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EDELWEISS JOURNAL

6 April 2018 • XVII

In defence of having reserves and hoarding gold

Let's be blunt about it. Despite all the modern academic theories and pseudo-scientific drivel about risk and risk management, financial folks remain perpetually bewildered. One large reason is that the idea of uncertainty, whether in economic results or in securities prices, is used interchangeably with risk. A greater reason is the lack of clarity about these issues among financial types who have created a phony framework vastly different from the way industry—say, your local baker—deals with the same problem.

Very simply, risk, that is, the fear that something goes wrong, can be simply avoided, embraced as an opportunity, or insured against. Uncertainty, on the other hand, is a permanent part of life.

We are surrounded by inescapable uncertainty. It is the natural state of humans to have incomplete knowledge of the world around us. And this limits our understanding of what the future holds for us and what will be the results of our actions. We have ends we aim to achieve and we use means to pursue them. But we always act within a setting of incomplete knowledge and uncertainty.

In seeking to deploy our savings, we are not really different from the world of an entrepreneur—the *doer* with his own capital, as opposed to the *talker* and *player* with that of others. In his world and ours, incomplete knowledge manifests itself in two important ways.

Firstly, we cannot know everything about all the objective factors that will influence the results of our actions. What will be the price of the factors of production in the future? What is the best way to produce something, or the most efficient mix of capital, labour and land? What will the competitors do in the future? How will advances in technology affect our competitive position?

Secondly, we have limited information about subjective factors, such as the choices, values and judgements of other people. These also directly affect any business. What kind of product do consumers want? What is important to them and how do they understand quality? What will they be willing to pay for the satisfaction of their needs and wants? Though we may be aware of such subjective factors, we do not know how exactly they will be manifested in particular circumstances.

Consider the example of a baker as Guido Hülsmann illustrates:

> Our would-be entrepreneur knows that the revenue of the bakery depends on a multitude of concrete causes, such as the number of other

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> bakeries within walking distance, the number of families with children, the revenue of these families, the effort he puts into merchandising his croissants and breads, the unit prices at which he sells, etc. But he does not know exactly the relative impact of each of these factors on his income. That is, he does not know how much the customers will value a nice presentation and how much their decisions will depend on price. He might have some rough idea about the relative importance of each of these factors in the past. But he cannot extrapolate this knowledge into the future. He needs speculate or, in Mises' words, he needs to bet on their relative influence in the future.[1]

To make matters even more difficult, we do not even know which factors will influence our economic endeavours. There are factors we don't even know exist or that they are relevant to us until they appear to be so.

In the face of such inescapable uncertainty we can never be certain about the ultimate results of our actions. Future conditions may be and will be different from the present ones. So, an entrepreneur uses his skills and judgement to determine the factors which may influence his business, positively or negatively. Then he acts in the present in such a way as to eliminate as far as possible the influence of factors likely to have a negative impact on his business, while increasing the influence of those factors likely to have a positive one. The job of an owner of money capital, such as an investor, is not at all dissimilar.

Wealth and uncertainty

Perhaps the best way to deal with uncertainty is by accumulating wealth. Wealth gives us peace of mind about the future. It enables us to be prepared to incur unexpected costs. Whenever uncertainty manifests itself in negative ways, we know that our chances to cope with it are higher when we have resources to manoeuvre.

But if wealth helps in coping with uncertainty, it is also subject to uncertainty itself. Private capital is subject to inflation, taxation, regulation and control by a myriad of state agents. But it is also subject to bad decisions, improvidence, misplaced emotion and the destructive effects of financial charlatanism. Once wealth is accumulated it is not a mundane task to preserve it over long periods of time. We believe that the only way to do so is to connect such wealth to economic processes that are sound and enduring. The preservation of wealth, just like the operation of our bakery, is an entrepreneurial activity requiring one to distinguish those options of investment that are economically sound from those which are temporary, transient, fragile and baseless.

So, like any entrepreneurial activity, wealth preservation means dealing with uncertainty. It requires contemplating what factors are necessary for the long-term survival and growth of a business, and then judging subjectively to what extent any particular investment opportunity possesses these factors. All this must be done in the context of limited information. However much we may learn about a particular business, there will be more we can never know about its current or future circumstances or about the motivation of those who direct such enterprise. Furthermore, much of what is unknown and uncertain is also unquantifiable by traditional financial metrics.

[1] Jörg Guido Hülsmann, "The Myth of the Risk Premium" in *The Economic Theory of Costs: Foundations and New Directions*, ed. M. McCaffrey (London: Routledge, 2018), 133-146.

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Uncertainty magnified

Our current monetary system adds considerably to uncertainty. Today's money is false money. It is created at the whim of central banks and is backed by nothing more than a hope that it will continue to be a medium of exchange in the future. Central banks do not hide that their aim is constant price inflation, that is, permanent dilution of the money supply.

The inflationary policies of central banks have numerous dire consequences. One is that our ability to see economic reality deteriorates. If money is no longer a legitimate representation of value or unit of account, then everything we express in terms of money is unreliable. Think of prices as the signals that coordinate economic decisions in the market. Fake money means fake prices and false signals. In an environment of fiat money, the discrepancies between prices of things and their real economic value are often substantial and unexplainable.

Secondly, a fiat money system distorts markets through the creation of artificial demand. When central or commercial banks create new money, it enters the economy through the financial markets. Those who receive the new money first—generally governments and those close to financial markets—are the benefactors of the system, who go on to command a higher stake of the resources in the economy at the expense of everyone else. This means that the structure of production in the economy and demand schedules for goods and services in the society are artificially distorted by the monetary system. In the long term, these distortions are unsustainable. They can only be maintained if supported by even further and larger money and credit creation by central banks. But in the short term, this process makes it difficult to distinguish which economic activities are generating real economic value as against those which are supported by artificial factors.

Naturally, the additional uncertainty generated by a flawed monetary system does not make the task of deploying our savings any easier. The veil of fake money severely complicates the identification of long-lasting economic endeavours. While some businesses are truly creating economic value—that is, transforming resources into products that serve genuine needs of people, there are many others whose apparent success is based on distorted prices and artificial demand. In our view, the preservation of wealth in the long term is inevitably connected to looking for the former and avoiding the latter. In the face of ever-present economic uncertainty, and seemingly increasing financial and monetary uncertainty, a correct understanding of the issue has important implications.

The role of reserves in capital preservation

Even under the conditions of routine life uncertainty, holding a portion of one's capital in reserves is essential. Let us return to the example of the baker as an illustration. If the baker is interested in the long-term survival of his business and he is successful, he will accumulate savings over time. These savings are his reserves. He does so partly to prepare for uncertainties and unexpected future events. But he may also want to use them to expand his business in the future. He is not sure yet, but he is considering his options and looking for opportunities. He may want to buy better equipment, expand his product line or even open a new store. He is not sure yet what the best option is, or even if he has considered all the options. But he is preparing for it all. He knows that, whatever the case, if he wants his business to survive and

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thrive, he will need reserves. These shield him through difficult times as well as give him the means, when the time is right, to increase the value of his business, its capacity, efficiency, sales and so forth. Having reserves provides him greater independence and hence a greater propensity to survive no matter what the future may hold. By giving him the means to act, reserves reduce his uncertainty.

In the case of our investor entrepreneur, his long-term savings may be in the form of equity participations that have real and lasting economic value. Yet, as is with our baker, he does not have all the information and there is natural uncertainty in what he ought to do. He keeps his eyes open, but he never knows when an opportunity, such as he sees it, will present itself. What he looks for is rare and difficult to find. Therefore, he keeps his options open by having sufficient reserves to allow him to act when the time does come. As owners of permanent savings, having reserves increases our independence and gives us the means to act upon opportunities as they arise.

Requirements for reserves

What kind of reserves should one hold? What are the qualities that make an asset suitable to be held as reserves?

Typically, investment companies hold reserves in money or some other money substitute such as government bonds. Our own practice is very different. We have cash in the bank merely so as to meet very short-term obligations. Most of our capital reserves are held in gold. In addition to being very liquid, only physical gold, in our view, possesses all three of these criteria we consider essential characteristics in a reserve asset: scarcity, permanence and independence. A brief explanation follows.

Today's money, that is, fiat currencies, do not pass the test of *scarcity*. It cannot be used as a long-term store of value since central banks purposefully debase them. The very goal of central bank policies is to constantly increase the money supply. The effects may not visible from one day to the next, but the fact remains that such policies effectively reduce the value of money in our pockets and bank accounts. The compound effect of a "mere" annual inflation of three percent effectively reduces purchasing power by one-third over 15 years. Cash is perfect for goods today, six months from now or next year, but for someone with long-term savings there is no value to such monies.

Gold, on the other hand, is quite scarce. Finding, mining and refining it entails considerable cost. It cannot be produced out of nothing. It cannot be increased in quantity by a few computer keystrokes. Compared to paper money, it is scarce indeed.

Examining next for *permanence*, we find once again that liquid reserves in the form of bank deposits or government bonds fall short. These are not true assets. They are liabilities, claims and promises to pay. Under today's system of fractional reserve banking, all commercial banks are technically insolvent, since they would go bankrupt if everyone with the right to withdraw their money decided to do so at the same time. Fractional reserve banking is the reason why commercial banks are so vulnerable to bad news and economic downturns and so rely on central banks to be saved. This means that our bank deposits hold considerable counterparty risk, that is, the liability of the bank. In this way, money in a bank, as a deposit, fails the test of permanence. Reserves deposited as money in banks have long-term value and permanence value only if we trust commercial banks and the whole financial system. We do not.

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The same is true for government bonds, commercial paper and other obligations that have been securitized. They are only as good as the trust we have in the ability of the issuers to pay back the debt. If the solvency of governments fails, government debt instantly loses its value. In our view, both bank deposits and other money substitutes are claims and promises but not genuine assets and thus not suitable to be held as reserves.

On the other hand, gold has no counterparty risk. It is a good in itself. It is not a claim for something else, a promise to receive something or someone else's liability. Gold does not perish; it withstands financial crises, political instabilities and rampant money printing by central banks. All this reflects permanence. We can trust that gold will not disappear even in the long term, and that it will always have economic value.

As for *independence*, as we've already seen, the value of financial assets used as reserves directly depends on central bank policies, on the solvency of commercial banks and governments and the stability of the whole financial system. In the case of any trouble, such as an economic downturn, major bankruptcies or political instability, there is no guarantee of being able to withdraw money from the bank or that the government will pay back its debt. Keeping savings or reserves in fiat currency or government debt thus makes one completely dependent on events and institutions outside one's control. Knowing the inflationary tendencies of central banks, the instability of the current financial system and unsustainable borrowing and spending policies of governments, to depend on these factors essentially contradicts the whole purpose of having reserves.

In contrast, gold gives independence. It holds its own regardless of the ultimate actions of central banking, if the financial system breaks down or if governments refuse to pay their debts. Its value may even increase in such circumstances, when others may want a reserve asset that is tangible, permanent and substantive.

These are the reasons why we keep most of our reserves in physical gold. We believe that reserves held in this way are in line with the low time preference of a sound investment practice, and are consistent with our values of scarcity, permanence and independence.

Will our reserves increase in value?

Despite the fact that reserves in gold give us the ultimate independence from the misfortunes of the present financial system and the liquidity to deploy when opportunities present themselves, gold in itself is not an investment. We do not own it so as to earn money. Perhaps, in the long-term, gold may will appreciate against fiat currencies, but we do not know when or by how much. No one really knows what the price of gold will be a year or two down the road. Indeed, its price in money terms is more volatile compared to fiat money substitutes, but such volatility is not concerning in view of the certainty that it embodies.

Some say that it is unwise to keep reserves and forgo the opportunity to earn something on them. If the aim of reserves is optionality, then what one needs is not money, but liquidity. Therefore instead of holding cash or some other form of money, he might as well be invested into some other very liquid assets (e.g. a broad index fund of government bonds). In this way one will not only have optionality via the liquidity of the reserves, but will also earn some interest. This view is quite prominent in the economics profession which claims that money held in cash balances is withheld from circulation and therefore unproductive and barren. And financial professionals have this

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precisely backwards; they don't recognize the opportunity reserves provide, only the opportunity cost.

We disagree, not only on the basis of economics but also from an investment viewpoint. Holding money cannot be considered unproductive or unwise because money as the most marketable good in the economy allows an individual to reduce his uncertainty. As Hans-Hermann Hoppe puts it:

> Faced with this challenge of unpredictable contingencies, man can come to value goods on account of their degree of marketability (rather than their use-value for him as consumer or producer goods) and consider trading also whenever a good to be acquired is more marketable than that to be surrendered, such that its possession would facilitate the future acquisition of other directly or indirectly serviceable goods and services. That is, a demand for *media of exchange* can arise, i.e., a demand for goods valued on account of their marketability or resalability.[2]

So, almost always, to varying degrees, people choose to hold savings in cash rather than spending or investing all their money. This cannot be considered irrational or unwise. For them, the value of having cash on hand and preparing themselves for events they cannot predict is greater than the earnings they forgo.

How much?

Most of the business literature on the subject confuses the idea of 'reserves' with the need for 'liquidity' and seeks to construct theories as to what is an optimum level. The outcome of such intentions may sound sophisticated but is not quite useful to our baker whose livelihood is on the line. In an age of zero interest rates and readily available credit, the measure of necessary liquidity can be gauged easily. The necessity for having reserves, however, as described earlier, is a far more difficult topic, if only because its measure can only be made by the owner of capital, without regard for what others do or think and after having considered, subjectively, the measure of uncertainty he faces, the dearth of opportunities to deploy his capital wisely, and his assessment of likely opportunities that may appear.

Owners of savings—investors—would be wise to think similarly and view the need for reserves on account of the optionality and relative certainty that they embody. Seeking to earn money on such reserves would compromise the main purpose of having them. Furthermore, maintaining such reserves in paper monies on account of their liquidity and general acceptance also compromises their value in that they represent not an asset but claims, promises and debts—all based on a faulty credit system.

The money value of our reserves may go up or down in the short term, but we don't count this as a risk. On the contrary, we see such reserves, in the present time, as a wise and necessary component to holding something scarce, permanent and independent in a world where both natural and man-made uncertainty dominates and overwhelms all economic calculation.

Paraphrasing the inimitable Nassim Nicholas Taleb, being an owner of savings is an *existential*, not just a *financial* thing.

[2] Hans-Hermann Hoppe, "'The Yield from Money Held' Reconsidered," *Mises Daily* (May 14, 2009), https://mises.org/library/yield-money-held-reconsidered.

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