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ETF INVESTING

Gold ETFs to hit market

Investors will be able to own bullion in a share of stock

By John Spence, CBS.MarketWatch.com
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SAN FRANCISCO (CBS.MW) -- Historically, gold has been one of the most difficult asset classes for the average investor to own, due to the high costs associated with purchasing, transporting and safely storing it.

Although traditional open-end mutual funds that invest in gold-mining stocks exist, there is no convenient or efficient way to invest directly in gold bullion, aside from perhaps buying a few gold coins and keeping them in a safety deposit box at your local bank.

That may all soon change, as the World Gold Council and Barclays Global Investors have each filed to introduce exchange-traded funds tied to gold bullion. See previous story..

Both ETFs will be structured as grantor investment trusts, not as registered investment companies, and the Bank of New York would be the trustee for both.

Although neither group can comment directly on the ETFs during the SEC's quiet period, from the filings it appears that they will provide investors with the opportunity to buy a physical interest in a bar of gold -- the World Gold Council filing says a share would represent one tenth of one ounce of gold.

For a comprehensive article that covers the new ETFs in the U.S. and discusses how similar funds have done so far in Australia and the UK click here.

"It's a good idea, because it makes a relatively specialized segment of the market easier and less costly to own," said Roy Weitz, editor of FundAlarm.com. "However, real gold bugs might not be interested in a piece of paper. Also, approval by the SEC isn't necessarily a sure thing, or a quick thing. But I think it will probably happen."

Some industry observers are now expecting the SEC to move on the earlier World Gold Council ETF now that BGI has also filed.

"There really is no indexed vehicle for precious metals out there," said William Bernstein, author of The Intelligent Asset Allocator. "Vanguard's precious metal fund is pretty good and it has low expenses, but it's closed now. Everything else is actively managed and fairly expensive."

According to the filings, the World Gold Council-sponsored ETF would have an expense ratio of 0.3 percent, while the BGI offering would have an expense ratio of 0.4 percent. An interesting quirk in the funds is that they will pay their fees by selling off small amounts of gold bullion that has been traded for ETF shares. In other words, the fractional amount of physical gold represented by each share will decrease over the life of the trust -- an important caveat.

If they are approved, the ETFs will allow ordinary investors access to physical gold that has not been available until now. The gold ETF shares can be traded intraday -- the Equity Gold Trust is scheduled to trade on the New

York Stock Exchange, while the BGI version will list on the American Stock Exchange.

Of course, it remains to be seen whether an active and liquid market for the gold ETF shares will develop. In the midst of a bull market for gold, BGI and the World Gold Council are wagering it will. Certainly, successful gold ETF launches in the U.S. could push gold prices up even higher.

"Exchange-traded gold bullion funds have been well received in foreign markets such as Canada, England and Australia, and there is no reason to expect otherwise in the U.S.," said J.D. Steinhilber of AgileInvesting, an advisory service that recommends all-ETF portfolios.

Gold, canned goods, and ammunition

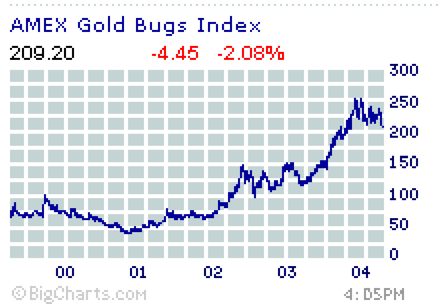
Gold proponents like to think of the metal as the ultimate insurance policy since it is highly uncorrelated with other asset classes.

Index	**Five-Year Correlation to Gold (London PM fix, USD) - 1998 Q4 - 2003 Q3**
Dow Jones Industrial Average	-0.133
Nasdaq Composite	-0.019
S&P 500	-0.081
Wilshire 5000	-0.062
3 month T-Bills	-0.096

"While gold stocks have historically a low but positive correlation to the broad stock market, bullion has had a negative correlation," said Steinhilber.

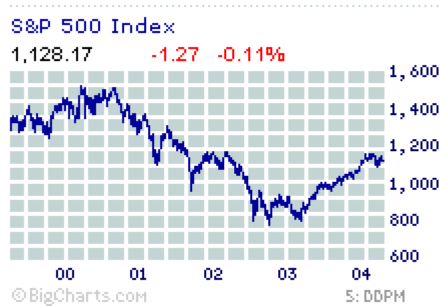
"This ETF would make sense in most portfolios for the same reason gold has always made sense: as an inflation hedge, and as some protection against economic and political disruptions," said Weitz. "The general guideline for gold in a portfolio has been in the maximum five to 10 percent range, and I think that still holds."

Certainly, gold has experienced a renaissance in recent years as the stock market faltered.



The charts show the 5-year daily returns of the AMEX Gold Bugs Index (HUI: news, chart, profile) against the S&P 500. (SPX: news, chart, profile)

"Gold tends to experience very long periods of low returns during periods of economic and political stability, and then during a crises very short periods of very high returns," said Larry Swedroe, head of research at Buckingham Asset Management in St. Louis.



"Of course, it is in times of crises that investors need those high returns most."

"Actually, gold's returns aren't that low," said Bernstein. "From July 1963 to December 2002, [Dartmouth Professor] Kenneth French's data shows that it had a return of 7.9 percent versus inflation of 4.6 percent -- i.e., a real return of 3.3 percent. And if you measured through the end of last year, [the base return] would have been about 9.5 percent." See chart.

ETF gold rush?

Gold can act as a portfolio buoy during stock market storms and crashes -- for example gold soared during the market crash of 1973-1974, and also during the uncertain times following terrorist attacks of 9/11.

However, since gold often goes through extended bear markets, many investors have neither the stamina nor discipline to hold the asset class long term -- the danger of buying high and selling low is very real for most investors.

Also, these ETFs will be the first of their kind, and there are no guarantees they will operate smoothly -- although BGI has a reputation as a first-class institutional indexer, and the Bank of New York plays an integral role in managing the world's highest volume ETF, the Nasdaq 100 Trust. (QQQ: news, chart, profile)

Finally, strange though it may sound, gold -- even gold bars in a vault -- are classified as "collectables," (artwork also falls under this category) and are therefore taxed at a higher 28 percent capital gains rate in the U.S. after being held for more than one year. Like any asset, if you sell it within a year, it is taxed as ordinary income.

John Spence is the editor of www.IndexUniverse.com, the leading source of independent index investing news, research and data. Reach him at jspence@indexuniverse.com.