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Gold ETFs, caveat emptor

Posted by **Izabella Kaminska** on Oct 08 15:42.

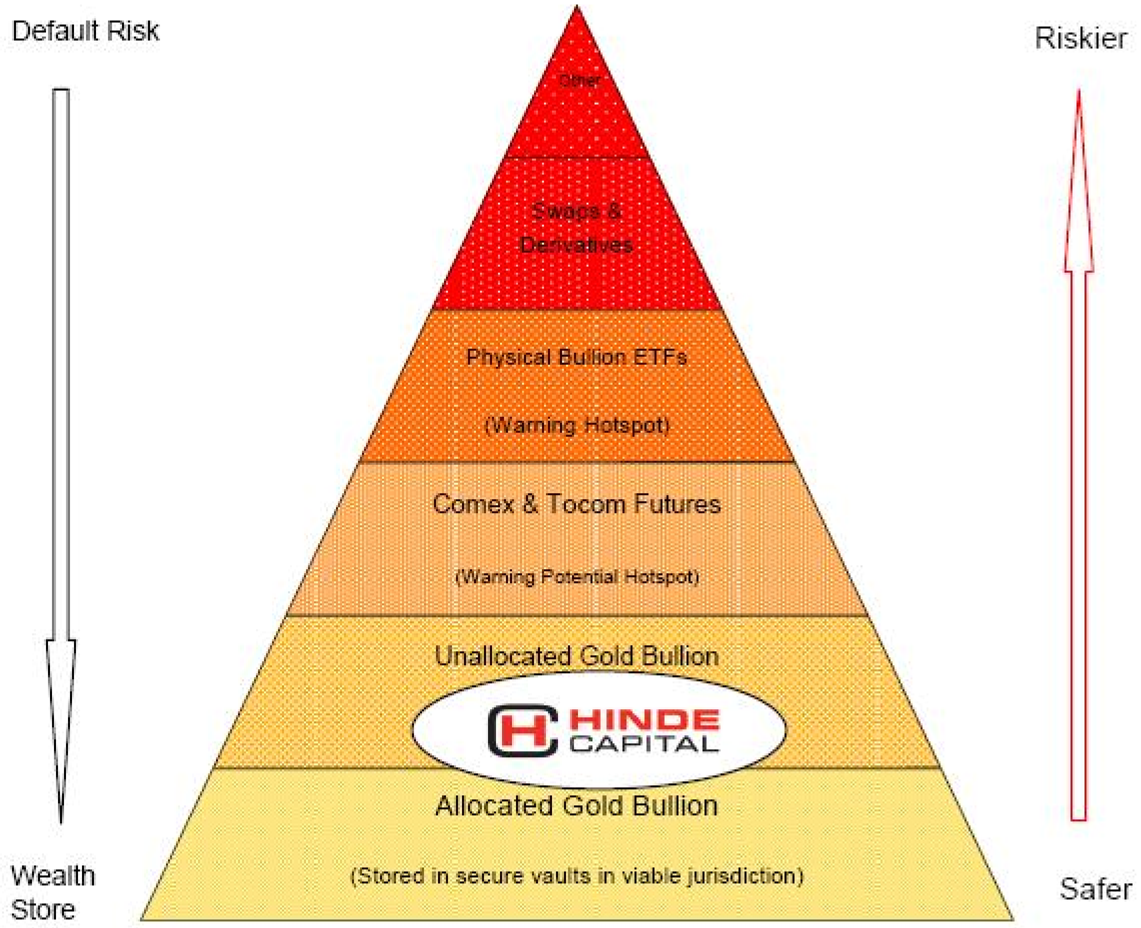
With gold prices on a tear of late it's no surprise bullion-investing exchange-traded funds (ETPs) are facing more demand than ever from retail investors. As Barclays Capital noted on Thursday:

> *Speculative interest remains close to record highs and ETP holdings continue to grow. Gold held in SPDR rose by 8.8 tonnes yesterday, the data reflect settled purchases which took place three days ago. Total holdings have expanded to another record high at 1754 tonnes, equivalent to the sixth largest official holding of gold.* ***Indeed total metal held is fast approaching our annual estimate for jewellery demand this year at 1880 tones.***

But should investors really be treating investments in gold and gold ETFs as one and the same?

As we noted earlier this week, concerns over commodity ETFs (or ETPs as they are also known) are mounting, specifically with regard to what these funds may or may not actually own. While we realise every commodity ETF is different, and it's unfair to generalise completely - we contend there are some common risks associated, especially where precious metals are concerned.

The following chart from Hinde Capital, for example, sets out the issue in terms of seniority of claims when it comes to different types of gold investments:



Hinde Capital, of course, manage a gold fund which makes a point of not investing in ETFs, so there is an element of talking their book here. Nevertheless, the point stands.

As Hinde explain, the issue comes down to whether the funds are invested in allocated or unallocated gold (our emphasis):

> *Allocated Gold -is held with a dealer in a customer's name evidencing that uniquely identifiable bars of gold have been "allocated" to the customer and are segregated from other metal held in the vault of that dealer. The client has full title to this gold with the dealer holding it as custodian.*
>
> *Unallocated Gold -most gold traded in the London market is traded and settled in unallocated form.* ***Gold held in this form does not entitle the holder to specific bars of gold but gives the holder a right to require the delivery of certain amounts of gold. Unallocated gold is not the investor's property. They are lending their gold to the bank, just like a cash deposit, but with no deposit protection).***

Accordingly, Hinde warn that investors should not confuse investments in gold ETFs with direct investments in gold. ETFs, they say, are paper products or derivatives tracking the price of gold of silver — a pledge in paper form for bullion ownership. Their viability depends on the solvency of their custodians. What's more, the structures have never really been tested under stress.

As Hinde conclude:

> *A failure of the ETF provider leaves the investor as a creditor. AIG created such a risk. The counterparty risk is high for most ETF providers. The Federal Reserve had to bail out AIG; others will not be so lucky or deserving of such attention. Furthermore the ETFs are under the stewardship of the regulators such as the SEC in the US who can change the rules as they did when recently banning naked short selling on financial stocks. Theoretically regulators could make ownership of gold via an equity very difficult. They could even ban or prohibit ownership.*
>
> *Gold ETF providers state that individuals can take physical delivery of gold. This has rarely been done and is certainly not encouraged.* ***The physical gold, if demanded, is placed into "unallocated bullion" accounts. This means the investor has a "general entitlement" to the gold. Just like the fractional reserve banking system ETF providers are relying on the fact that investors will not all demand their gold at the same time.*** *Like a bank they would be unlikely to deliver. The providers also state that they reserve the right to settle on cash not bullion terms under certain or extreme market circumstances.*

All these risks, by the way, should be clearly set out in the ETF prospectuses concerned.

Related links:
How ETFs are like mortgage-backed securities - FT Alphaville
The problem with commodity ETFs - FT Alphaville
Looking at precious-metal flows - FT Alphaville

This entry was posted by Izabella Kaminska on Thursday, October 8th, 2009 at 15:42 and is filed under Capital markets, Commodities. Tagged with bullion, etfs, gold.

This item is closed to further comments.

Comments

VoidStar *Oct 9 00:28*

The source report helps to define the line between "Gold Bug" and "Crazed Unabomber Survivalist."

The global financial market is not going to collapse with the Undead roaming the earth eating brains, on the other hand, there is a strong possibilitiy that the majority of developed country fiat currencies are going to be debased significantly.

Gold is a currency worth trading as paper because central banks are stuck with the stuff. However in the event of the total collapse of civilization, a good semi-automatic and a cabin in Colorado is a better investment than a lump of shiny yellow metal.

praxis22 *Oct 8 18:32*

@Izy & hedgehog

Yup, this is exactly why I don't trust gold. Most people are not holding physical gold, they're holding paper. I'd be more concerned at the price of the paper, as I'll bet many people are buying it and mentally "putting it away" but I'm willing to bet that the price of the paper is more correlated to interest in gold, than the price of the underlying commodity.

I suspect that by the time the retail punter thinks to sell the paper the smart money will have move the price already as they got out.

User4377747 *Oct 8 18:01*

But this report doesn't make it clear that some physical gold ETFs, such as PHAU, are backed by allocated gold. There isn't a problem with all gold ETFs, is there?

Such as PHAU: http://www.etfsecurities.com/en/updates/document_pdfs/ETFS_Physical_Gold_Fact_sheet.pdf

hedgehog *Oct 8 17:24*

Izabella

As private investors are likely to be late to the party your point is very important but I am afraid will be largely ignored (as just pointed out by daddy)

If you buy gold largely as an insurance against financial/economic breakdown then it clearly makes sense to hold physical.

For those who take the view that we are past the worst and won't be seeing March type lows again and are buyers just because Gold is the momentum play of the moment they won't give the third party default risk a moments thought despite what they should recently have learned.

daddy *Oct 8 17:16*

"All these risks, by the way, should be clearly set out in the ETF prospectuses concerned."

... and yet, as always, if and when one blows up investors will claim they had no idea of the structure they were investing in.

Austrian Banker *Oct 8 16:38*

No mention of under pillow?