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A CDO-esque gold investment

Posted by **Izabella Kaminska** on Aug 13 14:10.

Hinde Capital, the London-based gold hedge fund — with an objective to outperform gold — have put out a note about what they feel are the CDO-esque qualities of the GLD gold exchange traded fund.

And yes, we realise they have a certain interest in criticising an alternative and rival gold vehicle — but it is worth looking at the points they raise, since they make a compelling case.

A chief criticism actually concerns the fund's vulnerability to double-accounting.

After all, the whole point of owning gold (for many) is to hedge against potential systemic meltdown. This is why many gold investors will make a point of investing in allocated gold, where every bar of gold is registered to the holder, rather than unallocated ones, where it is not.

The idea being that you want to own the gold outright at all costs.

With GLD, no such allocation is possible since specific bars are not designated to specific shareholders.

In the event of liquidation, shareholders have a claim over the pool of assets held by the fund — and also come second to alternative claims (like those of direct creditors, trading partners *et cetera*).

As for the double accounting exposure, Hinde feel it's not clear whether the pool of assets, in its own right, is definitely unencumbered.

There are two reasons for this.

First there's the structure of the fund itself which features an unallocated component. As Hinde note:

> **All of the gold owned by the GLD Trust is held in the Trust's Allocated Account, **except when one creates or redeems the baskets, then the gold passes through the Trust's Unallocated Account.** This exposes the investor to unsecured credit risk – it is encumbered gold.*

While the sums stored in the unallocated account may appear minimal relative to the sums held in the allocated account in normal circumstances, in the event of market stress — say when gold is spiking higher alongside strong inflows into GLD — those unallocated portions may be forced to grow in size, or else risk net asset value disruption.

And as the unallocated portion grows, the rights of shareholders to unencumbered assets become diluted.

As Hinde note:

> *The prospectus declares the custodian has been "instructed" to hold no more than 430 ounces of gold in the Trust's unallocated account overnight, but in systemic failure, it is highly likely the investor is exposed to larger amounts. {emphasis added}*

The other issue is down to the structure of the gold market itself.

There are fears amongst some market watchers that double-accounting practices within the market have led to multiple claims for every piece of gold.

Hinde cite a paper by the IMF's Hidetoshi Takeda, which suggests double counting of gold can occur when a bullion bank sells outright gold acquired through gold deposits/loans from other monetary authorities.

And as they note:

> *"These particular accounting principles could pose a problem when **international statistical standards allow swapped/deposited gold to remain in the reserve assets of the gold provider.**" {emphasis added}*
>
> **There is a problem – swapped or loaned gold that has been sold into the financial system has led to multiple counting of titled gold***
>
> **It is evident that gold with multiple owners has entered into unallocated and more importantly allocated accounts. We see it as highly likely that encumbered or leased gold could thus be in ETF products.*

Hence, while gold held in the GLD's allocated account is not traded, leased or loaned under any circumstances, what is harder to determine is whether or not the gold they actually possess already has another claim on it.

In Hinde's opinion, it is quite likely that encumbered/leased gold has found its way into the GLD via the unallocated accounts.

As for the allocated accounts themselves:

> *Custody of the Trust's Gold Form 10K:*
>
> **Allocated gold held with subcustodians – Bank of England, Via Mat and LBMA market-making members that provide bullion vaulting and clearing services to third parties.*
>
> **"The Custodian **does not** have written custody agreements with the subcustodians it selects. The Custodian's selected subcustodians may appoint further subcustodians. These further subcustodians are not expected to have written custody agreements with the Custodian's subcustodians that selected them. The lack of such written contracts could affect the recourse of the Trust and the Custodian against any subcustodian in the event a subcustodian does not use due care in the safekeeping of the Trust's gold."*
>
> *"The Trustee **does not** undertake to monitor the performance of any subcustodian. Furthermore, the Trustee may have no right to visit the premises of any subcustodian for the purposes of examining the Trust's gold bars or any records maintained by the subcustodian, and no subcustodian will be obligated to cooperate in any review the Trustee may wish to conduct of the facilities, procedures, records or creditworthiness of such subcustodian." {emphasis added}*
>
> ****These disclosures clearly explain there is heightened and multiple counterparty risk***

For more risks still, see the full report in the usual place.

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This entry was posted by Izabella Kaminska on Friday, August 13th, 2010 at 14:10 and is filed under Capital markets, Commodities. Tagged with CDO, CDOs, GLD, gold, Hinde.

Comments

"There is absolutely, no possible way that there is enough available gold in the entire world, for all of the various gold ETF's to have all acquired physical gold to back them."

All the ETFs and other products only hold 7.8% of th estimate privately held gold stocks of 895 million ounces. You seem to have missed where Hinde says "It's probably not a question of do the ETFs have the bullion, it is a question of 'ownership' - we have shown that GLD gold could have multiple claims" At no point do they claim GLD does not have the physical allocated gold behind the shares.

Surely the point of holding real gold is the fear of meltdown, as pointed out above. If so what does it matter if there's a short squeeze, since if you sell then you lose you hedge against the apocalypse. Unless you're just speculating, in which case IMO, gold is just another "investment" and we know what happens to those.

And what will generate such a squeeze?

@TheWord.
That is the sheer joy of being long the physical stuff in an allocated account when the underlying commodity can't meet all open interest claims . The short squeeze will be brutal...

Well done Hinde some very good points

Now we await the case for the defence

There is absolutely, no possible way that there is enough available gold in the entire world, for all of the various gold ETF's to have all acquired physical gold to back them.

It is a fractional reserve, paper gold scheme which would never withstand proper scrutiny.
