PRECIOUS METALS

Gold Futures vs. Gold ETF's

UNDERSTANDING THE DIFFERENCES AND OPPORTUNITIES

There are significant differences in the liquidity, leverage and costs of futures and ETFs that need to be understood before any investment decision is made.

Gold has historically served as both a legitimate hedge against inflation and as an integral part of a diversified investment portfolio. But how can individual investors participate in the resurgence of gold and use gold as a vehicle for investing, preserving and increasing one's wealth?

Today, more than any other time in history, active investors have available to them a variety of ways to invest in the performance of gold. From gold bars to mining stocks or derivatives, individuals have flocked into gold-related investments in an attempt to benefit from the renewed interest in gold. Two of the more popular gold investments chosen by professional money managers are Gold futures (COMEX) and exchange traded funds (ETFs) based on gold. In many cases either the futures or ETFs are a suitable choice, but there are significant differences in the liquidity, leverage and costs of each that need to be understood before any investment decision is made.

Differences in Market Liquidity

It's estimated that world gold reserves fall in the range of 120,000– 140,000 metric tons. The largest gold ETF, SPDR Gold Shares ETF (GLD), is in its fifth year of existence with a total of $42 billion dollars under management and 1,100 metric tons of gold bullion in reserve. Originally founded in 2004, the SPDR ETF was specifically developed to track the price of gold and become an inexpensive alternative to owning physical gold. Investors can purchase a share in the ETF which represents one tenth of an ounce of gold. It sounds great in theory, but the amount of bullion under management is fairly insignificant and the volume of gold traded by the SPDR ETF is fairly small when compared to the daily volume transacted using COMEX Gold futures.

- Source: Bloomberg

Currently, the SPDR Gold ETF trades an average of 24 million shares (GLD) on a daily basis representing 2.4 million ounces of gold. In comparison, the average daily volume for COMEX Gold futures is over 200,000 contracts which equates to approximately 20 million ounces changing hands on a daily basis with an additional 48 million ounces (or 1,366 metric tons) held in open positions. Over 90 percent of these futures contracts are traded electronically. This, combined with the large number of market participants and the significant daily volume, has the effect of making the futures markets very efficient. And all transactions, as well as the best bids and best offers, are publicly available in real-time which further enhances liquidity and provides what is known as transparent price discovery. Transparent pricing and small bid ask spreads are key to a market's success and a great benefit to the investors who use them.

Market Size:

COMEX Gold Futures = 20 million ounces/day
SPDR Gold ETF = 2.4 million ounces/day

Opportunities for Leverage

To put it plainly, gold ETFs don't provide leverage. Many securities brokers will loan you 50 percent of the money to purchase stocks or ETFs, but similar to any loan there are costs associated with this. A unique feature of futures contracts is the ability to use leverage, which is built into each contract via a system of margin rules and regulations. Brokerage firms extend the exchange enforced minimum margin requirements along to their customers and manage the daily margining of their customer accounts. Margin can sometimes represent as little as three percent of the notional value of the contract. This is a tremendous advantage for investors who wish to use leverage to take advantage of a specific opportunity in the market. However, unlike stocks, futures margin is not partial payment or a down payment for the purchase of the underlying asset, it is simply "good-faith money". This money is placed on deposit to guarantee that each participant has the ability to perform to the terms of the contract and withstand the average daily price fluctuation of the underlying asset. Brokerage firms constantly monitor margin balances and update account balances to reflect changes in market prices at the end of each day. If market conditions change, so may the exchange required margin required to trade that market, but there is never a need to borrow money from a broker nor are there fees associated with using this margin.

At current prices, a $5,000 investment in a gold ETF would buy you shares that equate to approximately four ounces of gold. While an investment of $5,000 represents a substantial amount of money, gold would need to make a fairly significant move before an investor would see any real profits. On the other hand, that same $5,000 placed in a margin account allows the futures trader to benefit from the movement of up to 100 ounces of gold through the purchase or sale of COMEX Gold futures. This strategy can provide more than 25 times the potential to make profits from the same move in gold (miNY and E-mini Gold futures contracts can also be traded which are smaller in size and require less margin).

Of course, there is no need to utilize all of the leverage available. Each investor can tailor the leverage they use to meet their individual investment goals. This is done by simply adjusting the amount of margin on deposit in relation to the value of the contract. The benefit of leverage is tempered by the fact that leverage magnifies both profits and losses. This means that investors that choose to use leverage should additionally protect themselves by using prudent money management techniques. Using stop loss orders "stops" to limit the investors' financial exposure to fast moving markets is one common technique used by futures traders.

	SPDR Gold ETF	COMEX Gold Futures	COMEX miNY Gold Futures
Initial Investment	$5000	$5000	$2500
Amount of Gold	4 oz.	100 oz.	50 oz.
Value of a $10 move in Gold	$40.00	$1000	$500
Return on Investment	0.8%	20%	20%

Minimizing Tracking Error

When compared to an investor trading gold futures, an individual who invests in an ETF will be exposed to costs and fees in addition to brokerage and ETF creation/redemption fees. Many of the costs involved with owning an ETF revolve around management fees and the associated taxes. These sometimes hidden costs can affect the pricing of the ETF itself and have very little to do with the actual price of gold.

By virtue of the asset class, gold (a physical commodity) produces no income. This presents a problem for the ETF manager since the fund generates ongoing administrative expenses. Whether it is management fees (normally about 40 basis points), marketing fees, or general expenses, gold bullion from the fund must be sold to cover these expenses. When the fund does so, they may incur additional transactional costs. This sale of gold diminishes the overall holdings of the ETF and over time will erode its value, which results in what is known as a tracking error.

In contrast, gold futures contracts do not experience any of these issues. Investors are able to buy or sell gold on the open market at their discretion and avoid the related management fees. Therefore, COMEX Gold futures, that are in many cases used for investment instead of acquiring physical bullion, can be arbitraged against gold bullion and have no measurable tracking error. Long-term investors should note futures positions may need to be rolled forward (exiting one contract and entering into a new one) to a contract with a deferred expiration to maintain a position longer than the length of the original contract, which may result in an additional brokerage cost.

Further Tax Implications

Another cost associated with owning shares in gold ETFs, as opposed to investing in futures, is the tax implication. Gold futures may also present tax advantages for certain investors. This is not intended to be advice regarding tax treatment and we advise that you contact your tax attorney or accountant for information that is applicable to your situation.

Taking Physical Delivery

Both the futures and gold ETFs provide a mechanism for the physical delivery of gold. Investors interested in obtaining gold through the purchase of COMEX Gold futures or gold ETFs should recognize that there are standard procedures and quantities used for delivery and redemption. For example, a large commercial bank, who acts as the trustee of the SPDR GLD ETF deals with creation and redemption of gold from its London vaults in blocks of 100,000 shares (10,000 troy ounces). This trustee does not deal directly with the public, so any individual investor wishing to exchange shares for physical gold would have to come to the appropriate arrangements with a broker. In contrast, COMEX Gold futures (100 troy ounces) are available for delivery, in accordance with the details of the contract, from an exchange licensed New York City depository.

There can be costs associated with security, transportation and insurance whenever you redeem shares and/or take delivery of physical assets, so be sure to consult an investment professional before doing so.

Summary

The information provided will hopefully help answer the question "Which gold investment is appropriate for me, gold futures or the gold ETF?" While there is a place for ETFs in any investment portfolio, there are several drawbacks that do not make them the first choice for individuals wishing to invest in gold.

When the goal is to simply benefit from a rise or fall of the price of gold, COMEX Gold futures are the logical choice. COMEX Gold futures offer the investor a fast and accurate pricing mechanism, the ability to leverage their trading strategies and the security of doing business on an exchange that has guaranteed the performance of each of its transactions for over 100 years.

Learn more at **activetrader.cmegroup.com/gold**

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