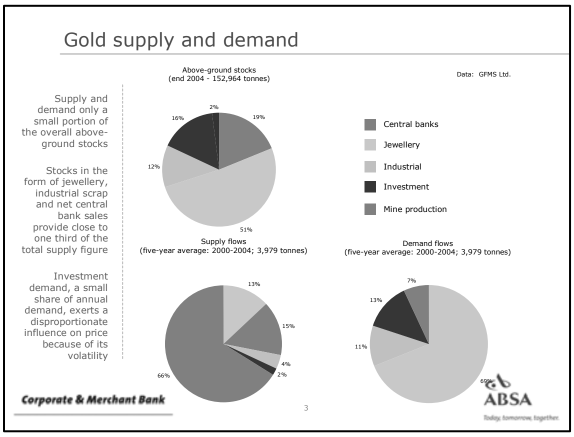
The Impact of ETFs on the Gold Market

Vladimir Nedeljkovic

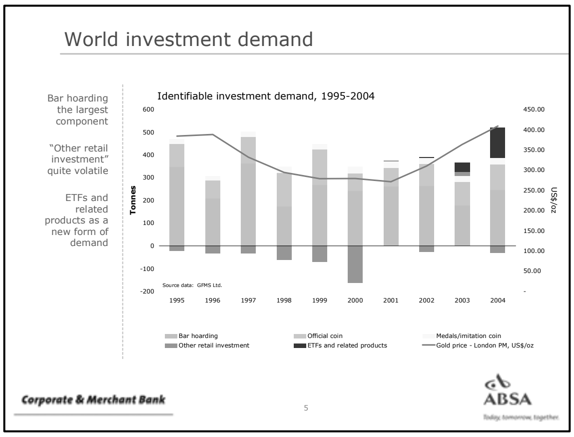
Structured Products, Capital and Debt Markets
Absa Corporate and Merchant Bank

Good morning ladies and gentlemen. The title says it all. I am here today to give you a couple of thoughts on a new trend in the gold investment, the gold-linked exchange rated funds, or ETFs, and their current and potential impact on the gold market. I will first set the scene and show you some well-known facts about gold demand, then zoom in onto the gold investments and zoom in again on the gold ETFs. I will specifically concentrate on the market penetration of the gold ETFs by looking at them in the context of the worldwide investment market. Finally, I will talk about the potential for growth for these products.

You have basically seen the gold supply and demand graph multiple times. Above ground stocks are approximately 150,000 tonnes, and I will come back to that number later. Supply and demand flow is about 4,000 tonnes per annum. On the demand side, the investment is about 13% of the total; to compare, 69% of the demand is in jewellery.



If we go into gold investment, most of it is in gold bars and coins, as well as other retail investment. Securitised gold in the form of gold-linked ETFs is a relatively new development, and this is the one that we will be concentrating on today.



If we look at year-on-year demand for the investments, we see that it more or less bound in the range of 300-500 tonnes. We've seen, of course, some growth in the recent years, and I would like to attribute some of it to the advent of the gold-linked exchange-traded funds. Interestingly enough, in the survey we took yesterday, 62% of the participants said that they believe that investment demand is going to drive the gold price going forward. Still investment demand is only 13% of the overall demand for gold. Why not 50%?

There are obstacles to investing in gold. Gold is traded over the counter, which excludes it from the investment universe of certain classes of investors. It is a physical transaction, so one basically has the issues regarding custody arrangements, insurance, settlement, and so on. It is specifically difficult for the retail investors. They do not really have much choice.

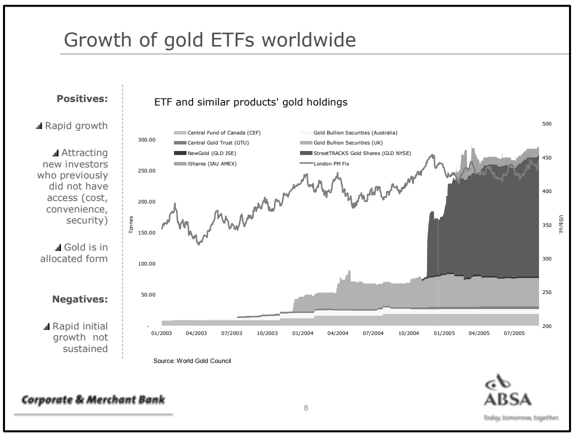
Most people cannot buy big bars, costs are significant, liquidity is low, et cetera. Of course, investors can buy gold coins, but there are issues related to that as well.

One important factor is the regulatory environment. For example, in South Africa gold is considered to be a foreign currency and falls under the Exchange Control regulations. In some countries, pension funds are not allowed to invest in gold.

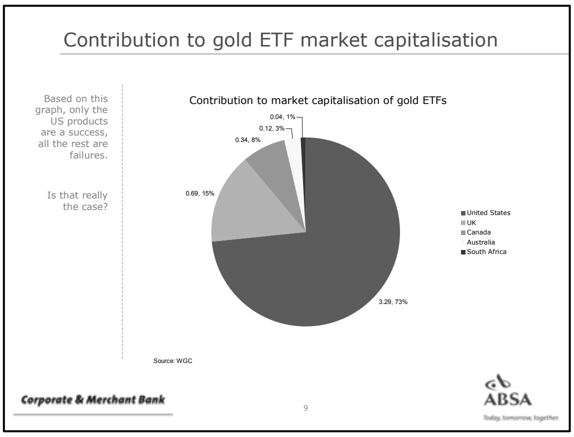
Add to that the relatively lacklustre performance of gold price over a period of years and, as a consequence, we get an asset that is really outside of the institution investors' benchmarks and as such not being followed and researched by them. We market our gold ETF and we talk to a lot of institution investors that invest in gold equities but do not really know about the properties of gold as an asset.

In order to address those issues, we had the advent a couple of years ago of securitised gold in the form of gold ETFs. Gold ETFs, compared to some other structured products, are very simple structures. There is a vehicle that holds gold in a trust, usually fully allocated, so there is no credit risk. On the basis of that, gold securities are issued, listed on an exchange and traded in the same manner as equities.

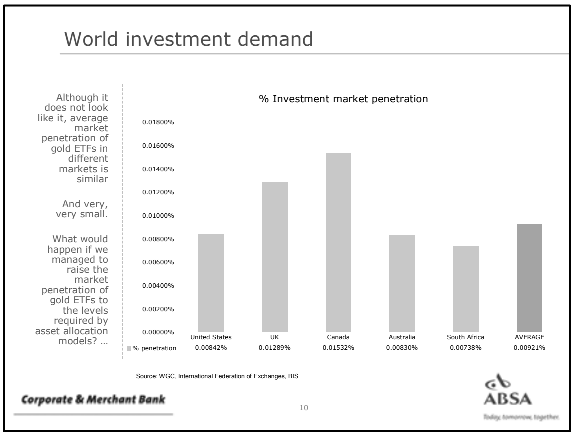
As a consequence, this type of investment is accessible and simple. It is listed on a stock exchange, quoted in local currency, with no minimum investment. It is very secure because the gold is, as I said, held in an allocated form. It is very cost effective. Depending on the investment size, it can be more cost effective to invest in gold through this channel than by actually buying physical gold. Finally, it is very liquid. Because gold ETFs are open-ended, i.e., their size can vary with supply and demand conditions, the liquidity of the securitised gold is exactly the same as the liquidity of the underlying spot market, which is actually quite high.



So we see that there are some good reasons to invest in gold through gold-linked securities. These securities have been around for a few years now, and it is a fair question to ask: have they made any impact? Consider the asset growth of gold ETFs worldwide. You can immediately see some positives and some negatives. The positive is that we have experienced a rapid growth in assets over a relatively short period of time. At the moment, there is about 300 tonnes of gold in all the ETFs worldwide. That is significant by any standard. The one negative is a trend that is similar to all gold ETFs. Initially, there a relatively sharp growth, followed by a plateau. The question that people ask is, is this it? Has the demand already been satisfied?



If you look at the contribution of different countries to market capitalisation, the situation is quite skewed, in that quite a large percentage of the investments in gold ETFs is basically in one country, the United States. Based on this, one could say that one should not really be bothered by any other country, that US gold ETFs are a success story and that the other ETFs are irrelevant and failures. The problem with that kind of reasoning is that it does not take into account the relative sizes of the corresponding markets.

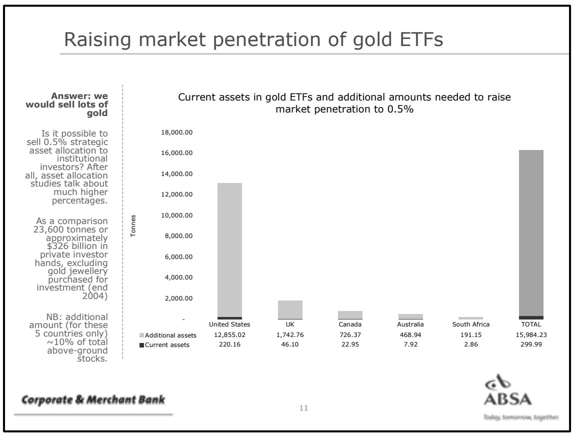


Taking the market size data from the International Federation of exchanges and the BIS, and expressing the assets in the gold ETFs as a percentage of the overall assets, the penetration of the gold ETFs in different markets is quite similar.

Excluding two Canadian close-ended funds, which are not real ETFs, the biggest market penetration is in the UK, followed closely by the US, Australia and South Africa. The worrying thing is that in all markets, penetration of gold ETFs is minuscule. Overall, average penetration is just 0.009%. Even this is an overestimate, because the analysis could not include all the different investment assets available for the lack of relevant data.

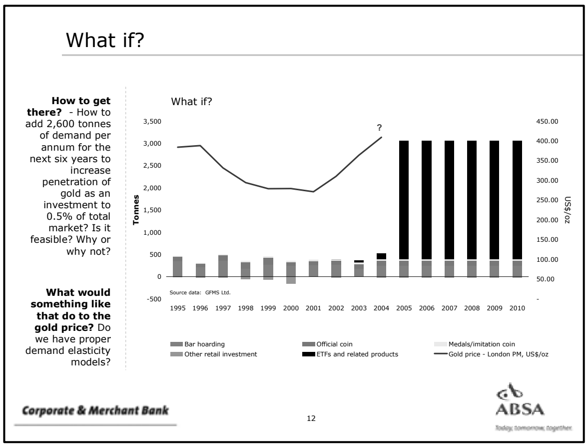
I worked with the World Gold Council on asset allocation studies for different markets, and they show orders of magnitude higher optimal allocations to gold than we have at the moment. Today, we have heard some central bankers discussing optimal allocation to gold in their portfolios of 5-10%. The margin between the current and the desirable is really wide.

So, the potential is here. But how do we quantify it? Let me be very conservative and say, okay, not everybody wants to invest in gold, and so let us say our aim is to try to increase the market penetration, not to 5% but to 0.5%, which is actually quite below what the most optimal asset allocation model tells us to invest. Also remember, I looked at only five countries. I did not look at European countries; I did not look at India; I did not look at China.



What do we get if we increase market penetration to 0.5% in the five markets we are considering? An additional demand of about 16,000 tonnes of gold. Remember, the total above ground stocks of gold are 150,000 tonnes, so we are talking about 10% of the total of above ground stocks. Also, compare it to the total annual demand for gold of some 4,000 tonnes.

We can get a good visual representation of the possible impact if we overlay 2,500 additional tones of demand per annum for the next six years over the current demand figures. The topic of my speech is 'What happens to the gold price?' Well, I ask you: what happens to the gold price? We cannot exactly say what would happen because we do not really have the proper gold demand elasticity models, but judging by this simple graph, I would think the gold price would react quite positively.



Is it possible? I do not know. I do not see why it would not be possible if we take seriously the case for gold. Everybody in this audience talks about the issues such as diversification, currency hedging, inflation protection. If the central banks think it is prudent to hold, say, 10% of their assets in gold why would not other institutions think it is prudent to hold similar amounts or maybe 10 times less of gold in their portfolios?

How do we get there? Currently, according to the Gold Bullion Securities' statistics, the largest investors in gold securities are institutions: mutual funds hold about 26%, individuals 11%, pension funds 2%, which is quite low, assurance holdings 6%, stock lending 7%. In the case of South Africa, for our ETF, we have about 90% - 10% split between the institutions and individuals.

What are the obstacles? I think the first one is lack of knowledge, again because of the fact that institutional exposure to gold, compared to other assets, is quite minor. As a consequence, there are not too many analysts that cover gold, which further makes the job of selling gold or gold securities more difficult. Another obstacle is a perception held by many that gold is a marginal and speculative asset with no real intrinsic value. Finally, there are regulatory obstacles in some jurisdictions to be overcome.

There is a very good investment case for gold, dealing with topics such as diversification, inflation protection, currency hedging. That case needs to be aggressively promoted. Secondly, we need to expand the investor base. We need to go beyond traditional gold bulls (after all, they are already invested in gold in one way or another). We need to reach mainstream equity investors, and position gold as another security with all the characteristics they know and like. Finally, we have countries like India and China that are traditionally very big on gold as an investment, but they currently do it in the form of jewellery.

Is there a potential? That is really a question I would like to know the answer to. Is it possible to sell securitised gold to investors in these countries without cannibalising existing jewellery demand? I suppose that is a well-posed question that can be answered by researching the relevant markets and taking into account relevant demographic and development trends.

To conclude, I believe that the potential of gold ETFs is far from fulfilled and that they can become a significant factor fuelling demand for gold and pushing the price of gold upward. Thank you very much.■