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Special Report:

GOLD ETF'S...

The Battle Lines Are Drawn

Where is the ETF's Gold

By James Turk
Freemarket Gold & Money Report

On Nov. 18, 2004 trading began on the NYSE for what is being called a "gold ETF". Here's how CBSMarketWatch described it just before launch: *"The first exchange-traded fund* ***investing in gold bullion*** *will begin trading on the New York Stock Exchange on Thursday (Nov. 18, 2004), said sources familiar with the situation. Called StreetTracks Gold Shares, the ETF will trade under the symbol "GLD" with the World Gold Council as the sponsor."* After the launch Reuters reported: *"The ETF… offers investors the ability* ***to access the gold bullion market****, with each share representing one-tenth of an ounce of gold."*

From these and other news reports it would appear that anyone buying this new ETF is buying gold bullion. But a different picture emerges from a careful reading of GLD's prospectus and accompanying advertising material.

By way of background, I have been following very closely the development of the gold ETF because I wanted to see if it would have a high level of governance over its bullion assets that was comparable to what my colleagues and I have achieved in GoldMoney. A product launched by the World Gold Council could have some competitive impact. Additionally, GoldMoney is exploring the possibility of creating its own ETF using goldgrams as the underlying asset.

Last year after analyzing the WGC's proposed ETF, I concluded that its custodial controls were inadequate. In December 2003 I wrote: *"The risks of the WGC's funds appear too great. Until more questions are answered and/or the fund's structure is changed to eliminate its loose custodial controls, I do not recommend that these funds be purchased."* To understand this conclusion, I recommend reading that article in full. See: http://ww.321gold.com/editorials/turk/turk120903.html.

Shortly after my article appeared, representatives of the WGC contacted me and threatened me with a lawsuit, unless I retracted the article. Needless to say, I was shocked, because I knew my work to be accurate, based as it was on publicly available information (i.e., the draft prospectus of the proposed US fund and the actual prospectus for similar funds in London and Australia). Also, it was clear from my article that I was focusing upon the importance of owning physical gold bullion, rather than just paper promises to deliver gold. Given that the stated mission of the WGC is to encourage ownership of physical gold bullion and to educate consumers about gold, why were they menacing me? But the threat of litigation does cause one to focus their mind, so I hired a top NYC attorney specializing in SEC law, just in case the WGC followed through on its threats.

Fortunately, they didn't. I assume that the WGC in the end recognized my work to be accurate, and that they didn't have a case. My attorney came to the same conclusion. What's more, he advised that the WGC was interfering with the work of an analyst, which is something the SEC seriously frowns upon. Remember the hot water Donald Trump got into when he intervened to have a brokerage firm analyst fired after writing a negative story on Trump's casinos?

Anyway, because of discussions with my attorney and some additional study, I learned a lot about SEC procedures. And one of the foremost requirements established by the SEC is that mutual funds must have absolute control over their assets.

In other words, this requirement exists to make sure that retail investors purchasing shares in a mutual fund are in effect buying the assets the fund is supposed to own, and not just some promise to deliver those assets. I understand that this safeguard is required because of past instances in which certain funds never really owned the assets they purported to own, and collapsed with losses to the fund's shareholders. Thus, by enforcing this requirement, the SEC is doing its job of protecting the "little guy". The conclusion of my December 2003 article was that the WGC's proposed ETF did not meet this requirement, which I took to be the reason the SEC had not registered at that time the WGC's proposed fund despite the many months it had been under review.

Given the GLD's recent launch, I was therefore interested to learn from its prospectus how GLD had been changed to provide the necessary assurances of integrity that the fund's gold bullion assets really exist. More specifically, I was interested to learn how the WGC had improved the custodial controls so that GLD met the same standard that the SEC applies to other mutual funds. The answer came quickly. It didn't.

Even before starting the prospectus, I downloaded the 2-page fact sheet from http://www.streettracksgoldshares.com and there on the first line was an eye-opener laying out the essential nature of GLD: *"Objective: Designed to track the price of gold."*

Its objective is not to provide investors with the opportunity to own gold bullion by investing in the shares of an ETF. Rather, GLD is *designed to track the price of gold.* That objective is no different than what is accomplished by a gold futures contract or any of the dozens of numerous gold derivatives available these days. More to the point, futures and derivatives are sold even if the seller does not own the underlying gold bullion needed to deliver on its obligation. They are in practice fractional reserve systems, which allow liabilities for gold to far exceed the quantity of gold owned by the seller of that liability.

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Notwithstanding the numerous news accounts that described GLD as a means of investing in gold bullion, GLD cannot be accused of false advertising. Based just on their 2-page fact sheet, the WGC has by its own description created a security which has been designed to bet on the price of gold, not to enable investors to own physical gold bullion. My subsequent reading of the prospectus confirmed this conclusion because on the face of it, the weaknesses I identified in my December 2003 article have not been corrected. GLD has the same loose custodial controls described in the early draft prospectus.

To explain this point, the London bullion market operates on a "trust-me" basis. Rather than move gold bars around when they are bought and sold – which is a costly process – the various participants accept the word of their counterparty that the bar they just bought really exists, and that it is safely stored in the counterparty's vault of the vault of another market participant.

Thus, for example, when GLD adds a gold bar, there is no assurance that the gold bar really exists unless it is in the vault of the custodian, HSBC. But the prospectus discloses that HSBC uses subcustodians and even sub-subcustodians, and what's worse, *"the Custodian is not liable for the acts or omissions of its subcustodians"*. In other words, if the subcustodian does not have the gold, GLD *"Shareholders cannot be assured that the Trustee will be able to recover damages from subcustodians for any losses relating to the safekeeping of gold by such subcustodian"*. This means that *"Because neither the Trustee nor the Custodian oversees or monitors the activities of subcustodians who may hold the Trust's gold, failure by the subcustodians to exercise due care in the safekeeping of the Trust's gold could result in a loss to the Trust."* To be blunt, these disclosures mean that there is no certainty that the gold supposedly owned by GLD really exists. After all, if there was complete certainty that the gold did exist, the objective of GLD would be to provide investors with the opportunity to own gold bullion by investing in shares of an ETF, rather than its stated objective to just *track the price of gold*.

To explain this gold storage risk in greater detail, it is necessary to describe how the London bullion market functions. There are several vaults in London used by the various market participants, but I want to draw attention to only one – the vault owned and operated by the Bank of England. The BoE plays a central role in the operation of the London bullion market, as its vault is actively used as a clearing agent. In other words, the various bullion banks keep storage accounts with the BoE, and here's an example of how the clearing process works.

Say, Morgan Bank buys a gold bar from HSBC. Rather than incurring the cost of shipping the bar from HSBC's vault to Morgan's, HSBC says that Morgan can have one of HSBC's bars held on account with the BoE. The BoE makes a bookkeeping entry (clearing HSBC's obligation to Morgan), while enabling HSBC and Morgan to save the expense of shipping the bar between different vaults. Morgan now owns the gold bar in the BoE vault that was previously owned by HSBC. The BoE is reputed to store more gold than any other participant in the London bullion market, and here is where the problem arises.

The BoE does not allow the gold in its vault to be audited. In fact, there is no way of substantiating that the gold stored there is not owned by multiple parties, or for that matter, that the gold supposedly stored there even exists. Like the gold reportedly stored in Ft. Knox, there is no verification of its existence by independent (i.e., non-government) auditors.

This reality is surprisingly not acknowledged by the GLD prospectus, which states: *"The Trust's independent auditors may... visit the Custodian's premises in connection with their audit of the financial statements of the Trust."* In what appears to be a glaring omission, the prospectus fails to disclose the important risk that the independent auditors will not visit the vaults of the subcustodians and sub-subcustodians, and more to the point, that the BoE does not allow auditors into its vault, even though the prospectus allows for the possibility that all of the fund's gold may be stored in the BoE.

Hence, by accepting the loose custodial controls of GLD, the SEC has thrown caution to the wind. It has inexplicably accepted for registration a fund that does not meet the same custodial standards required of other retail-oriented mutual funds. The question is why? For what reason has the SEC established this dangerous precedent with these nebulous custodial arrangements that could be exploited in GLD or in the future by unscrupulous operators who mimic the custodial structure, but have no intention of delivering the underlying assets to the fund? And after sitting on the WGC's filing for 18 months, why was GLD finally registered and launched on Nov. 18, 2004?

Readers who are familiar with www.GATA.org and its research will no doubt recognize the subtle coincidence of surprising occurrences. For those not familiar with its work, GATA is an informal association of analysts (I am a card-carrying GATA member and proud of it) who contend that the gold price is being managed by the central banks. For several years GATA's analysts have been providing ongoing evidence to support this conclusion.

For example, in a recently published article, John Brimelow <JB@johnbrimelow.com> states: *"It was interesting to find in Paul Volcker's memoirs the following comments about the aftermath of the successful American effort in 1973 to force a 10% currency revaluation on Europe and a 20% revaluation on Japan:* The key was the yen currency of Japan, which had an enormous trade surplus. Appreciating the yen 10% against gold, and devaluing

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the dollar 10% against gold would mean that the yen would have appreciated by 20% against the dollar. European currencies would remain stable against gold and appreciate 10% against the dollar. On the condition that Japan agreed to revalue the yen, the European countries agreed to the realignment of exchange rates and the U.S. announced that the dollar would be devalued by 10%. By switching the yen to a floating exchange rate, the Japanese currency appreciated, and a sufficient realignment in exchange rates was realized. Joint intervention in gold sales to prevent a steep rise in the price of gold, however, was not undertaken. That was a mistake. Through March, the price of gold rose rapidly, and that knocked the psychological props out from under the dollar.' *One can infer that the mistake of allowing gold an unrestrained voice at times of policy shifts was subsequently guarded against."* In other words, the gold price is being thwarted by active central bank intervention, so that central banks do not repeat the 1973 experience described by Mr. Volcker – or more broadly, today as in 1973, gold and the dollar are competitors, and gold is being managed to make the dollar look better than it really is.

Therefore, is it just coincidence that British exchequer Gordon Brown was recently trotted out again as the gold price was climbing to raise that old canard about the IMF selling some gold? When his statement had no effect and the gold price continued to rise, it was clear that gold's price managers needed stronger medicine.

So on Friday, Nov. 18, the Banque de France said it would dishoard 500 tonnes of gold over the next five years, a conspicuously timed announcement given the quiet accompanying the 2nd Washington Agreement on Gold after the IMF meeting in early October. As John Brimelow astutely remarked: *"Experienced observers of the gold market will have been amused to see the French gold sale announcement, sustaining the long tradition of this type of thing happening during interesting phases of gold price activity."* But in contrast to past anti-gold announcements by central banks, recent jawboning has had little visible effect in talking down the gold price, which continues to rise.

Thus, jawboning by central banks is no longer enough. And given the ongoing decline in hedging by gold miners, the central banks need new tools in their attempts to suppress the gold price. Because of its loose custodial controls and the opaque cloak thrown over vaulting at the Bank of England, GLD can deflect demand for physical gold into the paper market. Mineweb.com makes clear the essential nature of a new security launched in South Africa with WGC support, "Paper gold for Johannesburg" http://www.mineweb.net/sections/gold_silver/385325.htm

People who might have otherwise bought physical gold coins or bars, but wanted the same thing with more convenience, could be misled into thinking that they are buying physical gold by investing in the shares of GLD. But given GLD's loose custodial controls, there is no certainty that the investor is actually buying gold bullion in the form of an exchange-traded security. They may instead only be buying paper (i.e., a promise to deliver physical metal, rather than the metal itself) because there is no possibility by independent auditing or other means to substantiate that the gold supposedly owned by GLD and stored in the BoE and other vaults (other than HSBC's vault) really exists. This mechanism thus provides the central banks managing gold's price with a tool to divert into paper promises the money coming from investors who otherwise think they are buying physical metal, thereby enabling these central banks to relieve the upward pressure we have been seeing on the gold price. Therefore, if you are intending to buy physical gold bullion, do not buy GLD.

I would like to thank the many members of the GATA army who supplied information and ideas for this article, particularly Ron Lutka. But I would like to call on the army for another task. A lot of important questions need to be answered.

We need to find out why the SEC registered GLD. What's more, why did it happen just as gold's price managers are starting to lose control of the gold market and need new tools to bolster their efforts to keep a lid on the gold price?

The SEC has broken with precedent. Like the bucket-shots of the 1920's that allowed investors to bet on price changes without owning the underlying security, GLD enables investors to bet on the price of gold, without GLD being required to meet the same custodial standards required of other retail-oriented mutual funds. Why? Did central banks force the SEC to register the WGC's fund? Did the SEC cave-in under central bank pressure, even though GLD's loose custodial controls conflict with longstanding SEC requirements and establish a dangerous precedent? Why did the SEC register GLD in a week when anti-gold jawboning by central banks wasn't working, making clear they need new tools to keep a lid on the gold price? And why doesn't the prospectus disclose the big risk that there are serious restrictions on auditing the gold supposedly owned by the fund?

The SEC needs to be called "on the carpet". And I call on the GATA army to do it.

In conclusion, as gold climbs higher, the nefarious scheme to manage its price comes closer to collapsing. When it does, many ill-fated and uninformed investors will come to understand that the promises they hold to deliver gold to them aren't worth the paper they are printed on. Don't fall for that trap. Don't take risks with your bedrock asset – gold. Demand physical bullion. Don't take paper.

Editor's Note: James Turk is editor of *Freemarket Gold & Money Report, A Commentary on Precious Metals and Monetary Matters*, P.O. Box 5002, North Conway, New Hampshire 03860. 20 issues a year, $260. www.fgmr.com

NOTED ADVISORS DISCUSS ETF's

streetTracks: A Golden Road

*Noted financial journalist and former editor of Dick Davis Digest, Steve Halpern, in the weekly online letter **Money Show Digest**, asked the Aden sisters and Vivian Lewis their views on ETFs. The Aden sisters and Vivian Lewis are a among the financial experts who will be hosting over 250 free workshops at the upcoming World Money Show, February 2-5, 2005 at the Gaylord Palms Resort in Orlando, Florida. For more information, visit www.WorldMoneyShow.com.*

"Our final Top Pick selection – streetTRACKS Gold Trust – was selected by "a trio" of financial experts, the Aden sisters as well as by Vivian Lewis. They have selected this gold-based exchange traded fund in large part on their expectations for continued weakness in the US dollar.

"The US dollar has been on the decline for the past couple of years," says **Pamela and Mary Anne Aden**, co-editors of The Aden Forecast, PO Box 754-1007, Centro Colon, San Jose, Costa Rica, www.adenforecast.com, "Due to the size of the massive US current account deficit alone, we believe this trend will continue in 2005. That in turn will keep upward pressure on the gold price since these two markets move in opposite directions. Against this backdrop, our top stock pick is the gold bullion exchange traded fund, **streetTRACKS Gold Trust** (GLD NYSE). It tracks the gold price and each share represents one-tenth of an ounce of gold."

Adds **Vivian Lewis**, editor of Global Investing, 1040 First Ave., Suite 305, New York, NY 10022, www.Global-Investing.com, "I am not normally a gold bug. But I think that Americans should be buying physical gold right now. There should be an offset to the US dollar in almost every American stock portfolio. I therefore am recommending **streetTRACKS Gold Trust**. The price of gold moves inversely to that of the dollar. And the dollar faces a day of reckoning. The US has a structural government budget deficit. The US has a private savings problem. The US is running a mounting trade deficit. All threaten the dollar. A larger deficit mean that more dollars have to be converted into foreign currencies to pay for the imports.

"The big buyers of US Treasury bonds to finance our trade and government deficits are Asian countries, notably Japan, China, Taiwan, Hong Kong, and South Korea. They want to keep us spending so they can export ever more to the Wal-Marts of America. This situation is inherently unstable and foreign investors sooner or later will dump billions of dollars in US T-bonds as the dollar plummets. I don't know when the red ink from Asia will hit the US Treasury market, but I expect it during 2005. To protect yourself from the huge current account shock-wave when the dollar crashes, you want to be in assets that will benefit, and that includes a position such as gold, which we recommended via buying streetTRACKS Gold Trust."

Editor's Note: Steve Halprn is editor of the **Money Show Digest**, published weekly by InterShow, 1258 N. Palm Ave., Sarasota, FL 34236. www.MoneyShowDigest.com.

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Gold ETF Begins Trading

It's Now Easier To Invest In Gold Bullion

By Sy Harding
Street Smart Report Online

But should you?

Until recently buying gold bullion meant dealing with such problems as taking delivery, assuring safe storage, providing insurance, and potential problems with buying and selling in a timely manner.

To overcome those problems, as well as significantly increase their profits (or losses), gold traders use derivatives in the form of leveraged 'futures contracts' to make their trades. Since futures trading in commodities (coffee, corn, pork bellies, gold, crude oil, platinum and the like) is an extremely high risk undertaking, most participants are those who have inside information, like the commodity producers themselves, and professional international traders.

Public investors normally invest in the gold sector by buying the stocks of gold mining companies, and the gold mutual funds that invest in those stocks.

However, it just became much easier for ordinary investors to buy, sell, and own gold bullion itself, without having to take delivery.

After more than a year of getting the details worked out and obtaining approvals, the World Gold Council's exchange-traded-fund (ETF), Equity Gold Trust, began trading on the NYSE under the symbol GLD. Unlike most exchange-traded-funds, which invest in stocks, GLD buys gold bullion, and sells shares in that gold to investors via the exchange-traded-fund. The shares can be bought and sold through any stock brokerage firm. The gold will be stored and guaranteed by HSBC Bank USA. Each share of the exchange-traded-fund is designed to be worth one-tenth of an ounce of gold. So, with gold trading at $440 an ounce, each share would be worth approximately $44. If gold drops to $400 an ounce, each share would also decline 10%, to roughly $40. If gold rises to $500 an ounce, the shares in the ETF would rise to $50.

The year-long lead-up to the introduction of the ETF has been one of promotional activities and bullish claims to hype interest. For instance, it has been widely claimed that the introduction of the ETF will create a large new demand for gold and therefore drive the price of gold much higher.

You may want to keep the sources of the promotional excitement in mind when considering GLD as a method of investing in the gold sector. The World Gold Council is headquartered in London, and is an association of the world's leading gold producers, "dedicated to the promotion of gold". Do not expect a balanced outlook for gold or the Council's new exchange-traded-fund, from that source. The other main source of information on GLD so far has been the TV financial shows, always eager for a story they can hype to build excitement.

The big question is whether investors interested in gold, who have been investing in the gold sector by utilizing gold stocks and gold mutual funds, should shift to investing in gold itself via the World Gold Council's new offering.

Here is an important fact to consider. When gold is rising in price, gold bullion itself does not have near the potential for profits that are available from gold mining stocks and the gold mutual funds. That's because the profits of gold mining companies, as with any company, depend to a significant degree on the price they can get for their product. An increase in the price of gold not only increases a gold mining company's top line (total sales), and bottom line (profit) but also increases the value of its gold reserves (the gold it still has in the ground).

The result of this multiplying effect from an increase in the price of gold, is that gold mining stocks, and therefore the mutual funds that invest in them, tend to move almost twice as much as the underlying gold bullion.

That is not theory, but fact, and is easily verified. For instance, gold began a new bull market in 2000. From its low in 2000, gold bullion has risen in price from $253 an ounce to $444. That's a nice rise of 75% in four years, an average annual gain of 15%. However, in the same period of time, the XAU Index of Mining Stocks has gained 163%, or an average annual gain of 27.4%. The Rydex Precious Metals fund, a typical mutual fund that invests in gold mining stocks, gained 184% over the same four-year period, for an average annual gain of 30%.

Let's look at the other piece of hype, that if a lot of investors pour money into the World Gold Council's new exchange-traded-fund GLD, it will significantly increase the demand for gold, and drive the price of gold higher. To begin with, it would take one heck of a lot of small investors buying one-tenth ounce shares of gold to have such an effect on the price of gold. But even if it happens, it would be even more bullish for investments in gold mining stocks and mutual

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NOTED ADVISORS: ETF'S

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Gold ETF's Could Create a Gold Shortage

James Stack: "Commenting on the first gold ETF, James Stack says there are obvious advantages to owning the streetTRACKS Gold Trust.

"Investors now have the chance to own gold backed shares without the worry of buying and selling, storing, and insuring the actual bullion. This alternative also eliminates the company-specific risk associated with owning mining stocks," says Stack.

However this ETF has some drawbacks, and potential investors should check the prospectus carefully. Here are a few points to consider:

- The IRS will treat shareholders as if they own the underlying gold. Since gold is considered a collectible, gains or shares held more than one year are taxed at a maximum rate of 28%, rather than the 15% rate applied to most long-term investments.
- Expenses initially are not to exceed 0.4% annually (which is high for an ETF). The fund will cover these expenses by selling gold, which means the amount of gold backing each share will gradually be reduced over time.
- The performance of mining stocks has historically been leveraged to changes in the price of gold. While ETF investors avoid company risk, they may also forfeit some of the profit. Our favored gold investment, **Newmont Mining**, (NEM), has far outpaced the price of gold bullion over the last few years.

We will continue to maintain our hedge in gold for now, but we plan to take some profit in 2005. The new streetTRACKS Gold shares and a second ETF soon to be offered by Barclays Global Investors have obviously attracted interest, but we continue to favor Newmont Mining (or American Century Global Gold for mutual fund investors).

As long as the environment is positive for gold, these investments should provide more gains than the ETF. Who knows… it's possible that these ETFs, since they must buy bullion to issue new shares, could create a gold shortage that would spell further profits for gold mining companies."

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Street Tracks Gold Fund is all that it has been made out to be

Dr. Richard Appel: "The initial trading of the gold ETF (exchange traded fund), **Street Tracks Gold Fund** (NYSE GLD) was a major success. In its first six days it traded over 40 million contracts. This allegedly represents 4 million ounces of gold given that each share is stated to represent 1/10 of an ounce. If the fund functions as people have been led to believe, it will take a significant amount of gold off of the market and should help drive gold higher given the reduced available supply. However, I remain to be convinced that the fund is all that it has been made out to be.

I have read that the fund will use subcontractors to store the fund's gold and that the funds not liable for the default of these entities. Further, Street Tracks may not be capable of auditing the gold that is allegedly held in trust by these entities. To me, this poses a greater risk of default than possessing the physical metal which is far easier to acquire than the public is repeatedly told. Additionally, I am not certain if the fund will acquire gold with all of the proceeds that it receives. It is interesting and could be quite telling that the fund refers to its mandate as "tracking the gold price," and not acting as a gold depository. Time will tell how Street Tracks will affect its purchasers or the gold market.

The near term outlook for gold is quite positive.

Silver is similarly becoming quite interesting and potentially extremely exciting. It has since risen in stealth fashion with nary an eye observing it, or a positive word uttered in either the press or even among precious metal enthusiasts. It feels extremely strong to me and should certainly post a new Bull Market high if gold continues its advance. Silver will likely outperform gold on a percentage basis during their secular Bull Markets. This may be the last chance to acquire silver at reasonable prices.

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funds, since they tend to move twice as much on a percentage basis as the underlying gold.

So while being able to easily invest directly in gold bullion may be a sexy idea, and the hype surrounding the introduction of GLD may push you in that direction, gold mining stocks and gold mutual funds should continue to be the investment of choice for the gold sector.

Meanwhile, it wouldn't be nice to hope that hoards of investors do pile blindly into gold bullion via the new ETF, without any such analysis, and drive the price of gold higher for those of us who stick with the gold stocks and mutual funds. So we won't.

Editor's Note: Sy Harding is president of Asset Management Research Corp., 505 East New York Ave., Suite 2, DeLand, FL 32724, and publisher of **The Street Smart Report**, now in its 17th year, available in two formats. The online version is $225/year and the printed newsletter costs $250/year (17 issues). Both subscriptions include a free copy of Sy's book, *Riding the Bear.* For over ten years, Timer Digest has ranked Sy Harding as a Top Gold Timer. His Gold Indicators currently remain on a buy signal of August 18 for the gold sector. Visit www.StreetSmartReport.com for FREE stock market commentary and a Special Trial Offer.

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