to keep their funding costs low. Currently even with low stated inflation, real returns on most government debt are negative.

So what kind of rate can you earn on holding gold? We believe the best way to have exposure to gold is to own the equities of those companies that produce gold. If gold continues to rise those companies that produce gold profitably should see their share prices increase more than the metal. Gold producers have significant earnings leverage to an increase in the price of gold.

We then sell call options or naked puts on these gold names to collect monthly income. We have been doing this continually in our income fund. Since 12/31/08 we have written 35 one-month options on various gold stocks. On average these options have been 4.1 % out of the money and we have received 3.6 % per month in option premiums.

That means we have been collecting income of approximately 43 % per year on our gold positions. We have sold away most of the upside returns in our gold names in return for the monthly option premiums. Given that those premiums have amounted to approximately 43 % per annum this is excellent risk/reward.

The gold portion of the income fund is analogous to owning the currency of the country called gold. This country has no debt, no deficits, or unfunded entitlements. It can not print gold as the gold supply increases only about 1% annually from global mine production. Meanwhile your money in that currency is earning a 3.6 % monthly return or approximately 43 % annually. Sounds a bit more attractive than Swiss Franc.

You will lose money if gold depreciates against the other fiat currencies. However, given the massive debts and deficits of the other major currencies such as the Euro, USD, Pound, and Yen this seems like excellent risk/reward.

– Derek Webb

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