A New Approach to Gold Investment:
The Story So Far

Graham Tuckwell
Chairman, Gold Bullion Limited

I'd like to thank the LBMA for this opportunity to introduce many of you, perhaps for the first time, to the concept of buying gold bullion by buying a share listed on a stock exchange, and to share with you some of the experiences thus far.

Gold bullion securities have only been listed as of two months, and so to us they are still very new and still being learned about by many market participants. Contrary to what Kamal mentioned, there has been a great deal of interest in the product, but it does take time for people to convert their interest into a sales order and into generating assets in the trust. We started with virtually a zero asset base and we’re already at nearly three tons. We think that’s not a bad effort with very, very little marketing behind us.

Gold Bullion Limited is a joint initiative with the World Gold Council, and I’d certainly like to publicly acknowledge all the help and support that the World Gold Council and their executive team have given us over the last six months.

Gold Investment

Where did we start from? The London gold bullion market, in my opinion, is a great market. It’s transparent, it’s well regulated, it’s truly global and highly liquid – but it’s not used by mainstream investors. It’s really a market for the gold industry. So when most mainstream investors want to buy gold bullion, how do they go about it? Well, with great difficulty, as John mentioned.

As the chief executive of the World Gold Council, James Burton, said in our prospectus and I’ll quote: “Many investors have found investing in gold bullion to be a cumbersome and costly process. Retail and institutional investors have encountered barriers to entry in the form of difficulties with purchase, storage and insurance.”

Even sophisticated investors who run gold funds have had great difficulties. I can cite specific cases of guys in London, San Francisco and New York who did want to buy gold bullion, spent months looking at how to do it, what authorities they needed under their trustees, what authorities they needed to open metal accounts, and all three gave up in frustration. If those guys can’t do it, what hope is there for the rest of us?

And for retail investors, what’s available? Deposit accounts — unallocated gold, as it’s known — are not widely available in the banking system or even generally known about if they are. Gold bars and coins can be bought over the Internet and from some banks and refineries but, as John mentioned, the premiums are high; the bid offer spread large. And you’re never too sure whom you’re dealing with and even if you are, the storage costs can be prohibitive.

Asking investors to buy and hold physical gold, in my view, is a bit like asking people dealing with currencies to hold suitcases full of bank notes. It’s just not attractive. So what happens? What do the investors do? They buy shares in gold mining companies. And that has a perverse effect on the gold market. Instead of increasing demand for physical gold, it increases the supply of physical gold because the capital supply for the mining companies is used to generate gold.

What is the best way to make gold investment available to mainstream investors? Firstly, make it widely accessible by using the stock exchanges. All investors have brokerage accounts, but very few people have metal accounts and many people are simply not
allowed to open metal accounts. But they can all buy listed securities.

Secondly, use the London market as I mentioned. It’s a great one, but securitise it – break it down so people can buy in small chunks. How do we do that? From our perspective, we sign one bullion account agreement that basically covers all investors. We issue shares that correspond to gold in the trust. We break the dealing size down to trading levels on the exchanges and of the issue, which in our case is a tenth of an ounce, so about US$30 per share. We run an open-ended fund so that the shares are freely exchangeable with the OTC gold. The custodian of the gold and share registry, once it’s set up, simply matches the gold in the trust with the shares on issue, one for one – that’s it. It’s that simple and that’s what investors need. From our perspective as a company, once we’ve put it in place, we focus on the sales effort.

The firms that act as an interface in creating these shares are those that have both an equities capability and a gold desk. Or, if they don’t have the gold desk, they’ve got an arrangement with a firm that does have a gold desk, and that’s what we’ve seen develop already. The securitisation of gold on an exchange is, in my opinion, really quite simple. But there can be differences in the documentation and the devil is in the detail.

Why has it taken so long? Why has the industry not had a product like this before? I don’t know – I find it quite bizarre. You hear about gold, people talk and get emotional about it, but can’t buy it readily. Very strange.

Was it hard to do? For us it took a few months to develop. The product was, in fact, ready late last year but with the help of the World Gold Council we improved it and brought it out a couple of months ago. I know a few firms looked at doing something like this themselves but gave up. They backed off because they thought it would just be too expensive to develop. The trick is to get it done in a cost-efficient manner and, in each jurisdiction where one’s doing a listing, work through the myriad of the corporate and taxation laws and the listing rules. The overlap of those in any jurisdiction does not necessarily present an opportunity to have these securities available. You may need waivers of listing rules which are probably a little easier to come by than asking the government to change taxation laws or the corporate law just to bring a product like this to market.

So that’s what we were able to achieve, fortunately, in the Australian jurisdiction, which is one that’s widely accepted by the international investing community – probably one of half a dozen legal jurisdictions that global investors feel totally comfortable with. As a result, Gold Bullion Limited became the first company to list on the stock exchange offering this product: a pure, unleaded, gold investment.

**A Gold Bullion Security**

What is a Gold Bullion security? It’s allocated gold first and foremost. It’s no credit risk. If Gold Bullion goes under, you don’t lose your money. The investors still own the gold. It’s held on trust in London with HSBC, which, as most of you know, is the largest clearer in the market. Even if HSBC went bust, and I’m sure they won’t, you’re still entitled to the gold. And that’s what investors are after. It’s an open-ended fund with creations and redemptions at the spot price.

New Gold Bullion securities are issued by the ASX Perpetual, in our case our share register, similar to DTC for example, only after gold is deposited in the trust. Until gold goes in the trust no new shares are issued. Someone deposits gold in the trust, you get new shares, and vice versa for redemptions.

Each Gold Bullion share is a tenth of an ounce, which will decline slightly over time because we will sell some of that gold to pay management expenses of storage and insurance and to run the company. It’ll take more than four years for it to decline to even 99% of a tenth of an ounce. Therefore, the decay is very small and in fact for the first couple of years will be minimal compared to which day you buy the gold price on or the brokerage you actually pay.

The fees are quite low, ten basis points for creations and a nominal amount for redemptions – really just an admin fee to stop retail investors coming to us. We’d rather they just sell on the exchange. And the monthly fee I mentioned is only two basis points per month. If you compare it with ETFs, there are very few in the market with lower fees than that, and they’re the really big ones such as the QQQs, spiders and the diamonds.

How does it trade? It’s pretty boring, really. It tracks the gold price – that’s what it’s meant to do. As trust assets build up, one would expect it to trade at a very small premium over the offer price for gold, reflecting the cost in creating new shares – the creation fee – and the cost of a market maker bothering to sit there trading. That’s what we’ve seen. It’s been very consistent.

We have all seen products announced or coming onto the market. How does one go about analysing the differences? They might each represent unleaded gold but the differences can
be quite important, particularly when an investor needs to make a choice between one or the other and just sit with that choice rather than bothering to analyse two different instruments.

There are three essential components of listed security in our opinion. Firstly, ownership of the gold. Investors want allocated gold. Not a third party credit risk, which is what unallocated gold is. In fact, you could argue unallocated gold isn’t gold, it’s just a piece of paper issued by a bank and in most cases unsecured risk.

Investors want to own gold bars. That’s the feedback we’ve been given and that’s what we’ve given them. On our website we publish all the details of every gold bar we hold in the trust. We don’t invite visits to the vault, but do give people the comfort of seeing the gold bars by going to the website. In any case, I don’t think unallocated gold is really on people’s radar screens at the moment given that there’s very little yield give up between unallocated gold and the storage costs on allocated gold because of the very low lease rates.

Liquidity is the second element. First and foremost, it must be redeemable in gold at the spot price. If it’s not redeemable at the spot price, I don’t think people are going to be interested, because they will always go to that market where they can exchange with gold and get that guaranteed liquidity and no discount.

The third element: it must be cost-effective. Once you’ve got the liquidity peg in the ground – in other words, you can always get the inter-bank spot price, you can always get gold with no discount – the only difference is fees. How much do you charge to create it? How much do you charge on an ongoing basis? That’s assuming the security structures are set off.

The Target Audience

Who’s our target audience? Where are we going on all of this? Well, it is not the people most of you in this room might deal with – they can deal with you directly; they don’t need this product. And it’s not those in business who are already buying gold mining companies where they get leverage to the gold price and the benefits and costs of exploration and corporate upside and downside. Well, we didn’t think it was those investors.

Our audience, by and large, is a whole new group of investors who have never bought gold before – the chief investment officers, the asset allocators and the fund actuaries. And it is financial planners and a broker for private clients. We are marketing gold as a financial tool to reduce portfolio risk. It doesn’t actually matter that it’s gold. What matters is that it’s negatively correlated to equities, it’s listed and highly liquid. The fact that it’s gold is purely coincidental.

So we’re tackling this from a statistical and actuarial approach. In fact, as part of our early development, we commissioned a report from the head of the actuarial department at Melbourne University to decide whether or not we wanted to go ahead with developing this product. That report subsequently became Price Waterhouse’s actuarial report, and it’s on our website.

Based on work with the World Gold Council which has been extremely helpful and has been alluded to indirectly by some of the speakers this morning, we argued that there should be an allocation of around 2.5-7.5% of a total portfolio to gold for a benchmark, depending on where one views potential price performance of gold relative to other assets.

Diego had 10% in commodities total, but only a small allocation to gold. We would consider the liquidity in gold and the ability to have it stored and not have third party credit risk. I wouldn’t want to store too many barrels of oil in my backyard or in a vault somewhere: you just can’t do it. In theory you might want to have a spread of commodities, but in practise, it’s the liquidity and the ability to store it that drives people to gold. Therefore, I think there can be a substantial allocation of gold within an overall allocation to commodities.

These arguments are, in fact, set out in an information booklet that we wrote with the help of the research people at the World Gold Council, which sets out why invest in gold, and how much to invest, and looks at it from a statistical point of view. Some of the charts presented this morning are in that booklet.

From where are we trying to access the demand? Both institutional and retail investors. We can market to institutional investors around the world because, from their perspective, it’s not a dollar investment, it’s a gold investment. A lot of institutional investors have the ability to buy equities or listed securities in most countries. So they’re interested in buying because it qualifies as an eligible investment under their trust deed by dint of it being listed on the stock exchange.

In fact, we issued a press announcement a couple of weeks ago saying that the majority of investment in funds so far has come from offshore. And I know that some investors are buying this in euros, in sterling and in US dollars, and they’re asking the market makers to give them a fixed price to deal in those currencies while Australia’s closed.
So an institutional investor can phone up and say, “What’s your price for gold bullion? What’s your price for Gold Bullion securities?” They can then cut a deal with the market maker and get a contract note issued in any currency they want.

Retail investors, though, are generally coming just out of the Australian market. International retail investors usually find it quite expensive to go cross-border because I often find they’re paying double amounts of brokerage.

**Market Reaction**

And the market reaction? Very positive. Exponential growth in trust assets, as I mentioned, from a zero base. We have a view on this, “from acorns do large trees grow”. We’d like to get the trust assets up as fast as possible, but we’re in no hurry. As I mentioned, we’ve got about three tonnes in there. We think we’ll get at least fifty tonnes within the first 12 months, and we think that’s not a bad start. Hopefully we’ll do even better.

When you look at it, that’s not a large amount. There’s 60 billion invested in gold equities alone. A number of investors have said to us quite clearly they will rotate out of mining companies into gold bullion because that’s what they’re really after, a play on the gold price. If they want a leverage play, they can arrange that leverage themselves. If they want an unencumbered purchase, they can just buy the gold bullion securities.

So we’re extremely pleased with the feedback that we’ve been given. Many times the meeting will start with, “what a great idea, why hasn’t somebody done it before?” People are very comfortable with the security structure. As I said, it’s just HSBC and ASX Perpetual – just matching it up. It’s that simple. Gold goes in, giving you share. Gold goes out, cancel the share.

Most of the questions have, in fact, been on how to go about buying it. Is there a currency exposure? What is the role of the World Gold Council? Now, all of you here may understand the bullion market, but I can assure you most of the people we see don’t understand the gold market. So, apart from convincing them as to why buy gold, they have to get comfortable with understanding that particular market. They understand equities but not the bullion market.

In fact, in many cases, working with the World Gold Council, we’ve been around for meetings where we have been the ones who have introduced the equity guy to the gold guy within the same firm. They’d never met. So, we are coming from a very low knowledge base for many of these people.

But once they work out how to do it – they’ve got to co-ordinate two trading desks, decide how to share out the profits and link the systems – once they do their first trade, they’re fine. They’re comfortable with it, but it does take time. We’ve got two market makers already and we think we’ll get more as the volume builds up.

How are investors buying this? We allow them to buy it directly from the company, but all of them have been going through the market makers. That way somebody’s got to buy the gold to put it in the trust. You may as well leave it to the investment banks that deal in the gold to do that. So a client simply phones and tells them they want an order. No matter what the size, as long as they can cover it in the gold market, they can deal on the securities. They do not need to look at the Australian stock exchange, the turnover, the amount on offer or the amount bid for. All they need to do – because new shares can be created or redeemed at any time – is simply phone up the market and make them say, “What’s your price for 15 million, 100 million?” As long as they can deal in the gold market they can get set. That’s what’s happening.

Private clients, as I mentioned, have bought in Australia, but international clients are having trouble accessing the market. In fact, the biggest hits to our website have come from the US and most of the e-mails we’ve received querying how to buy also come from the US.

Asset allocators and financial planners are interested. Some of them are putting their clients into it quite quickly on the brokers of private clients side. The asset allocators and actuaries will take time – I’ve no doubt that it could take 6-12 months before we convince the first of the big actuarial firms to make a recommendation to their clients. But once those gatekeepers to the big pots of money turn a positive recommendation, the floodgates could truly open.

**Global Rollout**

How do we see the global rollout? At the moment, Gold Bullion securities, and more recently, the Perth Mint-issued warrants are only listed on one exchange, the ASX. As we all know, the World Gold Council has filed for a NYC listing but the timing of that will clearly depend on SEC approval.

The Central Gold Trust, the same managers that manage the Central Fund of Canada, is in the market at the moment, having filed for a TSX-listed product but, in our opinion, it’s more like a closed-end fund. The devil in that detail – their
documentation – is that redemption is at 90% of market value or even less. As I mentioned, the big peg in the ground has got to be that it is redeemable at the spot price.

From our perspective, we’re currently examining the costs and benefits of other listings, but the viability of any new listing will obviously depend on the legal requirements in each jurisdiction and the incremental demand. I’d stress that in examining other listings, obviously we’ve got to be very mindful of the WGC’s role and objectives with its products and we’re working together with them closely on that.

So without pre-empting anything, I believe that over the next 12 months there will be a rollout of these products on a number of different exchanges, particularly so that retail investors and many funds that are restricted to investing only in their domestic market can buy.

I think, in fact, this product will end up being listed on every major stock exchange around the world, possibly within 12 months, other than perhaps Japan.

I believe the product will be available in the US, Canada, UK, Europe, Australia, South Africa and Asia.

We will see. It will be interesting to find out what the New Year brings in terms of demand. We believe we’ve witnessed the birth of a new source of demand for gold. Time will tell just how potent that new source of demand is.

Thank you.