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Strategic Asset Selector

Risks of investing in precious-metals ETFs

During a recent trip to Toronto, Canada, David Ranson met with one of our subscribers, Nick Barisheff,* an expert in precious metals, and president and CEO of Bullion Management Group Inc. (BMG). Talking about investing in precious metals uncovered some points that may be important for all of our subscribers. We present the content of this discussion in Q&A format here.

Q: First, please explain the major differences between ETFs and open-end mutual funds.

Barisheff: They are entirely different at their core. The common misconception is that ETFs take in investor money and then go out and buy the assets according to their investment mandate, like a traditional open-end mutual fund. But ETFs are structured completely differently from mutual funds. Instead, ETFs receive a defined "Basket" of assets from "Authorized Participants." Banks and brokerage houses acting as Authorized Participants contribute the Basket to the ETF and in turn receive "Creation Units" priced at net asset value from the ETF Trustee.

The Authorized Participant then sells the new units to investors at an intra-day premium over NAV. This intra-day premium does not show up during the day and the advertised price of the ETF is brought back to NAV at the end of the day.

To enhance profitability, Authorized Participants can either *buy or borrow* the assets that they contribute to the ETF. While the ETF prospectus is silent on this point, it is known to people familiar with the details of the ETF structure. The ability of Authorized Participants to buy or borrow the assets that they contribute to an ETF is discussed in a recent report by Deloitte.[1]

Q: What's the concern about the precious-metals ETFs specifically?

When equity ETFs were first introduced, they were set up as index trackers for the major equity indexes. Brokers have the legal right to borrow equities from their clients' margin accounts in order to short a stock or contribute to an ETF. The early index-tracking ETFs simply used equities that were borrowed from their clients' margin accounts.

The precious metals ETFs are probably structured in the same way, as it is more profitable for the Authorized Participant to borrow the metals rather than actually buy them. Authorized Participants probably lease the gold from central banks. These are points of concern, and they are highlighted in the original prospectus for streetTRACKS Gold Trust (GLD).[2] The current prospectus is not as helpful. It is about half the size of the original and omits much of the material that discloses the custodial arrangements.

Q: What specific disclosures should precious-metals ETF investors be concerned about?

There are several. Here are a few, taken from the original prospectus for GLD filed in August 2005 (my italics):

"The Trust will *not* insure its gold."

"In addition, the Custodian and Trustee will *not* require any direct or indirect subcustodians to be insured or bonded with respect to their custodial activities or in respect of the gold held by them on behalf of the Trust."

"The Custodian is only liable for losses that are the direct result of its own negligence, fraud or willful default in the performance of its duties."

"The Custodian is *not* liable for acts or omissions of its subcustodians unless the selection of such subcustodians was made negligently or in bad faith."

"There are expected to be *no written* contractual arrangements between subcustodians that hold the Trust's gold and the Trustee or the Custodian."

"If the Trust's gold is lost, damaged, stolen or destroyed under circumstances rendering a party liable to the Trust, the responsible party may *not* have sufficient resources to satisfy the Trust's claim."

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1. "Creating ETF Units," in *Exchange-Traded Funds: Challenging the Dominance of Mutual Funds?* Deloitte Development LLC, 2009, p.4.
2. streetTRACKS® Gold Trust Prospectus, State Street Corporation, August 26, 2005.

"Because neither the Trustee nor the Custodian oversees or monitors the activities of subcustodians who may hold the Trust's gold, failure by the subcustodians to exercise due care in the safekeeping of the Trust's gold could result in a loss to the Trust."

"The Trustee may have *no right* to visit the premises of any subcustodian for the purposes of examining the Trust's gold or any records maintained by the subcustodian, and *no* subcustodian will be obliged to cooperate in any review the trustee may wish to conduct of the facilities, procedures, records or creditworthiness of such subcustodian."

"The ability of the Trustee to take legal action against subcustodians may *be limited*, which increases the possibility that the Trust may suffer a loss if a subcustodian does not use due care in the safekeeping of the Trust's gold."[3]

"The Custodian may *not* have the right to, and does not have the obligation to, seek recovery of the gold from any subcustodian appointed by a subcustodian."[4]

"The Trust's independent auditors may also visit the Custodian's premises in connection with their audit of the financial statements of the Trust. Visits will *not* be allowed when no gold of the Trust is held in the Custodian's vaults."[5]

Q: Few investors or brokers read the fine print of a prospectus but, legally, are these points included so that the investor is ultimately responsible?

Perhaps, but of greater importance than what is disclosed in the prospectus is what is *missing* from the prospectus. In the course of transactions involving hard assets throughout the western world, someone usually certifies title to the seller. In the case of ETFs in general, and the GLD in particular, the Authorized Participant does not certify that it owns the gold and has clear title to it. Nor does it certify that the gold is not encumbered in any way.

Q: How is this different from an open-end fund?

It is entirely different. Investors have no need for concern with a traditional mutual fund that receives investor funds and then purchases its bullion outright from a member of the London Bullion Marketing Association. Title to specific bars is transferred to the fund, and the fund takes physical delivery and then stores it on an allocated, insured basis.

Q: Apart from the disclaimers in the GLD prospectus, what specific reasons cause you to doubt that it holds unencumbered physical bullion?

Although there is no proof of the amount of gold in the GLD that is borrowed, or possibly encumbered by its true owner, it is likely that the process for both equity ETFs and precious metals ETFs is the same. In the case of precious metals ETFs, it simply would not be profitable enough for the Authorized Participants to buy the assets that are to be exchanged for ETF units at NAV and then resell them at NAV to investors. In my opinion, if the bullion were actually purchased in the marketplace, the price would already be significantly higher than it is today. In this respect the growth of ETFs has not had the expected impact on the gold price, but rather deflects the demand for physical gold into a paper gold proxy.

Q: What do you think might go wrong in the future with the precious-metals ETFs?

In my opinion, ETFs are another type of derivative that could experience problems in a crisis. The main vulnerability is that you could have as many as three parties that have a claim to the same bullion—the original lender (central bank), the ETF investor, and the investor who bought ETF units from a short seller that borrowed the units. Of course, this does not include any unreported naked short positions, which even mainstream reporters are claiming is epidemic.[6] This could add a fourth party that believes it has a claim on the bullion. If anything went wrong, it would take years for the judicial system to determine the rightful owner.

In contrast, units of open-end mutual fund trusts cannot be borrowed for shorting.

If the Authorized Participants in an ETF lose control in maintaining the bid/ask spread or become insolvent, someone is going to lose. That's not likely to be the central banks—it will be the ETF investors. So although ETFs function as good tracking vehicles during normal conditions and can be used by traders, they may not be suitable for long-term investors who are seeking wealth preservation. When the time comes, in a crisis, when you really need your bullion to protect your portfolio, that is likely to be just the time that the ETFs may experience problems and not perform as expected.

Q: There is now over $30 billion in precious-metals ETFs. Has everyone missed these problems?

I'm afraid a lot of people have made erroneous assumptions without actually reading the documents.

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3. *Ibid.*, pp 11-13.
4. *Ibid.*, p. 44.
5. *Ibid.*, p. 48.
6. Matt Taibbi, *Wall Street's Naked Swindle*, Rolling Stone Magazine, October 14, 2009, http://www.rollingstone.com/politics/story/30481512/wall_streets_naked_swindle/print

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