GOLD EXCHANGE TRADED FUND (ETF) – A BULLISH INVESTMENT OPTION

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INTRODUCTION

A new investment option, nomenclatured Gold Exchange Traded Funds is fast emerging and is going to attract the fancy and frenzy of gold crazy Indians and common/small investors. In olden days, gold was considered to be a safe investment. Currently, gold price is sky-high and it is surprising that this price rise has come when the demand for gold is low. In India, the use of gold forms a part of the country's culture and tradition and is not considered a mere investment. Before the liberalization policies, gold price in India was mainly based on domestic inflation, stock market performance and the demand-supply factors. But after the New Economic Policy (NEP), the Indian gold market was associated with international factors like currency exchange rates.

The low interest rate in the economy can also be a reason for the increase in gold price. So, investors can capitalize this price hike by liquidating a part of their gold holdings. This is only a short-term phenomenon. Gold ETF typically is an Exchange Traded Mutual Fund Unit listed and traded on a stock exchange. Gold is the underlying asset for the units of that fund. Every Gold ETF Unit represents a definite quantum of pure gold and the traded price of that Gold Unit moves in tandem with the price of the actual gold metal as is traded in any big gold merchant or in any metal exchange. A mutual fund house launching a Gold ETF appoints Authorised Participants who initially buy the units of Gold ETF from the mutual fund by exchanging actual pure gold for the units of Gold ETF. These Authorised Participants facilitate secondary market trading through the Gold ETF Units through the Stock Exchange, wher132e investors can buy or sell gold units on payment, for quantities as small as one unit. The underlying asset — that is, gold — is held by a mutual fund house issuing such units either in a physical form or through a 'gold receipt' giving right of ownership. Authorised participants can go back to the mutual fund house to redeem the gold ETF Units and can demand equivalent value of actual pure gold at any time.

Jewellery demand constituted 67% of the total world gold demand in '06, with India being among the major jewellery-buying countries in the world. The usual buying season in India is October to November, coinciding with the marriage season in India (gold prices typically tend to harden during this period), while Christmas-related sales account for the peak period in the US and Europe.

The demand for jewellery has shown a sharp increase in the first quarter of '07, according to the latest figures released by the World Gold Council. The demand has gone up by 17% in tonnage terms in the first quarter of '07, compared to the same period last year. This is striking compared to a mere 4% growth in fourth quarter of 2006. The demand for jewellery has picked up after witnessing an average fall of 20% in the previous four quarters. This was because gold buyers were avoiding or postponing buying gold last year, since prices rose too much, too soon. To some extent, the growth in demand indicates that the buyers are probably accepting current price levels. Since domestic gold prices generally appreciate in the latter part of the year, gold purchased around July 1 and sold at the year-end does not incur losses.

ORIGIN

The idea of a gold ETF was first officially conceptualised by Benchmark Asset Management Company in India when they filed a proposal with the SEBI in May 2002. It was not launched since it did not receive regulatory approval. The first gold exchange-traded fund actually launched was in March 2003 on the Australian Stock Exchange under Gold Bullion Securities (ticker symbol "GOLD"). Gold Bullion

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Securities (GBS) are fully backed by gold which is both deposited and insured. India which has gold worth Rs 24 lakh crore is also one of the largest consumers of gold in the world and absorbs around 700 tonne of the world's annual consumption of about 3,200 tonne. GBS was launched to give financial institutions and private investors the ability to own gold and gain exposure to the price, without the inconvenience of storing physical bars.Typically a commission of 0.4% is charged for trading in gold ETFs and an annual storage fee is charged. The annual expenses of the fund such as storage, insurance, and management fees are charged by selling a small amount of gold represented by each certificate, so the amount of gold in each certificate will gradually decline over time. In some countries, gold ETFs represent a way to avoid the sales tax or the VAT which would apply to physical gold coins and bars.

The GETF idea in India was proposed by Finance Minister P. Chidambaram, who proposed in the Union Budget 2005 that Sebi should permit, in consultation with the RBI, mutual funds (MFs) to introduce Gold Exchange Traded Funds (GETFs) with gold as the underlying asset. Such a move would enable any household "to buy and sell gold in units for as little as Rs 100," and these units could be traded in the same manner as MF units.

Table showing comparative Gold Prices(Per 5 gm) as on June 12th, 2007

Particulars	Purity %	Amount(Rs.)
Mumbai Bullion Market Price	99.5	4,320
Average Price Charged By Banks	99.9	5,046
Average Price Charged By Jewellers	99.5	4,672
Average Price Incurred on ETFs	99.5	4,379

Source: Economic Times, ET Investors Guide,18th June, 2007, p.1.

GOLD ETF

Exchange Traded Fund is a security that tracks an index and represents a basket of stocks like an index fund, but trades like a stock on an exchange, thus experiencing price changes throughout the day as it is bought and sold. Gold Exchange Traded Funds with 'gold' as the underlying asset will facilitate buying and selling of the yellow metal even in the smallest of units. This is a welcome move that signifies India is catching up with the developed markets. Gold ETF (Exchange Traded Mutual Fund Units) will facilitate hedging and arbitrage opportunities apart from providing traders with a more transparent platform. Gold ETF is a small beginning of what could possibly change the way in which the Indian public has been looking at their family wealth that has been lying idle in the form of gold. In the case of UTI's proposed gold fund, the units issued under this scheme will be referred to as UTIGoldshare and will have a face value of Rs. 100 each. Investors who want a cost-effective and convenient way to invest in gold can get an instantaneous exposure to the physical asset. Its units can be traded like a share and one can buy and sell them quickly at the ruling market price, unlike physical gold that can be sold only for a discount and by a cumbersome process.

GOLD ETF – IN INDIAN CONTEXT

In India, traditionally gold is acquired in the form of jewellery, which is most often passed on from one generation to another, and is thus also a significant means of saving for the family. India is the world's largest consumer of gold jewellery. It accounts for 20 per cent of the global gold off take in any year. An estimated 13,000 tonnes of gold rests in India, which is about 9 per cent of the global cumulative mine production. Banks and specified agencies are allowed to import gold; they later sell it to the domestic wholesale traders, fabricators and industrial consumers. Export oriented units and units in SEZs are also allowed to import gold directly. The price risk is borne by the fabricator or the consumer. Recently, gold imports were allowed under Open General License. Gold ETF will provide an additional transparent platform for traders, fabricators and jewellery manufacturers to take long or short positions on the metal and also facilitate hedging and arbitrage opportunities. For the retail investor, it will facilitate easy buying of standard quality gold in small units without the hassle of safekeeping of the precious metal and cost of insurance. Gold ETF have the potential to increase mobilisation of gold and are expected to increase hallmarking of the metal. Regulated mutual funds with strong brand identity would provide comfort for retail investors to deal in gold through them.

GOLD ETF AS BETTER INVESTMENT OPTION

GOLD ETF will provide a screen-based platform to investors to accumulate quality gold in small lots. For example, a father wanting to gift gold to his daughter need not buy the metal (or the jewellery) only when he intends to gift it to her, instead he can start buying in small lots. This reduces the strain on one's budget. Unlike in the case of chit funds, which package a gold purchase at a future date for its members at the price prevailing on the date of purchase, Gold ETF will facilitate locking standard quality gold at current price points. Unlike physical gold bullion which is held in personally allocated storage, the investor will only become a general creditor if an ETF provider went into liquidation. Gold ETFs are a form of debenture. The new fund will track the price of gold. Its appointed custodians will buy and sell gold bullion as investors look at positions in the ETF.Gold has proven to be a good hedge against inflation and maintained a long-term value. Gold is not highly correlated with other financial assets such as stocks, currency and bonds, which are directly affected by the country's economy. Hence, it offers a good diversification and reduces overall risk/volatility of investments. Gold has a ready and wide acceptability. Hence, exchanging it for cash or raising money against gold is easier. Gold ETF backed by the standard hallmark quality can provide a safe and liquid investment avenue though price volatility in the short term cannot be eliminated. Procurement cost of gold for similar purity level and quantity is least through the gold ETFs route. Infact, buying gold ETFs works out to be 15% cheaper than procuring gold coins from a bank. For this, the cost of buying 5 gm of gold(99.5% purity level) was compared on june 12th, 2007 across jewellers, gold ETFs and leading bank counters. While banks' gold coins have a higher purity level of 99.9% even after adjusting for the purity difference(i.e. Rs 25 for 5 gm) , gold ETFs work out to be cheaper. However gold ETFs may lose out to jewellers and banks in the long run due to the expense ratio of 1% per annum charged on gold ETF schemes. Since these expense ratios are charged on the market price, a sharp appreciation in gold prices can reduce the cost advantage. This is because no annual charge need to be paid in the case of gold coins.If we assume that historical gold returns repeat themselves and the impact of the same is added to the current procurement cost of gold, then the price of buying gold ETFs is lower than the rate charged by jewellers for a five year period. Simillarly, gold ETFs are cheaper than gold procured from a bank, if the former are held for atleast nine years. Thereafter the cost of procuring a gold coin from a jeweller or a bank is lower than that of holding a gold ETF. However, buying gold from a jeweller is often questionable on grounds of purity. Hence it is important to purchase the same from a reputed and reliable jeweller.

Table Showing Price Impact on Holding Period of Gold ETFs

Particulars	Holding Period (Rs)			
	1 Year	3 Year	5 Year	7 Year
Average Procurement Cost	4,379	4,379	4,379	4,379
Returns for Holding Period (%)	-10.7	51.3	68.9	122.7
NAV For Holding Period	3,912	6,626	7,396	9,754
Fund House Expenses @ 1 % PA	39	165	295	497
Brokerage @ 0.75% (One-Time Charge)	0.29	0.29	0.29	0.29
Service Charge On Brokerage @ 12.36%	0.04	0.04	0.04	0.04
Total Cost Incurred	4,418	4,544	4,674	4,876

Source: Economic Times, ET Investors Guide,18th June, 2007, p.3.

REGULATORY FRAMEWORK

Globally, the gold market is overseen and regulated by both governmental and self-regulatory organizations. In addition, certain trade associations have established rules and practices for market participants, for example, the London Bullion Market Association (LMBA) for British markets. In India, a regulatory framework is in place. As there is no self-regulatory organization in the mutual fund industry, trade associations under the overall legal framework of the regulator, need to assume a much greater role to ensure fair market practices in respect of purity and other standard specifications. Other issues such as liabilities and responsibilities of the participants including the custodians, valuations, benchmarking, fees and expenses, capital adequacy norms and counter-party risks are also very important. There are methods to reduce the cost of import, transportation and insurance costs by possibly choosing custodians who are nearer to the place where the actual gold is procured. The lower the cost of operations, the greater will be the popularity and trading of gold ETF units.

Now, it is proposed to give the list of pros and cons i.e. drivers and blocks of procuring Gold from various sources like banks, jewellers and Gold ETFs.

BANKS

Drivers

- These days' banks offer imported, 24 carat pure gold coins and bars of 99.9% purity. Banks are always considered trustworthy and reliable. Hence, there is no doubt that banks are the safest mode of procuring physical gold.

Blocks

- Investors can only purchase gold from banks. But they need to visit a jeweler if they want to sell gold. No bank purchases gold coins from a customer, even if the coin has been bought from the same bank.
- Any cost incurred to assure safety and insure the gold so procured has to be borne by investors.
- Banks charge a hefty mark-up price, which is 14-16% above the market price, on the gold sold by them. Since there is no provision where by banks can repurchase this gold, any premium paid to procure gold from banks is as good as written off at the time of purchase itself.
- Gold in physical form attracts wealth tax. The advantage of long-term capital gains, wherein the maximum tax payable is 20% instead of 30% on any gains arising on sale of gold, accrues only at the end of three years of purchase; investors are required to bear additional 10% tax liability

Table Showing Gold Rate In Different Ban

Bank	Gold Rate (Per 5 gm)
ICICI Bank	5,094
IndusInd Bank	5,091
HDFC	5,059
UTI Bank	5,045
Punjab National Bank	5,034
Union Bank of India	5,005
Corporation Bank	4,994
(Rates as on June 12, '07)	(Rs)

Source:www.etinteligence.com

JEWELLERS

Drivers

- Gold procured from a jeweler, in the from of coins or jewellery, can be resold for cash or exchanged for a new piece of coin or jewellery, by visiting the same or any other jeweler, at any time during the year.

Blocks

- Purity of gold purchased from a jeweler can be a cause of concern. Jewelers today offer coins of 99.5% purity, against 99.9% purity offered by banks.
- Any cost incurred to assure safety and insure the gold so procured has to be borne by investors.
- Gold sold by jewelers is marked up by 7-15% above the market price. Payments by credit card increase the procurement cost of gold by an additional 2.5%.
- While investors can resell gold to a jeweler the cash they get in return is usually 2-5% lower than the market price of gold on the date of sale. However, investors can get the full value of gold if it is exchanged for another piece of jewellery or coin.
- Gold attracts wealth tax and the advantage of long-term capital gains accrues only after three years.

GOLD ETF

Drivers

- Investors can obtain gold at near market price. Variation, if any, is 1-1.5%.
- The units can be resold any time on the stock exchange at the trading price on the date of sale.
- Since resale is not subject to tax deducted at source (TDS), investors can obtain full value of the units sold.
- Holding gold in demat form does not attract wealth tax and the benefit of long term capital gains accrues at the end of the year. Thus, the tax liability on the gains arising from sale of the units is 20% after one year.
- No storage or insurance costs have to be borne by investors.

Blocks

- Fund housed charge an expense ratio of 1% per annum on account of administration and custodian expenses.
- Investors have to bear brokerage charges at the time of purchase of units from the exchange, which can range from 0.10-1%.
- Other expenses include service tax on the brokerage, paid at 12.36% per annum, and securities transaction tax, which is 0.125% of the value of the transaction.
- As of now, investors cannot exchange gold ETF units for physical gold or jewellery.

The return from investments in gold has not been very lucrative so far. Gold has generated a return of around 69% in the past five years, compared to 360% returns from equities. However investing in gold can impart stability to the portfolio, it not only diversifies an investors portfolio, but also reduces volatility.

CONCLUSION

From the above, we may infer that Gold ETFs is going to emerge as one of the best investment options. It safeguards the investors from high volatility/fluctuations and losses. It is observed that gold prices are always on the rise and the investors are assured of steady returns from investments made in GETFs. The purity factor is an added incentive for GETF investments. GETFs is a better investment option compared with shares or stocks or bank deposits or real estate investments, as it can be observed that all of them are highly speculative investment options.

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cent, which can be regarded as considerable one. Finally it can be extracted from above analysis that the NIM has made enormous progress in recent years, moving away from fixed- price offering to price discovery through a screen-based auction for IPOs. This has reflected a quest to discover the price through an open fair, competitive auction, which is done in a fully transparent way, where all investors participate in an equal setting, and the investment bankers' or other influences do not vitiate the allocation of shares. All these resulted huge fund mobilization from NIM as total fund mobilized in FY year 2006-07 gone up to Rs. 114577 crore. Still NIM is mobilizing less than one percent of total domestic saving which account more than 32 percent. This is just a beginning and NIM in India has to go a long way.

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Firstly, Investments in shares or bonds are highly volatile and the investor should have in depth knowledge of the share market and the share values in some cases may plummet to zero also. Secondly in the case of bank deposits as an investment option, the retail investor has to pay TDS (Tax Deducted at Source) and also normally the return on investment on bank deposits is very low. Thirdly, investment in real estate is a mere gamble and the return is usually unpredictable and also the price of the real estate depends on so many other factors like political, legal. So unlike the above said investment options, GETF option caters to all – small or big, literate or illiterate, as it is less speculative unlike shares, bonds, real estate or mutual funds and the price fluctuations is easily predictable by even a layman. And, in a few years, the phrase 'Born with a Gold ETF spoon' may become the most commonly used adage.

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