Murray's Musings

WEALTH AND CRISIS: THE ROLE OF DIAMONDS IN ASSET ALLOCATION

The modern understanding of asset allocation is based on the premise of social stability. If the assumption of social stability is removed, the conceptual foundation of modern asset allocation vanishes along with it.

For example, a basic building block of asset allocation is the notion that short-term government securities represent a risk-free asset. This is obviously untrue in an inflationary environment, since the asset will lose purchasing power. It is also untrue in an environment of war or civil war.

Inflation has not usually been a problem in the developed world since World War II, with the great exception of the 1970s decade, although inflationary episodes did occur in the aftermath of World War II, as one might expect.

Globally, however, inflation is not uncommon. Trading Economics recently produced a list of 10 nations with very serious inflation:

Table 1: Nations with Highly Problematic Inflation

Country	Annual Inflation Rate
Venezuela	1198.0%
Sudan	340.0%
Lebanon	201.0%
Syria	139.0%
Suriname	62.3%
Zimbabwe	60.7%
Argentina	51.2%
Turkey	36.1%
Iran	35.2%
Ethiopia	33.0%

Source: TradingEconomics.com

This list is only comprised of the nations with the highest recorded rates of inflation. If problematic inflation is defined as a recorded rate that exceeds 10% per annum, this list would double. Twenty countries, or about 10% of the world's nations, are experiencing serious inflation.

Inflation, though serious, is not the most grave threat to wealth preservation. The most serious threats are war, civil war, and social unrest.

Civil war can last surprisingly long. In the Western world, investors generally ignore such conflicts. It is astonishing to learn that the Myanmar civil war has been raging since 1948.

The country, once known as the British colony of Burma, achieved independence that year. Since then, seven states of that nation—representing a variety of ethnicities—have engaged in a continuous armed struggle for either autonomy or independence.

This is not the only example. A left-wing armed revolt against the government of the Philippines has been continuing since 1969. An armed struggle between the government of Colombia and the drug cartels has been ongoing since 1964. The civil war in Syria began in 2011. In Sudan, the war in Darfur has been continuing since 2003. The civil war in Yemen has been happening since 2014. Conflict still roils Afghanistan, a nation that's been in a continuous state of armed conflict since 1978.

One might be tempted to dismiss these conflicts as irrelevant to industrialized nations, but one must note that the low-intensity Ukrainian civil war that commenced in 2014 has evolved into an actual Russo-Ukrainian war.

None of the long-term studies of wealth and investment returns really take into account the influence of war and social unrest. Few studies of the impact of war upon wealth appear to exist. Many books have been written on the French Revolution and the Napoleonic wars, but the focus is on military strategy and social change. Similar remarks might be made about the First and Second World Wars. One reason for this is that the period from the Battle of Waterloo in 1815 to the beginning of the First World War in August 1914 is usually considered to be a peaceful era, but it is only peaceful from a Eurocentric or American perspective. In fact, even the American perspective ignores the wealth impact of its own Civil War.

At least 50 19th century civil wars have been almost entirely ignored by historians. One example is the Seinan Senso or Southwestern War, so called because it was largely fought on the island of Kyushu in Southwestern Japan. Essentially, the samurai class was not initially opposed to the Meiji Reform that implemented imperial rule in Japan in 1868, but it became increasingly concerned with the direction the government was taking and established an independent military academy. This was viewed as a serious challenge to governmental authority, and eventually a series of incidents quickly deteriorated into civil war. The government eventually prevailed, but the cost of the conflict nearly bankrupted the country. The war forced Japan off the gold standard and effectively tripled the country's national debt.

This very brief survey of conflict should be sufficient to establish that the probability of destabilizing conflict is not zero. Therefore, an investor's asset allocation profile should contain one or more assets that could maintain value and possibly even increase in value in the event of such a conflict.

Cash, bonds, stocks, private equity, and real estate—the current standards in asset allocation strategies—are vulnerable in the event of war. Cash and bonds are vulnerable since they are obligations of the government, and the creditworthiness of the government is in question during such a crisis. Equities represent business enterprises. Amid conflict, an enterprise might be subject to much higher taxation. Its business prospects could be greatly diminished during war, and might even be seriously damaged by the ensuing violence. The same points would apply to private equity. Real estate can obviously be damaged during an armed crisis, as well. It is also a highly visible asset that is not movable and could be expropriated.

Given the problematic features of conventional assets during a true crisis, the obvious and conventional alternatives are gold and silver.

One could readily dismiss silver as a crisis asset on the question of value density—that is, the physical quantity of an asset needed to afford protection. To demonstrate, let us assume that the basic unit of account for wealth is $1 million. Using the current silver price of $23.56/ounce, 42,444.82 ounces of silver would be required to store $1 million in value. Each troy ounce is 0.18 cubic inches, so this equals 7,674.8 cubic inches, or 4.44 cubic feet, of volume. The challenge of transporting 4.44 cubic feet of silver is not trivial; it would weigh 2,910 pounds, or about that of a Nissan Sentra 4-door sedan.

This is not to assert that silver wouldn't appreciate in a crisis, but the primary wealth management problem in a crisis is not the maximization of return, but the prevention of seizure.

In the case of gold, seizure can be prevented if it is held outside of the regulated custodial system. In comparison with silver, a gold price of $1,788 per ounce requires only 559.2841 ounces of gold for $1 million of value, thus mitigating the transportation problem to some extent. Although this is far simpler than transporting 22,444.82 ounces of silver, weighing 38 pounds it still requires a transportation conveyance and is not easily concealed.

Art, in the form of a painting, is potentially value dense. The transportation problem is not necessarily complex and it does not necessarily require specialized conveyance. However, a painting is very fragile. It could be concealed, but maintaining the proper storage conditions to preserve the painting's value in a crisis is not a trivial problem.

This leaves diamonds as an important crisis asset that has not yet become an accepted asset class. Diamonds are light. One carat weighs one-fifth of a gram. Stated in other terms, one carat is equivalent to 0.007 ounces, and there are approximately 2,265 carats to a pound. The average person should have no problem locating a one-carat diamond worth $2,000 for purchase, although much more expensive stones can be found. Even with a $2,000 average per-carat price, one pound of diamonds—or 2,265 carats—is worth $4,530,000.

In contradistinction, gold's value density is much lower. A pound contains 14.5833 troy ounces. At $1,788 per troy ounce, the value of one pound of gold is 14.5833 (troy ounces) x $1,788 (price/troy ounce), or $26,075. Assuming the purchase of relatively inexpensive $2,000 diamonds as the basis for the calculations, one pound of diamonds is worth $4,530,000, whereas one pound of gold is worth $26,074. The ratio of the two assets, $4,530,000 versus $26,074, means that diamonds are 172.58 times as value dense as gold. It should be noted that this exercise greatly understates the potential value density of diamonds.

Investors might not understand the importance of the concept of the value density of diamonds, but the idea has been explored thoroughly in popular literature and film. For instance, in the short story titled “The Adventure of the Blue Carbuncle” by Arthur Conan Doyle, Sherlock Holmes investigates a theft of a priceless gemstone from the hotel suite of the Countess of Morcar. The story would have been impossible to write, had the premise been that the equivalent value of gold were stolen: there would be no reason to have such a quantity of gold in a hotel suite. Moreover, Doyle would’ve had to explain the logistics of removing a large quantity of gold from a hotel suite without being observed. Similarly, in the Alfred Hitchcock movie *To Catch a Thief*, a cat burglar steals jewels, not gold. The jewelry theft is the MacGuffin, or plot device, upon which Hitchcock weaves the story based on David Dodge’s novel of the same name. A burglar’s escape by rooftop while carrying a large quantity of gold simply couldn’t happen.

Accepting the value density aspect of diamond investing leads to the logical conclusion that diamonds should be the asset of choice for the circumstance when social cohesion is in question. Social cohesion has been in question many times in history, and it is now unraveling in at least 10% of the world’s nations. Nevertheless, diamonds have yet to attract institutional interest.

This is probably because most investing in the contemporary era is institutional investing, and institutional investing can only exist with sufficient social cohesion for the institution to continue to function. If a financial institution’s investment committee were ever to turn its attention to the potential loss of social cohesion, it almost necessarily follows that the committee also must reflect on the possible inability of the committee and the institution to function. For such a committee considering that possibility, it would essentially be preparing for its own demise, in which case it might have an enhanced interest in a diamond portfolio to access in a genuine state of emergency. That would be much like planning for beneficiaries while simultaneously imagining the demise of the management.

As difficult as it might be to plan for the loss of social cohesion, the great number of breakdowns of the institutional order in many nations just in the first part of the 21st century makes an allocation necessary to an asset that can endure, is universally accepted, is transportable, can be hidden and protected from seizure, and appreciates over the course of time. Such an asset is diamonds.

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