*Tocqueville Asset Management L.P.*

# A Surplus of Gullibility

May 2009

Since the implosion of credit, gold has become a much more respected topic. This is a significant change in the character of the market. When we first launched our gold fund in 1998, it was the Rodney Dangerfield of investment ideas, a laughable outcast on the utmost fringe of investment strategies. However, times have changed and now it is okay to mention gold in polite company. The dollar price of gold has advanced nearly 4 fold since its 20 year low in 1999. In nominal terms, it stands at an all time high. More important than the price advance, however, is the progression of investment thinking. Gold as armor against potential monetary debasement or continued deflation is an idea that won't go away.

A review of the most recent Form 13F filings for GLD, the NYSE listed ETF which is essentially securitized physical gold, shows a significant number of elite investment thinkers among the top 20 holders (see below). In many instances, the holdings are sufficiently large to suggest that gold is a core component of their investment thinking. The top twenty holders represent 24% of shares outstanding. The high concentration among a relatively small number of holders also suggests that exposure to gold in the investment world, and especially the public remains quite low.

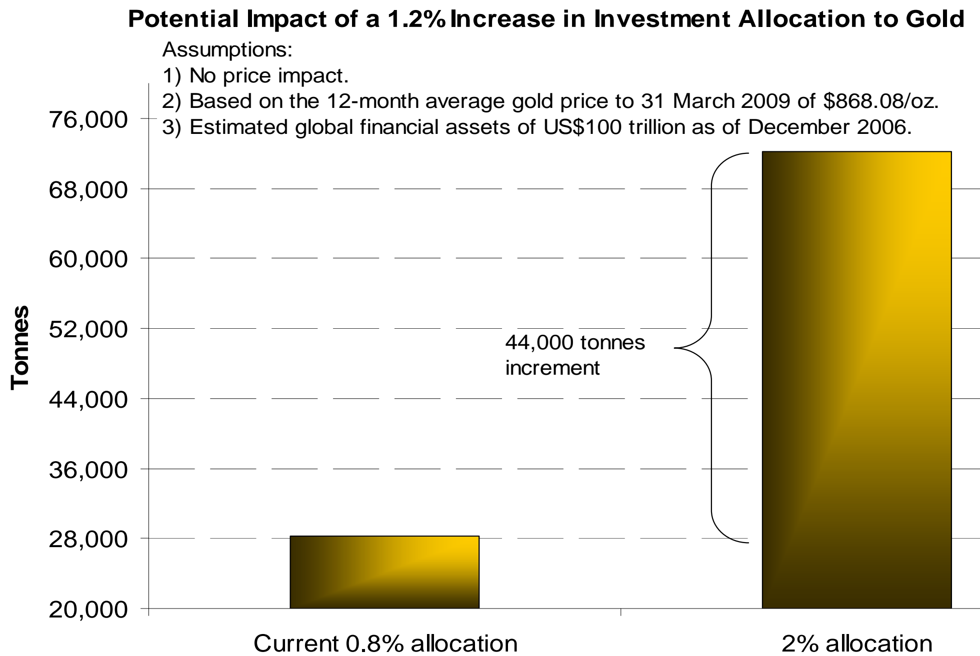
| | *Holder Name* | *Position* | *% O/S* |
|---|---|---|---|
| 1 | Paulson & Co., Inc. | 31,500,000 | 8.7 |
| 2 | BlackRock Advisors, Inc. | 6,264,842 | 1.7 |
| 3 | CI Investments, Inc. | 4,747,842 | 1.3 |
| 4 | Bank of America Merrill Lynch | 4,233,321 | 1.2 |
| 5 | Greenlight Capital, Inc. | 4,209,090 | 1.2 |
| 6 | Eton Park Capital Management LP | 3,657,337 | 1.0 |
| 7 | Citigroup Global Markets (United States) | 3,311,751 | 0.9 |
| 8 | Morgan Stanley & Co., Inc. | 3,227,414 | 0.9 |
| 9 | Highfields Capital Management LP | 2,894,720 | 0.8 |
| 10 | Wellington Management Co. LLP | 2,834,780 | 0.8 |
| 11 | Goldman Sachs & Co. | 2,788,539 | 0.8 |
| 12 | BlackRock Investment Management (UK) Ltd. | 2,571,800 | 0.7 |
| 13 | Windward Investment Management | 2,274,936 | 0.6 |
| 14 | Aletheia Research & Management, Inc. | 2,029,101 | 0.6 |
| 15 | Mason Street Advisors LLC | 1,999,300 | 0.6 |
| 16 | Tiger Global Management LLC | 1,944,000 | 0.5 |
| 17 | Northern Trust Investments | 1,821,561 | 0.5 |
| 18 | Pequot Capital Management, Inc. | 1,697,500 | 0.5 |

| | | | |
|---|---|---|---|
| 19 | UBS Global Asset Management | 1,562,936 | 0.4 |
| 20 | Lazard Asset Management LLC | 1,518,973 | 0.4 |
| | | | |
| | *Top 20 Holders of GLD* | *87,089,743* | *24.1* |

*Note: Positions and respective percent of shares outstanding as of March 31, 2009.*

*Source: FactSet Research*

As we have often noted, the capacity of gold bullion to absorb capital market flows is tiny. The chart below shows that a 1.2% increase into physical gold by global pension funds would require more than 44,000 metric tonnes, or roughly 27% of all the gold that has ever been mined.




*Source: World Gold Council*

Once the broader investment community begins to follow the leaders in earnest, the price reaction of the metal will be far more dynamic than the consensus view, which we judge to be essentially agnostic. The steady influx of capital into the various gold ETFs is encouraging. New GLD shares are created only if an authorized dealer purchases bullion and delivers it to the custodian, HSBC. This simple act of arbitrage is how GLD shares are created and the process has in recent years become the most important reason for the steady rise in the gold price. The current market cap of all gold ETFs is $49 billion (as of May 19, 2009), a considerable rise since the inception in November, 2004. Still, this is a moderate sum by capital market standards, and further growth seems both possible and likely. Bullion held by the GLD trust is in allocated form, which means that the custodian (HSBC) may not lease the gold back into the market. More importantly, allocated bullion is not commingled with the general accounts of the bank. In a hypothetical bankruptcy of the institution, creditors would have no claim on the bullion. The past and prospective growth of GLD has the effect of tightening the noose for the considerable superstructure of paper short positions that are marked to gold but are in large part naked.

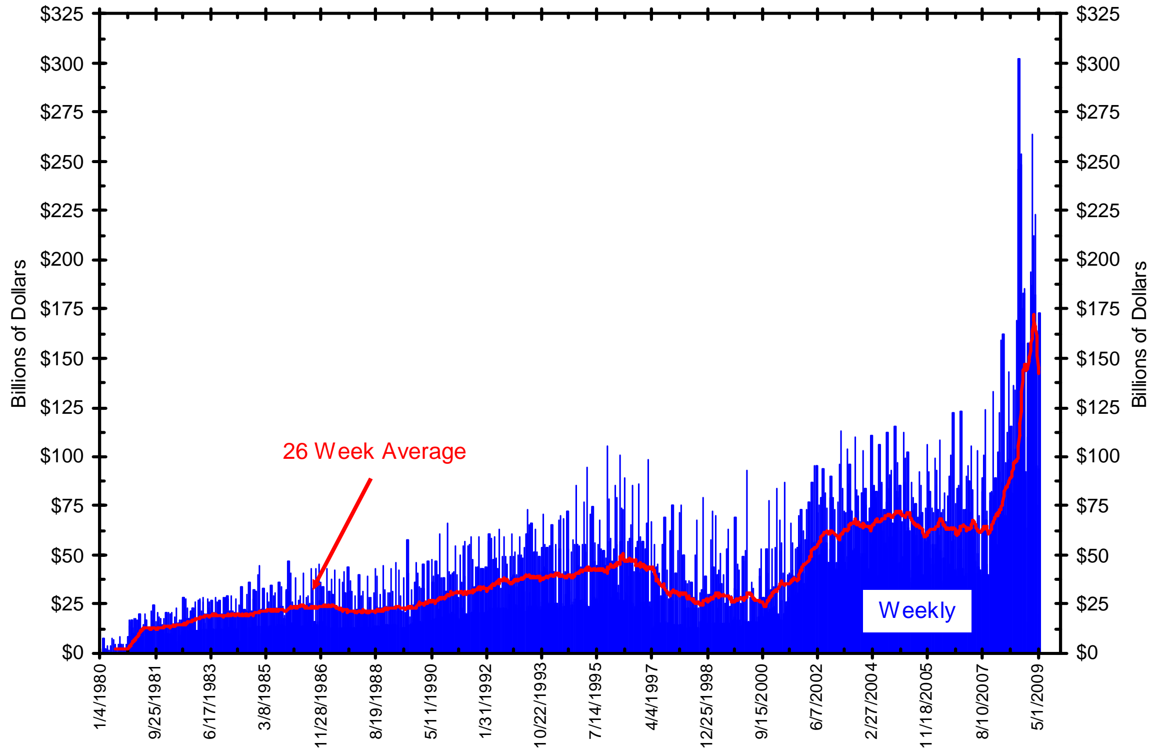
We believe the macro economic conditions for gold will remain favorable as long as the U.S. government displays a current willingness to intervene at any cost to right the economic ship. The dynamic is simple. Bad news on the economic front empowers politicians to pump up the dose of monetary and fiscal medicine. This spectacle is bound to worry all who hold dollar denominated assets, especially low yielding U.S. Treasuries, both here and abroad.

What about the ever present debate over inflation vs. deflation? There are good arguments on both sides, and it may take years to find out which view turns out to be right. Despite the intellectual intrigue, this debate is irrelevant for gold. Either outcome would be positive, as both the 1930's and the 1970's illustrate. In each of these decades, those who had a significant exposure to gold and gold shares came out ahead of those who didn't. In the meantime, a prolonged standoff in which either outcome seems plausible will only generate more worry and suspense for investors. It is hard to see how this could be bad for gold.

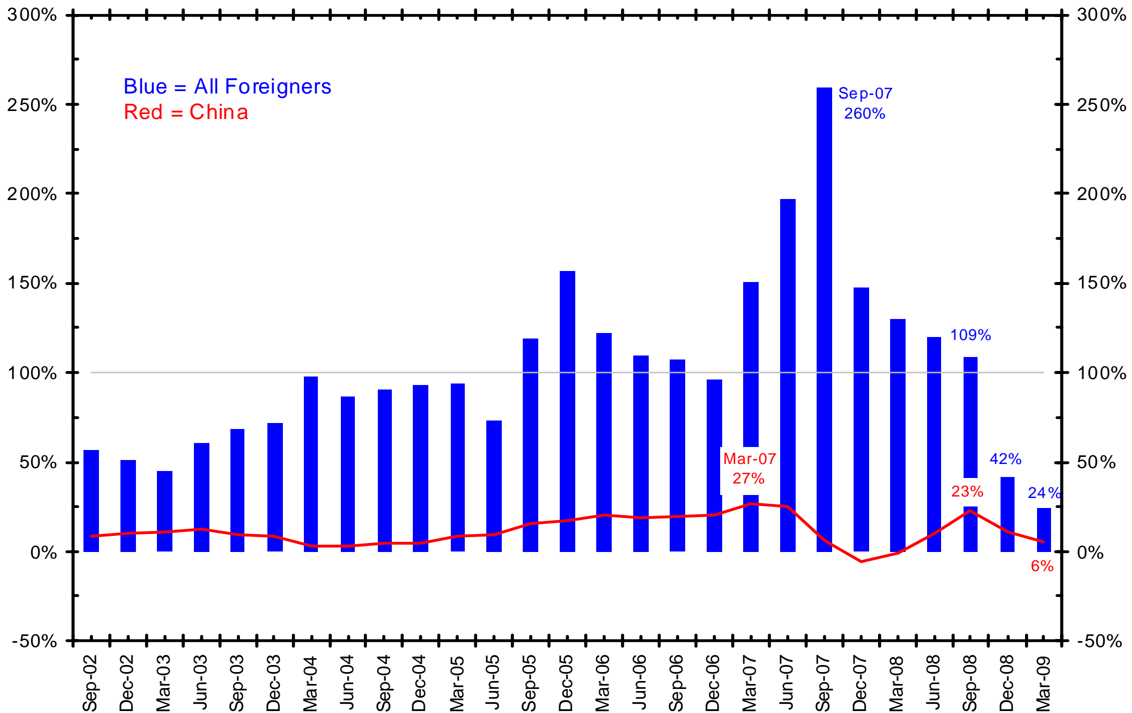
It seems intuitive that huge deficits and unprecedented monetary creation would result in inflation. On the other hand, repairing credit might take decades. Without credit growth, government responses that seem extreme might only offset the void left by the slump in the private sector, and inflation would remain latent. In either instance, Western democracies appear to be on course for a fiscal disaster of epic proportions, because the essence of their policies is to inflate collateral values in nominal terms by debasing their currencies. Of course, the notion of currency debasement is not explicit. The most ardent advocates of inflationary policy responses to deflationary market forces most likely believe in their hearts that there is no risk of damage to the currency because monetary velocity is low. Their conviction is clothed in the myth that central bankers and politicians have the expertise to navigate economic and financial crises, which of course has little basis in reality.

Faith in government's ability to correctly judge the precise moment to withdraw liquidity and stimulus is the only basis I can think of for rejecting gold as an investment option. Alan Meltzer, in a May 4, 2009 Op-Ed piece in The New York Times, "Inflation Nation", argues that the Fed has ceded its independence to the U.S. Treasury for political expediency. How will it regain that independence? "Surely not right away. But sooner or later, we will see the Fed, under pressure from Congress, the administration and business, try to prevent interest rates from increasing." As President Reagan once remarked, "the nearest thing to eternal life we will ever see on this earth is a government program."

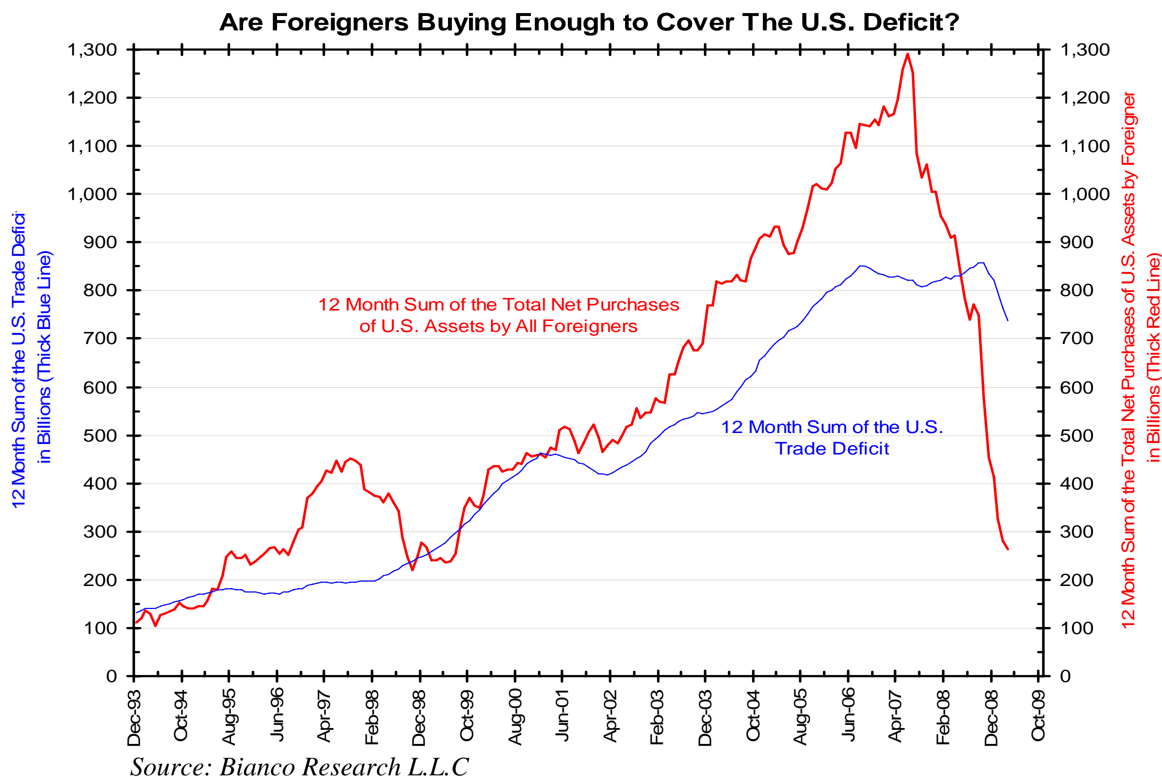
As the three charts below show, the issuance of government debt to finance the various stimulus programs has already risen sharply to multiyear highs. This issuance will rise still further as fiscal stimulus ramps up and tax receipts fall away. At the same time, foreign buyers have cut back sharply on their purchases of U.S. Treasuries. This leaves only the American consumer or the Federal Reserve to make up the difference:




*Source: Bianco Research L.L.C*




*Source: Bianco Research L.L.C*



*Source: Bianco Research L.L.C*

Foreign buying of U.S. paper appears to be on the wane, notwithstanding the spike in March, which Bianco Research has suggested might have been front running a strong Fed bid based on its quantitative easing statement. Dollar weakness has already erased the meager gains from this strategy. The risk of further dollar weakness is posed by the simple question of who will absorb the increase in supply of treasury issuance? Traditional foreign purchasers have fewer dollars to invest because of declining trade flows. While U.S. households will take up some of the slack, the Fed will have to shoulder much of the burden, as it has already stated it will do.

While all paper currencies seem in danger of losing value, the dollar seems particularly vulnerable because its existing and prospective supply is high in comparison to the others. As the cornerstone reserve asset of foreign central banks, it is the most vulnerable to a progressive downgrading of opinion as to its utility. Muttering about the dollar's reserve status has been led by China and Russia but it is shared by others who remain silent on the matter.

China, in its critique of the dollar's reserve status, reveals its own ambition to benefit from privileges of seigniorage. However, it still pegs its currency and must accumulate dollar reserves to do so. As for gold backing in order to look more like a reserve currency, they remain far short of the 23% backing for the euro at only 1.7%. The recent increase in their gold position was most likely disclosure of gold held by the finance ministry that was previously unreported. The disclosure may have been a response to internal criticism as to vulnerability to dollar weakness and their underweighting in gold. While this may not qualify as a watershed in behavior, there is clearly pressure for China to diversify away from the dollar.

We understand that other central banks, having spent more than a decade divesting their gold holdings in favor of "higher yielding assets, such as U.S. Treasuries", are beginning to show renewed interest in the metal. While such changes in thinking and behavior can seem glacial, there is no doubt they are potentially game changing for the gold market. The shift in central bank thinking is incipient and barely detectable at present, but the change is real. It is based on doubts about their key reserve asset (63% U.S. dollars) and the price behavior of gold. With central banks potentially shifting from net sellers to net buyers, it will take much more courage and/or stupidity to attempt a bear raid led by naked short selling similar to the 2008 event which saw gold decline nearly $300 in the wake of the Bear Stearns demise.

The major difference between the 1930's and the 1970's and the first two decades of the current century is not whether inflation or deflation will rule the day, but the precarious position of the dollar as a reserve currency. Fiscal and monetary actions that seem expedient for domestic purposes also stand to fuel wariness and weariness of the dollar's unique position. The dollar must be replaced as the anchor of the international monetary system. While everyone seems to know this, there are no obvious answers. In time, the solutions will be driven by the markets, following historical precedent. We would be surprised if world governments, especially Asia, would sponsor gold as the new anchor as they are underweight the metal. In the meantime, gold ETFs will avail private citizens of an alternative to government scrip and on that basis, we anticipate robust and steady growth.

The fact that gold and gold shares have outperformed most other investment strategies over the past ten years is still a well kept secret. However, one cannot fail to note that gold has more recently attracted the interest of highly regarded investment professionals, who we would classify as early adopters. While gold's plausibility and respect has improved over the past year, we reckon that most investors are still on the sidelines. The high abstention rate seems to us to be based on concern that gold's ten year run is over (see our website article: "Is Gold Still In a Bull Market?") or belief that government policies will work the miracles their proponents claim. We feel that the bull market in gold is still young, but that it has crossed an important threshold. No longer obscure and laughable, broader awareness and interest among a wider circle paves the way for capital inflows still to come. Unless the macro economic outlook undergoes a miraculous change for the better, it would seem that the prospects for gold and gold mining shares remain excellent.

John Hathaway
Portfolio Manager and Senior Managing Director
© Tocqueville Asset Management L.P.

May 22, 2009

*This article reflects the views of the author as of the date or dates cited and may change at any time. The information should not be construed as investment advice. No representation is made concerning the accuracy of cited data, nor is there any guarantee that any projection, forecast or opinion will be realized.*