How to Invest in Gold: Six Options to Consider

"All that glitters is not gold."

by Kieran Osborne, Merk Investments

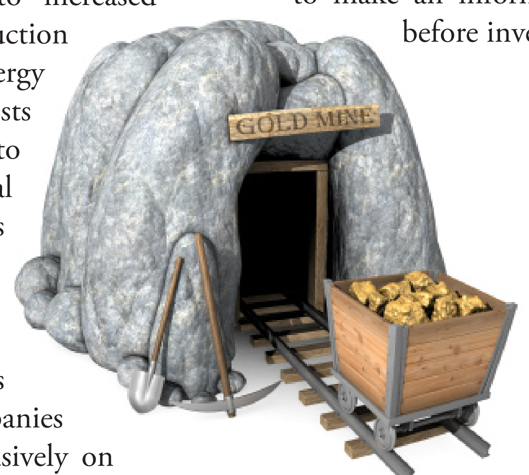
Shakespeare's writings provide a gold mine for quotes, both literally and figuratively. He was certainly onto something beyond gold's lure when he wrote: "foul cankering rust the hidden treasure frets, but gold that's put to use more gold begets".

Gold has long been used as a protection against inflation and as a safe haven investment. Given the current economic environment, you too may be increasingly thinking about investing in gold. So, what's the best alternative? We discuss six options available to you.

Striking Gold with Gold Mining Stocks

There are a plethora of listed gold companies. Be aware that while a gold company's stock price is linked to the price of gold, as it represents a major revenue stream, it is not a "pure play" on gold; it's unlikely that a company's value will directly replicate the price of gold.

Gold companies can be divided into two generic groups: "Juniors" and "Majors". Each category has company-specific characteristics that impact its value. Generally, Juniors focus on exploration and are more risky than Majors, which typically are already in the mining and production phase. A Junior gold mining stock can be thought of as an option play on the likelihood of striking gold and getting bought out by a gold Major. Junior gold mining stocks do, however, typically rely heavily on credit, a key risk when credit markets are under duress. In comparison, gold Majors offer the possibility of operational leverage through gold price appreciation. The theory being that costs to produce gold are relatively fixed, such that gold price appreciation expands margins and the bottom line. In reality, such costs have not been fixed – many stakeholders have wanted a piece of the pie, from increased taxation to increased wages. Gold production is also extremely energy intensive, meaning costs are closely tied to the price of natural resources, such as oil, which has been elevated.



Complicating things further, many companies may not focus exclusively on gold. Some may also focus on other precious metals or minerals, such as silver, palladium or diamonds. If you invest in these companies, you may end up with a wider exposure to precious metals and minerals than just gold.

Like any company, management will also have a large impact on the value of a gold mining company's stock price. Good and bad management decisions can have a larger impact than the price of gold and in some instances may make or break your investment. Above all, make sure you know enough about a company to make an informed decision before investing.

Gold Mining Fund - Basket of Golden Eggs

Don't have the time to research, but still want to invest in gold mining companies? Similar to gold stocks, gold mining mutual funds and gold mining Exchange-Traded Funds (Gold Mining ETFs) are not a "pure play" on gold, but rather invest in a broad basket of gold mining companies. This makes it easier to access a wide range of gold mining companies with one investment. Many will focus specifically on gold Juniors or Majors, as described above. Most Gold Mining ETFs and mutual funds are easy to purchase directly through a broker.

The manager of the Gold Mining ETF or mutual fund makes all the investment decisions independently, so there is no need to research companies. For this convenience, Gold Mining ETFs and mutual funds charge an expense ratio. The expense ratio is generally lower for Gold Mining ETFs because they often aim to track a static basket of gold stocks. On the other hand, mutual funds typically offer active management, rotating in and out of select securities as the manager deems appropriate. For this reason, mutual funds' expense ratios are typically higher, and some may also charge front-load and/or back-load fees in addition to an annual expense ratio. As with any investment product, make sure you are aware of any and all fees before investing.

Overall, when considering an investment in gold stocks or in gold stock funds, you should understand that neither will give you direct exposure to the price of gold. Instead, you will gain exposure to a company or companies that operate in the gold mining industry.

Paper Gold - Gilded Notes with Risks

There are an array of funds that offer exposure to gold without ever owning the "real thing." One option is Exchange Traded Notes (ETNs) that seek to track the price of gold. Note, however, that an ETN is a debt instrument: a promissory note made by the issuer. In times of turmoil, ETN prices may increasingly reflect the creditworthiness of the issuer.

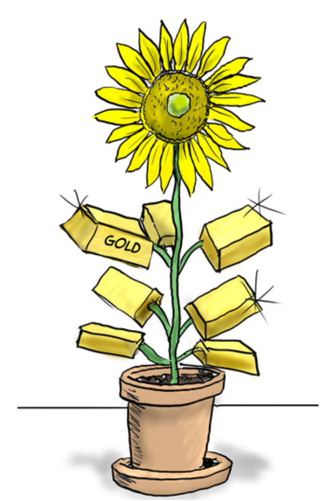
In the world of paper gold, leveraged gold funds are available to take speculative bets on the outlook for gold. These funds may use futures and other derivatives and are available in multiples up to three times the price of gold, long and short. Due to costs associated with leverage, such vehicles may not necessarily track stated multiples of the gold price over time. As such, these investment vehicles may not be suited for a buy-and-hold strategy. And tempting as the upside may be, be cautious of the severe downside risks, as leverage compounds volatility.

Open-End Gold Trusts - Fractional Ownership

We're talking about GLD, IAU, and SGOL to name a few. By owning shares in an exchange-traded open-end gold trust, you have fractional ownership in the underlying gold. The trusts are called open-end because gold shares are issued and redeemed to accommodate investor demand. As a result, open-end trusts closely track the price of gold. There are a number of options available with relatively low expense ratios. Different funds may hold physical gold in different locations – from London to New York, even Singapore.

If a key priority of yours is to invest in physical gold, but like the convenience of investing in gold through an exchange, make sure that is clearly stipulated in the fund's prospectus to ensure the trust uses no derivatives. If you're interested in taking delivery of the physical gold, make sure you are aware of any limits imposed before you invest, as some funds may set fairly high requirements that could preclude you from accessing the underlying gold you own. These details can be found in any fund's prospectus.

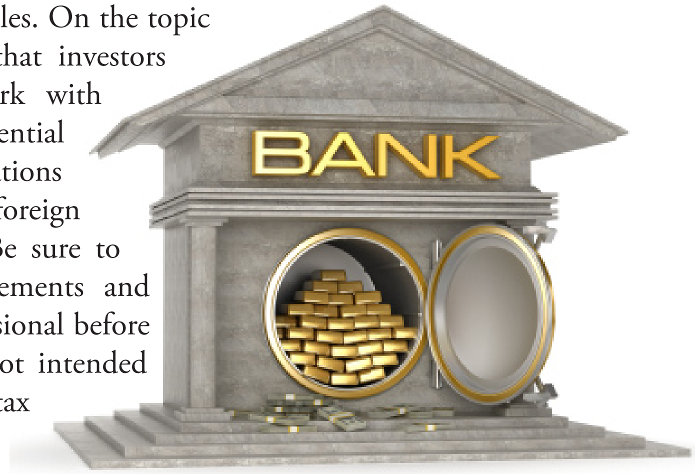
Overall, open-end gold trusts may offer an effective and relatively inexpensive way to invest in gold.



Closed-End Gold Trusts - Real but Pricey

Closed-end trusts are another option that you might want to consider. The closed-end trusts available to U.S. investors store gold in Canada. Similar to open-end trusts, investors have fractional ownership in the underlying gold bullion, however, unless there are offerings of new shares to the public, gold holdings in the trust remain constant.[1] As a result, the share price of closed-end trusts fluctuates based on supply and demand of shares in the trust, not necessarily the price of gold. When closed-end trusts trade at a premium to net asset value (NAV), you'll be paying more for shares in the trust than the value of gold the shares correspond to; it is possible for shares to trade at a discount to NAV.

When a closed-end trust offers new shares to the public, the gold received by the trust reflects a deduction to pay for underwriting fees, which can be substantial. Closed-end trusts are still popular because selling shares of the trust may be taxed at the long-term capital gains rate rather than the tax rate for collectibles. On the topic of taxes, beware that investors must file paperwork with the IRS to avoid potential negative tax implications of holding a foreign (Canadian) trust. Be sure to check these requirements and consult a tax professional before investing. This is not intended as, nor can we give, tax advice.



Some closed-end trusts may also allow for the redemption of your units in return for gold bullion. Please read prospectuses for further details.

Physical Gold - Bona Fide with Baggage

Physical gold – think gold bars and coins. These are readily available from gold dealers and online retailers. You can purchase it in various weights, making it relatively flexible – from 400 ounce bars to fractional ounce coins – bear in mind, though, the mark-up is likely to be a lot higher for smaller sizes. This mark-up shouldn't be taken lightly; we have found premiums over the spot price of gold approaching 40%! If you need your gold delivered, it's possible that you'll pay additional shipping and insurance costs. Be sure you are aware of the premium you'll pay, along with any other costs, before committing to purchase.

Once you've bought your gold, make sure you have a safe place to store it! A safe buried in a deep hole in your backyard might suffice, but most people prefer a secure local vault. If this is the case, you'll need to factor in the additional storage costs as well as recommended insurance.

The reputation of a gold dealer is an important consideration; you want to be safe in the knowledge that you are buying gold which has had its weight and purity properly authenticated. However, even taking such a precautionary step may not protect you: the Secret Service is apparently investigating a number of counterfeit gold bars which have been hollowed out and filled with tungsten (a metal with a density approximately the same as gold) sold from reputable gold dealers.

One final point: as we mentioned above, some exchange traded trusts may allow for delivery of physical gold. This may be preferred if you'd like the option of taking the delivery of gold without the headache of worrying about where to store it in the meantime.

[1] Both open-end and closed-end funds periodically sell some gold to cover expenses.

Ultimately, when investing in gold, first ask yourself whether you want to track the price of gold or whether you'd prefer to have exposure to gold-related

companies. Gold mining stocks and gold mining funds provide exposure to the value of gold companies, not directly to the gold price. The other options discussed aim to track the price of gold. Once you have made a decision, weigh the pros and cons of the various available options.

Final nugget of wisdom from an old English proverb: when we have gold we are in fear, when we have none we are in danger.

About the Author:

Kieran Osborne, CFA is a Senior Analyst at Merk Investments. Kieran is an expert on macro trends and currencies and has a comprehensive quantitative background. He frequently publishes research reports focused on global economic trends, as well as currencies and gold.

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