

## **WHY SILVER WILL OUTPERFORM GOLD 400% & HOW YOU CAN JOIN THE PARTY**

By Franklin Sanders

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*Abstract:* Over the course of the present bull market in silver and gold, probably another 10 years, silver should rise about four times as fast as gold. That forecast arises from silver's historic performance, especially during the 20th century, as well as its present fundamentals. The best way to profit from that trend is to swap back and forth from silver to gold with the rise and fall in the gold/silver ratio. That strategy will convert a sterile investment into one that pays dividends, and possibly double the ounces you own over the life of the bull market.

### **GOLD vs. SILVER**

Alas, poor silver is the Rodney Dangerfield of precious metals – *it can't get no respect*. It certainly should merit respect, since its 20th century performance has far outpaced gold. It's volatility and superior fundamentals ought to make it much more attractive than gold.

The fact is, gold bugs (with their blind, monomaniacal devotion to gold) miss the point. They are so ideologically wedded to the yellow metal that they overlook both history and facts. It is not a monometallic gold standard that history overwhelmingly demonstrates, but bimetallism. Shortly after I wrote *Silver Bonanza* for Jim Blanchard in 1993 but before it had been published, Jim teased this gem out of Nobel Laureate economist Milton Friedman: "The major monetary metal in history is silver, not gold." (I remember it well because the statement struck Jim so strongly that he had it printed up on a sticker and inserted it on the flyleaf of the original 8-1/2 by 11 version.) Friedman was right, of course. For most of mankind throughout most of history, silver has been the much more important monetary metal, familiar as the metal of daily commerce. Gold was used only for very, very large payments, which most people make only rarely, if ever.

Both silver and gold are monetary metals, *i.e.*, they both benefit from monetary demand. (Monetary demand is also called "investment" demand. It is demand for silver *as silver*, and as an ingredient making something.) Most analysts miss silver's monetary demand because they focus on silver's use in industry. Certainly, since silver was *politically* demonetized beginning in the mid 1870s a vast amount of purely monetary demand disappeared. Today, most silver is used in fabrication, roughly split three ways among silverware and jewellery, photographic, and other industrial uses. But when confidence in central bank issued *fiat* money begins to fade, when fear strikes investors' hearts, they run not only to gold, but also to silver. Especially in America.

That demand profile makes monetary demand for silver *more* important, not less. Why? Because all of that monetary demand hits silver *at the margin*. Fundamental demand changes only slowly, but monetary demand comes out of nowhere, adding huge, insistent demand for silver *at the margin*. Because the silver market is so much smaller than the gold market, a new dollar invested in silver also has a much greater affect on the price.

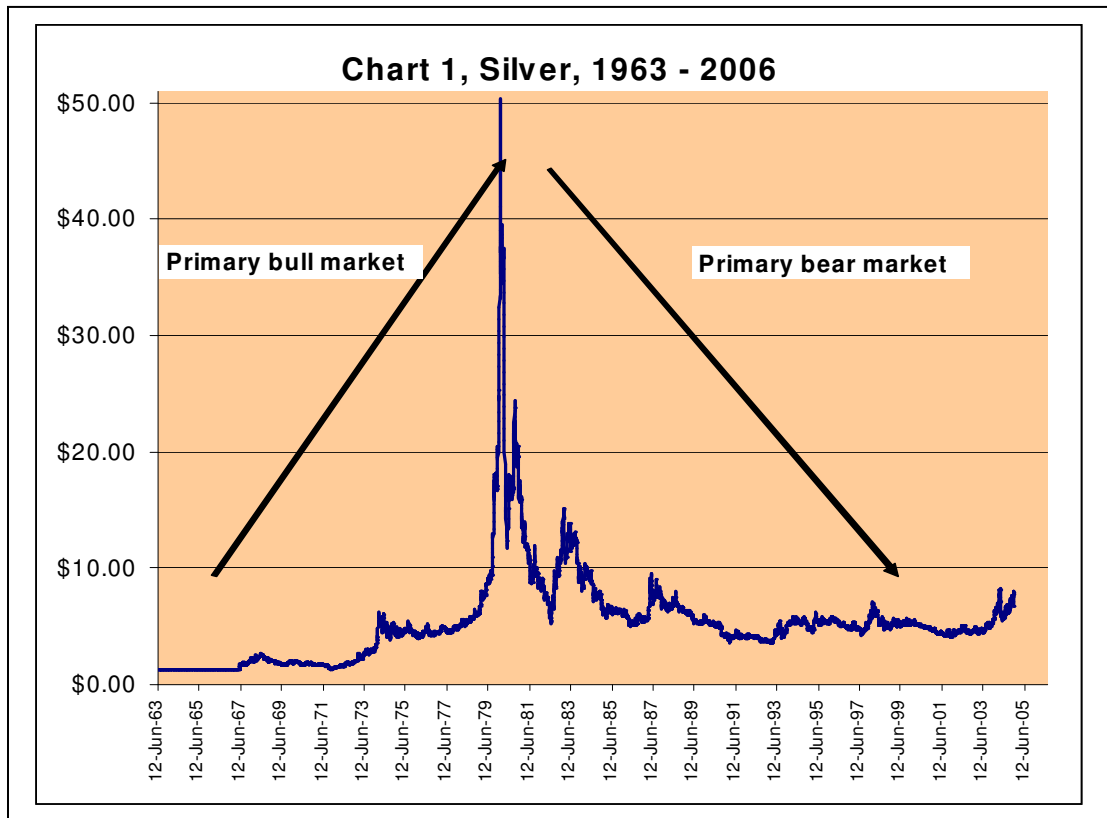
That makes silver more volatile than gold, which wears on your nerves but swells your profits.

Be advised, I am not arguing for investing in silver *only*, but rather for a more subtle strategy. I want to show you a way to invest in BOTH metals, swapping them back and forth at the appropriate time, possibly *doubling* your return over the life of the bull market, which is probably another 9 – 10 years.

When I began musing over this article, the gold/silver ratio was hovering around 60 (it took 60 ounces of silver to buy one ounce of gold). By the end of this bull move, I expect that ratio to drop to 16:1 (16 ounces of silver will buy one ounce of gold). In the meantime, the ratio will zig and zag, and we'll take advantage of those moves, too, by trading the ratio.

### THE ONE GREAT SECRET OF INVESTING

There is one Great Secret of Investing that you must not ignore: *always invest with the primary trend*. Look at Chart 1, **SILVER, 1963 – 2006**. It offers a good picture of a primary uptrend (“bull market”) and a primary downtrend (“bear market”).



What is the primary trend? Like the tide in the ocean, the primary trend is the long term -- 10 to 20 year -- move where the *general* trend is up or down. Just as you wouldn't want to try to launch your boat *against* the tide, you never want to launch your investment boat against the primary trend. Within that trend, like waves on the tide, are zigs and zags up and down. We can also ride these waves to profits, but must be much more

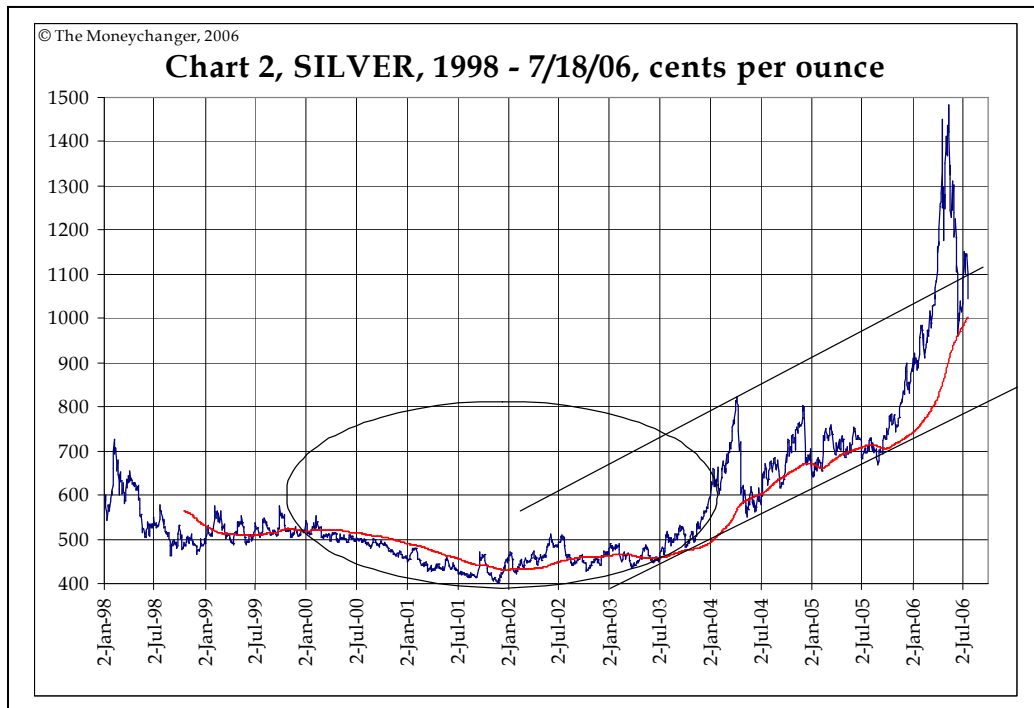
careful with them since they move so much faster. Our strategy keeps your money invested with the tide, but takes advantage of waves on the tide as well.

Stocks' primary trend turned *up* in 1982. Without exercising a great deal of discriminating brain power, you could have bought almost any stock in 1982 and made huge profits by 2000. How could you have helped it? Measured by the Dow Jones Industrial Average, stocks rose 12,000% over that 18 years. A rising tide lifts all boats, even the garbage scows.

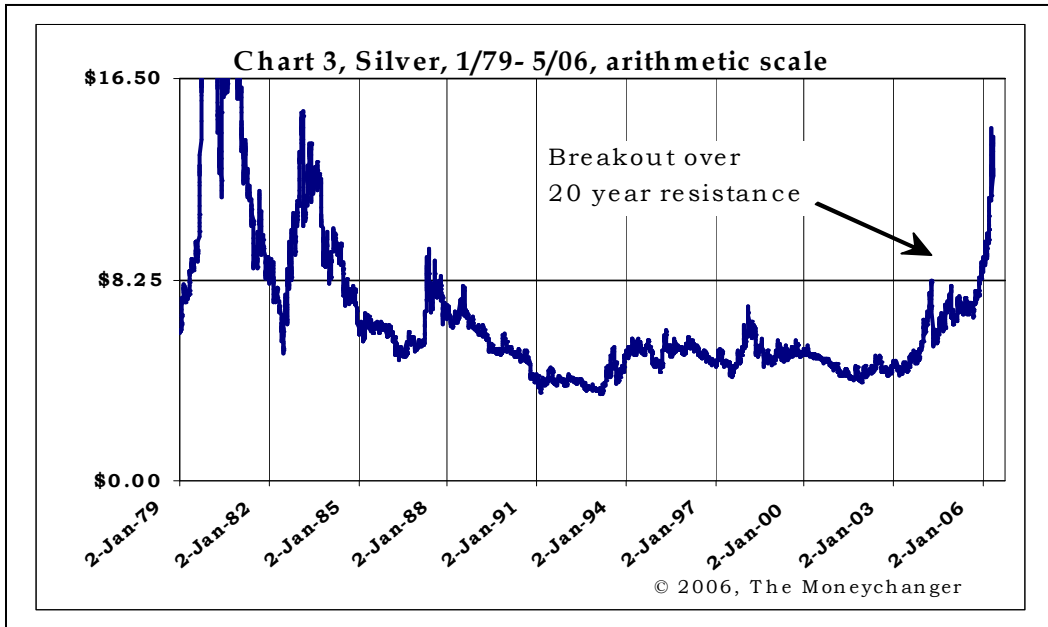
Likewise, it makes no sense to buy stocks now. A primary downtrend ("bear market") commenced in 2000, and it must work itself all the way to exhaustion. That process will take from 10 to 15 years, and not even the almighty Federal reserve creating tidal waves of money out of thin air will keep the stock market up. The rule of thumb says that a bear market will give up 50% to 95% of the foregoing bull market rise. Do the math, and you will come to a Dow target of roughly 6,000 to 1,250. Do you really want to buy stocks now, and hang around for Dow 6,000? Or Dow 1,250?

### IS SILVER IN A PRIMARY UPTREND?

First we have to answer this question: Is silver in primary uptrend? Let's look at the charts. Chart 2, **Silver, 1998 – now, cents per ounce**, shows a very long, rounding bottom. This formation is typical of bear market bottoms, and very reliable. Not only did silver emerge from that rounding bottom in an uptrend, it has also now burst through the top of that uptrend.

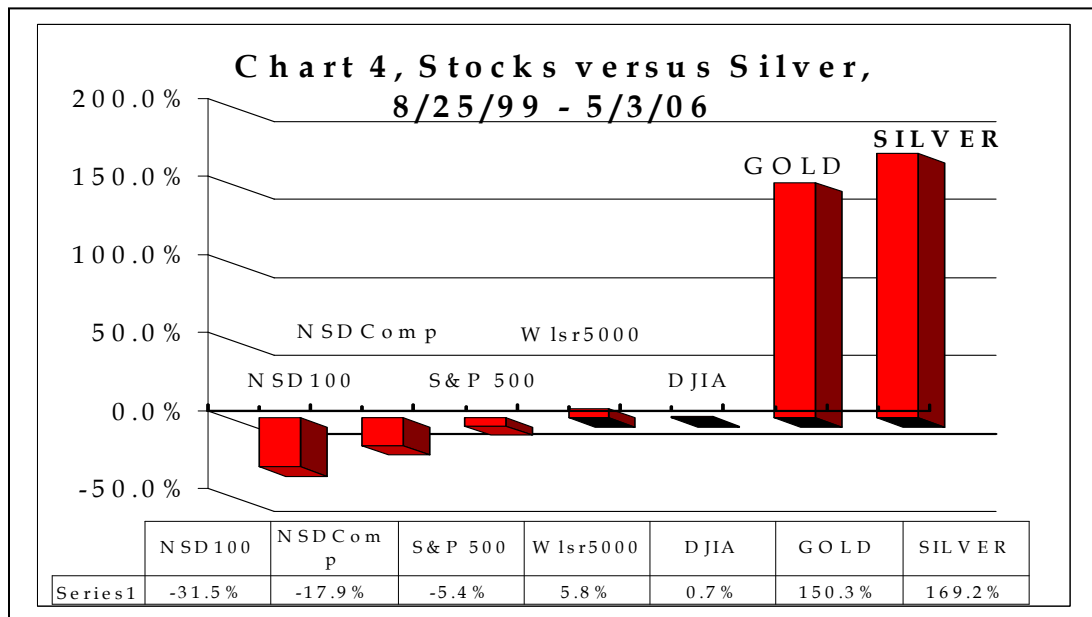


Now look at Chart 3, **Silver, January 1979 – June 2004, arithmetic scale**. Again, notice the long rounding formation beneath \$8.25 resistance. For about 20 years that \$8.25 resistance turned silver back time and again. You can see that in April, 2004, when silver first touched that line, it fell



back, corrected, and then challenged \$8.25 again. When it finally broke through \$8.25, it ran away to the next resistance at \$15.

Comparing silver's performance to stocks' over the last 6-1/2 years offers us another witness that silver is in a primary uptrend. Chart 4 shows **Stocks versus Silver, 8/25/99 – 5/3/06**. The little flat pancakes (and drooping slag-sickle) on the left show how various stock indices have performed. The towering stacks on the right depict the performance of silver & gold. While stock indices have dropped by as much as a third, or done nothing at all, gold has risen 150.3% and *silver has risen 169.2%* (2.69 times where it began).



Lest I be accused of bias, let's see how silver and gold have performed against some other investments. Look at Chart 5, **Investment**

**performance as of 30 April 2006.** Only the HUI, the unhedged gold stock index, has outperformed silver in the last one, three, or five years. What about the Dow, the S&P 500, and the US Dollar Index? Silver has left them in the dust.

**Chart 5, Investment performance as of 30 April 2006**

	4/30/06	% change		Annualized % change			
		Month	YTD	1 year	3 years	5 year	10 year
Dow	11,367.14	2.3%	6.1%	11.5%	10.3%	1.2%	7.4%
S&P 500	1,310.61	1.2%	5.0%	13.3%	12.7%	1.0%	7.2%
HUI	378.79	12.6%	36.8%	112.8%	44.8%	46.5%	n/a
XAU	158.11	11.6%	23.5%	89.3%	34.3%	23.5%	1.0%
US \$ Index	86.11	-4.0%	-5.6%	2.0%	-4.0%	-5.8%	-0.2%
CRB	379.53	4.9%	9.1%	25.0%	17.7%	12.1%	4.0%

### HISTORICAL OUTPERFORMANCE

If I had a chart 45 feet long on which every foot represented 100 years of human history, the gold/silver ratio would remain under 16:1 for all but the last 15 inches. In fact, for the first 40 feet (until about 1500) the ratio oscillated *under* 12:1, and spent most of its time between 8:1 and 12:1. Only after the discovery of huge silver deposits in the Americas does the ratio begin to climb above 12:1. I can only speculate about the reasons for the ratio's relative stability. Probably it arises from the relative ratio of silver to gold in the earth's crust, which geologists estimate at 17.5:1.<sup>1</sup>

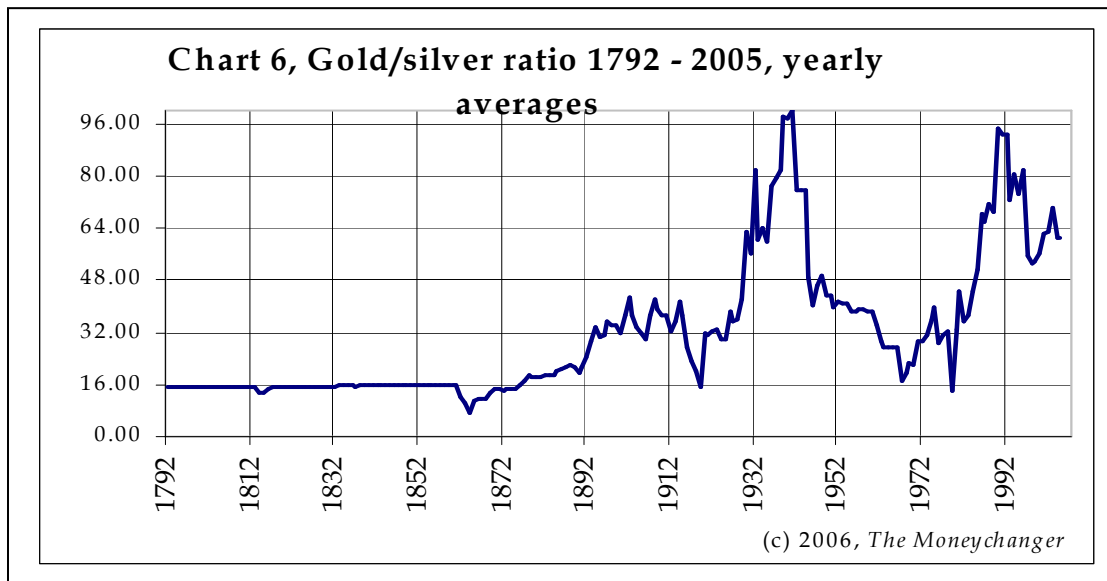
### BIMETALLISM & ALL THAT HOGWASH

Reading the standard economics and history texts you would think that bimetallism led the 19th century into a riot of monetary confusion, but that is hogwash. It wasn't bimetallism, but state action that caused the problem. Rather than following the market ratio (as the US monetary system was designed to do) England and France set their official mint ratios at different levels, so whichever metal was temporarily cheaper in one country would drain out to the other country. This chronic misevaluation tended to drive out of circulation the more under-valued metal – generally silver. After about 1815 the ratio began to fall (silver gained value against gold). Though small by today's standard, that drop sped up in the 1830s and 1840s as huge new gold deposits were discovered in Carolina, Australia, and

California. The price of silver in gold dollars (\$1.00 in gold = 0.048375 troy ounce) rose from \$1.29 in 1848 to 1.35 by 1857<sup>2</sup> (the ratio *fell* because it took fewer ounces of silver to buy an ounce of gold). Silver's rising price forced the US to make its fractional coin (half dimes, dimes, quarters, halves) *subsidiary*. Since silver bought more gold as bullion than at its face value, speculators were melting the small silver coin. Dollar coins had already disappeared. Congress reduced the silver content of the fractional coin by 6.5% (from 0.7734 ounce per dollar to 0.7234 ounce) just to keep small coin from disappearing.

So the cause of the bimetallic problems was not a rising supply of silver from the Comstock Lode (the red herring usually trotted out), but a rising supply of new gold. More disruptive than that, however, was the policy of setting official mint ratios *politically* rather than following market determined prices. After the US demonetized silver in 1873, followed shortly by Germany and other nations, the ratio of course rose. The loss of monetary demand for silver sharply reduced overall demand, and therefore price, although silver didn't fall as quickly as you might expect.

Chart 6, **Gold/silver ratio 1792 - 2005, yearly averages**, shows how the ratio behaved during two centuries. What interests us most as we try to devise an investment strategy is the pattern. The ratio trades in a *range*, with tops at 100:1 separated by 50 years, and bottoms at 16:1 or lower in 1919, 1968, and 1980.



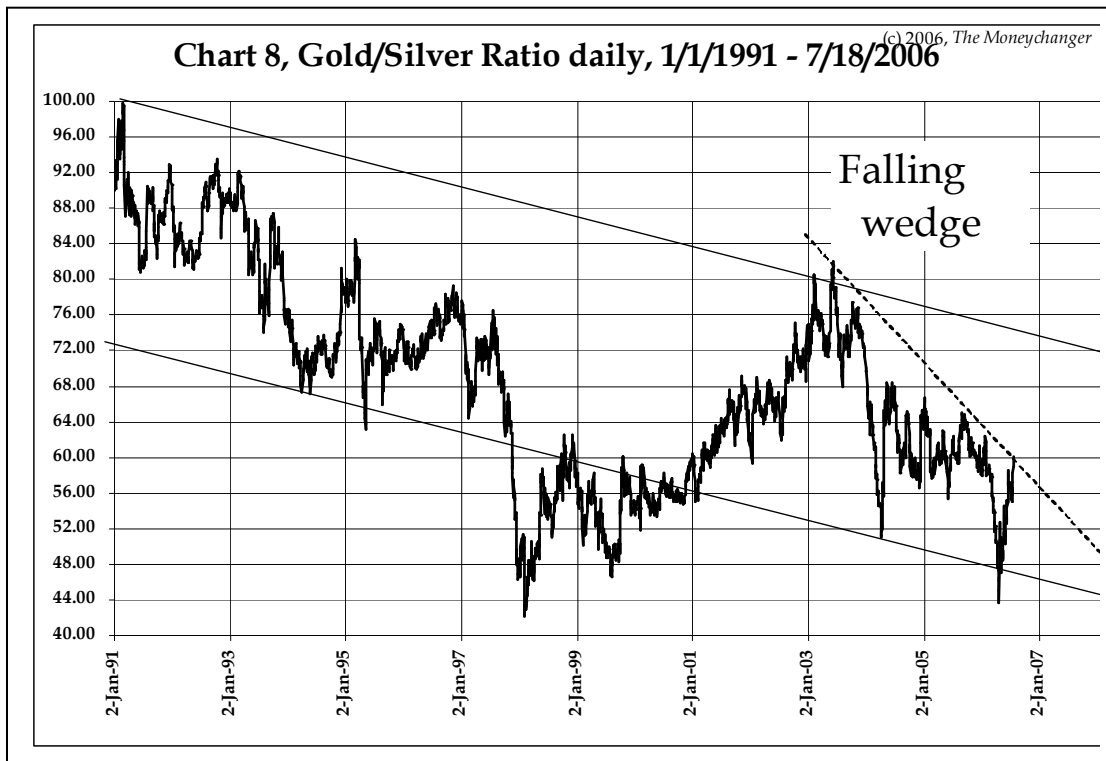
A closer look at price action refines our perspective. Look at Chart 7, **Gold/Silver Ratio daily, 6/1963 - 5/2006**. In the five year bear phase of the market from 1968 to 1973, the ratio rose from 13.76 to 46.96. However, in the following seven year bull phase the ratio returned to 14.91 at the very top of the metals bull market in January, 1980. In the following bear market, for eleven years the ratio rose to 99.81 in 1991 as money drained out of silver and gold. From there it turned down and has steadily fallen.



For a closer, more recent view, look at Chart 8, **Gold/Silver Ratio daily, 1/1/1991 - 5/6/2006**. Today's chart shows a falling wedge pattern, that usually resolves in a breakout to the *upside*. That implies that after the recent fall to 43.6, the ratio should spend a long time rising to the *upper* side of the trading channel. (In fact, that's what it has indeed done, through July 2006.)

**Our swapping strategy takes advantage of the ratio's moves from the top to the bottom of this trading channel. Near the channel's top, where silver is cheap in terms of gold, we swap gold into silver. Near the channel's bottom, where gold is cheap in terms of silver, we swap silver into gold.**

From Chart 7 you can tell that the upper line of the trading channel has moved outward. When the ratio first began declining from its 1991 peak, it declined at a steeper rate. Because that top channel line lay lower down on a steeper angle, we began making trades out of gold into silver at 60:1, and continued all the way up to 82. That proved to be the uppermost extent of the move, and enabled us to draw a new upper channel line for the downtrend. Now glance at Chart 9, **Gold/Silver Ratio daily, 1 June '00 - 3 May '06**. The ratio plunged fairly quickly to 51, and I made a big mistake. Not realising how many hedge funds had put on the long silver/short gold ratio trade, I was waiting for the logical target, 50:1, to swap silver for gold.



However, all the big players bailed out at 51. the ratio turned around on a dime and never looked back, so we missed our silver-to-gold trade in 2004.



A long sideways correction followed, from April 2004 through August 2005, ending at 64.93:1. I was targeting 43 or 40 to 1 for the bottom of the next move, but my friend Bob Ladone (see his article, "Ode to Beauty," in the January 2006 *Moneychanger*) made such a persuasive argument for 46:1 that I moved my target there. As it turned out, we had only four (4) days to

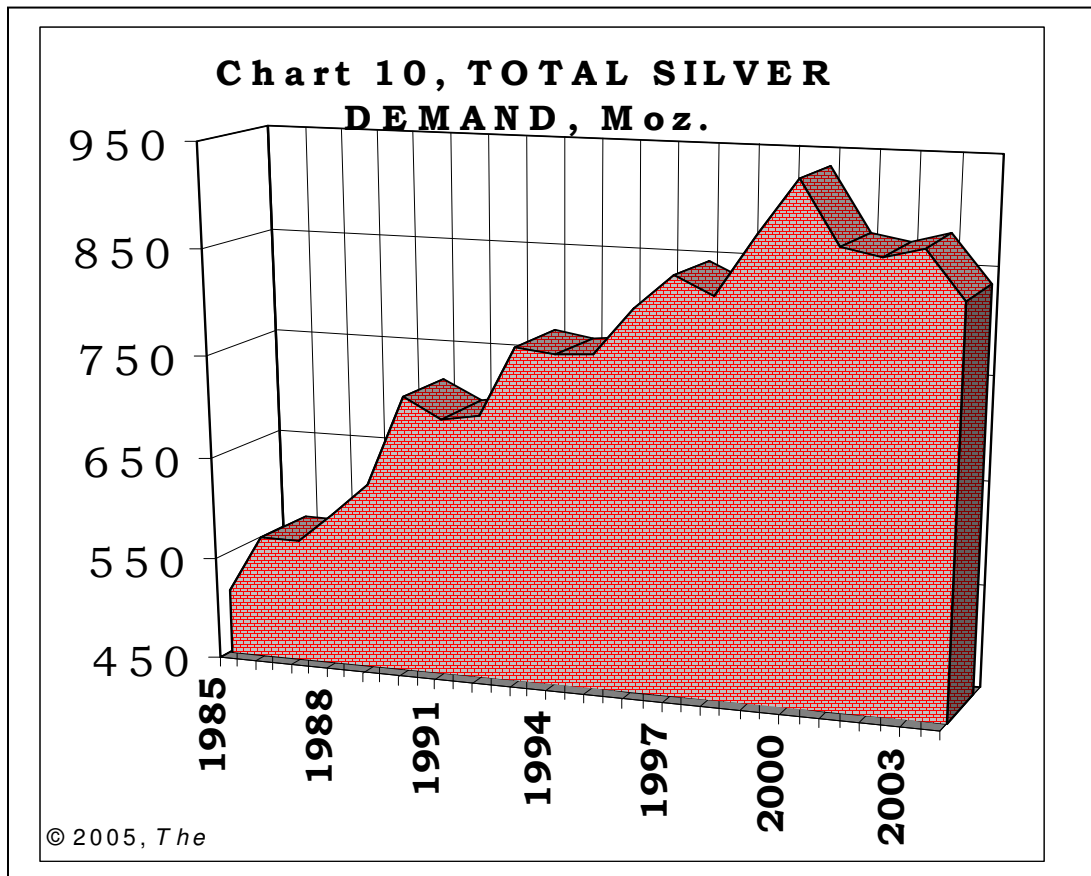
make the trade at 46:1 or better, and wouldn't have gotten to do them if we had waited for 43.

**SILVER SET TO OUTPERFORM,  
AND ALREADY OUTPERFORMING**

Silver will always show greater volatility – the violence and size of moves and their sudden reversals -- because it is so much smaller market than gold.

In the teeth of the common wisdom that there's plenty of silver available, there is far less silver aboveground and ready to come to market than there is gold. According to Gold Fields Mineral Services in Dec. 2005, Central Banks claim 29,000 tonnes gold reserves, about 935 million ounces ("moz"). Call that "ready to come to market" stocks.

My guess is that that at most there is about 900 moz aboveground, ready-to-come-to-market silver stocks, or about same as supply of gold. (Others whose opinions I respect estimate as little as 300 moz.) Valued at the 3 May 2006 market (665.90 & 13.704), the gold was worth about \$622.3 billion, the silver only about \$12.3 billion, or about 2% of the gold. Therefore only a small amount of money flowing into silver has a huge



impact. A billion dollars flowing into gold would raise the price of an ounce only about 90 cents or about 1/10 of one percent. The same billion bucks flowing into silver would raise the price 90 cents an ounce, but that amounts to 6.5% of the current price.

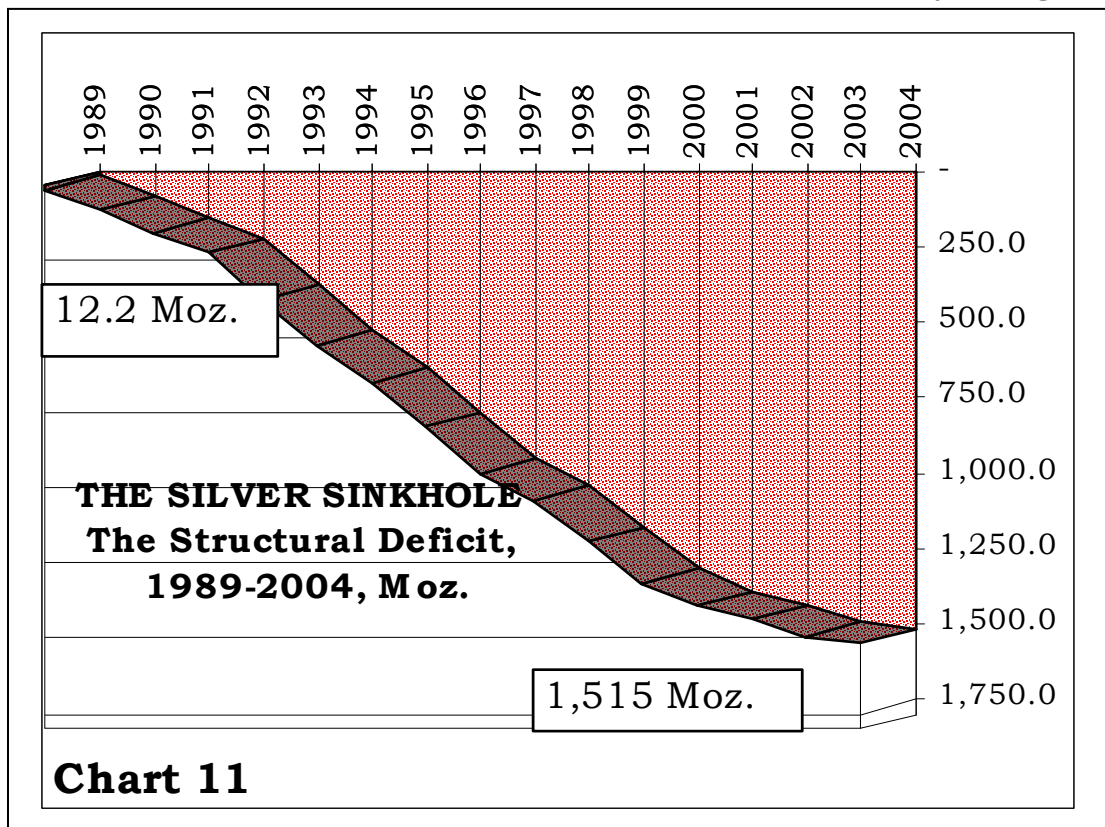
### NOT FUNDAMENTAL BUT MONETARY DEMAND

As I pointed out before, it is not fundamental but monetary demand that drives silver and gold prices. *Keep that point in mind and never forget it. It is monetary (or investment) demand that drives both silver and gold, not fundamental.*

Fundamental demand only needs to be neutral or favourable to silver, and not negative, *because it only changes slowly*. In other words, we don't want to see any big silver surpluses or hoards overhanging the market, as Indian silver and the US silver hoard did in the 1960s and 1970s. Neither of those is a problem any longer.

Monetary demand really drives silver's price crazy because it hits at margin as incremental demand, & changes *very quickly* -- so suddenly that supply has no time to adjust, so only the price can adjust – upwards. (It takes 5 – 10 years to bring a new silver mine into production.)

At present we have all those conditions. **Total Silver Demand** (chart 10) runs around 800 million ounces yearly, and is not dropping. Moreover, since 1989 silver has been in structural deficit (“more silver consumed than produced”), as chart 11, **The Silver Sinkhole**, plainly shows. Over those 16 years the yearly shortfall has averaged 12% of consumption. By now that shortfall has consumed some 1.5 **Billion** ounces, far and away enough to



consume the surplus brought to market during the 1980s. We know that monetary demand has already hit, because of silver's performance in the last couple of years. Refer back to Chart 5, **Investment performance**.

**JOINING THE PARTY –  
OUR INVESTMENT STRATEGY**

If silver is going to rise faster than gold, then we want to own more silver than gold. If the Gold/Silver ratio (the price of gold in terms of silver) rises and falls within an overarching downward trend, we can also use that to our advantage.

Our goal is (1) to own and hold *physical* (not paper) silver & gold throughout the bull market and (2) to increase the number of ounces we hold while we wait for prices to rise. Our tool is *arbitrage*.

Arbitrage is “the simultaneous purchase and selling of an asset in order to profit from a differential in the price.” Usually it involves buying in one market and selling in another to take advantage of price discrepancies. (Actually, we are doing exactly what the arbitrageurs did in the 19<sup>th</sup> century when they shipped silver from England to France to take advantage of its higher gold price there.) We either trade from silver to silver, or from silver to gold. I admit, arbitrage is, strictly speaking, simultaneous, but we trade from gold to silver and silver to gold *over time* based on the primary trend. (Remember trading from top to bottom in the ratio trading channel?)

- When silver is relatively cheap to gold (ratio is relatively high), we buy silver with gold.
- When gold is relatively cheap to silver (relatively low), we buy silver with gold.

**Chart 12, REALISED SWAPS FROM GOLD TO SILVER**

<b><u>Trade No. 1</u></b>	<b><u>GOLD</u></b>	<b><u>Ratio</u></b>	<b><u>SILVER</u></b>
Began 2003	(78.0312) oz	63	(4,915.97) oz
Ended 2006	<u>100.0000</u> oz	49.16	4,916.00 oz
	<b>21.9688 oz. gain =</b>	<b>28%</b>	
		-	
<b><u>Trade No. 2</u></b>	<b><u>GOLD</u></b>	<b><u>Ratio</u></b>	<b><u>SILVER</u></b>
Began 2003	(20.0000) oz	73.28	(1,465.60) oz
Ended 2006	<u>27.6316</u> oz	52.47	1,449.83 oz
	<b>7.6316 oz. gain =</b>	<b>38%</b>	
		-	
<b><u>Trade No. 3</u></b>	<b><u>GOLD</u></b>	<b><u>Ratio</u></b>	<b><u>SILVER</u></b>
Began 2/03	(561.0000) oz	70.52	39,562.88 oz
Began 4/04	(500.0000) oz	63.9	(31,949.78) oz
Ended 2006	<u>1,559.2354</u> oz	46.77	72,930.00 oz
	<b>498.2354 oz. gain =</b>	<b>47%</b>	
		-	

On Chart 8 **Gold/Silver Ratio daily, 1/1/1991 – 7/18/2006** look at the trading channel. We trade gold for silver toward the top of channel, and silver for gold at the bottom.

### **THE TEST**

Does it work? As always, the proof is in the pudding. In Chart 12, **Realised Swaps from Gold to Silver**, you will see some actual swaps that we executed. They include all expenses *except* taxes. What taxes you pay depends on too many variables for me to predict. In fact, if you sold gold or silver you had bought at higher prices, you would actually have a capital loss on your trade-in. If you pay taxes, they will range from 10% to 28% of *the gain*. However, don't take my word for it, but see your tax expert.

In these three actual trades we averaged gains from 28% to 47%. The first half of these trades (swapped from gold into silver) was done two to three years ago, so some patience is needed with this strategy. Observe that the strategy works for large investors or small.

**Our goal is to convert a sterile investment – silver or gold – that throws off no dividend or interest into a paying investment. While we are waiting for the price to rise, we make that sterile investment fertile by swapping back and forth from silver to gold to increase the total number of ounces we hold at the bull market's end.**

### GOLD/SILVER RATIO SWAPPING STRATEGY

Here's my strategy in a nutshell:

- We always own & hold precious metals, for the duration of bull market.
- We swap gold for silver or silver for gold when the price is right, to increase the total number of ounces we hold.
- *Worst risk:* we swap too soon, and end up holding gold instead of silver when the ratio reaches its low at 16:1.
- *Another refinement:* As silver market offers opportunity, we swap from one form of silver to another, increasing the number of ounces we hold. (From 25 years experience in the silver and gold market, I know one thing is true: "Premium always disappears." Therefore whenever any form of silver or gold develops a large premium over its metal content, I'm going to swap that off for something cheaper to increase the number of ounces I hold.)
- Goal: To end the bull market holding mostly silver (70% or more), because it will rise faster.
- Goal: To double the number of ounces we hold over life of the bull market.

So far, so good.

■ F. Sanders

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<sup>1</sup> American Geological Institute Data Sheets for Geology in the Field, Laboratory, and Office, Third Edition, Data Sheet 57.1, "Abundance of Elements," on average the naturally occurring ratio is 17.5:1.

<sup>2</sup> James U. Blanchard III & Franklin Sanders, *Silver Bonanza: How to Profit from the Coming Bull Market*. Jefferson, Louisiana: Jefferson Financial, Inc., 1993.