Background

Silver

The Gold Silver Ratio

For centuries an ounce of gold traded at a ratio of 15:1 to silver. This was not a man-made ratio. There is, in fact, roughly 15 times the amount of silver as there is gold in the earth's crust, so this ratio was more of a geological truism. That all changed in the 1980's, a time when silver was largely de-monetized.

However, today this price ratio has swung to an extreme level of nearly 67:1. With the gold/silver price ratio absurdly out of balance relative to the amount of raw ore on our planet, and with that ratio declining every year, we believe at some point there must be a dramatic rebalancing in price between gold and silver.

Given that much of the world's silver has been permanently depleted, and given what the long-term price ratio was while silver was abundant, it is natural to assume that restoring a sustainable equilibrium between gold and silver would result in a gold/silver price ratio lower than the historical average, in other words below 15:1.

If we were to assume that the ratio reverted to its mere historical average this still suggests a silver price of around $70/oz. And if we were to predict a conservative "ceiling" for the price of gold at $2,200/oz (inflation-adjusted high of $875/oz reached in 1980), then that would imply a silver price of close to $150/oz, a rather large leap from today's lowly price of $16.30/oz.

Demand

A Store of Value

Silver is a precious metal just like gold, and has been used as a form of currency for centuries. In the form of electrum (a gold-silver alloy), silver was coined to produce money in around 700 BCE by the Lydians. Later, silver was refined and coined in its pure form. Many nations used silver as the basic unit of monetary value and the words for "silver" and "money" are the same in at least 14 different languages.

In fact, the name of our own monetary unit "pound" reflects the fact that it originally represented the value of one troy pound of sterling silver.

Jewellery

Jewellery and silverware are traditionally made from sterling silver, an alloy of 92.5% silver with 7.5% copper.

We are currently seeing investors squeezing out jewellery-buyers for the dwindling available supplies of gold. With the price of gold going higher, and the world in the midst of a recession, this trend can only accelerate. By default, this means a dramatic increase in the demand for silver jewellery. The other alternative to this scenario is a sharp decline in consumers desire to own and wear jewellery.

We dismissed such a concept.

Industrial Applications

In addition to its use as a store of wealth or as jewellery, silver has something going for it that gold doesn't - it has real applications in both industrial and technological products and processes.

Silver has unique characteristics. Of the 92 naturally occurring elements, it is one of the best conductors of heat and electricity as well as the most reflective and the second-most ductile and malleable. Silver also has the lowest contact resistance of any metal.

Silver was always involved in traditional photography. Though its use in this industry is declining on the rise of digital photography, it is an important component in many newer, eco-friendly technologies. Photovoltaic solar cells as well as hybrid and electric car batteries are two examples. Silver is so important and irreplaceable to the manufacture of these items, it has picked up the nickname "the green metal".

Supply

Most silver (just under 80%) is produced as a by-product of gold, copper, lead and zinc mining from mines principally based in Peru, Mexico, Australia, Chile, Poland and Kosovo.

The majority of silver mined each year is used industrially. In almost every one of these applications, the silver is used in very small amounts (relative to the particular process or product). Because these tiny quantities of silver are not recoverable, most silver is effectively consumed in the literal sense: it is gone forever. None of the uses of gold on the other hand uses, destroys, or uses up the gold, so essentially all the gold that has ever been mined is still available somewhere in the world, with a small amount added each year through production.

In just the last century, most of the world's stockpiles of silver have been "consumed" in this manner. When it comes to the relative total supplies of gold and silver, the ratio of silver to gold in the world steadily shrinks every year. Many estimates of existing stockpiles of silver to gold are of ratios of 6:1 or less.

Despite its widespread uses, the silver market is surprisingly small. There are only a few hundred million ounces of silver actively traded around the world. By contrast, gold trades at 2.5 billion ounces. Trading mere 1 million ounces of silver can move the entire market.

The famous hedge fund manager, Jim Rogers, is fond of noting that no one can repeal the law of supply and demand. During the long bear market from 1980 to 2003 - when silver traded mostly in the $3.50-$5 per ounce range - silver was more valuable when it was left in the ground. As a result, over the course of the 1990s, the gap between silver supply and silver demand began to widen. The Silver Institute notes that mine production of new silver rose only 4% from 1990–1999, while demand increased by 22% during the same period.

At the same time, the above-ground silver supply is projected to shrink to a critically low level in 2010. According to research consultancy CPM, in 1990, there were around 2.2 billion ounces of silver held in above-ground stocks. As recently as 1995, there were 1.4 billion ounces of bullion in stockpiles. Today, there are probably only about 300 million ounces. That's a 50-year low.

Therefore, at the same time that the gold/silver price ratio has swung to an extreme, favouring gold, the actual supply of silver (compared to gold) has never been lower.

The Slingshot Effect

At the current gold price of $1,080 an ounce, a more conservative ratio of 50:1 would look more like $21.6 plus for an ounce of silver, a gain of 32.6% on the current silver price.

Now that the price of gold has broken through the $1,000/oz level and managed to form a base at that level, we believe the foundations are in place to pull the price of silver higher at a much faster rate than gold going forward, as silver is a much smaller market.

The silver market is so tight and unaccustomed to speculators (compared to the gold market), that if someone calls for physical delivery of the metal (which a contract enables them to do) the entire mechanism could break down, triggering an explosion in prices due to the physical scarcity.

Picture the stored potential energy of one end of a rubber band being held back (representing silver prices) as the other end of the rubber band is being pulled forward (gold prices). The further you stretch the "gold" end of that rubber band, the more the potential snap you're going to get when you finally release the silver end. That's what we could be looking at with a 66:1 gold to silver ratio and a tight market with few ways to get exposure. That's the Slingshot Effect.

Silver reached a record high of $49.45 in 1980. Though this was driven by speculation, the price is not adjusted for inflation, which would be approximately $100/oz today. Trading at barely 33% of its previous record level, silver must be one of the most oversold assets around with many silver bulls predicting the metal rising 10x from its current levels between now and the end of the commodities super cycle around 2015.

How to buy silver

Traditionally, silver as an asset class has been difficult for retail investors to access with its accompanying high costs of brokerage, transportation, storage and insurance. However with the introduction of exchange-traded commodities, investors can now buy silver via a single share. The ETFS Physical Silver (PHAG.L) for example can be bought on the London Stock Exchange during normal market hours, in pound sterling as well as US dollars with an annual management fee of just 0.49% which covers the cost of storage (allocated silver is held in a vault by HSBC) and management.

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