

## Gold ETFs Change the Marketplace

ETFs have transformed the gold market and helped push the real gold price to a historically high level. Gold investing may never be the same.

by **Steven R. Cunningham, PhD, Director of Research and Education**

**G**old exchange-traded funds (ETFs) have revolutionized the gold market. While they have popularized gold, ETFs also have fundamentally changed the structure of gold investing, with enormous implications.

For the first time in history, buying gold is as easy as buying stocks. This has opened up the market to a much broader pool of buyers and allowed gold to be added easily to any portfolio. Long and short positions are possible, and portfolio adjustments are trivial.

At last, small investors are in the game. Each share of the SPDR Gold ETF represents just one-tenth of an ounce of gold, and each share of the iShares Gold ETF equals one-hundredth, making them very affordable.

These new investment vehicles also opened up the market to pension funds, hedge funds, and other institutional investors. Pension funds, for example, that could not or would not invest directly in physical gold may now do so via gold ETFs. Hedge funds have made huge profits. Hedge fund manager John Paulson made an astounding \$5 billion in 2010 by investing in gold,

and his fund is reportedly the largest shareholder in the SPDR ETF.

At the same time, more investors view gold as a separate asset class from stocks and bonds that offers an opportunity to benefit from diversification, along the lines suggested by Modern Portfolio Theory and asset-class investing.

**In terms of the traditional motive for buying gold—uncertainty about the future—the list of reasons to be worried is long.**

Driven by this and market conditions, ETFs backed by physical gold and silver enjoyed an inflow of more than \$10 billion last year, and the price of gold rose.

The most obvious impact has been on the investment demand for gold. The Central Fund of Canada, a closed-end fund founded in 1961, was the first gold exchange-traded product. It was restructured in 1983 as an exchange-tradable product for ownership of gold and silver bullion.

Benchmark Asset Management Company in India conceptualized a gold ETF in a proposal filed in May 2002, but the first gold ETF formally launched as such was Gold Bullion Securities, listed in

March 2003 on the Australian Stock Exchange.

The World Gold Council, an industry group of gold mining companies like Newmont Mining and Barrick Gold, helped create another early gold ETF (the SPDR fund) as a way of spurring demand for gold. Apparently they succeeded. The 10 biggest such funds now hold a combined 2,113 metric tons of gold, and the SPDR Gold Shares ETF, by far the largest, holds 1,211 metric tons.

As shown in the table on page 2, that is more than the official reserves held by any country in the world except for the United States, Germany, Italy, and France.

The timing could not have been better. The financial crisis began in 2007, followed by the global recession and extraordinary efforts by governments and central banks to fight it. The great innovation of gold ETFs coincided with the great scare over the economy, taking gold prices to new highs.

In terms of the traditional motive for buying gold—uncertainty about the future—the list of reasons to be worried is long indeed. The worst financial crisis since the Great Depression wiped out trillions

**Inside this report** A new e-book by free-market economist Tyler Cowen examines the slowdown of American economic growth and the forces behind it. In *The Great Stagnation*, Cowen traces our current difficulties to permanent changes that took place during the 1970s. Senior Fellow R.D. Norton reports on Cowen's findings. See back page.

**Also** Legal changes made it easier to provide for a pet. Steven J.J. Weisman explains in Ask the Expert. See page 3.

in wealth and triggered the most severe recession since the end of World War II. The mortgage mess and the housing bust continue to weigh down borrowers and lenders and to hamper economic recovery.

The urgency of the crisis has passed. But it has been replaced by growing concerns about the unsustainable path of fiscal deficits at all levels of government here and around the world, the Federal Reserve's loose monetary policy, and fears that recent government actions could culminate in higher price inflation and a currency crisis.

The Fed is not the only central bank affecting gold demand. According to the World Gold Council, the U.S., Germany, France, and Italy hold about half of their capital reserves in gold bullion. Adjustments to their gold reserves in the face of soaring sovereign debt could potentially have a big impact on the gold market.

The political turmoil in the Middle East and North Africa adds another item to the worry list. Rising oil prices have been a factor in most U.S. recessions and episodes of higher price inflation since the 1970s, and gold is the traditional

### Largest Gold Holdings

SPDR Gold Shares, the largest gold ETF, holds more gold than most countries hold as official reserves.

	<i>metric tons</i>
United States	8,134
Germany	3,402
IMF	2,827
Italy	2,452
France	2,435
SPDR Gold Shares ETF	1,211
China	1,054
Switzerland	1,040
Russia	784
Japan	765
Netherlands	613
India	558
European Central Bank	501
Taiwan	424
Portugal	383

Official reserves of countries and IMF, January 2011. SPDR ETF, March 3, 2011. Source: World Gold Council.

hedge against inflation.

At a meeting of the World Economic Forum early last year, famed investor George Soros referred to the run-up of gold prices as the "ultimate asset bubble." Many ask: Is the inevitable collapse the next crisis that will hit the economy?

ETFs and other innovations in the gold market may have precipitated other changes. Uncovering them and spelling them out rigorously is challenging at this point because of the lack of data. Gold ETFs haven't been around that long, so data series are short. That said, the preliminary analysis is interesting.

As pointed out by gold analyst Frank Holmes, gold's volatility has

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changed. For 2010, the annualized daily volatility of gold was 16.1 percent, compared with 21.4 percent in 2009, and 31.6 percent in 2008. Currently the volatility is moving around in the 12-14 percent range.

The annualized daily volatility for gold was less than half that of metals like palladium, zinc, lead, and nickel, and gold's return for the year was less volatile than the S&P 500 stock index. Since the 2010 volatility number is not out of line with historical levels of about 15 percent, one possible interpretation is that volatility increased with the introduction of the ETFs and now is returning to its norm. This is why we need more experience with the ETFs to definitively say whether the volatility has fallen or will continue to fall.

Whatever gold volatility is doing, it appears investors are going to have more tools available to deal with it. CBOE Holdings has announced that on March 25 futures based on its CBOE Gold ETF Volatility Index (CBOE: GVZ) will be available. Options on the ETF will follow a few weeks later. The GVZ,

also referred to as the Gold VIX, is an estimate of expected 30-day volatility based on real-time bid-ask quotes of SPDR Gold Shares options that are listed on the Chicago Board of Options Exchange.

Because gold price movements have tended to be uncorrelated with those of other assets, gold is widely used to diversify portfolios. Among others, research by Chua, Sick, and Woodward (1990) and Jaffe (1989) provide findings in support of this practice.

As late as 2006, Hiller, Draper, and Faff also find empirical support at the 99-percent confidence level for gold diversification through a rather sophisticated technique called

GARCH analysis. The inclusion of gold or silver in a portfolio reduces systematic risk, they find, particularly in turbulent times. They also find that the inclusion of gold in

a buy-and-hold portfolio improves portfolio efficiency (the relative reward-to-risk ratio) over portfolios with only financial assets. Gold performed better than silver or platinum in this capacity. Moreover, even ignoring brokerage costs, the buy-and-hold strategy yielded superior results to a trading strategy.

But the use of gold in diversification strategies depends upon the relative independence of its price movements with those of other assets, an assumption that is increasingly coming under attack. Silver has historically maintained a correlation of about 60 percent with gold. Chaos theorists Frank and Stengos (1989) were able to demonstrate that the dependence between gold and silver is likely nonlinear. This suggests that the traditional measurements of the relationship may be invalid. Chan and Moun-tain (1988) found a simultaneous relationship between gold, silver, and T-bill rates. While the T-bill relationship hints at a problem with the independence of gold and bonds, these two studies do not pose

a strong challenge to the independence of gold-price movements. They are not terribly surprising, and do not go too far to challenge gold's use in diversifying portfolios. While the demands for gold and silver are quite different, people do turn to these precious metals in similar ways during uncertain or inflationary times. The relationship between gold, silver, and T-bill rates probably reflects the response of both metals to monetary policy.

To explore the independence of gold in portfolios further and with currently available data, we looked simultaneously at gold, silver, T-bill rates, and the S&P 500 index. Statistical tests confirmed that all four series form random walks. Our co-integration tests provide evidence at the 99-percent confidence level that these random walks “walk together.” This implies that there is a long-term equilibrium relationship among these variables. This finding is evidence only of a loose structural relationship that would not interfere with the use of gold as a diversification tool. But it does suggest that changes could be on the way.

Besides making it relatively inexpensive to add gold to a financial portfolio, ETFs also make it easy to sell, to short, or to make portfolio balancing adjustments. While it is largely speculation at this point, it is possible that these changes could produce a more significant correlation between the price movements of gold and financial assets. Portfolio rebalancing means selling one asset class and buying another. As stocks rise in value, an investor may sell stocks and buy gold ETFs to maintain his or her gold allocation.

Rebalancing efforts can amount to a lot. In the first two months of 2011, SPDR Gold Shares alone has seen net outflows of \$2.4 billion. Tom Anderson, global head of ETF strategy and research at State Street Global Advisors, says: “The outflows can be viewed as being seasonal—driven by year-end rebal-

ancing in addition to reaction to the decline in the price of gold plus the rally in equities in the U.S.”

There were similar redemption levels in 2010. If Anderson is correct, rebalancing efforts, related to financial portfolio performance, could have a significant impact on gold prices.

With \$55 billion in total assets, the \$2.4 billion outflow of SPDR shares may not sound like so much. But this is only two months activity, with most of it occurring in January. The question remains whether this linkage to financial asset performance through rebalancing will create anything more than a loose structural relationship. We will continue to analyze this as more data become available.

In our view, there is no way to predict short-term fluctuations in the price of gold. It still makes sense to include gold in a diversified portfolio as a form of insurance against financial and economic upheaval. Trying to anticipate the best time to do this (i.e., market timing) is inadvisable, as is trying to guess the best time to sell gold after its price has appreciated.

As described in our book *How to Invest Wisely*, there is ample evidence that most investors are better off using a passive investment approach rather than trying to time the market. This means choosing a fixed percentage of your funds to invest in various asset classes and maintaining that percentage by periodic rebalancing.

Because gold has outperformed most other asset classes in recent years, it has tended to become a larger proportion of portfolios that are not rebalanced. In contrast, investors who rebalanced probably sold some of their gold in order to buy other assets. This approach has allowed them to continue to hold gold, and to benefit from its tendency to rise in value during times of unusual financial stress, without unduly increasing their exposure to it.

## ASK THE EXPERT Pet Trusts

**W**hen is Trouble worth \$12 million? When Trouble is the dog that belonged to billionaire real estate investor Leona Helmsley. The Maltese terrier initially received \$12 million from Helmsley's estate only to have the court reduce the amount to a bare bones \$2 million.

For many people, not just the notorious “Queen of Mean,” providing for the continued care of a much loved pet is a major consideration. For a long time, setting up a trust to provide for the care of a pet was illegal because pets were considered property and therefore not able to be a beneficiary of a trust. Particularly in the last 10 years, however, the movement to enact legislation to authorize trusts for animals has spread. Now 44 states and the District of Columbia have specific legislation providing for trusts for pets. Massachusetts recently became the latest addition to this list.

Establishing a pet trust is a relatively simple matter. It can be done either as a testamentary trust, where the trust appears in the pet-owner's will. Or it can exist as a separate trust outside of the will.

When establishing a pet trust, consider the amount of money that will be needed for the pet's needs, whom you wish to act as trustee, and whom you wish to receive any assets remaining in the trust after the death of the animal. It is particularly important to discuss the care you wish your pet to receive with anyone you are considering naming as trustee prior to appointing them.

—Steven J.J. Weisman is a lawyer and author. His website is [www.stevelaw.net](http://www.stevelaw.net).

To submit questions for future columns, email [asktheexpert@aier.org](mailto:asktheexpert@aier.org). For guidance on specific situations, consult your lawyer or financial advisor.

# The New Normal?

In *The Great Stagnation*, free-market economist Tyler Cowen places today's economic and political difficulties in historical perspective. The result is not a pretty picture.

by **R. D. Norton, PhD, Senior Fellow**

According to economist Tyler Cowen of George Mason University, virtually all our major economic problems today reflect a slowdown in American economic growth that we have yet to fully recognize. As he puts it, "We have built social and economic institutions on the expectation of a lot of low-hanging fruit, but that fruit is mostly gone."

So writes Cowen in his new "e-book," which cost \$4 to download from Amazon to a free Kindle reader app.

This was a new technology to me. It is also the kind of innovation that Cowen views as "private," as opposed to "public." It gives me new options on how to read a book, but it doesn't actually create many new jobs, and it may destroy a few.

As he puts it, "Recent and current innovation is more geared to private goods than to public goods." This proposition connects what he sees as the big three macroeconomic problems of recent decades: slow income growth for many Americans, rising inequality, and the recent financial crisis.

Chapter 1 lists three examples of the low-hanging fruit that used to drive U.S. economic development. One was free land. A second was breakthrough technologies, which gave us the age of machinery and then the age of communication over the interval 1880 to 1940. A third was the pool of smart, uneducated children who could benefit decisively from being brought into the system of public schools.

By about 1970, Cowen says, these three sources of job and income growth had been pretty much ex-

hausted. Since then, he argues, our economic engine has stalled. Moreover, the official data on economic growth fail to reveal the extent of the slowdown.

Developing that argument, in Chapter 2 Cowen cites government, health care, and education as examples of how productivity growth has been overestimated. The way output is measured (by costs of production, rather than by market prices) in the three service sectors overstates their productivity gains.

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Chapter 3 dissects the Internet juggernaut, which Cowen finds spectacular in some ways, but no rival to the old-time transportation and electricity wellsprings of a century ago. As he describes the current digital innovations, "You can be an optimist when it comes to our happiness and personal growth yet still be a pessimist when it comes to generating economic revenue or paying back our financial debts."

As a result we are left with the politics of frustration, in which Americans expect and are used to a growth in real income of 3 percent, but have to settle for only 1 percent a year. This is the underlying source, he contends in Chapter 4, for the current polarized and generally nasty political stalemate. A frustrated electorate blames Washington and the politicians, who in turn have become ever more partisan, seemingly unable to come up with workable solutions.

Chapter 5 proposes a core cause

of our impasse: "We thought we were richer than we were." Most people have been slow to come to terms with the deceleration in growth and incomes since 1970. By the same token, the underlying explanation Cowen cites for the meltdown is overconfidence. Too much borrowing, too much lending, too little supervision by the regulators—all premised on the assumption that nothing really serious could go wrong with the financial system.

"Can we fix it?" This is the title of Chapter 6, the concluding chapter. The answer, in effect, is not any time soon. We can find hopeful signs in the offing such as the rise of a middle class in China and India that

will spur world development, as yet unforeseeable advances from the Internet, and the drive to reform K-12 public schools. But the payoffs to such possibilities will be gradual and uncertain.

In the meantime, we are left to confront "the new normal": economic stagnation and an over-committed government. So says Tyler Cowen in a stimulating and provocative book.

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Price of gold, March 11, 2011, London PM fix.