Gold bullion investing

Solutions for an evolving marketplace

Strategy Spotlight

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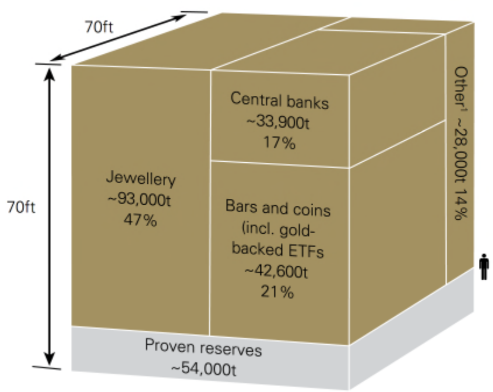
Gold has been long viewed as a store of value and still plays an implicit role as a monetary asset despite the fact that it has not been directly convertible into the U.S. Dollar since 1971. Gold is unique as a precious metal, with very little direct industrial use. As a result, most of the gold mined throughout history is still a part of the existing supply. The relative scarcity of gold is highlighted in Exhibit 1, showing that current gold holdings above ground (and proven reserves yet to be mined) could fit into a space smaller than three Olympic swimming pools.

Over the last couple years, with record low Treasury yields rendering portfolio diversification less effective, we have seen a growing number of institutional clients consider tactical and strategic investments to gold. The gold marketplace has developed to the point where there are efficient funded and unfunded solutions that can accommodate the varying size, timeframe, trading/management costs, and risk management objectives of institutional investors.
In this review, we focus on four viable implementation approaches for institutional investors to access the gold bullion market:

1. Vaulted physical bullion
2. Exchange-Traded Funds (ETFs) backed by physical bullion
3. Over-The-Counter (OTC) Forwards and Swaps[1]
4. Exchange-traded futures

Exhibit 1: Gold supply fits in 2.6 Olympic swimming pools[2]



Source:
World Gold Council,
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The relative scarcity of gold…could fit into a space smaller than three Olympic swimming pools.

1. Vaulted physical bullion

The gold bullion market operates globally, 24 hours a day, with its epicenter revolving around the London Bullion Metals Association (LBMA) which is primarily an OTC-oriented dealer market. Spot trading and physical gold depositories continue to expand globally but we focus here on London (versus the U.S. or other markets) given its long history as the largest marketplace for gold bullion.

An investor seeking to own gold bullion may choose to hold the asset on an allocated or unallocated account basis. Most of the gold bullion traded in the London market is settled on an unallocated basis, but an investor may seek the added security of owning full title to specifically allocated numbered bars held in custody on their behalf.

Currently, seven members of the LBMA and the Bank of England physically hold the gold traded in London. The LBMA is responsible for maintaining the standards and specifications for the 400 troy ounce bars produced by the refiners on their good delivery list.

Centrals Banks, dealers, and other institutions are large holders of vaulted gold, but it is worth noting that various ETFs holding physically vaulted gold are a rapidly growing component of the market.

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2. ETFs backed by physical bullion

Owners of ETFs such as GLD and IAU can enjoy the benefits of holding custodian vaulted bullion in the form of liquid securities. These ETFs are fully funded investment pools that hold gold bullion in allocated accounts with uniquely identified bars. Gold backed ETFs have seen significant growth and popularity globally over time for both retail and institutional investors.

- **SSgA SPDR Gold Shares (GLD) ETF** is the largest gold bullion ETF traded in the U.S. with total assets of $70 billion and average daily trading volume of $2 billion. Given GLD's excellent liquidity and higher expense ratio of 0.40%, it is a clear leader for investors trading in size with shorter-term holding periods.
- **Blackrock iShares Gold Trust (IAU) ETF** is a competitor that may be considered more attractive to some longer-term investors thanks primarily to its lower 0.25% expense ratio. Total assets are $30 billion and average daily trading volume of $400 million.

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Both ETFs hold fully allocated gold bars which are identified by number, refiner, and assay (or fineness) by their custodian and are valued each day at the LBMA Gold Price PM fix. Investor exposure can be implemented by trading shares on the exchange or through an Authorized Participant that facilitates the creation or redemption of Trust units. These ETFs offer efficient investor access to the allocated gold bar market with varied holding period horizons.

Other information: Both product offerings are grantor trusts. There are special tax implications for relevant taxable investors as gold ETFs are considered “collectibles” with a higher tax than the current long-term capital gains rate. Neither of these ETFs are currently allowed to own futures, they hold cash and vaulted bars.

3. OTC forwards and swaps

The OTC forward or swap market is primarily geared toward producers/miners, banks, dealers, and investors who prefer to trade in a more customised manner. OTC gold forwards are generally structured on an unallocated basis for physical settlement/delivery at maturity while swaps tend to be cash settled.

As previously mentioned, the LBMA is still the center for gold bullion trading, but this primarily OTC-based market is experiencing increased competition as the result of growing global demand for ETFs and futures. As such, a London Good Delivery Bar as outlined by the LBMA is acceptable settlement for any OTC transaction (and ETFs such as GLD and IAU).

The OTC forward market offers liquidity on an unfunded basis (though initial margin requirements between counterparties generally apply). While ETF pricing focuses on the spot (current) price of gold and futures markets provide reasonable liquidity for timeframes less than one year, the OTC forward market offers reasonable liquidity from 10 to 20 months and out to 5-years based on the supply/demand of longer dated hedgers. Tactical investors may find opportunity in this arena during times of market dislocation, especially for longer maturity points.

4. Exchange-traded futures

Gold futures provide highly liquid and nearly 24-hour access to the gold market on an unfunded basis (with initial margin of ~6% which changes based on market volatility levels). The dominant player in the gold futures marketplace is the **CME Group's COMEX exchange** in the U.S. Futures exchanges in Asia are relatively small, though the Shanghai Gold Exchange (SGE) is an example of growing physical and margin trading exchange for gold bullion. The primary focus for the London marketplace is still OTC but gold futures are traded on the London Metals Exchange (LME).

COMEX gold futures are centrally cleared with daily mark-to-market of the gain or loss. The most active months for COMEX gold futures are February, April, June, August, and December. The on-the-run futures contract has averaged $50 billion of notional traded a day during 2020. The key specification difference for CME/COMEX gold is that it can be settled at approved depositories with a bar size of 100 troy oz. versus LBMA specifications of 400 troy oz. COMEX gold futures are held on an unallocated basis until exercised (with most traders/investors choosing to roll). When a contract is exercised, the holder receives a warrant which is a certificate of title for bars that meet the COMEX exchange's good delivery requirements. The holder of the warrant may choose to continue to maintain their position at the exchange's depository, take delivery, or move to another depository.

Investors with a short time horizon tend to value the liquidity and low trading costs of gold futures. In addition, EFP (exchange for physical) and EFRP (exchange for related product) markets exist that allow investors to move between futures and physical gold/ETFs. However, since gold futures are a contract for future delivery, they are subject to "basis" and "roll risk" versus the spot market. A good example of these risks occurred during the spring/summer of 2020 when COMEX gold futures tended to trade rich to the spot market given COVID-19 related supply chain and logistical disruptions[3]. This presented temporary arbitrage opportunities in London and other markets to transport 100 oz bars to New York that met COMEX delivery specifications. In the spring of 2020, the COMEX exchange launched "**Enhanced Delivery Futures**," which expanded good delivery requirements to increase the fungibility of New York deposited bars (100 oz. and kilo bars) with London gold 400 oz. bars.

Key takeaways regarding the gold futures market is that it is a very liquid, short-term exposure management tool and benefits from nearly 24-hour transparent price discovery with risk management benefits related to its highly regulated trading rules and centralised clearing process.

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Conclusion

As mentioned, gold has long been viewed as a store of value. However, the ways for investors to efficiently own the world's most widely held investment commodity continue to evolve over time.

Some long-term institutional investors may prefer the security associated with owning fully funded physical gold bullion that is vaulted with a custodian bank. However, as this market has evolved, a similar risk profile associated with ownership of vaulted gold bullion may be accessed by investing in an ETF such as GLD or IAU that holds allocated gold bars at a depository custodian on their shareholders behalf.

For an investor seeking more tailored unfunded exposure, OTC forwards or swaps can be utilised. Futures offer similar unfunded exposure characteristics and delivery potential, as well as the standardisation and risk management benefits of an exchange and centralised clearing.

[1] Defined-risk strategies such as option structures are viable for investors with tactical objectives but are beyond the scope of this review.
[2] The World Gold Council, The relevance of gold as a strategic asset, US edition, February 2020, p. 9. Illustration used with permission.
Based on 2019 above ground estimates and the standard Olympic swimming pool dimensions of (length = 164ft, width = 82ft, depth = 9ft).
Other includes "other fabrication" (12%) and "unaccounted for" (2%)
Source: World Gold Council, Metals Focus, Refinitiv GFMS, US Geological Survey
[3] The World Gold Council, Market Update – Gold supply chain shows resilience amid disruption. May 2020

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