Session 3: The ETF Market

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I know very few of you but I think a lot of you know the ETFs by now. I think in 2006 at first people thought that ETFs would be the new prion of the mad cow disease but it became something different. I can give you an insight into the pure precious metals play, there are a lot of ETF players in the market that have a very diversified portfolio or location and give you a lot of possibilities, but we are here now to talk about precious metals.

The agenda for the next few minutes will be to give you a flavour about the current ETF and ETP landscape. I will tell you about my bad feelings on the mixture of ETPs, ETFs, ETNs and ETCs, because it is very important for your business. On the other side for me, the gap between knowing and understanding – when we talk about gold being a safe-haven investment, if we dilute a brilliant idea by choosing a wrong vehicle, we dilute the shining of the gold industry. This is not a good play. On the other side, I will try to give you a little flavour of how ETFs work today, meaning weekly updates on holdings, performances, kilograms, bar lists, etc., which I think is progressing well. Finally, I would like to give you a kind of 'on receipt' of how to make a product backed by physical metal successful. You can copy it, please do so as I love competition! It is the best way to shift the industry.

ETFs landscapes: The global ETF and ETP asset growth, they are just two numbers, but the depressing thing is the curve (shows image), 2,400 in existence by end of August 2009 by now 900 billion [assets under management?] (AUM)a few years later. The other thing I like is that we have a lot of product in the market, some are brilliant and some of them, in my view, are a waste of time. Nevertheless, it gives you a flavour that you have a tremendous AUM growth in this industry and what we are really talking about is the commodity sector, which is about 2%. If you think how much gold is in commodities, how many banks you know that have a binding allocation of gold, I know just a few in Switzerland. If we talk about those banks, what is the motivation to go into gold? We will cover this point a little later.

The second image I'm showing you is the sector allocation. For industries, you can have on one side the equity business, and on the other side, you can find yourself in the commodity business. Nevertheless, you should be very careful where your assets are going to. I will show you why. I talk about two pure plays, which I developed, which are ZKB ETFs (Zürcher Kantonalbank and JB ETFs (Julius Bear). That is a pure play precious metal thing, they are among the top 11-12 performers and, combined together, we are talking about close to 7 million ounces AUM within three years. On the other side, you see here now the first tricky thing about the industry. There are a few big players and lots of players that I don't think will survive the next five years, as ETF business came up to the level of 'me 2', and that's non a business model. 'Me 2' is not the base for success.

Let us move on to success. What is key for those things? Compared to you guys I have no clue about mining. But I have a clue about product and legal engineering. So what we are taking in the ETF business is the best you possess, the refined ounce and nothing else, so we take no risks. You have this huge experience in mining and refineries and we don't care – we take the end of the value chain. On the other side, we take what gold or precious metals are standing for. We take this meaning of payment. It's not up to our business model as an ETF provider that we can just claim that we are the gold guys. You are producing the gold, we are just wrapping it in the right product.

Now to something that I dislike – ETPs (exchange traded products). I am a lawyer and sometimes I am less than amused when I read in newspapers that ETFs are growing at a very fast pace because ETFs use accentuated funds, funds imply a legal structure. Funds is of the balance sheet and, in most countries, funds is a protected word. You can't just claim that something is to be a fund. On the other side, the second expression ETN (note), these are both expressions where you need to be very clear, what is the balance sheet risk of the two products. But ETCs, ETPs, etc., you need to be clear what they are, but you have no clue (trusts, notes etc.). For me, this is very key, because if you talk about precious metal investments, you have to be careful of people just reading 'funds', but what does ETF actually imply? It is a liquidation-resistant vehicle and doesn't fall into liquidation with the balance sheet of the bank, which is very important.

We may not risk diluting the benefit of the gold. I will show you a little of what I mean by that. Giving an example just gives you a little bit of a flavour of what the biggest ETFs are. Spider is among the best-managed and biggest gold funds in the world. Physically backed, talk of passive insurance. 1,100 tonnes. Spider is a trust, not a fund. It doesn't mean it is a bad structure; it's just that if you think about it from a fifth perspective, asking why should I invest in a product where the gold is held more or less in England or in the US. Why should I when I am Swiss? Because we talk about a safe-haven investment. On the other side, you see this ZKB ETF, which is now the second-biggest gold fund on this schedule, which is a very simple and stupid product. It is just a normal product reflecting the spot gold. The other side, you see my youngest development, JB; in 10 months, we have had more than 2.1 billion AUM. Why? It was not a 'me 2' product. The problem with gold investment is for a non US-dollar investor, you dilute the whole benefit of the investment because you make the right call on your commodity, but if you lose on the currency translation, you have lost everything.

Not all that glitters is gold. Since we were babies we know this, but this is very special for me, because since I have been working in this business of ETFs, I have talked about counterparty risk. Six years ago, people started to become disinterested in it. But since Lehmann collapsed, what are people talking about? Is it counterparty risk? Is it credit risk? You should think about how your gold investment wrapped and what happens to your physically backed gold investment if the bank goes bankrupt. This links to two substantial problems; you should try to differentiate between whether you are looking for an investment objective or you are looking of a return objective. In my eyes, a return objective is clearly seen with a compelling mining stock. So you could say that those guys take the risk, we arrange it in the right way, I want to see it. But the other option is to invest in physical because you have no risk, you have no exploring risk, no political risk, you buy it, have it and you're obeying to pay the actual ounce price.

So on this curve, you have to understand and divide what is good and what is wrong in my selection because you don't get a prime for a bad gold product, which is the bad thing about it. On the other side, as the picture shows, I like to pour something into a more compelling form. This is 12.5 kilo bars. All that glitters has to be gold or precious metals, we see just a little of how you make funds successful. We are talking about a fund. This is key; funds mean to me that the legal structure is off balance sheet. Alternatively, you can invest only in allocated physical metal. Physical metal, to allocate, you might say is pretty expensive. I can tell you if you deal the right way with the right people in Switzerland, you are even able to deal on a few bucks, per bar, per handling, per year. You are even talking about 50 base points per AUM as a management fee. So what are the benefits to having unallocated gold if you could allocate it? Because whenever something happens and the gold is not allocated and physically stored under your name, you risk not having the excess. It's not even that you have caused your own problem; it's that you are dependent on third parties, and an investment fund that reflects only the pure gold price is a no-go.

Another very special point, which people normally don't understand, no other exposure like derivatives because you are dependent to the balance sheet quality of the one who is guaranteeing your gold exposure. Don't do that. Full investment ratio is key because you want to be fully exposed to gold price developments, you don't want to be participating by 0.8%, which would be nonsense. On the one hand, something perhaps you won't like to hear from me is that I prohibit every product I do, lending and borrowing. Why? As soon as something is in the lending and borrowing, you are not any longer the proprietor of your gold bars. Very simple. If you run a business model that is based on lending fees, do it but not on the simple gold funds. Because investors come up and say that they would like to reflect the gold price without any third-party risks so no lending and borrowing accents please. On the other hand, liquidity links to the full invested ratio, which is not very normal, and to allocate and segregate the metal, this is key for a product. The LBMA partners make a lot of success by providing the bar lists; even if people can't charge for the bar lists, it is a good bar list, and also they can't come down into the vault and ask to check the bars. They have something that they rely and trust. It's the next level of having a good image of the funds.

What I would like to show you is that performance holdings and ounces are reported weekly or fortnightly, or even in a more frequent way, because it is very special in gold trading. We had an inflow of 160 million ounces in gold, which seems like a good thing, but you have no clue if they are coming from a metal account, are they already allocated on the bank's balance sheet somewhere and shifted into the gold fund. That's why, sometimes, you have to be careful with all of the reporting. The reporting may be precise but not accurate in my eyes.

So what makes it really successful is this point, currency hedging. Perhaps 90% of you think in US dollars, then you can go on sleeping, as this is not an interesting part for you! For the other guys, the currency hedging preserves the function of gold in the portfolio context. If you don't pay attention to that, you will lose a lot of money and, more specifically, you don't just lose money but you will lose the function of gold. This is key.

Just to give you a flavour, does anybody know how much the actual hedging costs are euro to dollar for a 12 kilo LBMA bar, 400 ounces? It's 8 base points income per year, so you would even earn additional money with the fx hedging. So those who just come up and say hedging just implies costs, I would prove them wrong. Not only that the instruments cost, the very bad thing about this is that if you concentrate on what happened before Christmas last year, we saw a huge drop in the dollar. What happens if the dollar drops normally? Gold depreciates. Up is good. What happens to the unhedged gold investments? This depends on the currency translation of the euro vs. the dollar. They go downwards due to negative correlation. So what we produce from the JB physical gold is a quanto hedged gold product. We preserve the function of gold. It's not a product placement for JB, this is just to show that we can clearly reflect the London fixing minus costs, that is the gold investment and everything else is gambling because you take two bets – you take a bet on gold dollar, and you take a bet on dollar, euro or British pounds. At the end of the day, it kills the function of your gold investment. You will hear next from Mr Hatheway a few things about perforeal design and if you are based on the sense that Mr Hatheway will show us that you can perhaps add a little bit of return by adding gold. This is only if you have used dollar gold in your portfolio and not if have another currency involved.

We have arrived at the end, just to put it into a nutshell. We have a huge chance with the gold industry, but for me it's key – let us suppose that gold isn't the right product because it falls back on our industry if we wrap pure investments in a bad legal wrapping. Another thing, try to preserve the function of investments and not make a mistake and go into something that you might communicate to customers, saying: "Hey, we made the right call on gold but we completely lost it with the currency aspect, bad luck!" But seriously, these are mistakes not to be made. Thank you for your attention.