

Should We Invest in Gold?

Over the years, several clients have asked for our view on gold as an investment and whether or not we would include it in their portfolios. As you can see in Graph 1, the gold price in dollars bottomed out in early 2001 following a 20 year downward trend. Since that point gold has levitated to today's level, around \$1,500 per ounce. Please note that this graph is adjusted for inflation in order to compare apples to apples – in 1980 dollars, the price of gold peaked at \$850 per ounce in January of that year.

Graph 1: Historical Gold Price, Adjusted for Inflation

Data as of March 2011



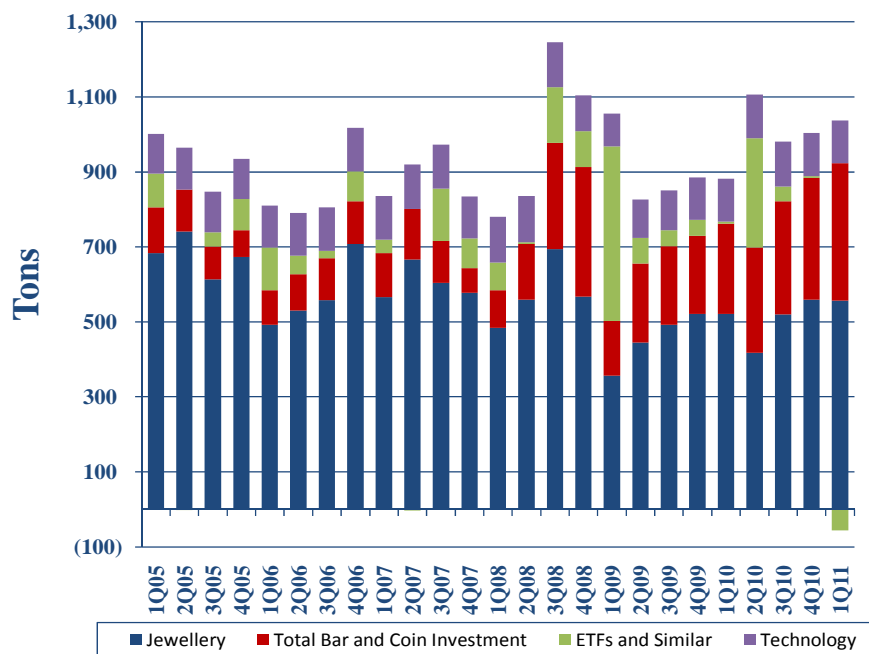
When an asset class rises in price like this, it is natural for clients to wonder whether they should be involved and if they are not participating, why not? Despite the financial media attention and advertisements you may hear on the radio or see on TV, the demand for gold, in tons, has remained fairly constant over the last five years. However, the sources of demand have changed, illustrated in Graph 2. Over this time period, demand has increased for gold bars and coins as well as gold exchange traded funds. An exchange traded fund (ETF) is an investment that one can buy and sell shares in and it trades like a stock on an exchange – typically an ETF attempts to mimic the price movement of a certain

index, like the S&P 500. In the case of gold ETFs, they are supposed to mimic the movement in the price of gold.

Since the market determines gold’s price almost solely by what the next buyer will pay rather than an industrial supply and demand relationship, it appears that the recent increase of buyers in very liquid markets, like coins and ETFs, has caused an extremely positive feedback loop for the price of gold as well as the shares of gold ETFs. Two popular gold ETFs have each increased 225% in price over the previous five years, in line with the rise in the price of gold.

Graph 2: Recent Sources of Gold Demand, measured in tons

Sources of Gold Demand



Source: GFMS, LBMA, World Gold Council

The concern that we have and reason why Darrell & King has not invested in gold, in the form of ETFs, is that we possess no way of valuing gold over time. As referenced above, gold has limited industrial uses, so it is mainly held as either jewelry or as an investment/store of value. Since gold is not depleted in the same way as other commodities, like oil or foodstuffs, traditional supply and demand analysis does not make sense. The new mined gold supply is constantly adding to the existing supply.

Although there is a convincing argument that gold has been a store of value when compared to paper currencies over time and that the US government has undertaken a number of measures that have led to a decrease in the value of the dollar, gold does not generate any cash flows, so it is impossible to estimate it’s real worth.

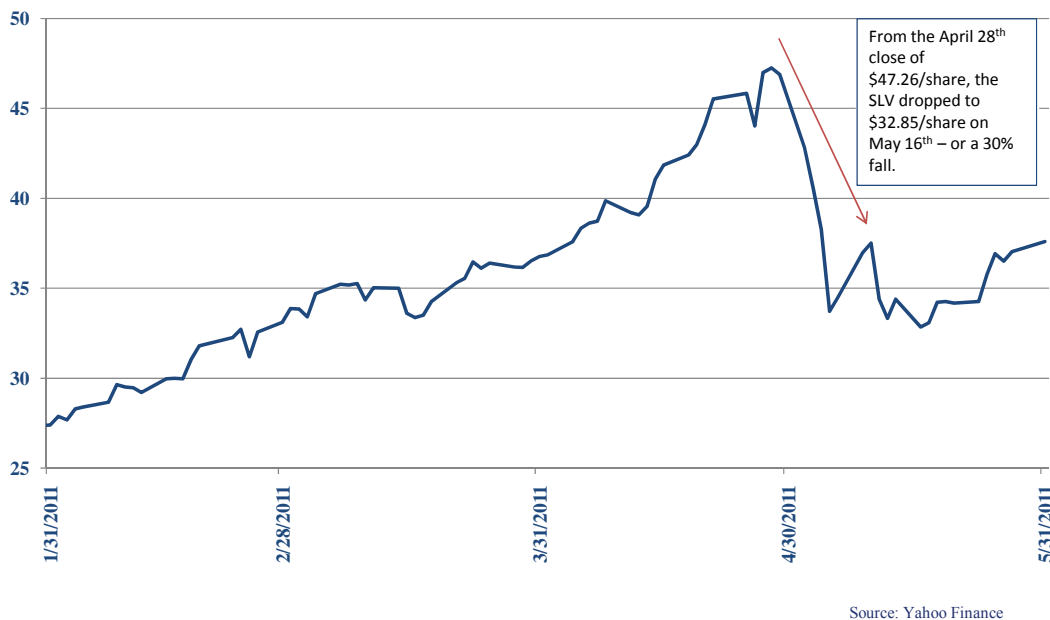
When clients called in during the depths of the stock market in late 2008 and early 2009, we could tell them that stock XYZ looked like an extremely exciting investment. We could point to things such as

recognition of the underlying company as a world class brand, the balance sheet looking great and the stock trading at a cheap multiple of cash flow. These factors provided a favorable risk/reward profile.

Significant price volatility risk exists with both gold and silver. What if the price of gold corrected tomorrow like the price of silver did in May, see Graph 3 (depicted by a swoon of 30% in the ishares Silver Trust ETF)? The truth is that Darrell & King could not determine whether the price of gold should be higher or lower, even if the price declined by half. Gold possesses no cash flow and cannot readily be valued. That is why there are no shares of the yellow metal in your Darrell & King account.

Graph 3: Recent Price Performance of the ishares Silver Trust ETF (Ticker: IAU)

ishares Silver Trust Recent Price History



Does Darrell & King Invest in Any Commodity Stocks?

The background on the recent movement in gold does not mean that Darrell & King avoids investing in all commodity related stocks. Several commodities exist whereby the underlying commodity is actually depleted through its use. For example, oil fits this description. The data on supply and demand for oil, as well as the Organization of Petroleum Exporting Countries' (OPEC) target minimum price per barrel, is readily available. Similarly, the reserves of the various oil companies are disclosed in company filings. Therefore, it is far easier to estimate cash flows and earnings for oil companies than for gold or gold related companies.

We are pleased to be your investment manager and continue to stay the course with our battle tested investment strategy. If you have any questions, please call or stop by at your convenience.

DARRELL & KING
INVESTMENT COUNSEL, LLC

410 White Gables Lane • Charlottesville, Virginia 22903
434-977-7010 PHONE • 434-977-6313 FAX • www.darrellandking.com