Three Ways to Invest in Gold

A reaction to zero interest rate policy around the globe. A long-term hedge against the tax of inflation. A safe-haven in times of crisis. There are many reasons you may choose to buy or invest in gold, but once you have made the decision, what are your options?

There are three basic ways to gain such exposure: 1) Physical ownership of coins or bars, 2) "Paper" exposure through Exchange Traded Funds (ETFs) or futures, and 3) Ownership of gold-mining stocks (or mutual funds, ETFs that hold mining stocks).

Depending on your time frame and objectives, any of these options may provide a solution.

Physical Gold: Coins and Bars

Most "gold bugs" would say that the best, safest form of gold exposure is physical ownership. This involves purchasing actual coins or bars and personally storing them in a safe or safety deposit box. Physical ownership eliminates counterparty risk. You are not dependent on someone being able to source and deliver gold that is owed to you. Shares that are yours can't be lent to someone else. The bank holding your unallocated bars can't go bankrupt and leave you a creditor of the company. While any of these events are unlikely in normal times, one of the justifications for holding gold is as a safe-haven in a time of crisis. The exact time that counterparty risk is greatest.

There are some drawbacks to physical ownership, however. First, it is going to cost a little more than buying paper gold. Coins and bars are typically purchased through a dealer or mint, and on top of the market price, an investor will typically pay a mark-up, as well as shipping costs. Once received, the owner also must store the gold. This can be accomplished with a home safe or a bank safety-deposit box. While storage is an issue, when one considers that a standard gold bar weighs 400 ounces, space is not the issue. Safety and insurance are the primary concerns of storage. Liquidity can also be an issue. While dealers will be willing to make a market and buy gold from you if necessary, the process may not be as fast and easy as selling paper gold.

Paper Gold: ETFs and Futures

A quick and easy way to get exposure to gold is by buying a gold ETF. In short, you are purchasing a piece of a trust that holds gold on an allocated (to the trust) basis. Many investors like the fact that an ETF is available through their brokerage account with the push of a button. It can be sold just as quickly. There is theoretically counterparty risk, however. When new buyers come into purchase the ETF, new units need to be created.
If the trust is unable to locate gold to buy, the market price of the ETF may trade at a premium to the actual holdings in the trust. In other words the trust is not fully funded. Further, the ETFs will carry an asset management fee that, over time may exceed the mark-up cost of purchasing physical gold.

Before the introduction of the gold ETFs in 2004, investors more frequently purchased gold exposure via the futures market. In the futures market, there is a non-zero risk that in times of crisis, those who have sold gold will not be able to make delivery on the contract settlement date.

While it is the role of exchanges to monitor and step in to prevent such situations –again during a systemic risk event, nothing is guaranteed.

Gold Mining Stocks

The third primary way to get exposure to gold is to buy stock in mining companies (or invest in mutual funds and ETFs that hold gold mining stocks). Mining stocks often provide a leveraged return in a rising market of gold prices. This happens when the cost of production remains constant while market prices rise. The increase in revenue goes straight to the bottom line.

In recent years, however the gold mining stocks have not performed as one might expect. Despite a big year in 2016, mining stocks have significantly underperformed the gold ETFs since their inception in 2004. Even markets that would expect to see the miners do well, such as 2011 and 2012 proved to be difficult for the value of mining stocks.

The miners often carry a heavy dead load, which can introduce risk. Another potential issue is the cost of production. In a crisis, the energy burdensome mining process could be affected and harm gold mining companies, especially if they have hedged or sold future production at lower than current market prices.

Summary

If you have a long-term perspective and are looking or the ultimate protection from financial crisis and systemic risk, physical ownership may be the best option. If you are not interested in taking delivery or are looking for some inflation insurance within a traditional investment portfolio, ETFs can fit the bill provided one understands the potential pitfalls. The gold mining stocks have been an enigma.

As with any investment decision, be sure to do your due diligence before making any decisions.