



Why Do You Invest In gold and Silver?

By: Joe the Investor

The first question to ask is: why are you investing in gold and silver? There are 2 main strategies behind precious metals investment – defense and offense.

Defense is when you want to preserve your wealth or day to day cash flows against crisis. What type of crisis? Gold is first and foremost a universal currency – so you want to be able to do with gold or silver what you can do with any other currencies. Many people think of currency for day to day transactions and not for the longer term – but currencies are useful for short and long term wealth preservation or conversion. The crisis gold is designed for is a currency crisis. What does this look like? When a currency is not worth as much as it once was (inflation), or the currency is not accepted (devaluation), or the currency has been diluted by poor governance (hyperinflation, large national debt). The epicentre of this type of crisis is poor money management by the issuers of the currency. Note that in many countries, the banking and financial systems are deeply interwoven with the government since currency issuance is typically done through debt issuance, which the banks control. Poor management can also include corrupt, heavily indebted, low liquidity, or lack of access banking and financial systems. Since currency makes its way into any form of trade, transactions and wealth generation, this type of crisis can come in many forms.

Gold in terms of defense is primarily for wealth preservation when currencies are in chaos, or governments are changing or being dissolved. World War II has many examples of this as boundaries were redrawn in many places. With a new boundary or government arises a new currency, and a deletion of the old currency. Silver in terms of defense is protecting your day to day trade and transactions with something that is universally recognized, easily divided, easy to carry and durable. If you are purchasing gold and silver for this use, it has to be usable in all forms of situations. The gold for defense is gold or silver coins and bars or perhaps physical collectibles if they are easily traded for other goods. *It has to be in your possession or easily obtainable at the drop of a hat.*

Gold and silver in terms of offense is trying to increase wealth or speculate based on the expected movements of gold and silver prices. The first layer of offense is Exchange Traded Funds (ETFs) and Bullion Trust products which imitate the price for gold on a one for one basis. These are considered offense because there are access risks and systemic risks that may plague these products which do not exist for physical gold as defense.

The second layer of offense is precious metals miners and groups of miners (stocks and mutual funds). This is true for 2 reasons. The returns tend to be amplified or leveraged due to the profit margin nature

of a business. If gold is trading at \$1000 per ounce and moves up to \$1,100 per ounce, the rise in profit is 10%. If you are a gold producer, and your cost of production is \$800 per ounce and gold is trading at \$1,000 per ounce, your current rate of return is 25%. If gold rises to \$1,100 per ounce, the rate of return is now 37.5%. The difference between 37.5% and 25% is 12.5%, which is higher than the 10% return for the metal price alone. On the downside, mining companies may have corruption issues, financing issues, geopolitical risk, environmental risk, cost pressures etc. which can create losses in your portfolio even if the gold price rises.

The third layer of offense is gold derivatives – options, futures or funds that are based on exaggerated movements in the metals prices. There is a larger potential rate of return, but the “what can go wrong?” risk increases because the nature of the traded instrument, how the fund is managed, systemic issues within the derivatives market, overuse of debt which can cause a fund to lose its positions etc.

Can you have offense and defense? Absolutely. The role of each part of the portfolio is different and they should be thought of 2 separate parts that work together.