Chapter 1

A Compelling History

In This Chapter

- Checking out the history of precious metals
- Taking a look at gold and silver's track records
- Reviewing the precious metals' bull market of 2000

Long, long before government-issued currency, such as the dollar or the euro, existed, people must have had something else to help them trade with each other. How did people buy stuff they needed? Before there was any kind of currency, there was bartering unless you were a barbarian and preferred plundering. Civilized merchants and consumers traded goods and services, but trade did get cumbersome. For example, what if the merchant selling food didn't really want your 47 pounds of lint in exchange for a head of lettuce?

To make commerce a little easier, the buyers and sellers in the marketplace slowly decided on what could be used to facilitate trade. They decided that something had to be used as a currency, and that currency had to be portable and widely accepted as a unit of transaction, a store of value, and a medium of exchange. Whatever they chose as currency needed to be something that performed the role of . . . money! For thousands of years, precious metals — primarily gold and silver — filled the bill nicely. Very nicely.

Gold and silver came to be recognized as precious, valuable, and desirable in virtually every nation across the globe dating back to the dawn of civilized society. Now, you might ask "What the heck does history have to do in a *For Dummies* book?" Actually, history is very important because it will impact your portfolio in the coming years. History has shown us that there were (are) two major types of currency: precious metals and manmade (or government-issued) paper currencies. This chapter explains why the vast majority of paper currencies lost their value and are now gone but precious metals are still . . . uh . . . precious, making them worth a long look from investors.

In this book, I even take a step outside the word "precious" because I don't want anyone to call me "baseless." So I give you a look at the great opportunities that base metals (such as zinc and copper) offer investors and speculators (see Chapter 9).

Mining the History of Precious Metals

Everyone has used paper currency or credit measured in paper currency, such as dollars, but precious metals have withstood the test of time as a "store of value" and as a "medium of exchange" while most paper currencies in history went kaput — precious metals experts always use such technical terms as *kaput.*

Understanding why less is more

Paper currencies have a big problem: They're "manmade." Precious metals, such as gold and silver, on the other hand, aren't. Depending on who you are, you may consider gold and silver as created by God or Mother Nature's money, but in either case, gold and silver aren't — and can't be — created by mankind. Yes, you can find and extract or mine precious metals, but you can't create them out of thin air. On the other hand, over the centuries paper currencies (also called *fiat* currencies) were created by simply running a printing press — government-approved, of course. These days, the money creation authorities can do so even easier using a computer!

But being manmade gives room for abuse and misuse. Because the primary creators of fiat currencies were governments, those governments (through their power to enforce and mandate) made fiat currencies the money of (forced) choice. Because man can make money, man can then make a *lot* of money. However, you incur risk by creating a lot of money: if you create too much of it, it can slowly become less valuable, which is known as inflating the currency. Keep in mind that money is a reference to something of value that is used in exchange for something of value (such as goods and services). Currency is essentially a form of money that is generally accepted by a society as a convenient way to pay for those same goods and services.

REMEMBER

Money retains its value by being limited or scarce. So, if you make lots and lots of money then each successive unit of that same currency becomes less and less valuable. This flaw in manmade currency explains why most currencies in history became worthless, and this danger still exists today. Yet, throughout time, gold and silver have retained their value. I guess you really can't fool Mother Nature!

Giving the gold standard a gold medal

Now before you think I totally love gold and silver while totally hating paper or fiat currency, guess again — it's the competition between the two that I'm not so crazy about. History tells us that the middle ground is actually a great place to be: Backing up manmade currency with gold — called the *gold standard* — works. Some forms of currency was backed up by silver by usually silver was used directly (in coinage, for example) since it was less valuable than gold. In modern times (the 1960s and later) silver generally disappeared from circulation as a form of money and was replaced by coins made of base metals.

Throughout history, the strongest and most stable fiat currencies were backed up by precious metals. Having a gold standard in place made the currency stable and its ability to purchase goods and services also tended to remain stable. Problems usually occurred when the currency was taken off the gold standard. Just take a look at American history for an ideal example: When America was on the gold standard from about 1800 to the late 1920s, general consumer prices were stable. However, as America gradually got off the gold standard and subsequently started to increase the number of dollars circulating in the economy, prices started to skyrocket. Alan Greenspan pointed out in 2002 that consumer prices doubled in the immediate years following the abandonment of the gold standard and had quintupled by mid-20th century.

A great primer on the history of money is available at the venerable Ludwig von Mises Institute (`www.Mises.org`). There are both a video and audio (MP3) to explain in laymen's terms the role of money and the Federal Reserve (America's "central bank"). This primer presents an excellent explanation of why gold and silver are critical to our economy's well-being.

The most common financial collapse occurs when too much money is created (inflation) thereby debasing it, resulting in a currency collapse or *devaluation.* The U.S. dollar is currently being created ("increasing the money supply") at a record pace and its value is shrinking at an alarming rate. History tells us loud and clear that diversifying even a small amount into precious metals is a prudent move.

Going for the gold

Nobody knows the exact details regarding the origin of gold usage, but the use of gold as money goes back to ancient times. Gold became an ideal form of money because of its durability and easiness to carry. It quickly became the most widely accepted currency among many different societies.

Gold became widely used as money in the American colonies with the Coinage Act of 1792. It played a major role in the U.S. economy up until 1933 when President Franklin D. Roosevelt prohibited the ownership of gold by private citizens. This prohibition only affected gold assets that could have been used as a competing currency, such as gold coins, bullion, and gold certificates. (For more information on gold coins and bullion, see Chapters 10 and 11.) Imagine that you do the smart thing in accumulating gold to preserve your wealth during the Great Depression and the government ends up confiscating it. Let's hope that it doesn't happen again.

Fast forward to our times and to what is unfolding in our economy and financial markets and you see that the conditions are ripe for gold to return as a necessary element in not only investors' portfolios but for consumers in general. As currencies lose valuable across the globe, more sturdy forms of money will emerge and nations will return to what has worked for centuries; precious metals.

Seeing the silver lining

Silver over the centuries had a unique dual role: monetary (used as money) and industrial. Going back to ancient times, silver was very commonly used as money, whether as minted coins or as a backing to paper money (such as silver certificates). Since it typically had a much lower monetary value than gold, it was actually more commonly used in commerce since it was great for smaller transactions. After all, wouldn't it be silly to buy a candy bar with gold anyway? Silver also proved to be a very versatile and useful metal for industry. Because of this, silver actually has some outstanding qualities for investment-minded folks. (See Chapter 6 for more details.)

Mentioning other metals

No book on precious metals would be complete without mentioning the other metals that have such great potential for investors. Here are some to consider:

- **Platinum:** A very pricy metal with attractive prospects for investors and speculators. (See Chapter 7 for more information.)
- **Palladium:** The "other white metal" offers some affordable investment opportunities as well (see Chapter 7).
- **Uranium:** Is a spectacular precious metal that is a great way to speculate in the world of energy as nations the world over build nuclear power plants (see Chapter 8 for full details).
- **Base metals:** They may be cheaper than precious metals but don't discount their powerful profit potential (Chapter 9 gives you the exciting details).

Taking a Look at Track Records

Before you check out each metal's track record, keep in mind that precious metals undergo major multiyear bull or bear markets reflecting the overwhelming economic and financial factors of that era (see the section, "Grappling with Bulls and Bears," later in this chapter for more about those markets in specific eras). Metals, both precious and base, are solid considerations for investors and speculators to get involved with but the bottom line is really the profit potential. The simplest way to judge the future potential of something is to check its past performance: the track record. Since 2000, metals and their related investments have had an enviable track record. I get into the specifics in the following sections.

Gold

Gold is the quintessential precious metal. "Good as gold" is more than a catch phrase; it 's the essence of gold's performance in recent decades. Some years from now they may change that phrase to "as sensational as gold."

That '70s metal

The 1970s was a historic time for our country's economy as well as for gold. For decades leading up to this decade, gold had a connection to the U.S. dollar. Gold began the decade at the government imposed fixed price of $35.08. However, the controls on the gold were gradually removed as the Federal government devalued the dollar in 1971. By February 1973, the government devalued the dollar again and raised gold's price to $42.22. During this year, the dollar ceased to be tied to the price of gold; it was now allowed to float and compete with international currencies in a free market. This unleashed the price of gold and its bull market was off and running! By June 1973, the market price of an ounce of gold reached $120 in London.

In 1974, the gold market really opened up. Americans were now permitted to own gold and many countries such as Japan lifted restrictions on gold buying and selling. In 1975, trading in gold futures (see Chapter 14 for more details on futures) began at New York's Commodity Exchange (COMEX) and the price of gold was left to find its free-market level. Market demand drove the price of gold per ounce to $180 in early 1975 before temporarily dropping to $100 in late 1976. Gold then steadily zig-zagged upward until it hit $240 in mid-1978 before . . . again . . . it fell temporarily to $190 in late 1978.

1979 was the big year for gold. By any measure, it had a great performance from the beginning of the decade to this point. Especially since it was a tough decade for the stock market and other investment vehicles. By early 1979, it was evident to all that commodities in general and precious metals & energy in particular. The cocktail parties were soon abuzz with people talking about international tensions, economic problems and . . . precious metals. I'm sure that if "The Graduate" came out in that year that some boorish party guest would have told Dustin Hoffman the opportunity of the day . . . "gold." The yellow metal zoomed to an all-time $420 by the fall of 1979 before taking a final breather to $380. Within weeks, gold spiked up to its famous-yet-brief high of $870 in mid-January 1980 before it came crashing down like a rocket ship that ran out of gas at the worst possible moment. It was time to switch your money from gold investments to parachute manufacturers.

For gold, 1980 started an extended bear market (a long period of dropping prices). However, the 1970s was one for the record books. Those who invested early on and persevered through the roller-coaster ups-and-downs of the gold market were handsomely rewarded with some spectacular profit opportunities: Gold's ride from $35 at the beginning of the decade to its peak of $870 at the tail end of the decade. That represents a percentage gain of a whopping 2,386%. To contrast, look at the performance of the Dow Jones Industrial Average (DJIA), a major barometer of stock market performance. The DJIA started the decade at 809 (January 2, 1970) and ended it at 839 (December 31, 1979). That 30-point gain represents a pretty measly gain of about 3.7% (for a whole freakin' decade!). To be meticulous about it, I realize that I'm off a few weeks; gold's all-time high occurred on January 21, 1980. That month, gold started at $559.50 before it spiked to its all-time high and then settling month-end at $653. Anyway, I think you get the picture. For the late seventies, it was indeed "as good as gold."

Gold stocks go berserk

As gold raced towards its all-time high during the late 1970s (hitting $870 in an intra-day high January 1980), gold mining stocks went ape. That's right; there was (and is) more than one way to make money with gold. During the late 1970s, stocks of companies that mined the yellow metal saw their share prices rise far greater than conventional stocks. Seeing share prices triple and quadruple in the gold mining sector was a common sight. There were two types of gold-mining stocks: the large companies ("the majors") and the smaller companies ("the juniors").

Large mining stocks easily beat the stock market averages. Homestake Mining, for example, was one of the majors. Its share price went from under $5 in 1978 to over $25 in 1980. Four hundred percent up in about two years: not bad! As a category, the large mining stocks did better in the last two years of the 1970s than the entire stock market did all decade long. Junior mining stocks did even better.

Silver

Silver isn't just a second banana serving as gold's sidekick. Its past, present and future look just as shiny.

Hi-ho silver!

Dubbed the poor man's gold, silver did extremely well in the late 1970s. While the world watched the higher-profile gold market, more astute investors and speculators noticed silver in gold's shadow. On a percentage basis, it did far better than gold. Silver started the decade at under $2 an ounce. However, the market for silver was opened up in similar vein to the gold market. Silver steadily rose to $10 by the beginning of 1979. Speculative demand by investors push the white metal's price past $20. The major influence on silver's meteoric rise came from a single private source: the billionaire Hunt brothers.

It is now a part of investment folklore but it was an intriguing true story. The Hunt brothers along with two wealthy Arab investors formed the company International Metals Investment Company, Ltd., for the purpose of cornering the silver market. Silver quickly soared to nearly $50 by January 1980. The market was to change rapidly as regulators moved in. Since the buying primarily took place at New York's Commodity Exchange (COMEX), exchange officials took steps to reverse the price rise. COMEX raised margin requirements (explained in Chapter 15) and temporarily allowed only sell orders on silver. These new rules created forced liquidations and caused the price of silver to plummet. By March 1980, silver fell to under $11, a drop of over 78% from its all-time high in less than two months.

It was indeed a wild ride for silver at the end of the 1970s. As the dust settled, nimble silver investors and speculators (learn more about the difference between these two in Chapter 3) made some spectacular profits in silver. The metal went from $1.29 in 1970 to its zenith of $49.45 in 1980. The percentage gain for the decade was an astounding 3,733%, certainly a silver lining for anyone's portfolio.

The 1970s might have been a great story and a distant memory that might cause us to daydream about what fortunes we coulda, shoulda, woulda made. The wealth-building power of precious metals is behind us, right? Well . . . not quite. This writer believes that the conditions are ripe in our time for a possible repeat performance. Why do you think I'm writing this book? Stay tuned . . .

Silver stocks go to the moon

In the late 1970s, there were silver mining companies that, of course, had a lot of silver. Millions of ounces of the stuff. How well do you think they (and their shareholders) fared? By 1979-1980, many of them experienced legendary profits. Take Lion Mines, for example. It was a junior mining company that you could have picked up for only 7 cents a share in 1976. By 1980, it was worth a staggering $380 a share. No, that's not a misprint. In other words, if you had bought $184 worth of that stock in early 1976, your shares would have been worth one million dollars only 41/2 years later.

Other metals

Platinum's general price action and market fundamentals were not that dissimilar to gold and silver. Just as the 1990s (for example) were relatively quiet for gold and silver, it was a similar experience for platinum. Its price moved in comatose fashion around the $400 level (give or take $25) from 1992 to the end of the decade. From 2000 onward, it was a different story. Its price soared upward and ended 2006 at $1,118 per ounce. Since it started the decade at $433, it rose a very nifty 158% during that time frame. A similar story line happened for its lesser cousin, palladium, during the early part of the decade. (Platinum and palladium are covered in greater detail in Chapter 7.)

Palladium traded for most of the 1990s in the $100-$200 range until 1996. Market demand (palladium is primarily an industrial metal) surged for it in the second half of the decade, driving its price skyward to just over $1,000 (Jan. 2000) before crashing down to the $300-$400 range in 2001. By the end of 2006, it hit a respectable $323.50. Even after you factor in the tremendous up-and-down of the 1999-2000 period, the price was still nearly a double after 10 years ended 2006. The market fundamentals for palladium (and the other metals) look very attractive going forward (I am writing this in early 2007).

Grappling with Bulls and Bears

The 1970s showed us a decade-long bull market while the 1980s and 1990s were an extended bear market (it was generally a period of falling prices for precious metals). The factors that made the 1970s very positive for precious metals (especially gold and silver) are back with a vengeance in this decade.

As the saying goes, “History may not repeat but it does rhyme.” History is an important tool in deciphering what to do today. If the 1970s, for example, were a period of high inflation and economic difficulty, how do people react? How will they react today with similar conditions? In a nutshell, the past gives us real-time information to help us make appropriate investment decisions with “cause-and-effect” conditions. For me, it was a big reason for writing a book on precious metals since their bull market is the “effect” from the causes (inflation, economic difficulty, and so on). Kapish?

The precious metals 1980–1999 bear market

More times than not, you’ll see a bear market after (and before) a bull market (duh!). For gold and silver, 1980–1999 was such a time. Although there were some interesting rallies (brief periods of price upswings), these two decades witnessed a long, painful zig zag down. 1980–1982 was indeed a brutal period for the metals. People walking the streets would have to watch out for traders and speculators hitting the pavement like water balloons at a shriners’ convention.

There was a batch of reasons for gold's plummet. The early 1980s witnessed a dropping inflation rate which in turn meant decreasing consumer prices. Gold plummeted from its all-time high in early 1980 to $297 in 1982. However, gold staged a brief rally where the price rose to $500 in early 1983. During the late 1980s the catalyst for driving the price up during its two brief rallies was not inflation, economic problems, or international tensions. It was a market phenomenon as more buyers came in because of more discoveries of gold as new gold-rich mines were found that sparked renewed interest.

The second rally in the 1980s drove the price of gold again upward to briefly kiss the $500 level (for the last time in the century) and then it continued its downward, long-term trend. In the 1990s gold was able to touch the $400 level on several occasions, but it ended the century under $300. (The New York spot market closing price on December 3, 1999, was exactly $287.80.) The new century brought better price action for gold investors and speculators.

For silver, those last two decades were especially trying. Except for a few brief rallies to the $10, $8 and $7 levels, silver traded most of that time in a narrow range from $3.80 to $5.50. It ended the century at $5.33. What can investors learn from this?

The greatest profits come from understanding that market conditions can change dramatically over a period of years and decades that offer bullish (or bearish) profit opportunities. Sometimes a market gets beaten up so much that it gets to a point where it ultimately has nowhere to go but up. When your investment or asset hit rock bottom (what better phrase for metals?) then investigate and see if the data suggests a good entry point. The years 1999–2001 was just such a period as both precious and base metals hit rock bottom and began a long-term, powerful up move that rewarded many early investors.

The precious metals bull market of 2000–

History isn't always about what happened thousands (or dozens) of years ago. It offers valuable lessons right here . . . in your own decade! The years from 2000–2010 are an inflationary environment. Every major nation has been inflating its currency and in 2006–2007 the pace has accelerated. This is not good. At all! Unless, of course, you are into precious metals. At the beginning of 2000, you could have bought gold for 288.50 (New York spot market price) an ounce and silver for about $5.34 an ounce. By the last business day of 2006, gold hit $636while silver ended the year at $12.85. Percentage-wise, gold went up 121% and silver 141%. In contrast, the Dow started the millennium at $11,497 and ended 2006 at $12,463 for a modest gain of 8.4%.

Gold and silver stocks fared even better. Goldcorp, for example, is a major gold-mining firm that could have been bought for $2.88 a share at the beginning of 2000. By the end of 2006, your stock would have been worth $28.44 a share for a long-term gain of 887%. Silver Standard Resources, Inc. is a major silver-mining company that you could have gotten that first crisp trading day in January 2000 for a paltry $1.25 a share. You would have seen it climb into nose-bleed territory at $29.49 a share for a whopping gain of 2,359%. Many gold and silver mining companies had phenomenal results similar (or close) to these results.

REMEMBER

Investors who had even a small allocation of their portfolio in precious metals or their related stocks could have boosted their total portfolio returns very nicely. In this chapter I use gold and silver as examples because they are the first things that people think of when they hear the phrase "precious metals." But the topic does encompass much more than the two famous metals. As you read earlier in this chapter, platinum and palladium offer great opportunities and their future looks pretty shiny too (pardon the pun).