

Physical Gold vs. Gold ETFs

Which Option is Right for You?



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THE PRECIOUS METALS LEADER

Physical Gold vs. Gold ETF



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Tips to guide you when deciding to invest in a Precious Metals ETF or owning physical gold or silver.

Well as long as you asked ...

I was recently with some friends and acquaintances in a social setting. It seems the topic of precious metals investing is moving to the forefront of many people's minds. Stocks are at record highs, bonds may also be in bubble territory and real estate is showing signs of topping and reversing a rising trend. A sense of uneasiness seems to be working its way back into lunch-table conversations.

In the course of the conversation, I was asked if buying into a precious metals ETF was a good way to invest in physical metals. I responded by saying, owning shares of a precious metals ETF may be better than zero exposure to precious metals in your portfolio. However, buying shares in a precious metals ETF isn't really the same as investing in the physical metal.

To say that holding a share of a Precious Metals ETF is just like holding onto a physical coin would be like saying owning a Mortgage Backed Security (MBS) is just like owning a house. In the end, and in the case of Mortgage Backed Securities, the lesson learned was that you didn't even own the mortgage let alone the house.

An ETF is a paper asset that precludes investors from actually ever holding on to the physical metal or redeeming shares for the physical metal itself. I believe that owning shares of a Precious Metals ETF are not as risky as owning a MBS. Nonetheless, I suggested to this person, that before investing in a precious metals ETF it would be prudent to actually read the fund prospectus before buying shares.





As with any investment, be sure to read the prospectus of a Precious Metals ETF to understand the risks and players involved. In this report, author Dave Engstrom gives tips on what to look for.

In the case of one prospectus for one of the most popular Gold ETFs, you don't have to read very far into the 32-page document to find some eyebrow-raising statements. But, before reading even one word, isn't it astonishing that a 32-page document is required to explain the risks to invest in what is perceived to be physical precious metals? That alone should tell you something.

As I began to read this particular prospectus, just three paragraphs in, I read this statement:

"It is expected that the Shares will be sold to the public at varying prices to be determined by reference to, among other considerations, the price of gold and the trading price of the Shares on the NYSE Arca at the time of each sale."

This was the tip-off. If I am investing in physical precious metals, what are the "other considerations" in determining the price of the share? Do these "other considerations" pose unforeseen risks?

When you actually hold the metal in your hand, the only risks associated with holding it are fluctuations in the spot price, and misplacing it. Unlike nearly every other investment on earth, when you hold gold and silver in

your hand, it can never be worth zero or less than the current spot price if you do business with a reputable dealer.

As I read further, I made note of other eyebrow-raising tip-offs that suggest owning shares of a precious metals ETF may not be for everyone.

Tip-Off #1 – No Claim to the Metals

In the case of the ETF reviewed here, the metals owned by the fund and used to back a portion of your investment, are held by HSBC in a London vault. There is no coin or bar with your name on it. The vault itself has no record of individuals who may lay claim to the metal held. This may seem to be a minor detail and it may be — until something goes wrong. In a September 2016 story broken by ZeroHedge.com, Deutsche Bank



When you acquire physical gold or silver from a reputable dealer, you exchange paper money for real money and then you decide what to do with it.

No ongoing management necessary.

defaulted on the delivery of gold owned by Xetra-Gold an Exchange Traded Commodity. A fund which bears some similarities to the ETF reviewed here. Where it was supposed to differ was that investors had the option to cash out and take delivery of the physical metal they owned. Were they ever in for a surprise.

After hundreds of instances where investors did redeem for the physical metal, Deutsche Bank brought that practice to a screeching halt. One day you could redeem and the next day you could not. Deutsche Bank defaulted. It is important to note, that clients did not lose their investment, but in order to redeem their investment they would be required to sell shares of Xetra-Gold, convert to cash and then repurchase gold in the retail market place. The irony? Avoiding the retail market place was exactly what investors were trying to accomplish in the first place.

Could something similar happen in the case of our ETF currently under review?

Tip-Off #2 – The Number of Players Involved ... Counterparty Risk

In reading the prospectus it becomes almost mind-boggling how many different people and entities are involved. There are trustees, custodians, authorized participants, marketing agents, banks, brokers and brokerages. All play a role in managing the performance of your shares. As the catch phrase goes, ***if you don't hold it, you don't own it!***

The more players involved, the more risk involved. Counterparty risk is the "risk to each party of a contract that the counterparty will not live up to its contractual

obligations." In most financial contracts, counterparty risk is also known as default risk. In the case of ETFs, the most obvious counterparty risk lies in the bank holding the metals pledged to back ETF shares. In the case of the fund under review here, gold held to back the shares is held by HSBC in a London vault — again, without your name on it! So, whose gold is it really? If the bank failed and had to file bankruptcy, would your share value be able to maintain a price that still closely correlates to the price of gold?

If there be one reason investors prefer holding physical metal instead of a paper representative of the same, it is to eliminate counterparty risk. If I hold it in my hand, there is no other person or entity that has a claim to it. No ongoing management necessary. You decide if you want to bury it or pay a nominal fee for storage in a safety deposit box or bonded facility. Regardless, you are always in control.





Four Unique Characteristics of Physical Metals

Easily Transportable. *It can conveniently be carried due to its size and small amounts can be worth a lot of money.*

Financial Privacy. *Once owned, there is no oversight from traditional financial regulatory institutions and can easily be passed on to heirs.*

Universally Recognized. *Governments and people around the world purchase precious metals for many reasons.*

A Form of Currency. *Precious metals have been used for transacting throughout history.*

Tip Off #3 – Liquidity Not Guaranteed

Owning and holding physical precious metals may be the most liquid investment one can make. Especially when dealing with a reputable dealer who literally buys and sells every day.

This is not necessarily so in the case of a precious metals ETF. The prospectus includes a variety of statements indicating liquidity is not guaranteed. Redemption orders are subject to postponement, suspension or rejection by the Trustee under certain circumstances. Under other circumstances, lack of liquidity can also affect the price of shares requested to be liquidated. In a fast moving market, lack of immediate liquidity can make it possible for one to miss their target liquidation price.

In the event that one or more Authorized Participants which has substantial interests in the Shares withdraws from participation, the liquidity of the Shares will likely decrease, which could adversely affect the market price of the Shares.

Although Shares are listed for trading on NYSE Arca, there can be no assurance that an active trading market for the Shares will be maintained. If an investor needs to

sell Shares at a time when no active market for Shares exists, or there is a halt in trading of securities generally or of the Shares, this will most likely adversely affect the price the investor receives for the Shares (assuming the investor is able to sell them).

Gold and silver are universal money that knows no borders and speaks any language.

The beauty of holding gold or silver coins in your hand is that you can be in any city, in any country or on any continent and you can find a place to trade a piece of gold or silver for any currency. It may be the ultimate travelers check. One would not think of carrying a stock certificate or a physical share of an ETF as an emergency source of funds.

Tip-Off #4 – Your Purchase May Not Be Fully Backed by Physical Gold

In many instances, an ETF does not hold physical gold on a 1:1 basis against the total of money invested in the fund. It would be prudent to ask your financial representative about the amount of physical actually held per dollars invested.



In some instances an ETF may also hold contracts in the *metals futures markets* to supplement physical holdings backing the investment made. That is not so in the case of the ETF being reviewed here. But under the section “Use of Proceeds” we read the following . . .

“Proceeds received by the Trust from the issuance and sale of Baskets will consist of gold and, possibly from time to time, cash. Pursuant to the Trust Indenture, during the life of the Trust, the gold and any cash will only be (1) held by the Trust, (2) distributed to Authorized Participants in connection with the redemption of Baskets or (3) sold or disbursed as needed to pay the Trust’s ongoing expenses.”

While the statement is unclear about how much cash may be held in lieu of physical metal, it is clear they are not required to hold physical metal in a 1:1 ratio against dollars invested. This would make it fair to say that in a rapid downturn in the price of the metals, having some cash could help preserve share value. However, the same would also hold if the value of the metal were to rise. The amount of cash held at the time could prevent the share price from moving higher in correlation to the price of the metal.

Tip-Off #5 – Paper Gold and Silver are Digital Assets

Square pegs do not fit in round holes. As hard as you may try to convince yourself that a metals ETF is just like investing in physical metals, it just won’t fit. Because shares of a metals ETF are more like stocks than physical metals, they are registered and regulated with every transaction recorded in digital stone.

Holding physical precious metals may be the last truly discrete way of storing wealth. Gold or silver coins are not hackable — there is no threat of a stolen password being used to snatch coins from your grasp. There are no accounts or account numbers that can disappear into cyber space due to an unexplained glitch in the Matrix. And, the only way anyone can have personal information about the physical metals you possess is if you tell them.

There’s no additional charge for peace of mind when you exchange some of your paper or digital wealth for physical gold and silver.

Summary

Clearly, investing in a precious metals ETF bears nuances that do not exist when investing in the physical metals themselves. Perhaps these nuances are worthy of consideration and perhaps not. That is for you to decide. One could argue that our financial system would have to fall into crisis before any of the legal disclosures included in a fund prospectus would have any bearing on the value of the shares owned. But, isn’t that why



we invest in precious metals to begin with? To protect assets in the face of crisis? Peace of mind?

In all fairness, I do not know of a time when shares in a precious Metals ETF have become worthless nor can I point to a time when the share price radically strayed from its correlation to the spot price of the metal itself. Certainly, many investors have found them to serve the purpose of diversifying their portfolios into the world's oldest hedge against disaster.

However, given the tenuous nature of our financial markets, it would be difficult to argue against holding a portion of your ETF holdings, indeed, a portion of your entire portfolio, in physical precious metals.



If I hold it in my hand, there is no other person or entity that has a claim to it.

It is mine!

MAKE AN INFORMED DECISION

Feature	ETFs	Physical Gold
Cost	Broker commission at purchase plus annual fee	Dealer commission at purchase but no annual fee
Liquidity	Highly liquid in stable market conditions. Less liquid during an unstable market.	Highly liquid in most market environments
Privacy	Subject to SEC reporting thus every transaction is reported	Outside the financial system so privacy is maintained
Redemptions	Retail investors cannot redeem for physical gold	Investor owns physical asset
Portability	Restricted; retail investors do not possess physical asset	Highly transportable and universally recognized
Counterparty Risk	Numerous participants in transaction and ownership chain	None with direct ownership unless stored with a third party
Dependency on stable financial system	High – ETFs are completely dependent on stability of financial system, brokers, exchanges and ETF sponsor solvency	None
Suitable for IRAs	Yes	Yes



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David M. Engstrom has been researching and writing about the gold and silver markets for 35 years. As the author of more than 1,000 special reports, Engstrom predicted the stock market crisis of 2001-2002

and the bursting of the housing bubble in 2008. He says something big is coming again. Follow him for his insights into the future of gold and silver and the role they will play when the next crisis strikes.

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