

## Choosing a Physically Backed Gold Exchange Traded Product (ETP)

Gold has long been a popular investment because of its many attractive characteristics, including:

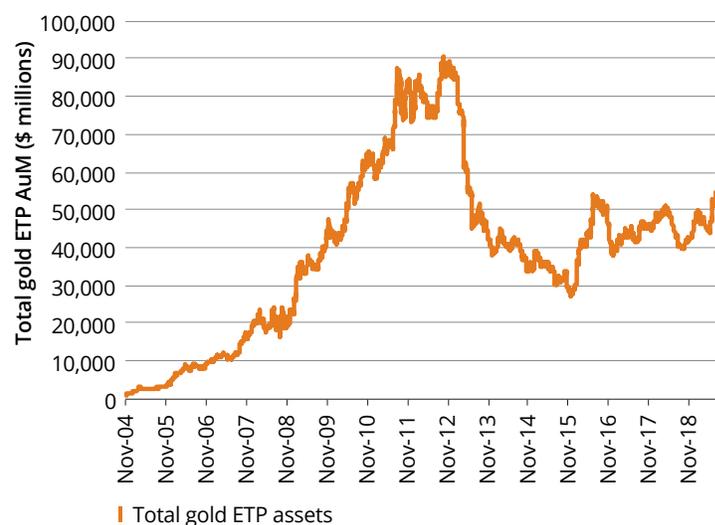
- Diversification benefits, thanks to low correlation to other financial assets
- Use as a hedge against unforeseen market events
- Ability to serve as a safe haven during periods of low interest rates

There are several types of gold exposure in a portfolio, but the most familiar are:

- Holding physical bars or coins
- Investing in an ETP, which may be physically backed by gold
- Employing derivatives, such as gold futures
- Holding gold mining stocks.

Given the rise of assets in ETPs that are physically backed by gold, this guide will supply investors with a framework for selecting the right vehicle. It is important for investors to understand the differences among gold ETPs to ensure that they select the right investment vehicle to meet their investment goals.

Chart 1: Gold ETP growth in the U.S.



Source: Bloomberg and Aberdeen Standard Investments, November 18, 2004 – September 26, 2019. For illustrative purposes only.

### Did you know?

- 3 Olympic swimming pools can hold all the gold ever mined in the world
- Gold is said to be so rare that the world pours more steel in an hour than it has poured gold since time began
- A one-ounce gold nugget is rarer to find than a five-carat diamond

From the outset, the goal of gold ETPs was to lower the barriers of entry and provide investors with a convenient, cost effective way to access physical gold.

## Five Key Considerations of Physically Backed ETPs

We believe any due diligence process should include the following five considerations:

- Cost
- Proven track record
- Quality
- Liquidity
- Trust

### Cost

While price or a fund's expense ratio may factor heavily in the selection process for investors (rightfully so), there are other important factors that determine the cost efficiency of an ETP.

- **Multiple Authorized Participants (APs)** — Multiple APs should be encouraged as they minimize the opportunity for a premium/discount to persist. They also reduce tracking error.
- **Multiple Market Makers (MMs)** — Multiple MMs should be encouraged as they provide liquidity, reduce spreads and encourage fair-value pricing.

### Proven Track Record

Physically backed gold ETPs are unlike other products in the exchange traded fund landscape. It is essential that investors carefully examine the track record and experience of the issuer.

It is paramount that all participants involved in the management of the product, including the trustee and custodian, are independent and have proven track records in their roles.

In order for an exchange traded product to be successful, it must have liquidity. A quality product should be supported by a network of liquidity providers to ensure tight bid/offer spreads and an efficient creation/redemption process.

### Quality

Gold ETPs should only deal in London Bullion Market Association (LBMA)<sup>1</sup> approved London Good Delivery<sup>2</sup> bars. This will provide the product with the security, reliability and strength needed to make investors sufficiently comfortable.

The chosen custodian should be a member firm of the LBMA. LBMA member firms have secure facilities that meet high standards for security and storage.

### Liquidity

Product liquidity has become synonymous with the trade-ability. The ability to trade easily is an important consideration in determining the differences between competing products. A more liquid product will allow for a more efficiently priced product.

All physical gold ETPs have similar access to the underlying gold so the primary market impact of creating and redeeming ETP units should be identical. This is not the case when one looks at the secondary market liquidity.

Secondary market liquidity, especially liquidity displayed on exchange, can differ significantly between products. The key measures of liquidity are the bid/offer spread and the number of market makers.

- **Bid/Offer spread** — the difference between the best price at which the ETP can be purchased and the best price it can be sold at any given moment.
- **Market makers** — Market makers compete to provide the best prices in the order book. The larger the number of orders, the more competitive the spread.

These measures combined lead to a more liquid product.

### Trust

Gold ETPs should be backed by physical LBMA Good Delivery bullion and should be held in allocated accounts. Small amounts of unallocated gold may be held to facilitate operational ease.

- Audits and bar lists should be verifiable against the LBMA Good Delivery list
- Bullion should be stored with a custodian steeped in experience in bullion storage
- No lending of or leasing of the bullion should be taking place
- Cash or certificates should be used as a substitute for physical bullion

<sup>1</sup> The London Bullion Market Association is the primary global bullion market trading platform for gold and silver. It is an over-the-counter market that has established standards for production quality of metals transacted and settled within the market.

<sup>2</sup> Good delivery refers to transfer of ownership of a security from a seller to a buy, with all necessary requirements having been met. The LBMA has specified good delivery criteria for physical gold that serve as a quality standard.

## Due Diligence Checklist

Due Diligence Checklist		Yes	No
<b>Cost</b>	Competitive management fee		
	Tight spreads and minimal tracking error		
	Multiple authorized participants		
	Multiple Market Makers		
	LBMA Gold Delivery Bars		
	Custodian is a member firm of the LBMA		
<b>Security</b>	Fully backed by physical bullion		
	No lending or borrowing against the bullion		
	No credit risk to the custodian		
	Limited operational risk		
<b>Track Record</b>	Issuer has a long operating track record		
	Partners are highly experienced		
	Fund size is sufficient and has a diversity of investors		
<b>Transparency</b>	All major counterparties are independent of the issuer		
	Transparent pricing		
	Easy to understand fee structure		
	Audit procedures that are published, including at least one random audit of the vault per year		
	Daily publishing of the bar list		

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