

## Strategic Asset Selector

### Who “owns” the bullion in a precious-metal ETF?

**W**ainwright recently published an interview with Toronto mutual fund owner Nick Barisheff about using ETFs such as GLD or SLV to invest in precious metals. Mr. Barisheff questioned whether such ETFs provide the investor with ownership of the precious metal itself, as would a direct purchase of bullion or investment in a closed-end mutual fund.<sup>1</sup> Some of these doubts arose from disclaimers that appeared in the original prospectus for the GLD fund.<sup>2</sup>

The attractiveness of gold as an investment is not in question. *Wainwright's* research over many years has made us consistent advocates of investing in gold, especially in (but not limited to) inflationary conditions like the present. The evidence, indeed, continues to pile up that official estimates of inflation are not timely or accurate enough to warn investors when their holdings in stocks and bonds are threatened by a general debasement of the currency.

We regard the price of gold, in contrast, as a direct market measure of currency depreciation and a predictor of its inflationary consequences. Gold also has other properties that are of enormous value to an investor. Its price movements are uncorrelated (or correlated inversely) with those in bonds and in most equity assets. It

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is a resilient investment in extremely adverse financial conditions and a leading indicator of asset price movements.

Also uncontested is the fact that the GLD has recently performed immaculately as an investment in gold throughout the deepest financial crisis since the 1930s. Liquidity was never an issue. The GLD does, as claimed in its prospectus, “reflect the performance of the price of gold bullion, less the Trust’s expenses.” And it provides many investors with “a cost effective investment in gold.”<sup>3</sup>

**Doubts about precious-metal ETFs.** Nevertheless, since there are a variety of vehicles through which an investor can benefit from investing in gold, investors need to be well informed about the advantages and disadvantages of different vehicles. Back in December, we did not have sufficient information to convert the doubts expressed into definitive conclusions and, to our puzzlement, some

of the questions raised have proven to be complex and contentious. After some further study of relevant documents, and thanks to input from the World Gold Council and other sources, we now take this opportunity to dig deeper.

The most frequently expressed motives for investing in precious metals reflect the desire for protection against adversity and the role of bullion as a safe haven. They are threefold:

1. Participation in the price appreciation of an asset which is expected to perform well under specified economic conditions such as currency depreciation and inflation;
2. Diversification of an investment portfolio otherwise devoted to equities, fixed income, and other conventional instruments;
3. Ownership of an asset whose purchasing power would be unquestionable in the most extreme imaginable breakdown of the financial system or the economy.

Gold and silver ETFs obviously satisfy the first two of these motives as long as their prices track the corresponding bullion prices closely, as they do. It is only the third that might be questioned. Presumably this is not a purely academic issue, but one that

1. “Risks of investing in precious-metals ETFs,” *Strategic Asset Selector*, H. C. Wainwright & Co. Economics Inc., December 22, 2009.

2. Prospectus, streetTRACKS® Gold Trust, August 26, 2005, p. 1.

3. *Op.cit.*

may or may not loom large in the mind of a private investor. As Alan Greenspan put it in congressional testimony: "...gold still represents the ultimate form of payment in the world. It is interesting that Germany in 1944 could buy materials during the war only with gold, not with fiat, money paper. And gold is always accepted and is the ultimate means of payment and is perceived to be an element of stability in the currency and in the ultimate value of the currency and that historically has always been the reason why governments hold gold."<sup>4</sup>

Indeed, though these views of Mr. Greenspan were not entirely shared by Robert Rubin, there can be little doubt that central banks such as the US Treasury hold vast quantities of gold bullion with the expectation that their financial powers will survive adverse events up to and including nuclear war.

For at least some private investors, therefore, it is an important question whether their bullion investments will be realizable *in extremis*. They must ask themselves whether ownership of ETF shares would provide the same degree of safety that they would enjoy if they held title to physical bullion under secure custody in an accessible and well-identified place.

**The problem of leased gold.** As explained in our earlier report, ETFs are more complicated than mutual funds. They do not directly take in investor money and then go out and buy the assets according to their investment mandate. Instead, commercial banks and brokerage houses acting as "Authorized Participants" (APs) contribute defined "Creation Basket Deposits" of assets to the ETF, receiving in return "Creation Units" which are

then sold to investors at a premium over net asset value. The investor's claim is perfectly transparent in the sense that the exact amount of gold that will be involved in the event that APs or their clients wish to redeem holdings in the fund is very clear.

It is well known that the best-known precious-metal ETFs, the GLD and SLV, hold only bullion and do not take positions in futures or other derivatives. The gold in question exists in the form of standard London Good Delivery Large bars. According to one recent article, "gold and silver ETFs, like the platinum and palladi-

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um funds, own actual metals," a fact that "seemingly puts them outside the jurisdiction of the CFTC, the regulator that has taken the lead curbing commodity speculation."<sup>5</sup>

But perfect transparency may be lost when leased gold is involved. In our report of December 22, Mr. Barisheff pointed out that, in gathering the assets that are contributed to the GLD Trust, the AP may either buy the gold or lease (borrow) it from a central bank. There is, of course, nothing unusual in either buying or borrowing such gold bars, which are

traded in large volumes spot and forward across the world in the wholesale market. Annual gold lending by central banks worldwide is estimated at 1,862 tonnes in 2009,<sup>6</sup> more than the total amount of gold produced by the world's gold mines.

The specifics of gold lease agreements between central banks and private financial institutions do not seem to be available in the public domain. Neither lease termination dates nor whatever encumbrances might have been agreed to in the use of the gold by an AP, as in contributing gold to an ETF, are known. But we can be sure that, when an AP borrows gold from a central bank, it is required to post 100 percent collateral in exchange. Otherwise a one percent or so gold lease rate could hardly compensate a central bank for the risk that the lessee could become insolvent or the victim of fraud.

**Title to leased gold.** It is hard to see how unencumbered title on the part of the ETF would be compatible with the use of leased gold. In common commercial practice a lessor always retains title to leased property, and a lease transfers only the right to use property. The International Monetary Fund explains gold leases in the following words. Central banks may "have their bullion physically deposited with a bullion bank, which may use the gold for trading purposes in world gold markets. ... 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 maturity of the deposits."<sup>7</sup>

Odd as it may sound, title to leased gold (in the sense of physical possession or access to it and use or

4. Federal Reserve Chairman Alan Greenspan, in an exchange with Congressman Ron Paul, in *The Architecture of International Finance*, testimony by Greenspan and Treasury Secretary Robert Rubin before the Committee on Banking and Financial Services, U.S. House of Representatives, May 20, 1999.

5. Ian Salisbury, "Will metal detector buzz on new ETFs?" *Wall Street Journal Fund Track*, February 5, 2010.

6. *The Yellow Book*, NBP Paribas Fortis / VM Group, November 2009, p.32.

7. Anne Y. Kester, *International Reserves and Foreign Currency Liquidity: Guidelines for a Data Template*, International Monetary Fund, October 23, 2001, paragraph 99.

control of it) passes to the borrower, but ownership remains with the lender. The lessee is free to melt down the leased gold for jewelry manufacture or other purposes, but retains an obligation to return the exact weight of gold back to the lessor under specified conditions or at a specified time. The central bank retains an ownership claim on the specific number of ounces that have been leased. That is presumably why tracking agencies such as Gold Fields Mineral Services, which has been publishing detailed statistics of the world supply and demand for gold for the past forty years, does not show any leased gold as adding to the world supply of gold, or being subtracted when leases terminate.<sup>8</sup>

A major question raised by Mr. Barisheff is whether, if part of the gold held by the ETF is borrowed, and something went wrong, it is the fund or the central bank who owns the leased gold? Would all the gold, whether leased or not, be accessible in the event of sudden liquidation of the fund? The Participant Agreement for the GLD casts some light on this,<sup>9</sup> but invites further questions.

According to Section 16 on “Title to Gold,” the AP “represents and warrants ... that upon delivery of a Creation Basket Deposit to the Trustees ... the Trust will acquire good and unencumbered title to the Gold ...” Section 8 on “Redemption” uses different but equally careful language. The AP “warrants ... and ascertains (i) that ... it owns outright or has full legal

authority ... to tender for redemption the Baskets to be redeemed and ... (ii) such Baskets have not been loaned or pledged to another party ...”

Precise interpretation of this legal language is beyond the scope of this report. But the language does not exactly say that the AP is required to hold or transfer to the ETF good and unencumbered title to the gold in exchange for Creation Units. The phrase “will acquire” in Section 16 leaves this question open.

Imagine a situation in which the market price of leased gold has risen substantially, while the collateral posted by the original lessee, for whatever reason, has not kept pace. The ques-

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tion is whether the ETF is obligated by the terms of the undisclosed gold lease agreement or any agreements between the ETF and its APs to return the leased gold to the central bank.

In another scenario, suppose an AP contributed gold that was encumbered by such a lease agreement, and subsequently became insolvent. Would ETF investors be at risk? If so, would they have legal recourse against

the trustee or the custodian for accepting encumbered bullion? We are still unsure of the answers to these questions.

In sum, we still cannot determine whether, at any given time, the GLD enjoys unencumbered ownership of the entire amount of the gold that the fund represents, estimated at about \$38 billion at the end of January.

**Investment conclusion.** There is little doubt that precious metal ETFs function as excellent tracking vehicles for bullion prices, at least during normal market conditions. No problems were reported even during the turbulent conditions of 2007-09, during which the gold market functioned normally. But direct ownership of gold is different from ownership of a security that tracks the gold price, however faithfully it may do so.

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8. Gold Fields Mineral Services, *Annual Gold Survey*, www.gfms.co.uk. The 2010 edition is scheduled to be published on April 14, 2010. Estimates for 2009 also appear in *The Yellow Book*, *op. cit.*

9. Participant Unallocated Bullion Account Agreement, streetTRACKS@ Gold Trust, need complete citation.



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