

Stabilize Your Investment Portfolio

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It's a well-known fact that modern international investing involves a fair amount of volatility and risk. But it seems totally unknown that a lot of this volatility and risk comes from the unit-of-account you are using to record and monitor your investments. You could very well avoid this, thereby reducing volatility and risk. Here's a basic do-it-yourself-guide on how to do that.

Sometimes it indeed seems the markets are too volatile to bother investing. And investing internationally sometimes seems even more risky. Calculations seem very messy, adjusting for currency swings etc.

What few people realize is that a lot of this volatility and risk comes from using a unit-of-account that itself is highly volatile and risky. Be it USD, Euros, Pounds or any other paper currency, because they have no inherent value, they are highly volatile and risky in themselves. This is basically obscured by the authorities since they are the ones creating the problem in the first place by making all alternatives illegal. It creates a lot of unnecessary problem when you want to keep you accounts and figure out how to act.

But I want to let you in on a secret about how to use a different unit-of-account that actually helps you to avoid a lot of volatility and risk. This is brief a guide to reducing volatility and risk through a more stable unit-of-account. It will likely change your views on investing forever.

Selecting a Proper Unit-of-Account

When doing our accounting and tax declarations we are all required to do this in our respective countries' currencies. If you live in the US, you are required to do this in USD, if you live in the Euro zone, you are required to use Euros, if you live in China, you are required to use RMB. And so on.

But we don't do accounting solely or not even originally because we want to declare our taxes. Accounting is nothing new and is of far greater importance. We do the accounting also because we need to be able to calculate profit and loss (p/l) and have such calculations guide us on how to act.

As it happens, p/l calculations are of extreme importance to any advanced society. You cannot aggregate and compare costs of various inputs if you don't have the cost amounts. 'Price x quantity = cost' and such cost amounts are comparable even if the prices and quantities refer to such different things as nails, labor or whatever. But you cannot simply set the prices arbitrarily; this requires prices that are allowed to change according to both the circumstances and the needs of the individuals involved. Through such a decentralized system of freely adjustable prices and p/l calculations, the society as a whole coordinates all the plans of all participating

individuals. Without freely adjustable prices and p/l calculations, planning and coordination is hampered. One way this would be manifested is through higher volatility and risk.

Without any pricing at all, p/l calculations and planning becomes almost impossible, as experienced in every place and field where freely adjustable prices have been abolished. Any attempts at central planning are totally dependant on the planning of individuals and their decentralized coordination. This is why the Chinese government can make such massive central planning nowadays but not 30 years ago. Today a billion Chinese are making their own p/l calculations and bargain as much as they can, thereby making everyone far better off (most also pay little or no taxes), while that was a clear no-no 30 years ago. Central planning means chaos and in practice no advanced planning is possible at all if freely adjustable prices are abolished and hence the individual p/l calculations are made impossible.

Thus, the importance of good accounting principles goes far beyond simple tax declarations.

A central prerequisite for being able to do good accounting is that the unit-of-account should be as stable as possible. We could look at the problems of an unstable unit-of-account by means of a simple analogy. Let's say your weight was measured not in kilos or pounds, but rather in degrees Celsius. Starting today, you can define your weight as equal to the amount of degrees outside. Let's say it's 30 degrees Celsius outside and that this is defined as your weight. But what happens if it's only 20 degrees tomorrow and 40 the day after that. Does this mean that you have extreme shift in your weight? Or is it just an illusion caused by having selected a very unsuitable unit-of-account?

Such a simple example might illustrate the fact that an unstable unit-of-account really can create problems. Picking a bad unit-of-account can itself create volatility and risk. So there is need to think twice before selecting a unit-of-account. The paper currencies of today move up and down compared to each other, something that creates a lot of instability. But they also move together up and down, most often down, in as far as we see inflation or deflation. And these changes could be substantial over time. If the currency is eroded by 'only' as little as 2% per annum, this means 50% inflation in only 20 years. And the accumulated inflation very soon becomes exponential, as seen by the fact that for example the USD has lost more than 95% of its value since the Federal Reserve expanded its powers some hundred years ago (it's the same story in most countries).

Historical comparisons

There's however one unit-of-account that serves especially well because of its stability. Let me show this by another simple example; 2,000 years ago, in 1st century AD Rome, a secretary earned 15 denarii, a lecturer 12 and a messenger 9 denarii per month. Translating this into current USD, we end up with yearly incomes of about USD33,000, USD26,000 and USD20,000. This is astonishingly similar to what the wages for these kinds of jobs are today in the US (I found typical numbers of USD32,000, USD28,000 and USD20,000 when googling secretary, teacher and mail delivery).

So what unit-of-account did I use for these calculations? Yes, you guessed right – gold! One gold denarius was 4.5 grams of gold at that time, and as one troy ounce equals 31.1 grams and if a gold troy ounce is USD1,250 we end up with these figures. Granted, the accuracy isn't very high

in using single numbers to represent a whole decade, but on the other hand, the prices were pretty stable before the debasement of the denarius started, a debasement said to have ended the Roman Empire, yet very mild compared to what we see today.

20 centuries later, common professions still pay the same salary in gold. This clearly shows that we don't really become richer as a whole because we all earn more money, but because we find ways of producing things cheaper, a fact hidden in the inflation prone environment of today. The same salary simply affords so much more today.

But what makes gold so stable when used as a unit-of-account?

Stocks-to-flow

In many ways gold is rare. It has been estimated that all gold ever refined would form a single cube 20 meter on a side, that's all there is. But in some more important ways gold is one of the most available substances in the world. The annual "stocks-to-flow" ratio of gold is 60, meaning that there is the equivalent of about 60 years of production above ground for every year of production. The only metal close to this ratio is silver with a ratio of only 1.5. By comparison, the same ratio for copper is estimated to be $\frac{1}{3}$, meaning that marketable stockpiles correspond to only 4 months of production. And while there is more steel created per hour than there has been gold dug up throughout history, this steel won't last very long and would very soon be gone. Although perhaps counter intuitive at first, gold is by no means scarce.

The extremely high stocks-to-flow ratio makes gold extremely suitable as a unit-of-account. There's nothing like it on this planet.

So gold has some unique properties that give it intrinsic value. Gold is also durable which makes it easy to store. It's easy to divide into smaller parts of exactly equal quality (or melt together again) and relatively convenient to transport. On top of this there are also the various industrial uses of gold.

Because gold is a tangible asset, gold does not have counterparty risk. When you own gold, you own an asset that is not dependent upon the promise of central bankers, politicians or someone else. And for similar reasons, it's the only asset that really can service as an extinguisher of debt.

Let's say the US government wanted to prematurely repay all US treasury bills, i.e. a big debt, to for example China. What should they pay with? Fed notes? But that would only transfer the debt to the Fed balance sheet, another US government agency (more or less). How could the Fed in turn repay the debt? By handing over Euros? That would only transfer it to the ECB. By using some imaginary IMF money?

GOLD FACTS

Physical properties of gold

The chemical symbol for gold is Au, which is derived from the Latin word "aurum," which means "shining dawn." Absolutely pure gold is so soft that it can be molded with the hands. The melting point of gold is 2,063 degrees Fahrenheit. A noble metal, gold is prone neither to rust nor tarnish and does not form an oxide film on its surface when coming into contact with air. Gold is a great conductor of electricity. Gold is the most malleable and ductile pure metal known to man. An ounce of gold can be beaten into a sheet covering 100 square feet. An ounce of gold can be drawn into a wire 60 miles long.

Mining

Gold can be found beneath the earth on all seven continents. There are 92 naturally occurring elements found in the earth's crust. Gold ranks 58th in rarity. Around 161,000 tons of gold have been mined by humans. Two thirds of the world's gold comes from South Africa. 90% of the world's gold mining has been done since the discovery of gold at Sutter's Mill in California in 1848. During the California gold rush, some speculators paid more for an ounce of water than they received for an ounce of gold. Evidence suggests that around 5,000 B.C., gold and copper became the first metals to be discovered by man. King Croesus of Lydia created the first pure gold coins in 540 B.C.

That would only be to transfer the debt to yet another balance sheet. You don't extinguish debt by transferring the debt to another balance sheet, the debt would still exist. There's nothing like gold in this regard either, and taken all this facts together we have a simple conclusion – gold is money.

Using gold as unit-of-account

There is nothing illegal about using gold as unit-of-account in any country in the world as far as I know. But you would in practice have to keep two books, one for the sake of the tax authorities, and one as basis for your own decision making.

As a leading monetary economist of today put it, "At the optimum, you would track the value of your assets not at their dollar price but at their gold equivalent. In other words, you would carry your balance sheet, both on the asset and the liability side, not in dollar or euro units, but in gold units (ounces or grams)."

Keeping your books in gold

Here are some simple steps towards reducing volatility and risk of your investment portfolio through a more stable unit-of-account.

Step 1. Specify Amount

Amount in local currency (USD or other paper currency). For example:

€1,999,000

Step 2. Convert to USD

Convert to USD (if USD isn't already the local currency). Use closing quote from your usual source (bank etc) for the day of the transaction. For example:

€1,999,000 x 1,22 €/€ = \$2,438,780

Step 3a. Convert to Troy Ounces (if desired)

Convert to troy ounces. Use closing quote from for example www.kitco.com for the day of the transaction. For example:

\$2,438,780 / 1,250 \$/oz = 1,951.0 oz

Step 3b. Convert to Grams (if desired)

Convert to grams. Use closing quote from for example www.kitco.com for the day of the transaction. For example:

\$2,438,780 / 40.2 \$/g = 60,666.2 g

Step 4. Book Your Transaction

Concluding remarks

There's a lot of talk about gold today as a hedge, as an investment and so on. But you don't really have to own gold to benefit from its monetary function, just like you don't have to own a plane in order to fly or own Internet in order to send emails. And after this basic do-it-yourself-guide you know the secret about how to do that.