Fools Gold: Five Common Mistakes with Gold Investments

by Merk Investments, Axel Merk

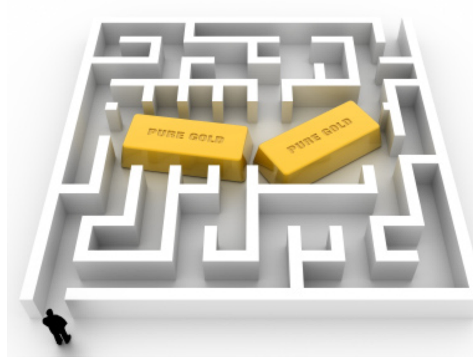
You want to own gold. Maybe you're worried about the potentially detrimental inflationary effects emanating from the Fed's and global central banks' policies; maybe you're worried that the fiscal cliff agreement is simply kicking the can down the road and fiscal Armageddon looms on the horizon. Whether you're in search of inflation protection, a safe haven asset, or both, gold may be a part of the solution.

Regardless of your reasoning, owning the ultimate currency is not as straightforward as you might think. To help out, we've compiled five common mistakes associated with investments in the precious metal. Avoiding the common pitfalls may help provide you with the desired investment exposure while minimizing any unanticipated drawbacks. Ultimately, we hope the following list can help reduce investment headaches associated with your future gold investments.

1. Gold Stocks Ain't Gold

A frequent mistake made by investors is to invest in gold mining companies (both juniors and majors) as a substitute for gold. There are a couple of reasons why this may be a mistake. Firstly, gold mining company's stock price does not precisely track the price of gold. That's because lots of other factors influence the share price of a company: management, cost pressures, mining diversification, stage of the mining process, to name just a few. This problem is generally more acute for juniors than majors, because juniors often have yet to "strike gold," therefore the stock price often trades more like an option. Moreover, many mining companies don't only mine gold, many also mine silver, palladium, diamonds etc. This dynamic also holds for baskets of mining companies – baskets of miners have significantly underperformed the price of gold over recent years.

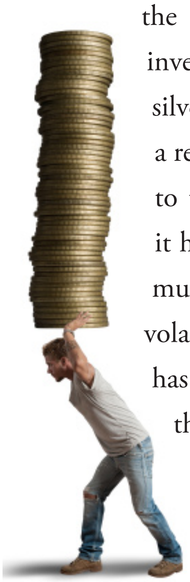
Some investors believe gold mining stocks may provide more attractive investment exposure to gold than gold itself. The investment thesis is as follows: gold mining companies are able to take advantage of an increase in the price of gold through enhanced operational leverage; as the gold price goes up, mining companies' margins widen, ultimately increasing the bottom line. However, this theory is predicated on fixed costs staying relatively constant. Unfortunately, recent performance does not support this investment idea. Indeed, gold mining stocks, on aggregate, have significantly underperformed the price of gold. The reality is that mining is a highly energy-intensive undertaking, and therefore many of the costs are closely linked to energy prices, such as oil, which has also experienced significant increases in price. As a result, many mining companies have not produced the anticipated



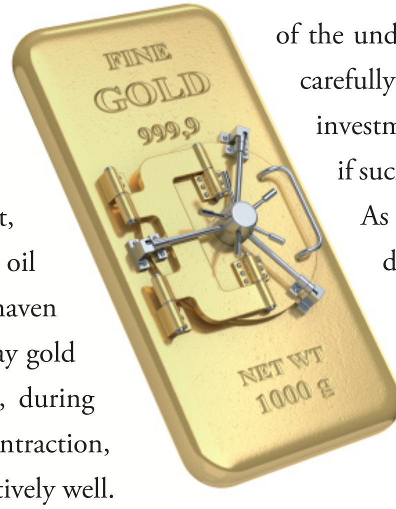
high level of profits. Additionally, governments may demand higher taxes and employees higher wages from mining companies should profitability increase, further limiting the upside potential for shareholders.

2. There is Only One Real Thing

Don't be fooled with the allure of other precious metals or commodities as a replacement for gold. Like investing in gold mining companies, other precious metals or commodities are likely to provide a very different return stream than that of gold. Indeed, a basket of commodities would have significantly underperformed gold over the preceding 10-year period, while exhibiting higher levels of volatility. While you should diversify your portfolio, and not hold all your eggs in one basket, you should be aware that all metals or commodities are not created equal. Specific characteristics, unique to each metal or commodity, effect both supply and demand, and ultimately the price, and therefore investment returns. Take silver for example. Silver has a relatively high correlation to the gold price, however it has historically displayed much higher levels of volatility. Silver generally has greater industrial use than gold, which may, in turn, increase the link between the health of the economy and the price of silver.



During periods of economic contraction or recession, silver may come under pressure. Likewise, similar dynamics may hold for the price of oil. As a result, investments in silver or oil may not exhibit a safe haven attribute in the same way gold historically has. Indeed, during periods of economic contraction, gold has performed relatively well.



3. Beware of Premium Over Spot

Let's say you want to keep your gold under your mattress, or at a local vault. Physical gold – gold bars and coins – may be the best solution for you. But before you rush down to the local gold coin dealer (or onto the internet in search of an online dealer) make a note of the spot price of gold per Troy ounce. That way, you can calculate the premium the dealer is asking for (be sure to include any delivery, administrative, insurance, or related fees) before making a final decision. As a general rule of thumb, the smaller the gold ounce content, the higher the premium over the spot price of gold. In fact, we have found premiums in the range of 40% above the spot price of gold! Obviously, the premium paid has a direct impact on your investment; you don't want to start off effectively -40% down on day one!

Don't assume buying from a gold dealer is the only way to acquire physical gold. Some listed exchange traded vehicles may also offer the option to take delivery of the underlying gold. Please read carefully the prospectus or related investment material to determine if such a vehicle offers delivery. As with buying from a gold dealer, make sure you are aware of all costs and related expenses that you will incur before committing to take delivery. Again, read the associated material carefully; each vehicle should provide comprehensive information covering all costs that will be borne by an investor wishing to take delivery of physical gold.

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4. Don't Overlook the Expenses

Many investors overlook the (oftentimes substantial) associated costs of holding gold in physical form. For instance, physical gold is commonly stored in a local vault and insurance is often recommended (if not required), both of which decrease the annual rate of return on your investment in the precious metal. That said, holding insurance in the case of a burglary may, in hindsight, turn out to be a wise decision. Investors should conduct a personal survey of the costs they are likely to bear – shop around, as you may find large discrepancies in insurance premiums. Investors should be mindful that some vaults are underinsured relative to their full gold holdings and factor that possibility into their assessment of insurance costs, as lower premiums may come with additional hidden risks. Unfortunately, there is often very little choice when it comes to local vaults, in some cases there may only be one realistic option. Many vaults also have limited capacity to accommodate gold (due to its weight), which may increase your storage costs. Be sure you can store your physical gold before buying it! Factoring in these additional costs and determining the impact on your annual rate of return may help you decide whether holding gold in physical form is the right choice for you.

Make Sure Gold is Really There

Let's say you've decided to buy an exchange traded investment vehicle that aims to track the price of gold. You want to make sure the vehicle really does have the underlying gold on hand. This may be particularly relevant in the case of a run on the vehicle – will the gold be readily accessible for you to liquidate funds? To answer this question, take a good hard look at the vehicle's prospectus. Make sure you understand whether the vehicle has the ability to lease the underlying gold and the extent to which it typically uses unallocated gold accounts. If this information isn't outlined in the vehicle's prospectus, please inquire directly with the vehicle's sponsor or online; there may be additional supporting materials discussing these subjects.

Unallocated gold is not physical gold that can be held and touched; it doesn't sit in a designated vault. Rather, unallocated gold accounts represent "paper gold," a claim on a third party's gold holdings. Be aware that a vehicle using large unallocated gold accounts as a proportion of total gold holdings may have insufficient gold in its vaults to cover all the underlying claims on that gold.

The ability to lease gold to third parties allows the manager of a listed vehicle to supplement the investor-paid annual expense ratio with a lease yield. However, it is a contentious topic to say the least, as **leasing causes uncertainty regarding the ownership claim on the gold** held within the vehicle. Regular audits don't prevent a vehicle to lease out the gold to third parties (who may, in turn, lease that gold again, perpetuating further claims on that gold) if it is allowed for in the vehicle's prospects. Should a large liquidity event occur, there are question marks surrounding the ability of the vehicle to readily draw upon the leased gold in order to meet the claims upon it. Gold leasing is a controversial subject and conspiracy theories abound regarding whether there is even enough gold globally to satisfy all the underlying claims outstanding. That it takes seven years for Germany to repatriate some of its national gold held overseas, in vaults in Paris and New York, may lend credence to some of these theories. In short, we don't have a definitive answer. If you are in doubt, it may be best to simply avoid vehicles that have the ability to lease large portions of its gold stock. M

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