# OTC Gold Investment

***John Reade***

***Precious Metals Strategist, UBS AG***

UBS is a global bank with more than $2 trillion dollars in assets under management, 70,000 employees across the world, and it is a major player in the gold market. As UBS's gold analyst for more than six years, I guess I am well placed to talk about over-the-counter – or OTC – gold investment.

But before I move onto this topic, I would like to share some thoughts about commodity investment in general and some concerns that I have about this growing trend.

UBS recently expanded its efforts in commodities. We have had a large precious metals business for fifty years and recently added base metals, expanded our energy trading and exchange traded commodity business and added a commodity index structuring group to create a large team of professionals located in one place on our FX trading floor.

Conversations within this team, together with some recent client meetings during LME week have confirmed a suspicion that I have held for a while.

There is a Wall of Money heading for commodity markets – a Wall of Money that is driven by non-traditional players in commodities, and it is set to overwhelm what have been traditionally small, largely professionally-driven markets that have had only modest speculative and investment involvement to date.

The Wall of Money is coming from real money managers who are looking to diversify into alternative asset markets, due to poor returns from their traditional fields of cash bonds and equities. One of the three key themes from our global economics team in 2004 was the challenge of declining nominal returns across asset markets, and this move into commodities, I believe, is an attempt by fund managers to overcome this low-return environment.

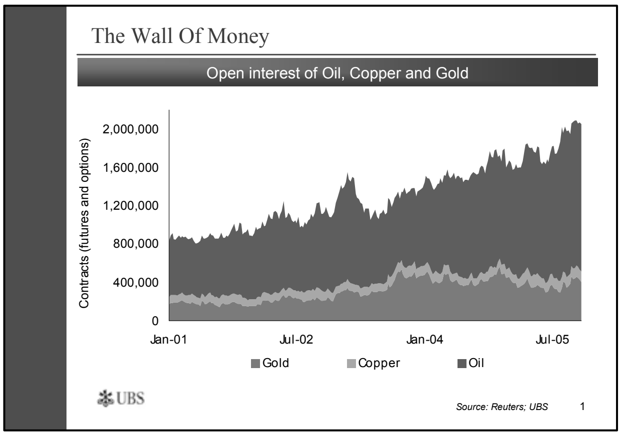
I am concerned about this because asset allocation is a top down process, and too much account may be taken of historic returns and not enough about current valuations. The charge into this asset class has been led by European pension funds, one of which presented to the LBMA conference in Lisbon, explaining this strategy. But the trend is spreading and, according to one client who has monitored these developments closely, is beginning to take off in the United States, which is apparently a couple of years behind Europe in this regard. Once the actuarial consultants become comfortable with a new asset class, it is only a matter of time before pension funds follow their recommendations.

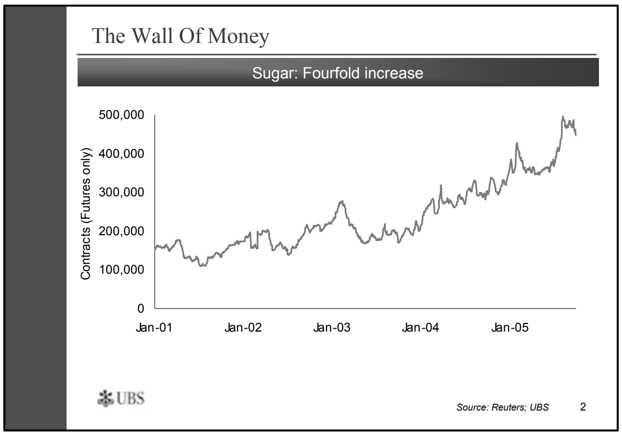
The Wall of Money is on its way and it is coming to a commodity market near you.

Our clients are demanding access to – and more information about – commodity markets, and we have responded to these demands in the following manner:

- Firstly, UBS investment bank's asset allocation team, headed by our Chief Economist Larry Hatheway, added alternative assets to their more traditional asset mix back in 2004, including an allocation to commodities.
- Secondly, this year UBS Wealth Management, our private bank, added a commodity team and are now recommending a sizable weighting in commodities.

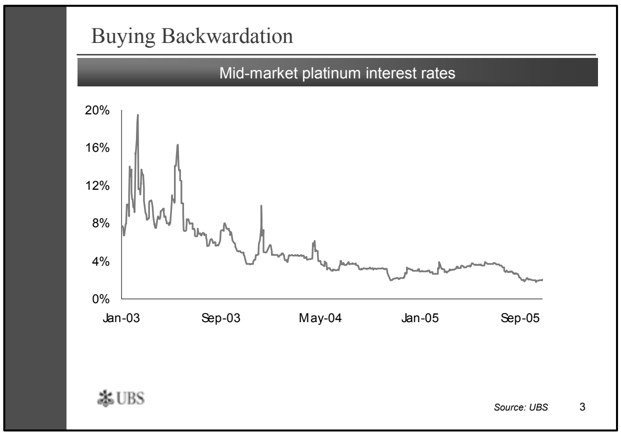
The extent to which this investment has impacted on commodity prices is hard to judge. I am no expert on most of these markets, and copper at an all-time high of $4200/t and oil at $60 dollars a barrel may be justified by fundamentals. But open interest in copper, crude oil and gold has collectively increased sharply over the past couple of years, as can be seen on the following chart.




For precious metals specifically, all four exchange-traded precious metals have seen increases in open interest and larger speculative long positions – as well as the remarkable success of the ETF products in gold.

Another way that the investment in commodities is showing up is in the flattening of commodity yield curves. Markets that have traditionally been in backwardation have seen investors buying and lending – another way of saying buying forward – to take account of high commodity interest rates. In precious metals, the most notable example of this has been in platinum, where three-month deposit rates have fallen from 10% to 2% since the start of 2003 despite high prices and a market in deficit over the whole period.




An interesting example of increased investment in commodities comes from the sugar market, which has seen open interest quadruple over the past few years.

Tim Woodward, our head of exchange traded commodity derivatives business, tells an anecdote about a new client attracted to sugar's fundamentals who wanted to buy what would have been half the total open interest in the sugar market – clearly this could not take place.

I have not found any reliable statistics on how much money is invested in commodities. Anecdotally I have heard of sums between 50 and 100 billion invested in commodity index products, although that could be more. But this is a tiny fraction of global funds under management. When I presented to the LBMA a few years ago, the market capitalisation of all bond and equity markets was about 50 trillion dollars – and is probably more now.

If real money continues to move into commodity markets in a meaningful way, investor interest could increase by a factor of 10 or more.

So what are the consequences of all this investment? Well, obviously, prices have moved sharply higher, lifting some commodities well beyond consensus estimates of long-term equilibrium prices.

But does this matter? One of the reasons that commodities tend to be mean reverting is that high prices leads to demand destruction and investment into new production capacity, bringing the markets – after some delay – into oversupply, dropping prices. Won't this happen again?

At the risk of using some of the most dangerous words in the investment world:

We believe this time is different.

Even if high prices return markets to oversupply, the weight of investment money can easily mop up these surpluses; what looks like a large surplus to a commodity analyst is small in the context of real money investment. This will limit or even eliminate traditional cyclical weakness.

The final point I will make about the Wall of Money entering the commodity markets is to analysts of other commodities.

To them I say: welcome to the world of a gold analyst. Classical supply and demand analysis will matter less in the future. Investment flows and speculative positioning may become the dominant drivers of your markets.

And just because prices are going up, it will not make your job easy. As one Alex cartoon from the 1990s said, "You may think my job as a dot-com analyst is easy, but try taking the investment case of **'buy it because it is going up'** and turning that into an 80-page report."

Gold's position in all of this is rather odd. It has superior depth and liquidity compared to most other commodities – which makes it one commodity that can accommodate substantial investment due to vast above-ground stocks.

But these stocks make gold fundamentally less attractive to commodity investors. Gold is almost always in contango and producer de-hedging and central bank lending look set to keep gold interest rates low. Still, gold is a part of most of these commodity indices and should continue to attract basket-based buying irrespective of these disadvantages.

Aside from the asset allocation argument, gold has traditionally attracted investment interest due to the metal's supposedly unique attributes. For the purposes of this presentation, please suspend your disbelief about some of these attributes and remember the Keynesian beauty contest.

- In a portfolio of currencies, gold has **diversification characteristics** – and not just against the US dollar.
- Gold is a **hedge against inflation**, especially where investors do not have access to – or confidence in – other usually more effective inflation hedges.
- Gold is the only financial asset that is nobody else's liability – although other real assets like real estate and commodities fit into this category as well. Real assets give **protection against systemic financial sector risk**.
- Gold returns are **uncorrelated with other asset classes** and arguably negatively correlated with other assets during **extreme negative events**.

UBS' main investors in OTC gold are wealth management clients – certainly in terms of the number of investors, but also in terms of activity. You will understand if I generalise and draw broad conclusions for reasons of discretion and client confidentiality: UBS is a Swiss bank, after all.

There was a trend during the 1990s for clients to reduce gold holdings. Equities were booming and gold prices were falling, at least in dollar terms, encouraging metal investors to liquidate their holdings and buy tech stocks instead.

But this behaviour stopped in the early years of this decade, and we have seen substantial interest from clients globally to buy gold. The reasons for their purchase were diverse and largely selected from the list above, although from North America we received considerable interest from investors concerned about the US dollar and the wider asset markets.

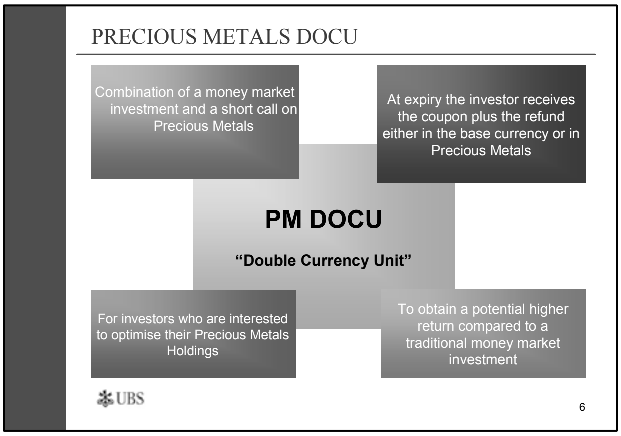
Our OTC clients invest mostly in gold via **metal accounts**. These accounts are like normal currency deposit accounts and are unallocated – which means that you have a bank account with ounces of gold in it. Metal account holdings of gold allow investors to use their metal via structured products, which I will describe in some detail below.

Some clients hold gold in **allocated, segregated accounts**. Clients hold specific bars of gold in our vault – like keeping dollar bills in a safe deposit box for safekeeping. Since this gold cannot be lent out by UBS, it is more costly, but fractionally safer, for the client to hold gold in this manner.

We do have some clients that **buy gold and remove it from UBS's vaults** – although as you can imagine, we don't recommend this. But some clients believe that holding their own physical gold gives them the most security, although clearly there are risks that the gold will be stolen or indeed lost. I know of one client that heads out every weekend in the summer with a metal detector trying to find his stash of buried Krugerands on his estate.

In addition to purchases and sales of physical gold, clients also use high gold volatility to enhance the yield on cash deposits.

There are many examples of these products. For simplicity, I will describe only two: The precious metals double currency unit, or DOCU, and the Guaranteed Return on Investment or GROI.




The precious metals DOCU is a combination of a money market instrument and a sold call option on gold, and is suitable for clients that own gold. The premium from the sold gold call is embedded in the interest rate and at expiry the investor receives the interest coupon plus the principle, either gold or in the base currency.

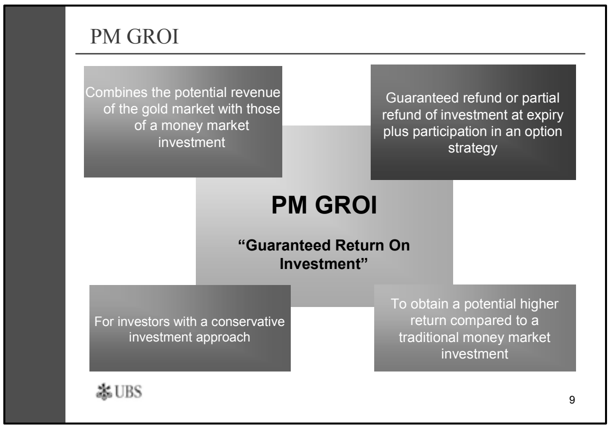
As an example, when gold was trading at $467.20 per ounce, a one-month DOCU with a strike at $480/oz would yield an interest rate of 7.10% per annum.

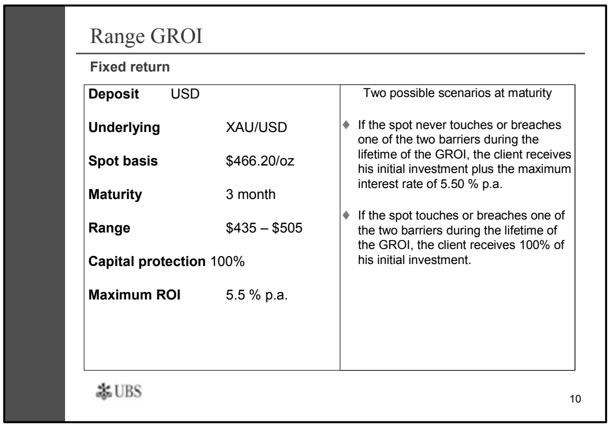
If at expiry the gold price is below $480/oz, the investor is repaid the initial gold investment plus the accrued interest of 7.10% per annum over the period paid in US dollars. If the price of gold is at or above $480/oz at expiry, the investor receives dollars converted at a price of $480/oz plus accrued interest at 7.10% per annum over the period, paid in US dollars.

Clearly this client has to be prepared to sell his gold under certain circumstances in order to transact a DOCU.

For investors who do not own gold but are prepared to buy gold under certain circumstances, a DOCU can be structured whereby the investor will invest dollars and sell a gold put. If the price of gold at expiry is at or below the strike price, the investor will get his capital back in gold rather than US dollars.

The Guaranteed Return on Investment, or GROI, combines the potential trading revenue of the gold market with that of a money market instrument. It offers a full or partial refund of investment at expiry together with participation in an option strategy. The partial or total capital protection element makes this suited to a more conservative investor who nevertheless is prepared to take some risk to try and increase returns compared to a traditional money market investment.




The example shown here is a Range GROI. Here the investor places dollars on deposit and takes a bet that gold will stay in a range over the entire three-month period. If gold does remain in the range for the whole period, the investor receives his money back plus interest at 5.5% per year. If gold does trade outside of this range, the investors only gets his capital back.

These examples demonstrate some of the ways that OTC gold investments can be structured with gold options to enhance yield on money market deposits.

In conclusion, I have tried to explain some of the interest we get in gold from our wealth management customers, explaining why they buy gold, how they hold it and what they can do with gold once they have it.

I have also explained some of my current thinking about commodities and about the consequences of continued Real Money investment in this new asset classes.

I hope this has been of some interest. I would like to thank my colleagues, Tim Woodward and Cristie Parker in London, for their help with the non-gold examples in this talk. ■