What the Precious Metal Investor Really Wants to Know

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Introduction

Good afternoon. The title of my speech today is 'What the precious metal investor really wants to know about the gold ETFs'. It could equally have been entitled 'Gold ETFs 10 years on'. This is only the second time I have ever spoken at the LBMA. The first time was in Portugal almost a decade ago and it is almost 10 years to the day that we filed the first gold ETF in Australia. We did not know anything about ETFs then and we certainly had no idea what was going to happen to the gold market as a result of these.

The former chairman of the LBMA, Jeremy Charles, in the *Alchemist*, which is the LBMA's regular publication, was asked, after having stepped down from 30 years of working in the gold market, 'What is the biggest change you have seen since you joined the business?' He said, 'Well, in 2002, someone I had never heard of before, Graham Tuckwell, called me up completely out of the blue with an idea to offer securities on the stock exchange that would be 100% backed with physical gold. I thought it was an interesting idea, but at the time I never realised it would be as successful as it has become.' Frankly, none of us did.

Agenda

Today, I am going to cover just a few short topics: the growth of the gold ETFs, a few questions on how the product is structured and I will talk a little bit about some of the questions we are asked about the gold price and how we address it.

Global Gold ETF Assets

This graph shows what has happened since the beginning. In the speech, I said, 'If this goes well, from acorns do large trees grow'. I have absolutely no doubt in my mind that the gold ETFs are the single biggest thing that has happened to the gold market. I am also absolutely clear in my mind that it has changed the price of gold probably $150 an ounce or more just as a result of the extra demand.

I saw a text question about whether everybody who could have bought into the gold market had done so and I heard earlier discussions about whether we are in a bubble. My view is we have already had the first decade of this and I think the next decade has a lot more to go. I am not talking just about the gold price, but about access to new investors. We have other ETFs on the other markets that the LBMA sponsors, namely silver, platinum and palladium, but by far and away the greatest demand is for the gold ETFs. They are available principally throughout Europe and the US. We have some of them around Asia, but very few exchanges around Asia have the extent of product that is listed that is already listed in Europe and the US. Therefore, I believe two things are going to happen over the next decade to continue to cause that graph to go up and up.

There will be a number of new products brought out in Asia, in Hong Kong and China, which will give a greater audience access to these products. You might say that they can already buy them on other exchanges, but that is not the way it works. Most investors only want to buy on their local exchange. These products are still not widely available in Asia.

The second change that will occur is, by and large, most of these products are still only bought by institutional investors. In the US, there is good demand from retail investors, but throughout the rest of the world there is very little retail demand for these products as yet. That will change over time. Distribution mechanisms will continue to expand and be put in place and therefore we will see greater retail demand in these products. Indeed, one of the speakers earlier today talked about if we are in a bubble and if everybody is talking about it and the answer is no, they are not. Still not that many people know about these products.

Creation of the First Physically Backed Gold ETF

Some questions I am often asked are:

- Where did the idea come from?
- How difficult was it to do?
- What success was predicted?

I have already talked about the third point. Interestingly, regarding where the idea came from, it was not a case of 'let us go and build ourselves a gold ETF', because as I said, I had never heard of ETFs in 2002. Quite simply, the Australian Stock Exchange came to me when I was on the Investment Committee of the Australian Gold Council and said, 'We have a couple of banks who want to do derivatives on gold', in other words, write put and call options, 'but they need gold as an underlying to be listed on the Stock Exchange'. That is why I embarked on the project. Hence this idea did not emanate from a desire to just create them because we thought it would be a great idea; it came from somebody else's idea of doing derivatives on gold.

How difficult was it to do? In fact, in all jurisdictions it is always complex, because one has to meld the corporation's laws with the listing rules with the taxation laws in order to find a way of structuring these products so that they can come to market. The concept of a physically-backed gold ETF is simple: you give somebody a security; it is backed by gold in a vault – easy. However, that is not the way it necessarily works when one gets down to the detail as to how to go about getting approval from the regulators and the listing authorities to get this done. In fact, in each jurisdiction we are involved we generally have slightly different structures, slightly different regulatory approvals in order to get it done. Thus it is very specific to each jurisdiction even though the end product, from an investor's perspective, looks the same.

How a Best Practice Physically-Backed Gold ETF Works

(a) Introduction

This is a specialist gold market audience, so can I ask how many people here can say that they honestly understand how gold ETFs work?

I suspect it is only a small number. Stewart, you were right. I have never had a presentation of mine rejected before, but when Stewart asked me to put together a presentation I gave him something that was a lot more complex, which is the type of presentation that we would give to Charlie or John; they ask many more sophisticated questions. However, just from that show of hands one can see that most people do not understand exactly how these work and, therefore, if this type of audience does not, there is a whole audience throughout the world that has still yet to be educated and that is what we spend most of our time on.

Simply put, the investor goes along, they buy and sell securities on the stock market and we have what we call 'market makers' making bid and offer prices. It does not matter if they do not own any of the securities, because if ever they are short or long, at the end of the day or at the end of the week, whenever they want to, they can come to us, the ETP issuer, and create or redeem securities. Very simply put, the investor deals in cash on the exchange (top line of chart) and we deal in gold (bottom line of chart). The person converting gold into cash all the time is not us, so there is no risk to the investor. It is always the market maker and the authorised participants who are doing that.

(b) Characteristics

These are some of the more detailed questions we get asked about the gold ETFs:

Is it physically backed? Yes. It always started from the premise that this thing had to be backed by gold bars sitting in a vault that were London Good Delivery, so we have always worked very closely with the LBMA to educate investors on what the LBMA is, what it does to ensure standards, what London Good Delivery bars are, what the London clearing system is. Those questions come up a lot and there is no lending. In other words, that is what gold companies used to do in hedging their prices.

We and other people tend to use independent counterparties, so that no single person can have their arms around the whole thing and therefore it is a 'trust me' trade. This is not meant to be a 'trust me' trade. This is a total integrity trade, whether it is the custodian, the registrar or other participants in it.

As I mentioned, there is no operational risk in these things. It is a very simple exercise and every security that is issued is always matched by gold in a vault.

We go to a number of different lengths regarding transparency. We publish every single gold bar by its details – the refiner, the bar number, the weight, the fineness and hence the gold content – on the website every single day, so that everybody can see exactly what gold is matching the securities on issue.

More recently, the persons who operate the vaults – in our case HSBC and JP Morgan on our two products – have invited certain institutional investors into the vaults, so that they can see for themselves that the gold is there. Everybody likes to say, 'I would love a vault visit', but for security reasons it is just not possible. As a further check as to whether the gold bars are there, we have independent auditors doing it all the time.

(c) Is the Gold Really There?

As you can see in this photograph, the fellow on the left is a 10-year younger version of me and that is one of the first photos we ever took in the vault. One of the things you very quickly learn about vault visits is that they are under high security. You are not told where the vault is. You do not get to go there in a normal car; it is blacked out. You certainly cannot take much in the way of recording equipment with you. These are one-off shots that I have been permitted to show here today and I believe this may be the first time photographs of the inside of the vault have ever been shown. That was the old vault when we started doing it and you can see we are doing a bit of a check.

This photograph was taken just over a year ago on a recent vault visit. I tend to go to the vault quite regularly, every year or two. If you want to know what gold really looks like, it is not like in a James Bond movie where it is all lined up beautifully; it is, in fact, a warehouse or, more particularly, it just gets moved around on pallets, as you can see. Each of those pallets is a ton. The bars are laid out seven across, two down the middle, five high and that is a ton of gold with those 80 bars. In that way, the gold can be moved around into segregated areas.

When the gold is sitting in the vault, our gold has to be kept in a separate allocated area so that if ever there is a problem with the bank's credit the receivers can come in and say, 'We know which is your gold as compared to the bank's gold'. In fact, our gold from the London product, the GBS, is on the left and the gold from the US product, the GLD, is on the right in this picture. It is very interesting that each time I go down for one of these gold visits I see each of our products lined up and, thankfully, the amount of gold there expands each time we go.

As I say, that is just one example of the gold being there, because that is the question we are asked all the time and I can assure everybody it absolutely is.

(d) Trading Spreads and Cost

A more sophisticated question we are asked by investors is about trading spreads and cost. There are two costs when an investor buys the securities. One is the difference between the bid and offer price, because those differences on a round trip are what it is going to cost to own the asset and that is a fixed cost no matter how long you hold it for. The other one is the cost of the product itself, because obviously there is a small management fee on it that is charged by almost slicing away a little bit of the gold each day by reducing the amount of gold that each security is entitled to.

The dark green figure on this chart shows the bid/offer spread on the four main securities listed in Europe and the three main securities listed in the US are on the right. The light green is the cost of the management fee expressed over a one month basis. As an example, you can see that for an investor holding for a one month period by far and away the largest cost involved in owning these securities is the bid/offer spread. In fact, that is where the market has moved to in terms of setting up these products to the benefit of the investors. We focus a lot on making sure that we have market makers with the tightest bid/offer spreads in the products. You can see that the light green means that the management fees are not a big issue in Europe for the shorter trades, because the spreads are wider.

However, in the US, where the products tend to be a lot bigger and have bigger trading volumes, the bid/offer spreads are a lot narrower and hence the cost of carry through the management fee is relatively higher. If one extends this out for a period of a year or more, the dark green stays the same and the light green continues to expand.

Outlook for Gold

(e) Investing in Paper Money versus Hard Assets

What other questions do investors ask us about these products? They tend to ask us 'where is the gold price going and are we in a bubble?' We have already heard a number of more technical explanations as to where we are going. Often in our presentations we try to keep it simple using what Charlie referred to as the 'Dow-Gold Ratio', which is the Dow divided by the gold price. As you can see from the graph on this slide, going back from 1920, it tends to go in peaks and troughs. I became very interested in the whole concept of this in 2000 when I thought gold really does have to outperform equities for some time to come and that has certainly been the case.

However, having been in a relative bull market against equities for some time now, one asks the question is it just about finished? You can see that it has fallen right down towards the bottom, but the interesting thing about this is, in terms of the ratio, once it gets to the small numbers even smaller falls are quite important. Therefore, the take away on this is that the Dow-Gold has already fallen by a factor of six times, but if it is to get back to the bottoms that we have seen in previous cycles, it still has another six times to fall. Hence from looking at the graph you might say we must be near the bottom of it already, but on a proportional basis one can look at this and say perhaps we are only about half way through this bull run in gold.

(f) Is Gold in a Bubble?

The other question we are asked is whether it is in a bubble and I think this has already been addressed a little earlier by Marc. This is another graph we use where we track the gold price this time against the gold price last time it was in a bubble and against the NASDAQ, which was clearly in a bubble. We say suppose it does not go up the way it was or suppose it does go up the way it was and then comes back, in the say way other bubbles have, what would the total investment return be? You can see that if it was to go the way of an absolutely classic bubble, we are talking about a 300% increase over that period of time. However, even if it were to go in a massive 'pop', then to retrace a lot of that you would still have a 100% increase in the gold price from where we are today.

By joining those two things up, therefore, when we talk to investors a lot of the time, we think we are only about half way through this massive bull run in the gold price and, secondly, we do not think we are in a bubble. In fact, even if we were about to go in a bubble and there is a correction, you can still make good returns from the gold price.

Thank you very much.