A GOLDEN DELICIOUS INVESTMENT

February 2017

"Nothing beats a little cash in a bear market, of course, and the oldest form of cash is gold."

— James Grant[1]

Having owned physical gold for more than a decade, we thought it worthwhile to revisit our investment hypothesis once again. In this analysis, we share our reasons for owning gold in today's investment environment, both from an investment standpoint and from an ESG standpoint.

We first began investing in gold for our clients and investors beginning in 2005. Since our initial investment, gold has generated attractive returns while, we believe, serving its proper role as a portfolio diversifier. Since our initial purchase of gold at $550/ounce, the price of gold has increased to $1,225/ounce today, compounding at an annualized rate of 6.9%.[2] In the process of its long-term appreciation, gold has experienced two bear markets in which the price declined by more than 20%, in 2008 and in 2013. Over the past twelve years, we have received many questions from investors about the investment rationale and Environmental, Social and Corporate Governance (ESG) rationale behind our investment in gold.

We say all of this by way of introduction in order to reiterate the fact that we have a long history of investing in gold. Our conviction with regard to gold is not founded on sentiment or on short-term technical trading patterns; it is the result of thousands of hours of analysis, reading, and self-questioning. In short, we have strong conviction about our investment in gold, but we have come to that conviction honestly and analytically. The purpose of this analysis is to share the high-level reasons that drive our strong conviction.

The Investment Case for Owning Gold

Our investment thesis for owning gold is underpinned by the following four fundamental factors:

1. Gold represents a hedge in the event of a currency crisis. Foreign governments and central banks are buying gold to hedge their foreign currency reserves, which today mostly consist of U.S. Treasuries.

2. Historically, gold tends to perform well during environments when real interest rates are negative.[3] The Federal Reserve and many foreign central banks are currently pursuing what appears to be long-term policies to keep real interest rates negative, and there is little indication that these policies will not continue for years.

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[1] James Grant is the founder and publisher of *Grant's Interest Rate Observer*, a journal of financial markets. In addition, Grant has written a number of books.

[2] The projections or other information illustrating the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results an investor may have experienced, and are not guarantees of future results. Results may vary with each use and over time.

[3] The *real* interest rate is the *nominal* interest rate minus the inflation rate.

3. Overall portfolio volatility generally declines with gold as a component and key portfolio diversifier.

All of the above three factors have been true for years. With the recent election of Donald Trump, investors now have a fourth reason to own gold:

4. The Trump administration will attempt to pursue monetary and fiscal policies to reduce the value of the dollar to accelerate the return of domestic jobs and the revival of U.S. manufacturing exports.

Let us now examine each of these investment thesis assumptions in more detail.

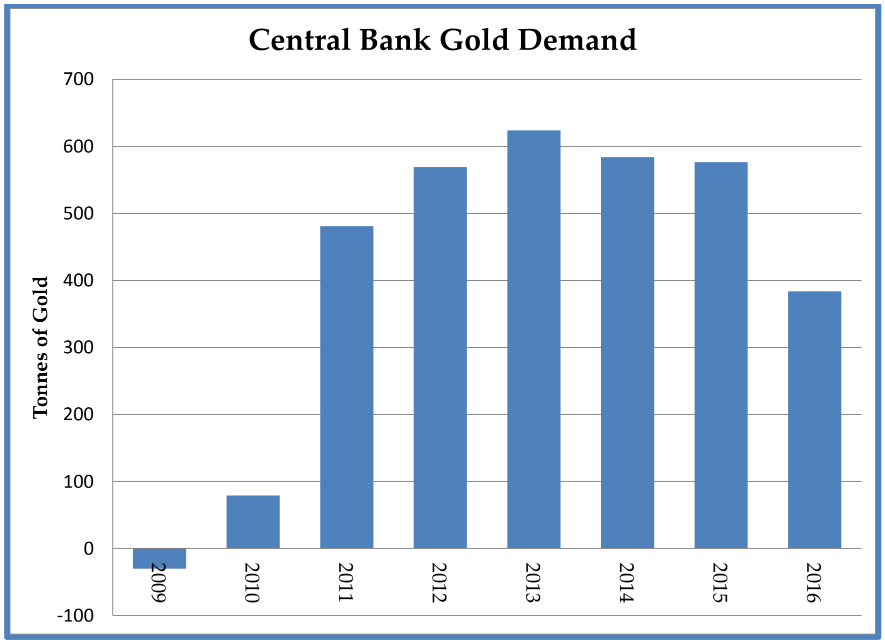
Gold represents a hedge in the event of a currency crisis. Foreign governments and central banks are buying gold to hedge their foreign currency reserves, which today mostly consist of U.S. Treasuries.

Despite misleading articles published regularly in the mainstream financial media suggesting that gold is about as useful as a pet rock, gold continues to underpin the international monetary system. Central banks around the world own gold in large quantities, and their holdings continue to increase. As of the latest report, the U.S. government owns approximately 8,000 tonnes and the European Union (including the European Central Bank) owns approximately 10,800 tonnes of gold. According to recent data reported by the World Gold Council, the United States has gold reserves representing 1.9% of U.S. GDP, the European Union has gold reserves representing 2.8% of Europe's GDP, and, across the world, official gold holdings representing 1.5% of worldwide GDP.

In the early 1970s, the Nixon administration took the United States off the gold standard, cancelling the convertibility of the U.S. dollar into gold. Henceforth, foreign governments would have to rely on the U.S. dollar to conduct international transactions, without the implicit backing of gold. For the next several decades, sovereign governments gradually reduced their gold reserves and steadily built up their dollar reserves. To facilitate this dollar-centric monetary system, the United States operated with a trade deficit in order to export U.S. Treasuries around the world that central banks purchased as foreign currency reserves.

That system continued, until recently. In the aftermath of the Great Financial Crisis (GFC), in 2009-09, after many years of gradually selling gold, foreign central banks reversed course and began accumulating gold once again as foreign currency reserves. Then, starting in 2014, foreign central banks also began selling U.S. Treasuries. These trends are worrisome for the ongoing role for the dollar as the world's reserve currency, but they are bullish for gold:

- *Gold purchases:* In 2016, central banks reported 384 tonnes of gold purchases, led by China, Russia, and Kazakhstan, continuing an unbroken record since 2009 of increasing gold reserves among foreign central banks. While European central banks have not been aggressive buyers of gold, they have been repatriating the gold that they already own.



Source: World Gold Council

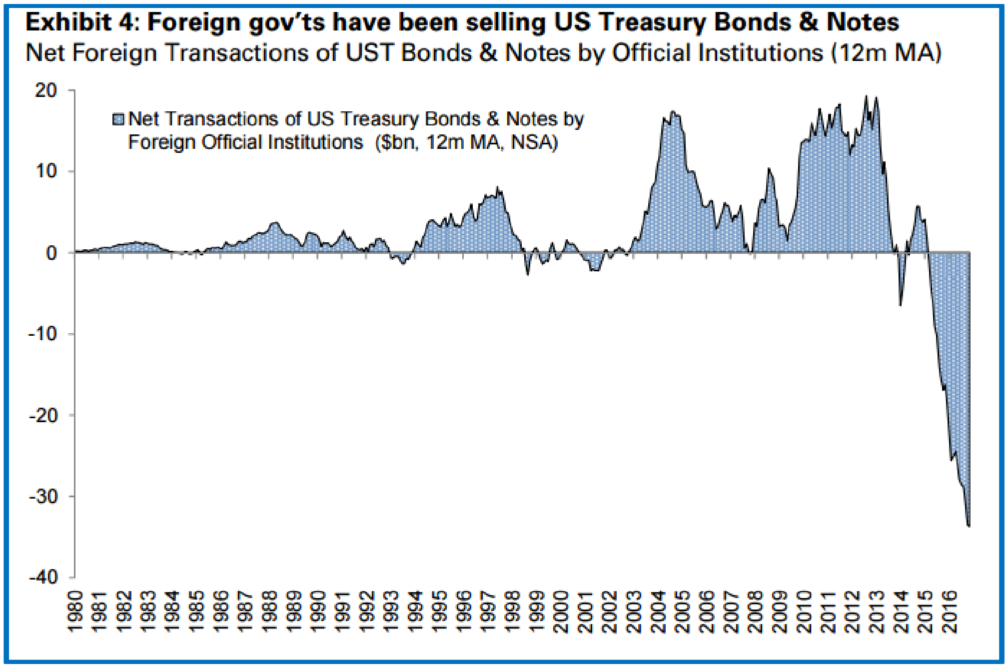
While central bankers are generally reluctant to discuss the reasons behind central bank gold purchases, Clemens Werner, Deputy Head of Market Operations for the Deutsche Bundesbank (the central bank of Germany), explained in 2013 why central banks want to own gold:

> For gold, we can identify four functions and attributes:
>
> - Universal acceptance – gold is accepted as the ultimate independent means of payment almost everywhere. Gold has no country and no currency risk. Gold has no rating.
> - Diversification – Gold provides an element of diversification to the foreign reserves of a central bank and for the balance sheet.
> - Robustness – Compared to other assets, gold is very robust against shocks, so it can be seen as an insurance in case of surprising events.
> - Gold allows for the absorption of some volatility in the balance sheet.

Source: 2013 LBMA Precious Metals Conference

We could not have put it better ourselves.

- *Treasury sales:* Since 2014, central banks in general, and China in particular, have been aggressive sellers of U.S. Treasuries. If anything, this trend appears to be accelerating. From January 2016 through November 2016, foreign central banks sold over $400 billion of U.S. Treasuries. We expect these changes are a result of an ongoing but permanent shift to a multi-polar monetary system in which the dollar's share of international transactions declines while other currencies including the Euro, the Yuan, the SDR, and gold increase in market share.



Source: US Treasury, Bloomberg, Goldman Sachs

We are continuing to see countries form bilateral agreements so they can trade directly with their own currencies. For example, China has formed currency cooperation arrangements with South Korea, Japan, Brazil, Russia, Australia, and others, in the past few years. These agreements reduce the demand for dollars and the need for foreign central banks to own U.S. Treasuries as foreign reserves. As the dollar's share of international transactions continues to decline, so too will the demand for U.S. Treasuries as foreign currency reserves. Unfortunately, for U.S. investors, these arrangements increase risk for any dollar-denominated investment assets and increase the likelihood that gold will continue to rise in price.

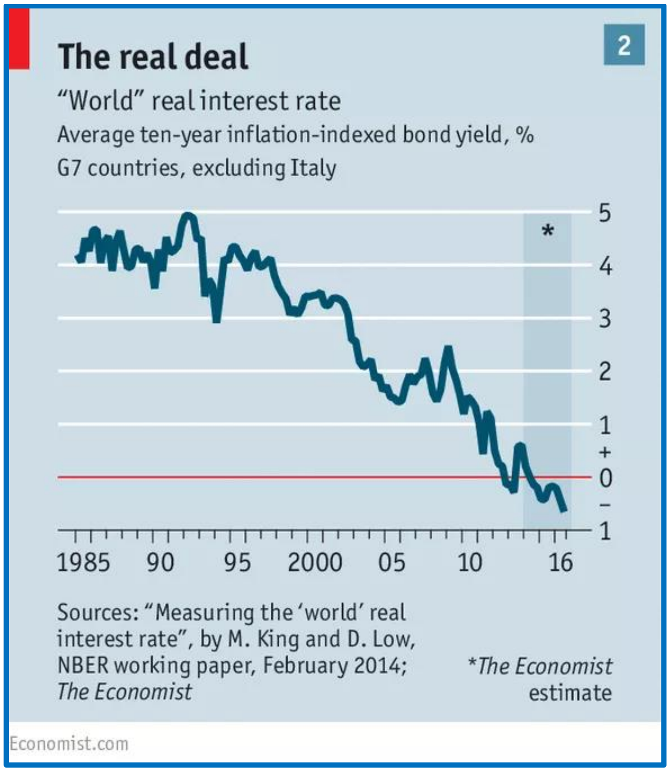
Historically, gold tends to perform well during environments when real interest rates are negative.[4] *The Federal Reserve and foreign central banks are pursuing long-term policies to keep real interest rates negative, and these policies should continue for years.*

The "real interest rate" for U.S. Treasuries is the inflation-adjusted investment return generated by owning Treasury bonds. When the real interest rate is negative, owning bonds is a recipe for long-term value destruction. During such periods, gold tends to perform well as a store of value.

The end of the last gold bull market occurred in 1981 when Federal Reserve Chairman Paul Volcker raised the Federal Funds rate to 20%, well above the inflation rate. His goal was to reduce inflation, even if his actions caused a severe recession (which they did). Once investors realized that Chairman Volcker was deadly serious about his intentions, his policies took effect, inflation declined, and the gold price plunged due to the relative attractiveness of U.S. Treasuries; it took nearly a quarter of a century for the gold price to reach its previous highs.

[4] The *real* interest rate is the *nominal* interest rate minus the inflation rate.

Real interest rates were negative only 6% of the time between 1980 and 2000, and gold lost its luster during that period.



Today, in contrast, real interest rates are negative (see chart above). Central banks are trying to reflate the global economy by keeping interest rates below the inflation rate. They are hoping to stimulate nominal GDP growth so that GDP will once again begin to grow faster than debts. Put differently, the Debt/GDP ratio in most countries is too high, and it is increasing rather than decreasing. To reverse this trend, central bankers are trying to raise the value of the denominator by pursuing monetary policies that generate accelerating inflation.

In double-checking this assumption, we turn to Carmen Reinhart, an economist who is one of the world's foremost experts on financial repression. Set forth below are several comments she made in recent months explaining 1) why negative interest rates are useful to central bankers and 2) why they are likely to persist for an extended period of time.

Professor Reinhart's first comment:

> As they have historically in the aftermath of financial crises or wars, central banks have been increasingly resorting to a form of "taxation" that helps liquidate the huge overhang of public and private debt and eases the burden of servicing that debt.[5]

[5] Source: Nikkei Asian Review, November 2016.

Today, we are still in the aftermath of the Global Financial Crisis. Governments have spent trillions of dollars bailing out the world's financial system, and now, as a result, countries across the world are suffering from growth challenges due to elevated private and public debt levels. This problem, while large, is not improving, despite best efforts to reflate the world economy on the part of central banks. Whatever the reasons were to keep interest rates negative in the immediate aftermath of the Global Financial Crisis, those reasons are only more important today. Moreover, according to Professor Reinhart, they are unlikely to disappear anytime soon.

Professor Reinhart's second comment:

> In an era when public debt write-offs (haircuts) are widely viewed as unacceptable (witness the European Union's position on Greece) and governments are often reluctant to write off private debts (witness Italy's reluctance to impose a haircut on holders of banks' subordinated debt), sustained negative *ex post* returns are the slow-burn path to reducing debt. Absent a surprise inflation spurt, this will be a long process.[6]

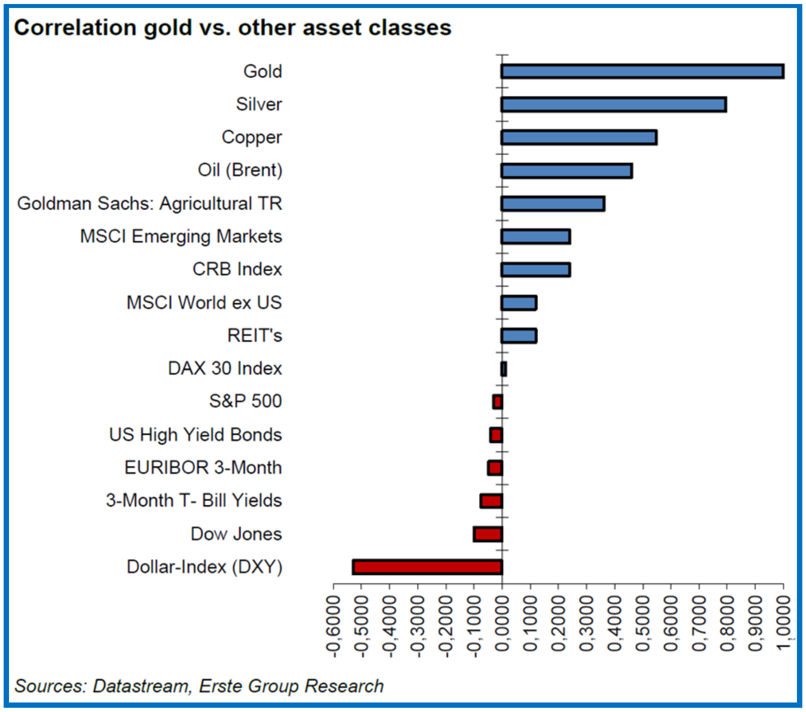
Given the backdrop described by Professor Reinhart, it seems highly unlikely that Chairwoman Yellen or any other Federal Reserve Chairperson would hike real interest rates today the way that Chairman Volcker did in 1981. There is simply too much debt outstanding that requires cheap financing, from corporate debt to auto loans to student loans to obligations of the U.S. government itself. Moreover, the same dynamic exists across the globe. An extended period of positive real interest rates would likely catalyze widespread bankruptcies and, in all likelihood, a systemic banking crisis, causing adverse consequences for the economy and for the world monetary system.

Today's central banks around the world have far less flexibility to raise rates as compared to the Federal Reserve of Paul Volcker. We expect real interest rates to remain negative until Debt/GDP ratios decline, and, as a result, we believe today's investing backdrop is an excellent environment for a higher gold price.

Overall portfolio volatility declines with gold as a component and key portfolio diversifier.

The price of gold tends to be inversely correlated to the dollar and largely uncorrelated to stocks and bonds. As such, we believe gold can provide an important role in investment portfolios by reducing overall volatility. The upside to this low correlation to stocks and bonds is that in significant bear markets, investment portfolios with significant stock allocations are partially protected from price declines. The downside for using gold strategically as a diversifier in a portfolio is that gold can hold back portfolio returns when stocks are appreciating sharply, such as what occurred in 2013 during a disinflationary environment.

[6] Source: Project Syndicate, July 2016.

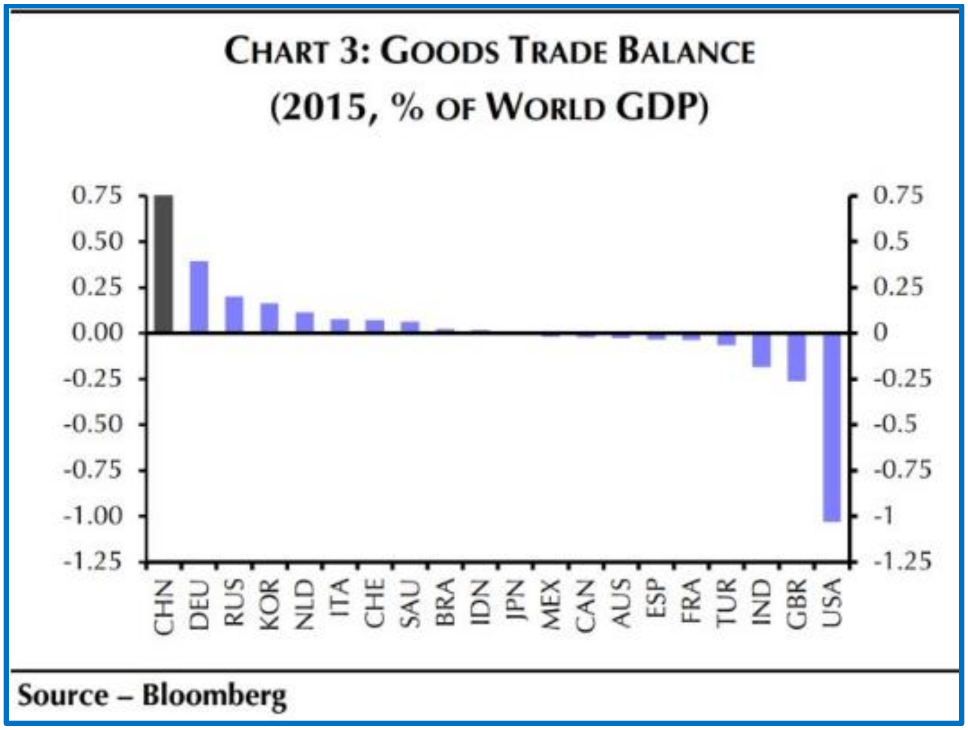


From a risk management standpoint, in the current environment, and given our view that the dollar and U.S. stocks are significantly overvalued, we think that gold serves as an excellent hedge for our investment portfolio.

The Trump administration is pursuing monetary and fiscal policies to reduce the value of the dollar to bring back domestic jobs and revive U.S. manufacturing exports.

Reviving U.S. manufacturing is a key policy priority for the Trump administration. Trump's electoral success hinged on certain swing states of the Midwest, and we think it will be a significant priority for Trump to attempt to deliver additional manufacturing jobs to these states. In order to succeed, however, Trump needs the dollar to depreciate against the Euro, the Japanese Yen, and the Chinese Renminbi. In January 2017, Donald Trump provided confirmation when he told The Wall Street Journal, "Our companies can't compete with [Chinese companies] now because our currency is too strong. And it's killing us."

There are a number of levers that Trump could pull from a policy statement. With an aggressive fiscal policy, Trump could probably reduce the value of the dollar by aggressively increasing the Federal deficit through a combination of infrastructure spending and tax cuts, financed by U.S. Treasury purchases by the Federal Reserve. Alternatively, if Congress does not pass a sufficiently aggressive fiscal package, the Federal Reserve could pursue monetary policies to reduce the exchange rate value of the dollar. Ben Bernanke provided a possible recipe in his famous 2002 anti-deflation speech when he suggested that the Federal Reserve could depreciate the dollar by printing money to buy foreign debt. He said, "The Fed has the authority to buy foreign government debt, as well as domestic government debt. Potentially, this class of assets offers huge scope for Fed operations, as the quantity of foreign assets eligible for purchase by the Fed is several times the stock of U.S. government debt."[7] The target of such purchases would surely be the two countries to the far left side of the chart below, China and Germany, which have the largest trade surpluses.



In our view, we think that Trump is likely to be successful in driving down the value of the dollar during the course of the next four years. If we are right, we expect the dollar to decline in value, and gold to appreciate in value.

Investment Risks

The primary risks of owning gold are three-fold, in our view.

1) *Dollar Strength*.
In the short-term there are reasons that the dollar could strengthen, and such an occurrence would temporarily depress the price of gold. For example, if Congress passes a law allowing U.S. companies to repatriate their foreign cash, a repatriation holiday would be very bullish for the dollar in the short-term. For many of the reasons previously discussed, any further dollar appreciation would likely be met with a strong policy response that would depreciate the dollar and support a higher gold price.

2) *Opportunity Cost*
Investors could suffer an opportunity cost in owning gold. While gold could perform well, we might be able to generate even better returns owning other asset classes besides gold. We think this risk certainly

[7] Source: "Deflation: Making Sure 'It' Doesn't Happen Here", Ben Bernanke, November 2002.

exists; emerging market stocks, in particular, could perform quite well over the next ten years, and we believe Japanese and Korean stocks are particularly attractive as a long-term investment right now. However, gold represents a portion of assets invested in Appleseed Capital strategies at the present moment, which gives us plenty of opportunity to deploy capital into other outstanding investment opportunities besides gold.

3) *Confiscation or Confiscatory Taxation*
   Sovereign governments could choose to confiscate gold or otherwise penalize owners of gold. While this is certainly a risk, we suspect this is unlikely to happen due to the threat of gold trading moving to the black market.

<u>Investing Opportunity</u>
In the long-term, we believe the price of gold will rise and should outperform the S&P 500 Index over the next five to ten years. Having said that, we do not have a strong opinion as to *when* the market will agree with us. The answer is probably less dependent on market sentiment and more dependent on geopolitics. Given the inexpensive price of gold relative to other financial assets, as gold investors, we are patiently await for events to develop.

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Environmental and Social Implications of Owning Gold
In Appleseed Capital portfolios, we are not just interested in generating an attractive financial return; we want to earn an attractive financial return by investing with a light footprint. We think there are a number of important environmental and social considerations which make gold an attractive investment from an ESG standpoint.

- *Owning gold is not the same thing as owning gold miners*
  Gold mining is admittedly a dirty business from an environmental standpoint, and, in many countries, gold mining is also a business with questionable human rights implications. Furthermore, gold mining also happens to be a terrible business with poor returns on capital. We have never owned any gold miners, and we do not expect we ever will own any gold miners. However, owning gold bullion locked in a vault is a very different proposition than owning a gold miner.

- *Gold bullion is recyclable*
  Many investors want exposure to commodity-related investments, due to the diversification that such investments provide to an investment portfolio. Many environmentally sensitive investors are attracted to renewable natural resource companies, such as sustainable timberland or farmland, or to alternative energy companies, such as wind or solar producers.

  Gold is not renewable, and it does not generate alternative energy, but it is a unique commodity because it is the only recyclable commodity that exists on the planet. Every other commodity is produced to be consumed, either as food, as energy, or as an input into an industrial production process. In contrast, gold is never consumed because it is a monetary metal. Instead, it is purchased, then held by its owner for a period of time, then sold to somebody else who also plans to hold it.

Because it is purchased for its value, gold is very rarely consumed. Furthermore, because it is recyclable, annual gold mining production represents only 1% to 1.5% of the above ground stocks of gold. In other words, when we buy gold in a vault, approximately 99% of it is coming from secondary sources, such as other gold investors, or central banks, or from melted down jewelry, while just 1% of it is coming from gold production. This makes gold profoundly more environmentally neutral than any other commodity as an investment. Indeed, most of the world's above ground gold supply was mined years ago or, in some cases, thousands of years ago.

In contrast, a related commodity like silver has very different characteristics. Silver is used primarily as an industrial metal, and, because of that, annual silver production is approximately equal to the above ground stocks of silver. If an investor wants to own silver in a vault, one would likely have to mine all of that silver out of the ground to do so.

- *Gold bullion is conflict free*

  The gold bullion that our gold trusts own are in the form of London Bullion Market Association (LBMA) Good Delivery bars. These bars must adhere to a certain set of criteria with regards to quality, including assurances that the supply chain from which the gold comes is conflict-free. The Responsible Gold standard is rigorous and requires the involvement of third-party auditors:

> The LBMA Responsible Gold Guidance mirrors the OECD five-step framework for risk-based due diligence in the mineral supply chain. The definitions are based on the OECD's definitions as well as the Financial Action Task Force on Money Laundering's definitions (FATF). International auditing standards that independent and competent third parties auditors must use include ISAE 3000 and ISO 19011:2002, to incorporate both US and EU auditing systems for AML and KYC. The LBMA Guidance goes beyond the requirements of the OECD Guidance in both its auditing requirements and its definition of conflict. Auditing is required for all refiners' production regardless of the source of their feedstock. This ensures that all metal going through the refinery is conflict-free.[8]

We take comfort in the fact that gold is recyclable as a monetary metal, but we are also encouraged that any LBMA Good Delivery bars are sourced through a responsible and audited conflict-free supply chain.

[8] Source: LBMA Responsible Gold Guidance.

Disclosure

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