The Billionaires Are Wrong on Gold

May 25, 2016

By Nick Barisheff

Recently the mainstream media has reported that several billionaires are concerned about global financial markets and have purchased significant amounts of gold to protect their portfolios.

Take Stan Druckenmiller, the famed hedge fund manager who managed money for George Soros as the lead portfolio manager for Quantum Fund. He and Soros famously 'broke the Bank of England' when they shorted the British pound sterling in 1992, reputedly making more than $1 billion in profits. He has reportedly used over $323 million of his own money to invest in gold. This is approximately a 30% allocation in his $1-billion family fund. His belief in gold can be attributed to his criticism of the Federal Reserve's massive money printing and near-zero interest rates. Ongoing low rates will drive both central banks and investors into gold.

Then there's John Paulson, the CEO of Paulson & Co., which manages over $18 billion in assets invested in credits default swaps. The company has made about $15 billion in profits by betting against subprime mortgages. In 2015 Paulson invested about $900 million in gold at close to what now appears to have been the bottom of the three-year correction. He believes gold has a place in portfolios as insurance against the unexpected. *"We view gold as a currency, not a commodity,"* Paulson said recently. *"Its importance as a currency will continue to increase as the major central banks around the world continue to print money."*

Typically the billionaires are ahead of the curve, making their investments before the market recognizes the trend, and increasing their wealth while everyone else wonders what happened. High net worth individuals and other savvy investors realize that owning gold is one of the best ways to manage systemic risk. However, in this case both Druckenmiller and Paulson have the right idea but the wrong execution. Instead of acquiring physical bullion stored on an allocated basis, these billionaires chose proxies of gold in the form of ETFs. Their investments in ETFs may ultimately negate the very reason for investing in gold in the first place. Only physical gold provides true diversification outside of the financial system. Physical gold is immune from counterparty risk or liquidity constraints. Investing in gold proxies may work under normal conditions for short-term trades and hedging strategies, but will be subject to the same systemic risks that financial assets will incur. The time when you need the protection of gold the most is the time when these proxies are most likely to fail and not provide the portfolio protection of bullion owned directly.

Gold ETFs are an investment choice that many investors and their advisors make. They are seduced by the ease of purchasing shares and the low management fees. However, as with all investments, it is critical to look under the covers and do your due diligence in order to fully understand how ETFs work and what the risks are. A paper by the Bank of International Settlements (http://www.bis.org/publ/work343.pdf) concluded:

> *"Crisis experience has shown that as the intermediation chain lengthens, it becomes complicated to assess the risks of financial products due to lack of transparency as to how*

risks are managed at different levels of the intermediation chains. Exchange-traded funds, which have become popular among investors seeking exposure to a diversified portfolio of assets, share this characteristic, especially when returns are replicated using derivative products. As the volume of such products grows, such replication strategies can lead to a build up of systemic risks in the financial system."

In an Investor Bulletin on exchange-traded funds (https://www.sec.gov/investor/alerts/etfs.pdf), the SEC recommended that:

"Before investing in an ETF, you should read both its summary prospectus and its full prospectus, which provide detailed information on the ETF's investment objective, principal investment strategies, risks, costs and historical performance (if any). The SEC warned 'Do not invest in something that you do not understand. If you cannot explain the investment opportunity in a few words and in an understandable way, you may need to reconsider the investment.'"

Unfortunately, most investors and/or their financial advisors have not read the prospectus or the underlying documents, such as the Authorized Participant Agreements. As a result they do not understand the underlying risks of ETFs. In the case of the gold ETFs a careful read, paying particular attention to the wording, is critically important. I have participated in the process of creating prospectuses dozens of times with some of the major law firms in Canada. In these drafting sessions, the lawyers for each side spent an enormous amount of time arguing about the subtleties of the wording that is carefully chosen for its precise legal meaning.

Most investors and many financial advisors assume that an ETF is similar to an open-end mutual fund with low management fees. The low management fees are the motivating factor, and they tend to overlook the fundamental structure of ETFs versus open-end mutual funds. In open-end mutual funds:

- Investors send their subscriptions to the fund manager;
- The fund manager purchases assets according to the fund's stated mandate;
- Investors are issued units that represent an undivided interest in the mutual fund.

In properly structured mutual funds, the only people that have any claim on the fund's assets are the unitholders. Fees are typically in the order of 1.25%, plus trailer fees and expenses.

ETFs are structured in a completely different manner. To start with, the GLD prospectus states:

*"The investment objective of the Trust is for the Shares to **reflect the performance of the price of gold bullion**, less the Trust's expenses."*

It does not say that the objective is to own gold. The ETF works well for investors who are frequent traders, and for investors who use ETF options to hedge their physical gold holdings or improve performance. However, they are not the best choice for investors who want to have all the benefits of owning gold. The SPDR website explains how ETFs operate:

*"Authorized Participants create fund shares in large increments—known as creation units—by **assembling** the underlying securities of the fund in their appropriate weightings to reach creation unit size and then deliver those securities to the fund in-kind. In return, the AP receives Fund shares which are then **introduced** to the secondary market where they are traded between buyers and sellers through the exchange.*

*APs also have the ability to redeem the fund shares through the same process in reverse. Large increments of fund shares—known as redemption units—are **collected** in the secondary markets and then delivered to the fund in-kind exchange for the underlying securities in the*

appropriate weightings equalling that redemption unit."

Given that very high-priced lawyers reviewed the above wording, it is interesting to note the unusual word choices: **assembling** instead of acquiring or purchasing; **introduced** instead of sold; **collected** instead of purchased. Based on my experience with lawyers, there is nothing unintentional about this vocabulary. On the contrary, a great deal of thought went into it.

A thorough report on the differences between mutual funds and ETFs was prepared by Deloitte (http://www.runtogold.com/images/Deloitte-ETF-report.pdf). The explanation there offers more clarity:

> *"A portfolio composition file, created by the sponsor, lists the composition and weights of the underlying securities or commodities that mirror the target index. APs then* ***buy*** *or* ***borrow*** *relatively large amounts of the underlying stocks from the capital markets that would mirror the index. If the proposed ETF tracks a commodity it* ***buys*** *or* ***borrows certificates*** *of ownership of that commodity. The basket of securities is delivered to the custodian who verifies that it is an approximate mirror of the index. The AP then subsequently receives a 'creation unit' delivered to their account at the Depository Trust Corporation. The creation unit is broken up into ETF shares, which represent a fraction of the creation unit. The AP* ***sells*** *the ETF shares on the open market like any other publicly traded share."*

I have clarified the way ETFs operate in two previous interviews with David Ranson of Wainwright Economics (http://bmgbullion.com/wp-content/uploads/2016/05/SAS_Risks-of-Investing-in-Precious-Meatals-ETFs.pdf) (http://bmgbullion.com/wp-content/uploads/2016/05/Strategic-Asset-Selector-Who-owns-the-bullion-in-a-precious-metal-ETF.pdf). Since Wall Street is all about making money, it is important to follow the money. What motivation is there for Wall Street to purchase bullion at spot price, contribute the gold to the ETF at Net Asset Value (NAV), get ETF shares at NAV and then sell the shares at NAV to market participants? In simple terms, the AP borrows the assets at little or no cost, exchanges these assets for ETF creation units, then sells these creation units in the market and **keeps the entire proceeds**. It should be clear to everyone that this is not about management fees at all, but about Authorized Participants getting 100% of the proceeds from the sale of ETF creation units. They then use the proceeds to invest in investments that pay higher returns than their cost of borrowing, and add a liability to their balance sheet. For financial assets, Authorized Participants, who are primarily the major banks and brokerage houses, have always been able to borrow the assets from their client margin accounts at no interest cost, and from hedge funds when they are the prime broker. In the case of gold, it is typically leased from central banks. However, in an IMF Issue Paper dated April 2006, Paragraph 99 of the Guidelines mentions that the monetary authority make gold deposits:

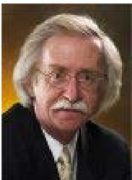
> *"…to have their bullion physically deposited with a bullion bank, which may use the gold for trading purposes in world gold markets" and "the ownership of the gold effectively remains with the monetary authorities, which earn interest on the deposits, and the gold is returned to the monetary authorities on the maturity of the deposits."*

As a result, the monetary authorities still show the leased gold as their asset—That is why it is called **"leasing."** While the gold ETF does in fact have gold in its vaults, the ultimate ownership may be with a central bank. At some point, an AP somewhere in the world, on some ETF, will become insolvent and then the lawyers will get rich arguing who is the rightful owner of the underlying asset—the ETF, or the original lender of the assets? While the litigation drags on, investors' assets will be

frozen to the NAV calculated at the time of the default of the AP. Even if the true ETF owners are successful in recovering their capital, this could be a significant lost opportunity cost in a rising gold market. If they are not successful, and it is more likely that the true owner—the central bank lender—will be successful, the *'gold'* investment that they made to protect their portfolio would be worthless.

With this in mind some billionaires, as well as investors and financial advisors, have the right concept of portfolio diversification but the wrong execution. ETF shares, certificates, and futures contracts are all proxies or derivatives of physical gold. What good is insurance if the insurance company is insolvent when your house burns down? In order to receive the benefits that gold has offered for thousands of years, investors need to own physical gold, not a financial asset, derivative, or gold proxy. Bullion Management Group Inc. has created a checklist to help investors with their due diligence to ensure that they actually own gold (http://bmgbullionbars.com/bullion-checklist/). Once you have acquired gold in the form of London Good Delivery Bars (http://bmgbullionbars.com/products-services/good-delivery) or bullion coins produced by the major government mints, you need to store the bullion in an LBMA-member vault on a fully allocated, insured basis. Allocated, insured storage will cost investors up to 1% depending on volumes. Any program that offers low-cost storage or a leveraged purchase program is not likely to provide true allocated, insured storage. Instead, investors may only own a liability of the bank or bullion dealer. Since gold could potentially be your asset of last resort, you do not want to save money on seemingly bargain storage fees and end up with no gold when you need it the most.

Don't be wrong like some of the billionaires who have the right concept but the wrong execution in their gold investment—Be sure to acquire physical bullion and store it on an allocated, insured basis.



Nick Barisheff *is the founder, president and CEO of Bullion Management Group Inc., a company dedicated to providing investors with a secure, cost-effective, transparent way to purchase and hold physical bullion. BMG is an Associate Member of the London Bullion Market Association (LBMA) and an Associate Member of the Responsible Investment Association (RIA).*

Widely recognized as international bullion expert, Nick has written numerous articles on bullion and current market trends that have been published on various news and business websites. Nick has appeared on BNN, CBC, CNBC and Sun Media, and has been interviewed for countless articles by leading business publications across North America, Europe and Asia. His first book, $10,000 Gold: Why Gold's Inevitable Rise Is the Investor's Safe Haven, was published in the spring of 2013. Every investor who seeks the safety of sound money will benefit from Nick's insights into the portfolio-preserving power of gold. ***www.bmgbullion.com***