MonetaryMetals
Unlocking the Productivity of Gold™

A New Way to Hold Gold

For high net worth clients, many firms recommend allocating between 2-5% of a portfolio to gold. However, gold is a static asset and offers no yield. It may not be clear why gold belongs in a portfolio, especially if it seems nothing more than a bet on the price of a commodity. Perhaps this is why most investors focus on other areas of their portfolio, where they have the potential for large capital gains (e.g. early stage companies) or to generate income. It is tempting to omit gold from a portfolio, or not to give it the same consideration as other investments. This could be a mistake, the consequences of which might not become apparent for years.

Why Gold?

The first question is why gold? It is the only financial asset that is not another party's liability. In a financial crisis, stocks and bonds can collapse if the issuer gets into trouble. Real estate or artwork are not financial assets, and they have wide bid-ask spreads even in good times. Tangible property may not be impaired, but if buyers cannot get credit then there may not be a bid. Gold is not subject to these risks.

Gold is outside the banking system, independent of the dollar, and widely held internationally. It is unique among commodities in that it is not generally purchased for consumption. Most of the gold ever mined in human history is still in human hands. The total global stockpile, estimated by the World Gold Council at 187,200 metric tons, is about 60 times the annual gold mine production. That is, global mining would take about 60 years to produce as much gold as people and governments currently own. There is no such thing as a gold glut or shortage, as sometimes occurs in wheat or even platinum.

Gold's extraordinary ratio of inventories to annual production gives it a high value inertia. It is the closest thing to an economic constant, historically more stable than the dollar or any currency.

Speculation

Federal Reserve policy seeks to devalue the dollar at 2 percent per year[1]. Sometimes it undershoots and sometimes overshoots. Therefore, in our view, one should not buy gold as a speculation on its price. We do not see any such rise as a gain in gold, but a loss in the value of the dollar. Owners of gold merely avoid the losses incurred by holders of the dollar, when the Fed succeeds in pushing it down.

Gold's unique properties aside, there is an important reason why most investors do not like to bet on commodities: it is not investing at all, but speculating. An investment finances something productive, and the profit comes from the increase in production. Speculation, by contrast, is a zero-sum transfer. The profit—if there is one—comes from the next speculator. Speculation is a process that converts one investor's wealth into another's income.

Conventional Gold Vehicles

There are five conventional vehicles that investors use to own gold, or obtain gold exposure.

1. Coins or bars stored at home

In Monetary Metals' view, everyone should have some gold at home. This is not a significant part of the portfolio, but just part of being prepared. However, we do not believe it is reasonable to keep a lot of wealth at home, uninsured. Large amounts of gold should be kept in a professional depository.

2. Allocated account at a depository

Like coins or bars at home, gold held in the investor's name in a depository has no counterparty risk. However, storage and insurance have a cost. This can be thought of as a negative gold yield, often 50 to 75 bps per annum.

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[1] https://www.federalreserve.gov/monetarypolicy/files/fomc_longerrungoals_20160126.pdf

3. Unallocated account at a bullion bank

The advantage is that there are no costs for storage and insurance. The disadvantage is that the investor does not own gold, but only a bank liability. The investor is granting gold credit to the bank, and is not generally paid for it. This vehicle offers a return-free risk.

4. Exchange Traded Fund such as GLD

The advantage is that the bid-ask spread is tight, typical of equities. However, the cost of carry is not much better than depository storage, around 40bps. As with the unallocated account, the investor does not own gold directly and there is no way to redeem shares for metal. GLD is a security backed by a counterparty. There is a custodian and sub-custodians. It is impossible to predict what would happen in a financial crisis if one or more of these counterparties became insolvent.

5. Gold futures

Futures offer leverage, so sophisticated gold traders often use them for betting on the price action. Futures are also used in arbitrage strategies, generally by professionals. Their disadvantage is that the cost to carry the position can vary widely and unpredictably. For example, it is currently about 150bps annually, up from 25bps at the end of 2015 (data source: Monetary Metals 12-month gold forward rate).

Each of these conventional gold investment vehicles has problems. The cost can erode the gold principal over years or decades. And the counterparty risk can be opaque and multitiered. These detractors can defeat the reasons to hold gold in the first place.

Three Gold Investments that Overcome these Disadvantages

1. Gold Fixed Income - Leases

This investment, through Monetary Metals, pays a fixed return on gold, in gold. The metal is leased to productive businesses, who need it for working inventory or work-in-progress. In exchange, they pay interest in gold. The investor retains ownership of the metal. There is no storage cost.

2. Gold Fixed Income - Bonds

Gold bonds also pay a fixed return on gold and are like conventional bonds, except both the principal and interest are denominated in ounces. Gold bond issuers are businesses which have a gold income (e.g. miners). Unlike leases, gold bonds are lending and have credit risk. For this reason, they tend to pay a higher interest rate. There is no storage cost.

3. Gold Exponential Fund

This investment, through Monetary Metals, owns gold, silver, or both—at all times. A proprietary arbitrage strategy trades between each metal depending on which is undervalued relative to the other. It has trading risk, but no counterparty risk as the gold is held in a depository. There are costs, but they are small compared to the potential trading gains.

As with any investment, Monetary Metals products involve risk. In our philosophy, there is nothing wrong with risk per se, so long as it is controlled, transparently disclosed—and investors are compensated.