

“I’m Melting, I’m Melting!!!”

The wicked witch in *The Wizard of Oz* screamed this infamous line at the climax of the movie, and we were all relieved as she evaporated, leaving behind nothing but her black hat. But unlike film viewers, many gold investors won't be rejoicing when this precious metal starts to melt down. When will that be, you ask? No one knows for sure. However, there's little doubt that gold is displaying all the classic signs of a bubble.

The late Hyman Minsky (1919–1996) was fondly referred to as “Bubble Boy.” He was an American economist and professor of economics at Washington University in St. Louis. His research attempted to provide an understanding and explanation of the characteristics of a bubble. He identified five stages: displacement, boom, euphoria, profit-taking and panic, which are explained as follows:

Displacement

Displacement begins when investors become enamored with a particular investment. It could be new technology (the Internet craze in the late 1990s), an innovative new strategy (Enron's approach to energy), or a combination of circumstances, such as the ones that created and fueled the housing bubble — reduced regulation and artificially low interest rates. He called this phase displacement because money leaves diversified capital markets and starts to pile into the hot investment.

Boom

During the boom phase, prices begin to rise — based initially on underlying improvements and fundamentals. People take notice, the media hypes it and the hot investment becomes common knowledge. The message to everyone becomes “Don't miss out!” As the market starts to overheat, the laws of supply and demand kick in and prices run out of control. As price increases gain momentum, it attracts more outsiders because of easy profits.

Euphoria

During the euphoria stage, accelerating prices eventually attract the foolish, greedy and desperate to enter the market. Wise, rational voices begin to stand up and say that the bubble can no longer continue. They will use convincing arguments based on fundamentals and sound economic logic as well as pointing to bubbles of the past. But they will be shouted down by the insanity of buying as prices continue to rise and “experts” proclaim that the world is different now. Those who haven't entered the bubble are stuck in a terrible dilemma. They know they've missed most of the run-up in value, but they continue to be bombarded daily by stories of easy money and of friends making big profits.

Profit-Taking

While those late to the game are still trying desperately to get in, a lucky minority begin to listen to the rational voices and make a quiet exit. The fundamentals that supported the run-up have surpassed any measure of reality. The upward trend might dip a little, but there is no noticeable signal because there are still enough speculators who have finally decided to buy. Why not buy, since this has been going up for months or years now? Why wouldn't it continue?

Panic

Seemingly overnight, something triggers the end of the bubble. It could be the end of cheap credit, the exodus of a large shareholder or the obvious unveiling of the fallacy of it all. It's as if the building is on fire and everyone starts to run for the door. Most want to sell, but there are no buyers. Who would want to buy at this point? Everyone now finally knows it is an unsupportable bubble. Panic sets in, prices plunge and losses start to accumulate and credit dries up.





The Internet Bubble

The Internet bubble is a good case study since its path in the market is so well-documented. The Internet did, in fact, change the way people do business and made the world more connected. So, it was natural that investors wanted to be part of it and had trouble determining its true value.

If you invested in the NASDAQ in 1995 and stayed through 2003 you ended up with an average annual return of 12.2%. That's not bad! Here is the performance year by year and the impact on \$1 million invested in January of 1995.

<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>
41%	23%	22%	40%	86%
\$1.4	\$1.7	\$2.1	\$3.0	\$5.5

Now the Meltdown:

<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
-39%	-20%	-31%	51%
\$3.4	\$2.7	\$1.9	\$2.8

You can see why the NASDAQ returns were so bewitching in the early years. Everyone was raving about the results. It was easy money. But how would the typical investor react? In 1999, after five years, that investor's account value had grown to \$5.5 million. However, that same investor had only \$2.8 million by the end of 2003 — IF they were still invested. An average annual return of 12.2% is good. But would it really feel good knowing you had "lost" almost \$3 million from 2000 through 2003? And how likely is it that you would still be invested in the beginning of 2003 after losing 90% from 2000 to 2002? If you missed 2003 you would have missed out on a 51% return.

For an interesting comparison, let's look at the results of an investor in the S&P 500 from 1995 to 2003. The average annual return would also have been 12.2% — an odd coincidence. Through 1998, the S&P investor was actually keeping pace with the NASDAQ investor (NASDAQ = \$3.0 million, S&P = \$2.9 million). Then in 1999, the NASDAQ investor almost doubled their money.

<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>
38%	23%	33%	29%	21%
\$1.4	\$1.7	\$2.3	\$2.9	\$3.5

Now the Meltdown:

<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
-9%	-12%	-22%	29%
\$3.2	\$2.8	\$2.2	\$2.8

Would the S&P investor be tempted to shift their money to NASDAQ after seeing that return of 86%? Many did — and suffered even worse losses from 2000 through 2002 as a result. Even if the S&P investor didn't switch to NASDAQ, would they have been able to stomach the 43% loss from 2000 to 2002? If so, the result would be the same \$2.8 million ending value as the NASDAQ investor. Again, a 12.2% rate of return is well within reasonable expectations for long-term investors.

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Next, we are compelled to look at how a globally diversified portfolio performed during this same time period. Guess what the average annual return was for 1995 to 2003? It was 11.9% — very close to the 12.2% earned by the NASDAQ and the S&P.

<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>
23%	18%	19%	7%	21%
\$1.2	\$1.5	\$1.7	\$1.8	\$2.2

Now the Meltdown:

<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
-5%	-2%	-15%	50%
\$2.1	\$2.1	\$1.8	\$2.7

Performance for a globally diversified portfolio was decent in the mid to late 90's but well below NASDAQ and S&P investors. It was hard for the diversified investor to listen to the others bragging about their 40% returns while the diversified investor got half. But, from 2000 through 2002, the diversified investor lost only 22% — still unpleasant, but not when compared to the 90% loss for the NASDAQ and the 43% loss for the S&P. Ironically, all three investment paths yielded similar long-term results, but it's very likely that only the diversified investor would have been able to withstand the dramatic swings in the market and actually realize those long-term gains.

Finally, let's look at what gold did during this same time period. Its average annualized return was only 0.9% for this nine-year period. Why would anyone have an expectation that gold would enhance their portfolio given this performance?

<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>
1%	-5%	-21%	-1%	1%
\$1.0	\$1.0	\$0.8	\$0.8	\$0.8

Now the Meltdown:

<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
-6%	-1%	26%	20%
\$0.7	\$0.7	\$0.9	\$1.1

We at RCG wrote our first article on gold in 2009. Since then, the price of gold has increased 80% to around \$1,800 an ounce. That is an 80% increase in less than two years. But that doesn't change our advice. Simply put, investing in gold at any time in the last 30 or more years would have been speculative. Said another way, there would be no expectation that it would enhance a well-diversified portfolio. In a September 17 *Wall Street Journal* column, Jason Zweig wrote: "Unlike bonds, which provide interest income, and stocks, which produce dividends and earnings growth, gold generates no cash flows. As a result, there isn't any reliable way to tell what it is worth. Folks on both sides would be more intellectually honest if they admitted that they are just guessing what gold is worth."

Bubbles are just another example of how investors can be their own worst enemy. Timing the market and chasing bubbles usually results in lower returns than just sticking with a boring, low-cost, globally diversified portfolio that is rebalanced with discipline.

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So, while speculators look at gold and say, "I'll get you, my pretty, and all those profits too," remember, this movie always ends the same way ... with a memorable meltdown!

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