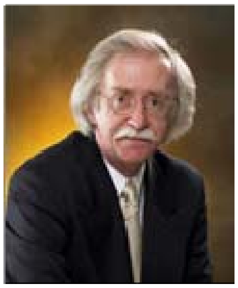
Gold Bullion: Currency for the Times



Nick Barisheff—Bio

Nick is the co-founder and President of Bullion Management Services Inc., which was established to create and manage The BMG BullionFund.

Realizing that Canadians had no way of holding precious metals in their RRSP portfolios, Nick conceived and implemented the Fund as a way of offering investors an alternative to conventional cash equivalents. His innovative design allows investors to purchase and hold gold, silver and platinum bullion.

Exclusive Interview

Nick Barisheff, President and CEO

Bullion Management Group Inc.

This week's interview is with Nick Barisheff, president, CEO and founder of BMG BullionFund, Canada's only mutual fund that invests exclusively in gold, silver and platinum bullion.

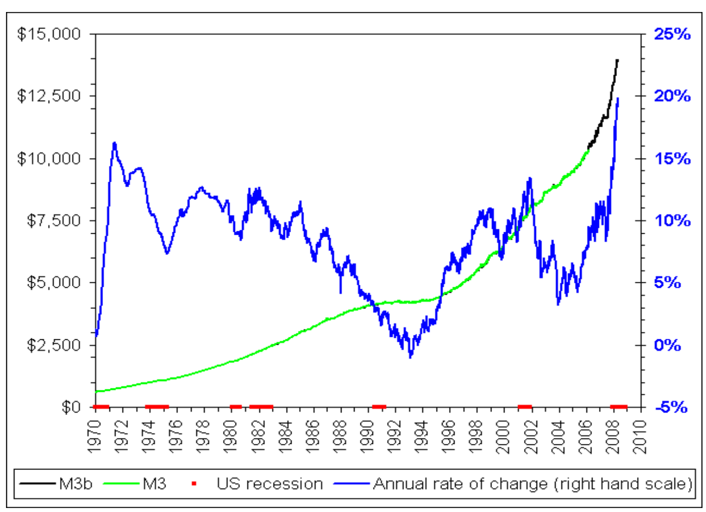
GreenLightAdvisor.com: What's the most important thing people need to understand about gold?

Nick Barisheff: Many people think gold is a commodity like copper, zinc or pork bellies, but it has 3,000 years of history as money. It was money that no government created by edict. It was just adopted for usage by itself, and it was and still is the best form of money. Currently, we have a 37-year global experiment in paper money. All prior paper money experiments ended in hyperinflation, with the currencies becoming worthless. All previous hyperinflations were contained within a single country, but this time, because of the reserve status of the US dollar, it is likely to be global in nature.

Right now, the price of gold is rising while most currencies are losing purchasing power as well as their value against gold. Gold comes back into its monetary role when there's a loss of confidence in the financial system or in paper money, and that's when people are attracted to it.

Before 1971, the monetary system was governed by the Bretton Woods Agreement. Under that agreement, the US dollar was backed by gold, and other currencies were pegged to the dollar. Other countries could trade their US dollars for gold. Essentially, US gold indirectly backed all other currencies. Then things changed. As the US was getting into the Vietnam War and into President Johnson's policy of guns and butter, US gold reserves started declining. Countries holding dollars were presenting their US dollars and asking for gold in return, and that led to US gold reserves dropping from a peak of 22,000 tonnes to 8,800 tonnes. On August 15, 1971, President Nixon *"closed the gold window"* and stopped the exchange of US dollars for gold. Closing the gold window was a euphemism, but basically the US declared *bankruptcy.* When you can't meet your obligations when they are due, that's what it is. So from that point in time, we've had 37 years where the entire world has been on a global fiat currency monetary system.

Since 1971, when the dollar was freed from the constraints imposed on a currency backed by gold, the US has experienced increasing federal government and current account deficits. The US is now borrowing $800 billion annually to fund its consumption of foreign-made goods and commodities, and the federal government is running a deficit of almost $350 billion. At some point, foreigners will become unwilling to continue funding US expenditures, forcing the Federal Reserve to expand the money supply at a faster pace. This will result in rising inflation, rising interest rates and a continuous decline in the US dollar.



Source: John Williams

GLA: We've had the fastest money supply growth in almost 40 years that's resulting in increased inflation. Why would an investor want to go into T-bills, given that interest rates don't even cover half of the stated inflation rate, which we know isn't even the *real* inflation rate?

NB: For the first time in history, we have an unlimited ability, by all central banks, to *print*, however much money we want, so to speak. Apart from the US M3 money supply growing at about 20%, we also have

India and China growing theirs at about the same rate. China is at 18%, India is at 20%, and Russia is at 45%. As China or India sell goods to the US, they take in US dollars and they print yuan or rupees against those US dollars. Japan's a little different; there, individuals and corporations can take their US dollars and buy US assets themselves. In China you have to turn your US dollars in to the central bank.

In today's inflationary environment, many who invest in fixed income investment do not appreciate that instead of being *"safe"* investments, they are in fact guaranteed losses of purchasing power when you take inflation and taxation into account. We have done some analysis into a systematic withdrawal from our Fund for those investors requiring income. Based on the fact that precious metals have a long track record of staying ahead of inflation, an investor would be far better off in precious metals in terms of maintaining principal after inflation and having more after-tax cash flow to spend.

GLA: What did you think of John Embry's (Sprott Asset Management) recent article about the manipulation of the price of gold? His assertion was that the central banks are deliberately keeping gold below $1,000 per ounce.

NB: John and Eric Sprott have recently written an extensive report called *Not Free, Not Fair*. The report brings forth a great deal of evidence that the precious metals markets may be manipulated. While it may seem like there's a conspiracy to suppress the gold price, I think it's simpler than that. It's a well know fact that it is the job of central banks to manage their country's currency, that's part of their mandate. Central banks understand that gold is a currency, but one that they can't expand as easily as paper money. I don't think there is any lack of understanding on the part of central bankers that gold is an alternative currency.

GLA: Isn't gold considered to be just a commodity with no real monetary role anymore?

NB: I'd like to refer to an article by Tony Fell , and it's particularly interesting, given that he was chairman of RBC Capital Markets at the time of writing. He talks about how gold has three attributes: it's a commodity, a store of value and a currency. He says so many people now think of gold only as a commodity or jewellery, or as an archaic relic, that there's a feeling of "who needs it anymore?" People don't think of it as money.

However, the daily sales volume gives a conclusive indicator that gold is much more than an industrial commodity. The physical turnover of gold by members of the UK's London Bullion Marketing Association is about *$25 billion per day. We're talking about net turnover between the LBMA members. The volume is estimated at 7-10 times that amount.

It's pretty clear that these are currency transactions. That's why gold, silver and platinum trade on the currency desks of all the banks and brokerages, not the commodity desks.

What people need to know is that gold is a *currency* [like dollars or euros or yen]. Gold is *not* trading at these volumes as a commodity or as some archaic relic.

"In 1971 you could buy a car with 100 ounces of gold, a car was about $3500. With a thousand ounces you could buy a house. Today, you could buy one hell of a car with a 100 ounces and a very nice house with 1000 ounces of gold."

GLA: What are your thoughts on technical analysis, given that gold *is* a currency?

NB: Technical analysis works if you're looking at widely distributed stocks like the S&P 500, for example, where there are many, many transactions that accurately reflect public sentiment. The price of gold, however, can be impacted by one country, or one very wealthy individual who wakes up one morning and decides to buy, and then you can throw the charts away. Or when a government decides to sell or a government intervenes. I've looked at technical analysis for gold in the past and tried to back-test with various techniques and found that they *don't work* more often than they do. In the most recent case, there is no justification for the drop in gold price; it should have been rising because nothing has fundamentally changed. In fact, the fundamentals got worse and the gold price should have rallied. None of the problems went away; nothing was solved; the conditions are as bad as or worse than they were previously. So the drop in gold's price has been a false decline.

GLA: So, it's the value of paper currency that changes, not the value of gold [so to speak]?

NB: One of the attributes of gold as money is that you can't simply create it at will, like paper money. It's no one else's promise of performance and it's not someone else's liability. It's not going to zero, no matter what. And, whether we're moving the measuring stick of inflation or deflation really doesn't matter, because the way gold should be measured is in terms of purchasing power. It doesn't matter if gold is priced at $1,000 in paper money per ounce or $2 in paper money per ounce, it will retain its purchasing power in either circumstance.

The first important step in the big picture of understanding gold is that it is a store of wealth with a 3,000 year history, and it's money. Over the long term, it retains its purchasing power. That's why they say that an ounce of gold will always buy a man's suit.

Apart from that, the US dollar is down 85% in purchasing power since 1971. In 1971 you could buy a car with 100 ounces of gold; a car was about $3,500 and gold was $35 an ounce. With 1,000 ounces, or about $35,000, you could buy a house. Today, you could buy several cars or a luxury car with 100 ounces, and a mansion with 1,000 ounces. You could also buy more units of the Dow Jones Industrial Average with your ounce today than you could in 1971. So that ounce has preserved its purchasing power while currencies have lost over 80% of their value.

GLA: Apparently, in the last 40 or 50 years, there's only been three years that there was net selling by gold investors, three years out of almost half a century. Is this true?

NB: People who hold bullion tend to hold it for a long time, as the core of their entire wealth. It's not sold once you understand its basic characteristics, because you have to have a reason to sell it, you have to use it to buy something better. I tend to look at investment performance as to whether I end up with more gold ounces or less gold ounces rather than percentage returns; you get a different conclusion then. For example, if you had invested 44 ounces in the Dow in 2000, you would now get back only 14 ounces.

This current cycle is not a conventional bull market in precious metals; I think we're in the midst of a change in the global monetary system. This is not going to be like a typical commodity cycle where we go up for four years and down for four years; I think we're witnessing a transition into another monetary system, whatever form that may take. At the end of this period the US dollar will no longer be the world's reserve currency.

GLA: What happens if the US dollar ceases to be the standard?

NB: What happened when the British pound ceased to be the standard? It just ceased to be the standard. Its decline in value is still ongoing. It's happened to every empire throughout history: the British, the Roman, the Greek, the Spanish, the Persian, and the Chinese. Every single empire ended up debasing their currency in order to maintain the empire.

"Every single empire has always debased the currency to pay the troops to defend and maintain the empire."

GLA: Is gold likely to increase further going forward or has it topped and investors have missed out?

Currently, we have a lot of noise in terms of the credit contraction, real estate bubble, record high debt at all levels, dangerous derivatives vulnerabilities and unsustainable US current account and trade deficits. These could still blow up into bigger problems at any time. However let's hope they get resolved or at the very least postponed somehow.

But there are two factors that are not changeable in all of this.

First: The US has to print money on an accelerating basis. Has to – because of the underfunded Social Security and Medicare obligations – which at present are about $60 trillion. If you took all of the net earnings of US individuals and companies it would not be enough to pay that off. You can't tax people enough and politically you cannot tell everybody, "Sorry, we can't give you your Social Security – we don't have the money. And no Medicare either." So they have to keep printing money.

Second: The issue of Peak Oil – it used to be a debate as to when the production of oil would peak. Now it looks like that has already happened, in March 2006. As a result we have a situation where oil production is declining while demand is increasing, particularly from India and China. This will result in ever-increasing oil prices, and also increasing prices for almost every product and service.

As these two forces – increased money printing and peak oil – interact, the result is a declining dollar alongside constantly increasing oil prices. This leads to even greater oil price increases in an effort to offset the dollar decline. These two highly inflationary factors are working in tandem, and they can't be changed.

Therefore, as oil rises and the dollar declines, commodities – and particularly precious metals – will continue to rise.

GLA: What's the relationship between oil and gold?

NB: There's not necessarily a great deal of correlation between the two in the short term. However, in the longer term, the correlation has been in the order of about 16 barrels of oil for every ounce of gold.

GLA: Has that been consistent long term and what is the outlook for precious metals?

NB: With only short-term fluctuations, this ratio has held up over the long term. At this point the price of gold is undervalued compared to the price of oil. Gold should be closer to $1,500 an ounce if you use this measure.

On top of this kind of inflationary issue eroding financial confidence, we're at peak production in gold. When the price of gold was low, miners employed high-grading to get the most easily attainable gold out of the ground. As the price rises, miners resort to lower-grade mining, which has become worthwhile – but in some cases you have to sift through tonnes of ore for each ounce.

Platinum, for instance; it takes six months to get an ounce of platinum out of roughly 10,000 tonnes of ore. Right now, almost all the platinum produced originates in South Africa, and the mines are miles underground, and electricity intensive. Power shortages in South Africa are interfering with production and slowing things down. All these forces are coming together, slowing production and driving up prices.

With silver, most of the aboveground reserves have been depleted – most of the silver that is produced is consumed each and every year. Silver also has two demand drivers – monetary and industrial. The number of industrial applications are growing every year while the monetary demand has also been growing in the past few years. It is important to remember that "silver" means "money" in several languages.

GLA: Why is gold so important as an element of diversification for investors?

NB: Take a look at the cycle from 1968 to 1982 – during that time it took stocks the whole 14 years to break even. If you factor inflation into it, it actually took until 1995. So stocks didn't look so good in the past cycle, and they are not looking very good now. The DJIA is well below its inflation-adjusted highs. Its performance is much worse when measured in gold ounces. The DJIA has declined from a high of 44 ounces of gold in 2000 to about 14 today, but if you look at a chart the Dow appears to be at new highs. It's like taking the Zimbabwe stock market and saying, "Look how well Zimbabwean stocks have done; the market was up 8,000%." But what if we adjust for the 100,000% inflation in that country? Not so good, is it?

BMG BullionFund is internally diversified. We buy physical gold, platinum, and silver in equal amounts. While some people like to focus on gold, they would miss out on the fact that silver and platinum have both outperformed gold since the beginning of this cycle in 2002.

GLA: What do you do about inflation?

NB: First, it is important to look at real inflation. What is real inflation? The real number is around 9%, not 3%. The calculations the government uses for the Consumer Price Index (CPI) are really meaningless as a true inflation indicator. The real definition of inflation is an increase in the money supply that leads to an increase in prices. Prices do not increase on their own unless you have a shortage; when you increase the money supply, what you're really doing is debasing the currency, and as the purchasing power of the currency declines prices appear to be rising. So with the US money supply (M3) growing at 20%, Canada's growing at 9%, and most other countries' growing at around 15%, that's going to result in rising prices and real inflation.

If you take real inflation into account, Wainwright Economics suggests that the appropriate bullion allocation for a bond investor's portfolio is 18%, and for the equity investor's portfolio 40%, and that's just to break even with inflation. Although this may sound incredible, think of the 1970s. How much bullion was required just to break even in an equity portfolio? Bullion went up 2,300%, while equities were flat on a nominal basis. Inflation was 15%.

So without even getting wrapped up in a discussion about the complex subject of money, those two points are fairly straightforward. Ibbotson Associates confirmed that precious metals are the most negatively correlated asset class to the traditional financial assets, so it gives the biggest bang for the buck for the least amount of allocation. In the process you also achieve a more balanced, diversified portfolio. Advisors would do well to have an allocation to precious metals to protect their clients from under-diversification.

GLA: Do you think this pullback in gold is an opportunity to add to positions at this time?

NB: Yes as long as there hasn't been a major change in the fundamentals that drive the price. When these pullbacks occur, you always get some technical interpretations, whether it's conventional technical analysis or Elliot Wave, coming out with the idea that the bull market in precious metals is over and that it's now going down forever and so on.

When these things happen, you have to ask if anything changed fundamentally to justify that decline. If nothing changed fundamentally, the only conclusion you can draw is that something's wrong in the technical interpretations. In all likelihood the technical interpretation is wrong because there's been an intervention by monetary authorities. Technical analysis only works when the markets are working freely.

GLA: Well, whatever it is they're trying to do to knock the price down, once again, he who wins in the end is he who has the most ounces and the most shares. It's got to have been a good year for you with gold prices up 10%, silver up close to 19% and platinum prices over 30%.

NB: Yes, it has. We have grown assets year-over-year by 80% this year alone, so it's been a substantial increase, and performance-wise, we're about 20% year-to-date.

GLA: Thank you very much for sharing your knowledge with us.

***All amounts expressed in US dollars, unless otherwise noted.**