DUE DILIGENCE: CHOOSING A PHYSICAL GOLD ETP

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Of all the precious metals, gold is the most popular as an investment. It has long been regarded as a potential portfolio diversifier due to its low correlation to the economy and other financial assets, hedge against extreme political events and market turmoil, and a safe haven during periods of low real interest rates and high monetary expansion.

However, it is extremely scarce. Above ground stocks are estimated to be around 197,576 metric tons which, if distributed equally to everyone in the world, would equate to less than 1-oz per person[1].

There are several ways to add gold to a portfolio:

+ Gold can be held physically;
+ Via exchange traded products (ETPs), many of which are physically backed by gold;
+ By using sophisticated derivatives such as gold futures; or
+ By holding gold mining equities, which are affected by gold prices

Given their surge in popularity over the last decade, this piece will focus on physically backed ETPs, with the aim of providing investors with guiding criteria for benchmarking whether a specific gold ETP structure is 'best of breed'.

It is important that investors understand the differences between individual gold ETPs to ensure the product they are considering investing in will intrinsically meet their investment goals. We believe that the robustness of the structures and processes that govern physically backed gold ETPs are key to selecting a vehicle that holds physical gold.

1 Metals Focus, Refinitiv GFMS, US Geological Survey, World Gold Council, December 2019.

6 KEY CONSIDERATIONS OF PHYSICALLY BACKED ETP

A strict due diligence process should encompass six key areas:

SECURITY

The ETP must be backed by physical bullion

To act as secure investments, physically-backed ETPs need to be backed by physical LBMA (London Bullion Market Association) 'Good Delivery[2]' gold bullion held mainly in allocated accounts owned by the issuer (with allowances for small amounts to be unallocated for the operational purposes of creation and redemption).

+ Neither cash, nor certificates representing the right to receive bullion, should be a substitute for physical bullion.
+ Neither the issuer, the custodian nor any other counterparty should be lending, leasing, trading or pledging as collateral bullion held in the allocated account.
+ Audits and bar lists should be verifiable against the LBMA 'Good Delivery' list.
+ Bullion should be kept in fortified, high-security vaults specifically designed for bullion storage. Investors should not be exposed to any credit risk towards the issuer or the custodian or any other counterparty:
+ The issuer should be a separate, bankruptcy-remote entity (all the bullion should be segregated from the issuer's other assets and liabilities).
+ Bullion should be identified as owned by the issuer and held in allocated form, and, as a result, be segregated from any other assets held by the custodian (both physically and in its books and records). The allocated account does not entail any credit risk exposure to the custodian. In an unallocated account, a customer does not own specific bars or coins, but has a general entitlement to a set amount of gold. In that case, the investor is not the legal owner of any physical gold, but rather is a creditor of the custodian. Hence, ETPs backed by fully allocated gold bars offer enhanced security.

2 The LBMA maintains Good Delivery Lists of approved gold refineries that meet certain minimum criteria and have demonstrated their ability to produce Good Delivery bars.

TRANSPARENCY

Published bullion holdings and clearly identified parties are essential.

Independent counterparties

Physically-backed ETPs should have independent authorised participants, market makers, custodians and a trustee acting on behalf of investors' best interests. Such independence has long been a hallmark of good corporate governance for the fund management industry; this increases transparency and reduces any potential conflicts of interest.

Transparent pricing

The ratio of the security's Net Asset Value to the London Gold spot price should be stable (reflecting only the historical cost) and easy to calculate; this allows market makers to efficiently trade the product and provide best prices and execution to the market. This ratio is called Metal Entitlement and should be available on the issuer's website. It is the amount of metal which security holders are entitled to on the relevant date. It takes into account a deduction for the fee (Management Fee and for some hedged product Hedging Fee). The price of a Security can be calculated at any given time by multiplying the previous day's Gold spot price by the "Metal Entitlement. Hence, the expected return of the product should roughly be the return of the Gold spot price less the applicable Fees.

Easily understandable fee structure

Fees should be clearly identified, broken down and their impact on the Net Asset Value should be easy to calculate. For an unhedged physical gold ETPs, the return will roughly be the return of the Gold Spot Price minus the Management fee. For a hedged physical gold ETPs, the return will roughly be the return of the Gold Spot Price minus the Management fee and the FX Hedging fee. These fees will be already incorporated in the Metal Entitlement. For hedged gold ETPs, it also important to check if there is no additional fees imbedded in the product that might affect the performance.

Reliable audit procedures

The issuer's allocated account should be audited by both the custodian's own rigorous internal audit procedures and by an independent LBMA-approved, independent bullion assayer. The Audit procedure should consist of semi-annual audits, at least one of which should be random and encompass both a physical inspection of the vault and a reconciliation of the bullion with both the custodian's and the issuer's records.

Daily bar list

Both the issuer and investors should receive updated account statements of the bullion backing the ETPs.

+ The custodian should provide the issuer with a bar list, updated daily for creations and redemptions, showing recognisable identifiers for each bar held. These generally comprise brand name, serial number, production date, weight and assay. These should be available to investors.
+ The procedures improve transparency and provide that the product is 100% backed by LBMA 'Good Delivery' bars.

COST EFFICIENCY

Product structure should be as cost efficient as possible

Multiple authorised participants (APs)

The structure should allow for multiple APs to reduce tracking error. Products with only one AP may trade at a premium as there are no independent arbitrageurs ensuring that prices remain consistent with the underlying physical gold price.

Multiple market makers (MMs)

The structure should allow for multiple MMs to provide liquidity, reduce spreads and encourage fair pricing of the ETP. Multiple market makers and APs also reduce operational risk in the event any one AP or MM is no longer able to participate in the market.

Physical delivery

Physical delivery may be an important feature for certain investors in terms of providing additional flexibility, security and in certain cases providing beneficial tax treatment. Conversely, certain investors may not wish to or may not be able to take physical delivery of bullion for regulatory reasons and therefore want to be certain that they would never be forced to take physical delivery.

Any investors seeking physical redemption should carefully assess many considerations including the cost efficiency of such physical redemption, countries available as part of the physical delivery mechanic, the quality and size of bars and coins available, the timescales involved and the reputation and reliability of any metal agent involved in the process.

Cash redemption

If allowed, this should not involve unnecessary costs.

Liquidity

Liquidity is the measure of the tradability of a product. It is an important consideration when determining the differences between products because more liquid products will be more competitively priced. This is even more important in volatile markets when the need to enter/exit a trade at a competitive price is paramount.

All physical gold ETPs have similar access to the underlying gold so the primary market impact of creating and redeeming ETP units should be similar. However, this is not the case when one looks at secondary market liquidity.

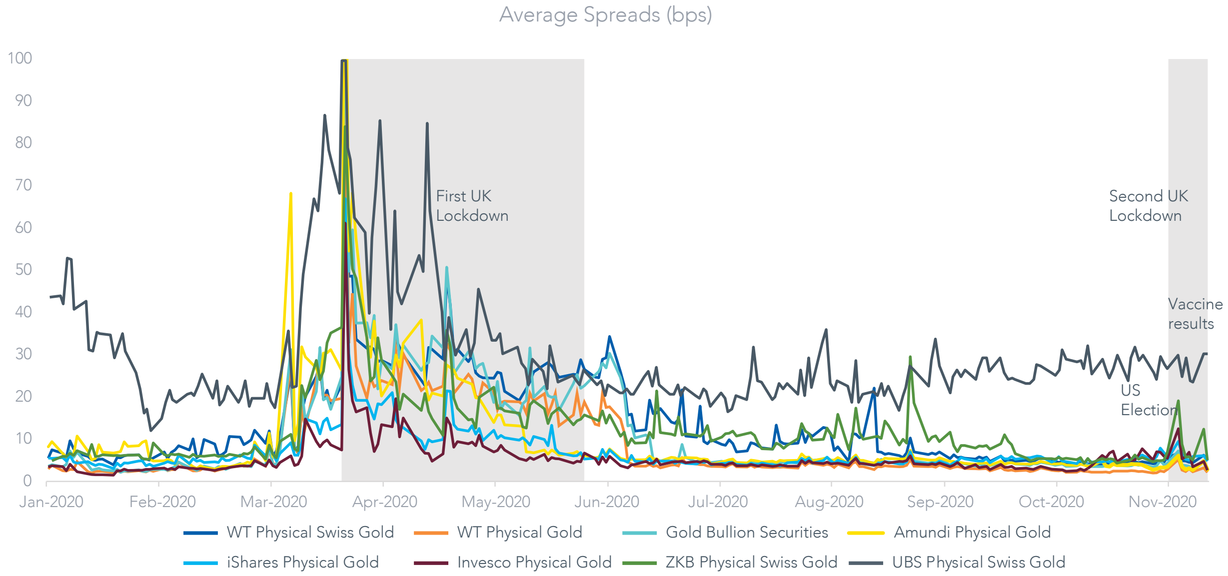
Secondary market liquidity, especially liquidity displayed on exchange, can differ significantly between ETPs. The key measures of liquidity are the bid/offer spread, the "depth" of the order book (the number of orders) and the number of market makers.

+ Bid/Offer spread – the difference between the best (lowest) price at which the ETP can be bought and the best (highest) price it can be sold at in a given moment.
+ Orderbook depth – The size, price and number of orders within the orderbook. The higher the amount of units that can be bought (sold) at a competitive price the better.
+ Market makers – Market makers compete to provide the best prices in the orderbook. Generally, the larger the number the more competitive the spread.

All of these measures combine together produce a liquid product, which can be especially important during times of market stress (see Figure 1). Market makers are drawn to products with high volumes. More market makers equal tighter spreads and more levels of order in the orderbook as they compete to provide the best price.

The same principle is valid for over the counter (OTC) trading. The higher the number of market makers for a product the more competitive the pricing of the product will be.

FIGURE 1: 2020 COVID-19 PANDEMIC: AVERAGE BID-ASK SPREADS FOR EUROPEAN PHYSICAL GOLD ETPS

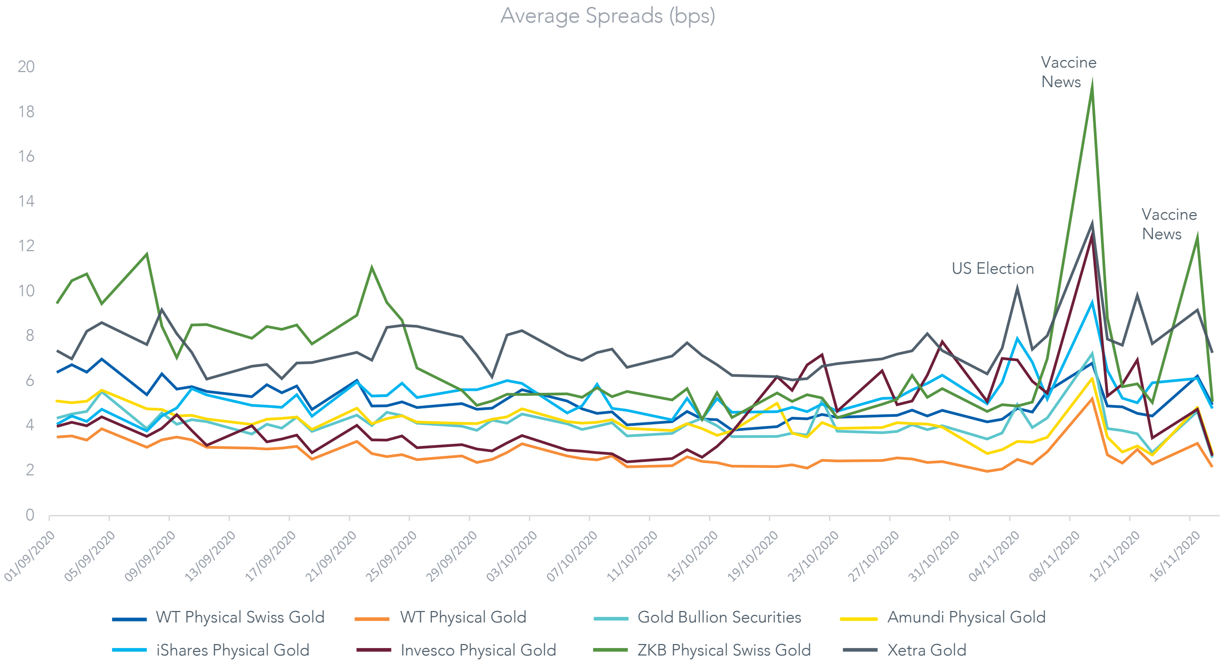


Source: Bloomberg, as of 18 November 2020. **Historical performance is not an indication of future performance and any investments may go down in value.**

It is important when assessing liquidity to look at the behavior of bid-ask spreads in times where markets may be stressed, and volatility is high. Above, we can see an example of the market reaction to the onset of the 2020 coronavirus pandemic. As the chart above shows, the crisis had a clear impact on gold ETPs bid-ask spreads. The lockdown measures that were implemented in March of 2020 saw extreme volatility across financial markets. Gold was particularly impacted by these events, as it suddenly became questionable whether physical gold could be transported between various global liquidity centres, something that market functionality depended on. This resulted in an unprecedented dislocation between the price of gold futures and physical gold and saw secondary spreads spike to similarly unprecedented levels as efficient pricing became very difficult. In the following weeks and months however, we saw both market adjustment to trading conditions, and dislocations ease as lockdown conditions were slowly lifted.

In the below chart, we can see more recent events of high volatility. These events saw gold less directly impacted than other asset classes such as equity, and remain highly liquid despite a slight increase in secondary market spreads. Overall it can be seen that while gold is not immune from market volatility, it is typically a stable and highly liquid exposure for investors to buy and sell.

FIGURE 2: BEHAVIOUR OF AVERAGE BID-ASK SPREADS IN A NORMALISED VOLATILITY REGIME FOR EUROPEAN PHYSICAL GOLD ETPS



Source: Bloomberg, as of 18 November 2020. **Historical performance is not an indication of future performance and any investments may go down in value.**

PHYSICAL HOLDINGS QUALITY

LBMA-approved London 'Good Delivery' bars are paramount. Physically backed ETPs should provide access to bullion with the security, reliability, and strength of the London wholesale OTC bullion market, therefore the bullion should be held in the form of London 'Good Delivery' bars. This is a critical point as non LBMA 'Good Delivery' bars cannot be sold in the London OTC market.

The custodian should be a member firm of the LBMA

Custodians that trade in these markets have vaults that are internationally recognised as meeting required standards for security and storage space.

Bullion should be LBMA 'Good Delivery' bars

+ These bars have a set number of ounces and a required fineness (purity) of 99.5%. They must bear the stamp of an LBMA-approved smelter/assayer.
+ They are the only bars permitted for delivery in the London OTC market.
+ Bullion held loco London[3] is the most liquid. If held anywhere else (e.g. loco Zurich[4]), bullion should be held with a custodian or sub-custodian who is an LBMA member.
+ Holding gold bullion outside London may result in metal trading at a premium or a discount to the London spot price.
+ Creating outside London may also require a loco swap with London; in the event of a shortage of metal, the swap price could increase dramatically.

3 Loco London: gold bullion physically held in London
4 Loco Zurich: gold bullion physically held in Zurich

RESPONSIBLE SOURCING

- Since 2012, the LBMA has required Good Delivery refiners to meet the standards of their "Responsible Sourcing Gold Guidance". LBMA's Responsible Sourcing programme for precious metals protects the integrity of the global supply chain for the wholesale precious metals markets.
- The LBMA's Responsible Gold Guidance was set up to combat money laundering, terrorist financing and human rights abuses globally. This framework is mandatory for all Good Delivery listed refiners wishing to sell into the London Bullion Market. This is intended to assure investors and consumers that all London precious metal stocks are conflict-free due to compliance with an audited, conflict-free process. Since January 2012, gold Good Delivery refiners have undergone annual audits against the LBMA's Gold Guidance.
- Gold ETPs that maximise exposure to post-2012 gold bars provide investors with products complying with enhanced ethical standards.

TRACK RECORD

Physically backed gold ETPs are unique in the exchange traded products world; unlike all other financial products they involve the management and the custody of a physical asset: gold bullion. It is essential that investors' carefully study the track record of the issuer and assess whether it perfectly understands the mechanics and the need for security of the precious metals market.

Therefore, it is crucial that all the participants involved in the management of the product, such as custodian, registrar, and trustee, are independent from each other and possess a proven track record fulfilling their respective roles. In addition, for any exchange traded product, liquidity is paramount. A competitive product should be supported by a network of liquidity providers (authorised participants and market makers), to ensure tight bid/offer spreads and an efficient creation/redemption processes. This then provides depth for the largest institutional capital flows. Also, it is important to note that tighter on-exchange spreads translate to lower trading costs for retail/intermediary flow. Hence why products with single or limited APs should be avoided.

RELATED PRODUCTS

Product	ISIN	Ticker	Currency Hedged	Physical Delivery	MER*	FX Hedging Fee
WisdomTree Physical Swiss Gold	JE00B588CD74	SGBS	No	Yes	0.15%	
WisdomTree Core Physical Gold	JE00BN2CJ301	WGLD	No	Yes	0.12%	
WisdomTree Physical Gold EUR Daily Hedged	JE00B8DFY052	GBSE	Yes	No	0.15%	0.10%
WisdomTree Physical Gold GBP Daily Hedged	JE00B7VG2M16	GBSP	Yes	No	0.15%	0.10%
WisdomTree Physical Gold	JE00B1VS3770	PHAU	No	No	0.39%	
Gold Bullion Securities	GB00B00FHZ82	GBS	No	Yes	0.40%	

*MER: Management Expense Ratio

	Due diligence checklist	Yes	No
Security	Fully backed by physical bullion held mainly in an allocated account		
	No lending of, or borrowing against bullion		
	Bankruptcy-remote issuer with segregated assets		
	No credit risk to the custodian		
	Limited operational risk		
	No new ETPs can be issued without the prior delivery of gold to the issuer's gold account with the custodian		
Transparency	All major counterparties are independent (APs, custodian, MMs, trustee, registrar, auditors and issuer)		
	Transparent and simple pricing		
	Easily understandable fee structure		
	Reliable audit procedures that are published, including at least one random audit of the custodian's vault		
	Published bar lists with unique LBMA identifiers		
Cost-efficiency	Multiple APs to ensure arbitrage opportunities and encourage fair pricing of the ETP		
	Multiple market makers to ensure maximum liquidity and reduce spreads		
	Liquidity: Tight spreads and minimal tracking error		
	Physical Delivery		
Physical Holding Quality	LBMA 'Good Delivery' bars		
	Held with a member firm of the LBMA		
	Held by a Custodian who is a loco London clearer, in vaults that meet required standards for security and size		
Responsible Sourcing	Post-2012 LBMA 'Good Delivery' gold bars provide investors with products complying with enhanced ethical standards		
Track record	Issuer has long operating track record under different market conditions		
	Partners are all highly experienced in their respective fields		
	Fund size is sufficient and reflects wide acceptance among investors		

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