ETFs vs. Physical Precious Metals

Comparing GLD to GOLD

By SchiffGold Team

SchiffGold *is the largest US gold dealer exclusively offering investment-grade bullion products. Founded in 2010, SchiffGold has built a loyal customer base through personal customer service and discount prices. Peter Schiff is Chairman of SchiffGold.*

Precious metals ETFs, the most popular being GLD and SLV, may seem like an easy way to invest in gold and silver, but investors should understand that convenience comes at a price. If your goal is to protect yourself from default contagion, then the popular ETFs will disappoint.

Unlike outright ownership of physical precious metals, ETFs don't provide a hedge against sovereign default, fiat money collapse, or bank system failure. This report clarifies which financial product is better suited to protect investors in light of Peter Schiff's analysis of the coming dollar collapse: physical gold and silver or the popular ETFs GLD and SLV.

I. What is an Exchange Traded Fund (ETF), and how does it work?

An Exchange Traded Fund (ETF) is a financial product designed to track the performance of an underlying asset. The underlying asset can be anything from a basket of stocks to a foreign currency to real estate holdings. ETFs are different from mutual funds in that they have a per-share price that trades actively throughout the day just like an individual stock. However, unlike individual stocks, ETFs include management fees and expenses associated with their particular fund structure, which this report will cover in more depth in subsequent pages.

The most popular ETF for gold is the SPDR Gold Shares Exchange Traded Fund, trading under the ticker symbol "GLD". Founded in 2004, the primary purpose of the fund is to track the market price of gold bullion – less the fees and expenses associated with the fund. By purchasing shares of GLD, investors can gain quick exposure to the day-to-day price movement of gold bullion.

The fund is primarily backed by two assets: 400-oz gold bars and cash. The gold bars are stored in an HSBC bank vault in London. Depending on how shares trade that day, GLD must either buy or sell gold bullion to keep its share price tracking the metal's spot price. It does this through "authorized participants," defined below, which provide the liquidity for these operations and tight correlation to the market price of gold.

"Authorized participants are registered broker-dealers or other securities market participants which have entered into agreements with the trustee and sponsor (these include major Wall Street names like Citi, Goldman Sachs, Morgan Stanley, JPMorgan Chase, and Merrill Lynch-Bank of America, among others), allowing them to deposit either gold or shares in exchange for the other at unallocated accounts until the operation is completed."[1]

While GLD is closely correlated to the market price of gold, it does charge fees and expenses that amount to 0.40% annually. **This means GLD will always underperform the market price of gold bullion over time.**

GLD shares are designed to trade at 1/10th of the market price of gold. Surprisingly, a large number of investors are fooled into thinking that each share of GLD represents a claim to 1/10th of an ounce of gold and that somehow they would be able to redeem it if needed. Nothing could be further from the truth. The fund was never intended to be a substitute for physical gold ownership, nor was it designed with future delivery in mind. Remember that the fund holds no bars smaller than 400 ounces, so if anyone wanted to take delivery of gold, they'd better be ready to receive a half-million dollar hunk of metal. But even if you had this much invested, the fund's rules still wouldn't allow you to take delivery.

1. Taken from Forbes article, "Is GLD really as good as gold?": http://www.forbes.com/sites/afontevecchia/2011/11/15/is-gld-really-as-good-as-gold/

According to the official prospectus of GLD, delivery of gold is limited to authorized participants only or in 100,000 share minimums (that is currently around **$12.5 million per lot!**). Furthermore, there is a clause in the prospectus that gives GLD the option to settle in cash instead of physical gold. So, even if you were to meet all those requirements, you would still not be guaranteed any gold.

II. What are the key differences between physical gold and silver and ETFs?

The following chart shows the key differences between the two leading precious metals ETFs and physical gold and silver. The chart covers differences in cost of acquisition, as well as other important factors to consider when investing – such as privacy, reporting requirements, liquidity, and counterparty risk.

CATEGORY	THE ETFs: GLD AND SLV	PHYSICAL GOLD AND SILVER
What type of asset are you buying?	Paper claim which tracks an underlying asset & proxy share of underlying asset.	Ounces of the actual precious metals.
What are the costs associated with the acquisition of each asset?	Broker commissions at purchase plus 0.40% annual fee.	Dealer premium at purchase. No annual fees.
Reporting Requirements and Privacy	Full reporting requirements regulated by the SEC and FINRA. Social Security Number and personal information required for account opening.	Potentially no reporting requirements when buying metal. Limited or no reporting requirements when selling. Very discreet and private.
Counterparty Risk[2]	Significant counterparty risks, including liquidity of market makers and authorized participants, which include major banking institutions, financial and electronic exchanges, London vaults, and financial brokers.	Zero counterparty risk when metal is in your direct possession. If metal is stored in a secure vault (typically privately owned and outside the banking system), the vault is the only counterparty risk to the asset.
Ability for Redemption	No delivery option for the average investor. Limited to either authorized participants (financial institutions) or in 100,000+ share blocks (current market value of around $12.5 million). All private requests must be approved by authorized participants and GLD retains option to settle in cash.	No redemption necessary, as assets already belong to you. If stored in a secure vault, metals are 100% allocated or segregated (in your name) and can be redeemed at any time.
Liquidity	Very liquid under normal market conditions in open financial markets. Questionable liquidity in abnormal market conditions where financial or banking system is at risk of system failure.	Very liquid under both normal and abnormal market conditions globally. Reputable local and online dealers both buy and sell with minimal transaction costs and quick.
IRA Eligible	Yes	Yes

2. Counterparty is defined as "the other person or institution entering into the financial contract or transaction." For example, "the counterparty defaulted on their obligations so I lost my investment."

A couple of the preceding categories warrant additional comment. It's common to hear investors claim that ETFs are cheaper than buying physical bullion. While it is true that the broker commission for an ETF trade is typically less than the dealer premium for buying physical precious metals, investors must remember that both GLD and SLV carry management and expense fees of 0.40% *every single year*. This is an ongoing cost that must be continually paid as long as the investment is held. Therefore, over time, physical bullion becomes the lower cost option. For example, it would cost less to own physical gold than GLD over a 5-year period. This discrepancy widens the longer GLD is held, as the following chart shows.

TIME HORIZON	GLD	PHYSICAL GOLD
1 year	.40% + Broker Commission	2.25%
5 year	2.0%	---
10 year	4.0%	---
20 year	8.0%	---

Another key difference between ETFs and physical precious metals is privacy and reporting requirements for the asset purchased. Buying physical gold and silver remains one of the few ways to invest wealth outside of the traditional financial system and maintain financial privacy. There can be no reporting requirements when you buy physical gold and silver in any quantity and very limited ones if you decide to sell back at a later date. With GLD and SLV, every transaction is recorded and reported, and you are subject to securities regulations. For investors seeking minimal reporting requirements, physical precious metals have great advantages over ETFs.

III. In light of Peter Schiff's analysis of a coming currency collapse, how will an ETF investor fare compared to someone holding physical gold and silver?

Many investors mistakenly ignore or overlook the inherent risks of ETFs, which would become immediately apparent in a currency crisis. While no one can perfectly predict what the world might look like under a collapsing US dollar, imagining such a scenario step-by-step is helpful in order determine which assets offer the best protection for your wealth.

Let's set the stage for how such events might unfold.

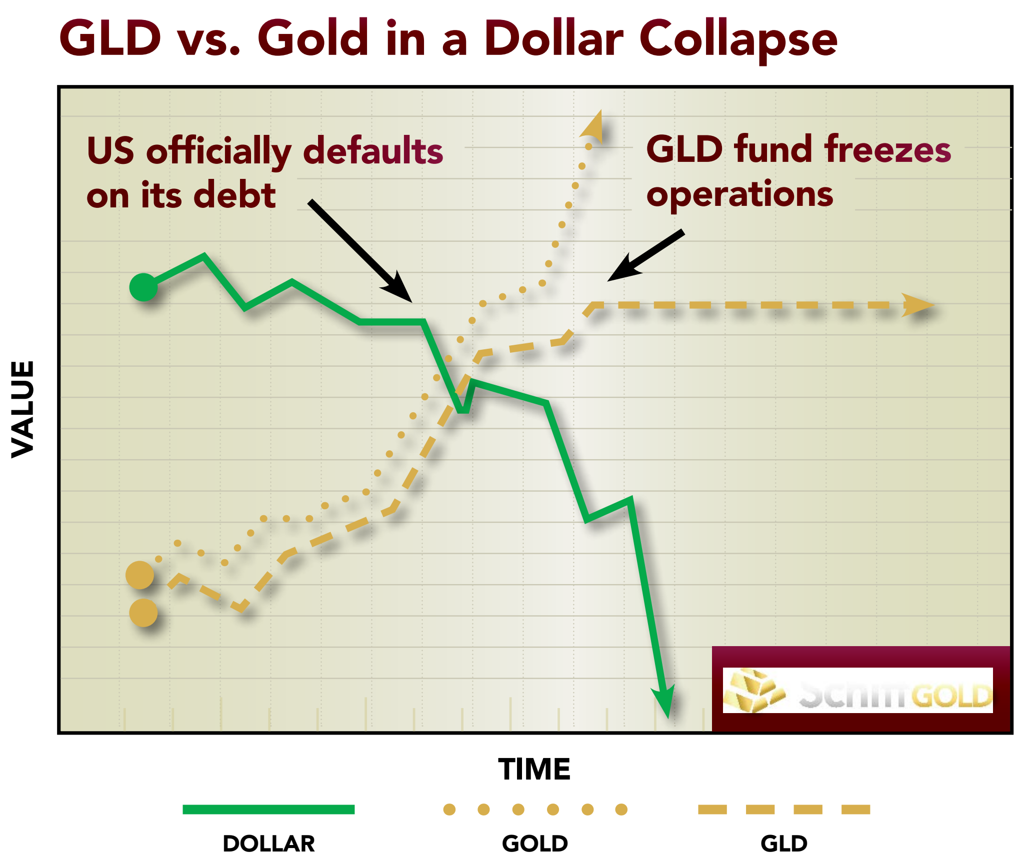
Two investors are seeking to hedge against a US dollar crisis. Investor A owns physical gold. Investor B owns shares in GLD.

The day everyone fears arrives, the US Treasury defaults on its debts – triggering a currency crisis. The value of the US dollar begins to decline dramatically. Major banks start to warn deposit holders about withdrawal restrictions, while smaller banks and other financial institutions declare bankruptcy and shut down altogether. One default triggers another and the dominoes start to fall. Runs on even major banks begin in earnest. There is panic in the streets.

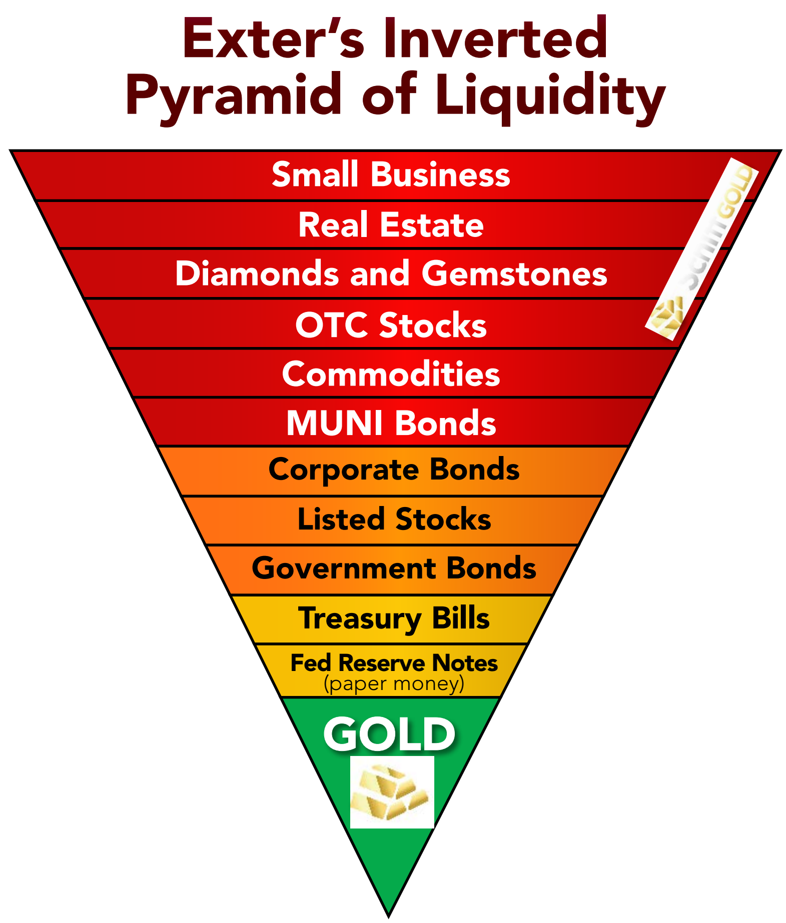
Initially, it may seem as though both investors have appropriately hedged because GLD is designed to track the price of physical gold. But then Investor B realizes that trading has been suspended on commodity ETFs.

As discussed previously, ETFs rely on upon the modern financial system pyramided upon the dollar. GLD can only function if its counterparties, the "authorized participants," are solvent. In the middle of a dollar collapse, these authorized participants of GLD will be forced to choose between their own solvency (as they control the gold bullion against which GLD is issued) or the continuing operation of GLD. If they continue operations in GLD, they will be forced to accept rapidly devaluing dollars in exchange for GLD shares. At the same time, they will be trying to find additional 400-oz gold bars in the bullion market, which in the midst of a collapsing economy will be extremely hard to find.

The following chart demonstrates these events occurring in sequence over time:



Even if GLD manages to continue operating as usual, Investor B might not be able to even access his brokerage account, as stock brokerage houses are often leveraged and tied into the financial system. How many investors hold their own stock certificates? Almost all are held in the investor's name by the brokerage house. If the brokerage goes belly up, Investor B has to get in line as a creditor or try to get compensation from the federal SIPC program. Either way, the lines will be long when the crisis hits, and there won't be enough underlying assets to make everyone whole. That's why the financial system is described as an Inverted Pyramid of Liquidity, pictured on the following page.



Since the average owner of GLD is not able to request redemption of GLD shares for physical gold and may lose access to their ETF or brokerage account in a crisis, Investor B is left in a troubling position as to what percentage of his capital he has protected.

Investor A, who owns physical ounces of gold and silver, is in a superior capital position. He already has in his possession the world's most liquid asset while everyone else – including the authorized participants of GLD – are trying to get their hands on it. Investor A has capital on hand in order to secure other assets as they are needed, e.g. food, shelter, and energy.

In essence, owning shares of GLD defeats the purpose of owning gold in the first place: diversifying a percentage of your assets outside the modern banking system which is built upon the failing US dollar. Only physical precious metals can accomplish this purpose.

IV. Is there ever a reason to choose a precious metals ETF?

The conclusion from the previous thought experiment is clear: ETFs would be at greatest risk precisely when investors need their gold most. In light of Peter's forecast of a coming dollar collapse, investors who want protection from such an event are better off buying physical gold and silver than shares of GLD or SLV.

However, there is no doubt that ETFs have served to increase exposure to precious metals markets and continue to play a key role in the broader markets for gold and silver today. Surely everyone owning these shares isn't simply foolish. So for which investment objectives are GLD and SLV well-suited?

ETFs make great vehicles for someone looking to speculate on the dollar price of gold or silver over a short timeframe. They offer a quick and easy way to enter and exit a position, as well as the availability of options strategies. They also work well for someone who has already created a personal reserve of physical precious metals and now simply wants to trade price movements in gold and silver markets.

Investors should note, however, that the short-term price movements of precious metals can be unpredictable. SchiffGold is built on the historical knowledge that gold and silver hold their value over the course of lifetimes. But the short-term spot prices of these metals can be influenced by everything from the Fed's latest rate decision to the demand for the latest iPhone (as silver is a key component in electronics). If you want to try your luck timing the market, then the transaction costs and shipping times of physical metals cannot compete with ETFs. But most people who attempt this market-timing strategy lose their shirts.

For most investors considering gold and silver, the objective is long-term preservation of capital from inflation and other risks. For that goal, physical metals are the wise choice. Once the upfront cost is paid, the metals are yours to keep in private without having to trust anyone else. Over time, physical metals prove less expensive than ETFs. And in desperate times, they are a reliable and liquid store of value.

Physical gold and silver are the most important financial assets of our generation. The Federal Reserve has miraculously managed to postpone the dollar collapse. Rather than returning to business as usual, this should be viewed as an opportunity to make choices that prepare you and your family for harder times ahead.

Disclaimer: This paper was written by the professional team at SchiffGold and does not necessarily constitute Peter Schiff's official investment recommendations. Peter Schiff recommends allocating 5-10% of your investable net worth in physical gold and silver to protect against a currency collapse. Nothing in this paper constitutes official investment advice or a recommendation to buy or sell any security or asset. Investments always have associated risks.