American Heritage Financial

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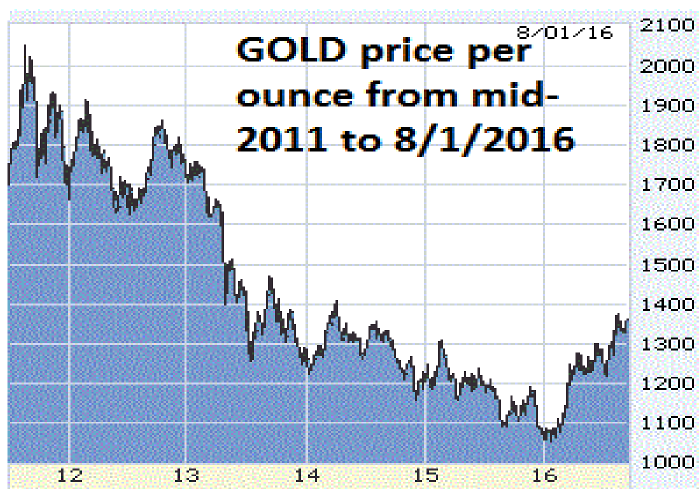
Golden Aversion to Risk

It seems our world is ever-more focused on ***avoiding risk*** while, at the same time, ***becoming much riskier*.** Whether we are protective parents, cautious seniors or simply average people trying to navigate the challenges of multiple laws, regulations or every day issues, we all spend an enormous amount of time, energy and money attempting to **totally avoid risk**. Yet, our world seems to be ever-more filled with scary new risks; things such new bacteria, scam artists, dangerous politicians and—worst of all—suicidal maniacs who kill helpless innocents.

The issues above are out of the realm of our **Market Comment** but *financial* ***risk***—always an element of investing—has become an overwhelming element of investment decisions and we want to address two areas currently affected by investor reaction to financial risk: **Gold** and **Utility Stocks**. These two very different investments have experienced a dramatic increase in price for similar reasons. We will review why and what to expect going forward.



Gold: After peaking at just over $2,000 an ounce in 2011, the price of gold was in a fairly consistent downtrend for over four years, until January—when that all changed. The price has moved from $1,065 early this year to near $1,350 as of the end of July. That is a 26% increase and, even more remarkable, 11% of that has come in just the last 60 days. Explaining the price of any financial asset is subjective but explaining the price of gold is…nearly impossible. That is because a huge percentage of the gold in the world has no intrinsic or economic value. Nearly all the gold found or produced throughout history remains held or stored in some form—approximately 7 trillion ounces of the stuff. Annual production adds less than 1% to that total each year. Yes, gold is prized in jewelry, art or decorative uses but only about 10% of annual production is used for jewelry and industry.

So, what determines the price of a metal which requires expensive storage and has virtually no intrinsic value? The short answer is psychology but there are some financial conditions which have an effect. Gold has long been accepted as a historical store of value. It was the primary form of money until modern times when fiat (paper) currency took over. It still carries a strong emotional and even cultural value, especially in countries like India and China. As a financial asset, its value is primarily tied to inflation. In theory, if paper money loses value (as a result of inflation), gold would increase relative to the declining value of paper money and act as a hedge against a loss in value from holding cash. The current increase in the price of gold seems related to new and unusual concerns relating to inflation—from one of the strange new risks the world faces— the risk the world's fiat currencies could became worthless as a result of dramatic monetary manipulation by the world's central banks, including our own Federal Reserve. While we are not expecting either a major up-tick in inflation or a draconian collapse in global currencies, we understand these concerns could continue to push the price higher and ***gold is a suitable hedge for a small portion of many portfolios.***

We should add a comment about the cost of holding gold. It is an "unproductive asset." It does not generate income or produce anything of value such as a typical stock or other investment. It has transaction and storage costs. In today's low interest rate, slow global growth environment the "cost" to own gold is lower since one is "giving-up" less than they would when interest rates and growth are "normal."

Utility Stocks: So while gold is a bit of a wild, wooly and speculative kind of investment, utilities are the historical "widows and orphans" stocks; known for providing stability and income. They satisfy the current demand for risk aversion due to their reputation as the most defensive of all defensive market sectors. Even more, utilities help satisfy the desperate search for yield which investors face in a world of near-zero returns in money market funds. For a specific example, using the **Utilities Select Sector SPDR** exchange-traded fund (ticker: XLU) as a proxy for utility stocks, the sector yields 3.1% and has appreciated in value by 20% year-to-date through July. So, the characteristic of safety and attractive income have driven demand for utility stocks and resulted in higher prices. The problem now is the *valuation*. While 3.1% is an attractive yield in today's market, it is the lowest yield for the utility ETF since the middle of 2008 while the price to earnings ratio (the basic measure of valuation) is 19 times forward earnings, the highest P/E for the sector since the year 2000.

High valuations for utilities could be justified based on the need for safety and income, but even considering minimal competition from low interest rates, utilities are most likely over-valued according Citigroup analyst Praful Mehta who estimates the sector is at least 10% over priced relative to the ten-year Treasury. Even more concerning is the long-term outlook for our fumbling utility industry in the face of low energy prices, the move away from both coal and nuclear and ever-changing regulations. The behemoth utility companies who invested billions based on future expectations which have moved far from prior projections, may not have the future financial stability desired in our risk adverse world.

So gold and utility stocks are just two financial examples of extreme aversion in our high risk world. Please consider that our comments are not a call to dump your utility stocks and pile into gold—but we definitely believe there is reason to reevaluate what is happening in all areas of the financial markets and make adjustments, at the margin, to insure your investment objectives will be met—while staying within your risk parameters. Your advisor stands ready to help you address these concerns or any other questions you may have.

Best regards,

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Questions or comments?
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