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How to Own and Invest in Gold

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The coin on the cover depicts AIER founder Col. E.C. Harwood (1900-1980). The one-ounce gold coin was first minted in 1979. Many more bullion-grade Harwood coins were struck over the years and were subscribed to by AIER's long-time friends and supporters.

Why Gold?

In the Beginning

Imagine it's around 3500 B.C. on the banks of the Nile River. You're fishing, perhaps, when you stub your toe on a particularly hard rock embedded in the silt. You stoop to pick it up, and it gleams like something you've never seen before.

You've discovered gold.

From that early discovery, the ancient Egyptians were drawn to gold for the same reason many are today: It's not only beautiful, but it's one of the easiest metals to work with, easily alloyed with other metals. It never rusts or corrodes, making it ideally suited for fashioning into ornamental objects or coins.

It's also incredibly rare. All of the gold ever pulled out of the ground would fit in a 65-foot cube. That includes all of the "easy" gold that came out of California rivers and South African surface mines. Every ounce of new gold that comes onto the market is harder and more expensive to mine than the last.

All of these factors—durability, rarity, and physical appearance—have led society to value gold for millennia. Because it can't be easily counterfeited, gold was the near-universal currency throughout the world until the modern era, and it backed the U.S. dollar.

That changed in the wake of the Great Depression. Responding to the work of economist John Maynard Keynes, the German, British, and U.S. governments abandoned the explicit ties of their respective currencies to gold. In the U.S., where fear about the economy during the Depression caused massive gold hoarding, the private ownership of gold actually became illegal in 1933 and remained restricted until the 1970s. This use of gold as currency—and the confiscation of private gold in the 20th century—underlies many investors' attitudes toward gold to this day.

The Modern Era: Why Gold Now?

Since gold is no longer the primary or even common way of conducting real-world economic transactions, perhaps the most important question any investor needs to ask is a simple one: Why own it? Only by answering that question can you make an informed decision about the best way to use your investment dollar.

For a modern investor, the case for owning gold can be broken down into a few factors:

1. **A "just in case" store of wealth.** Many investors believe that physically owning gold in an accessible form is a prudent strategy in preparing for unlikely—but not impossible—events in the global and local economy. Whether it's distrust of the U.S. economic and political system, concern about external disruptions to the modern electronic economy from war or disease, or even global warming, history would suggest that no matter what happens to the value of a paper dollar bill, an actual physical gold coin will likely retain economic and transactional value.

Often you'll hear this argument referred to as the "guns and butter" argument for gold. If you're really worried about the state of the world, it makes sense to go back to the basics, and gold has been the most basic store of wealth in recorded history.

2. **An inflation and currency hedge.** Many investors are also drawn to gold because there is ample evidence that over a long enough time, gold can retain value relative to physical goods, whereas fiat currency such as the dollar rises and falls. A common axiom is that "an ounce of gold has always bought a man's suit," and there's some truth to that. According to Casey Research (caseyresearch.com), in the Roman Empire, an ounce of gold purchased a toga, a belt, and a pair of sandals. With gold at $1,500 an ounce, a modern gentleman can be attired in the style of the times. In 400 B.C., an ounce of gold bought about 350 loaves of bread. At roughly $4 a loaf, that formula still holds true.

Over short periods of time, however, there's no guarantee that gold will rise and fall with inflation. In fact, since the 1970s, the price of gold has been far more volatile than the actual rise of consumer prices.

Similarly, when considering the value of gold in relation to other goods, many investors look at the long-term relationship between gold and oil for guidance.

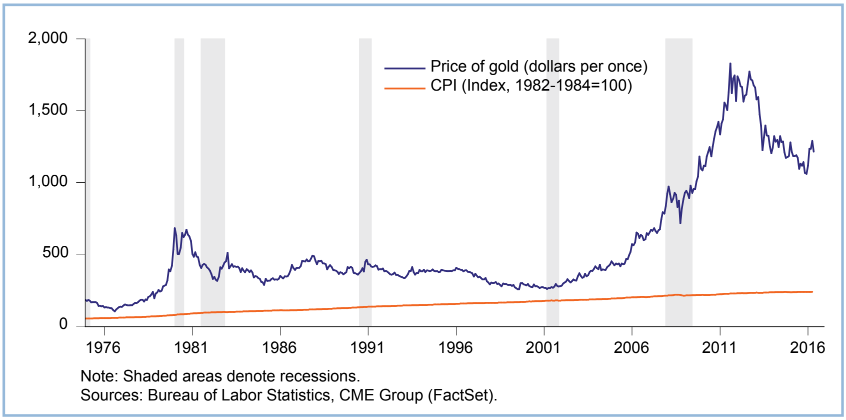

Chart 1. Over 40 years, gold prices have varied widely from consumer price changes.

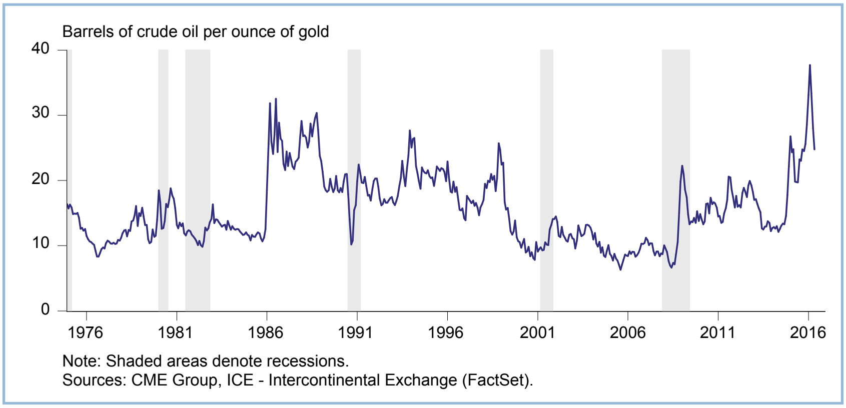

Chart 2. Gold and crude oil prices also have a volatile relationship.

Any tight correlation between gold and oil broke as soon as the dollar stopped being pegged to the price of gold in 1971. There are many periods when gold is either "expensive" or "cheap" relative to a barrel of oil, compared with the long-term historical average.

One thing that has held true, however, is that gold acts as a kind of "inverse dollar" bet quite effectively. When the value of the dollar falls versus other world currencies, the dollar price of gold goes up—that is, gold's value remains intact despite fluctuations in exchange rates.

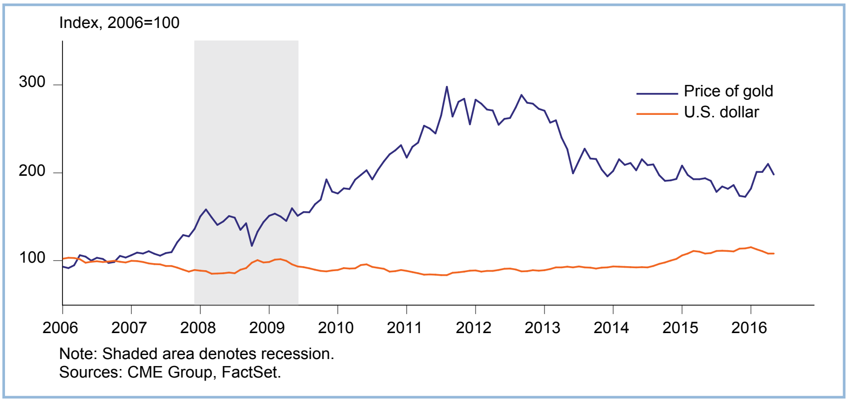

Chart 3. Gold prices and the dollar's strength are inversely related.

Here, over even relatively short periods, we can see that when the dollar strengthens, gold declines (as we saw in 2008 and 2014). When the dollar weakens, the price of gold increases (2009, 2016). So if you're looking for a hedge against a rapid or persistent decline in the value of the dollar, gold may make sense.

3. A non-correlated investment. Finally, many investors who aren't worried about the collapse of either the country or the economy look to gold as a source of diversified returns in their portfolios. For this purpose, the results are mixed. According to this theory, when stocks or other financial assets are down, gold will be up, or at least its returns will be unpredictably correlated. Here the jury is still out; gold can have periods of both high and highly negative correlations with financial assets, and in fact, that correlation can shift quite rapidly.

It's important to recognize that as a portfolio asset, gold is very, very different from every other asset you're likely to own. Stocks have value based on their assets and their future cash flows from participating in the global economy. Bonds have value based on their credit worthiness and their coupon payments. Commodities have value based on their worth in industrial processes or as primary consumables like food.

Gold, on the other hand, has value because a large group of individuals, central banks, and institutions choose to own it for one of the above reasons. While about 10 percent to 15 percent of the gold that is mined each year is used for industrial purposes, the vast majority is not "useful" in a traditional sense. This means that as an investment, a decision to buy gold (in one of the many forms discussed in this booklet) is a bet on the psychological importance of now vs. the future.

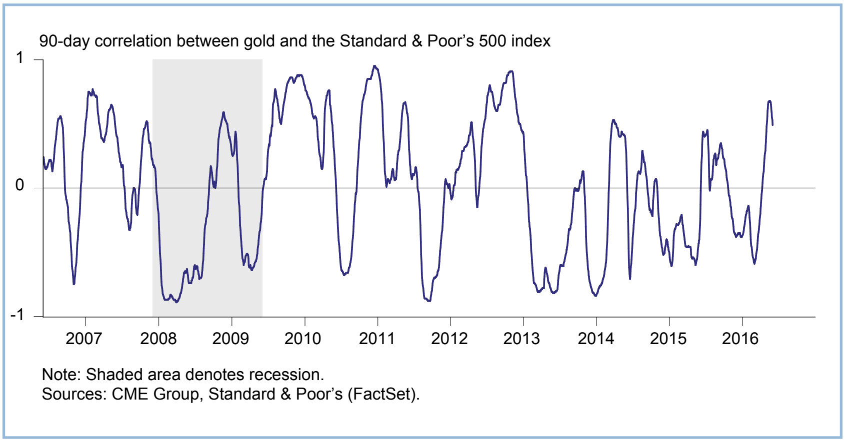

Chart 4. The price of gold versus the price of stocks

Knowing Your Reasons

Perhaps the single most important factor in your success as a gold investor is knowing why you're buying gold in the first place. Understanding that will help you navigate the often confusing world of gold ownership and avoid potential pitfalls.

The Gold Market

Unlike most securities, physical gold doesn't trade on one exchange—it trades all over the place. If you want to buy an ounce of gold, you can likely get it at a big-city bank branch, a jewelry dealer, a dedicated precious metals seller, or even in a private transaction with another investor.

Of course, that's not really how most gold changes hands. Most physical gold trading actually happens in London.

The London Bullion Market Association (LBMA) is made up of large trading firms, banks, and gold dealers who all agree to abide by the rules the LBMA sets, and those rules are unique. All of the gold traded actually sits in the vaults of seven large London banks. Trades are negotiated among members for ownership of 400-ounce bars known as Good Delivery bars. The LBMA clears the trades and simply adjusts the ownership records showing which members own which serialized bars.

While market makers keep a continuous price all day, twice a day, at 10:30 a.m. and 3 p.m. London time, the 13 largest banks conduct an auction to set a "fixing" price at which the banks all agree to buy or sell based on their needs at that time. These a.m. and p.m. "fixes" are the anchor points for gold pricing around the world, as the LBMA accounts for the transfer of some 20 million ounces of gold in an average month, roughly 10 times the amount of any other gold market.

When the London market closes, the price of gold globally is generally pegged to the trading in gold futures—contracts for delivery of gold at a future point in time—that trade on the COMEX futures exchange in New York. Whichever contract is closest to today's date and has the highest volume is used as the "spot" price. Each contract in New York is for 100 ounces of gold.

During the night, when both the New York and London markets are closed, other markets' trading (electronic, Sydney, and Hong Kong) sets the price, so there truly is a 24-hour live price for each ounce of gold.

Supply and Demand

If you're wondering what determines the price of gold, it's actually simpler than you think. Like virtually all commodities—and most financial assets—it comes down to supply and demand.

One of the reasons gold holds such attraction for many investors is that its supply is limited. If there's a predictable demand for, say, corn, a farmer can choose to plow under his soybeans and grow more corn. If there's tremendous demand for Microsoft stock, Microsoft can simply choose to issue more shares. And if people keep buying 10-year Treasury bills and at low interest rates, well, the Treasury will just keep making more bonds to auction off.

Gold, however, can ultimately only come out of the ground. According to the World Gold Council, as of the end of 2015, just 186,700 tonnes (metric tons) of gold existed above ground. Each year, gold miners around the world add about 3,000 tonnes to that total, and the cost to get that gold continues to climb, year after year, as gold deposits are deeper, less pure, and more dangerous to access. Due to consistently high demand, the gold recycling industry contributes about another 1,000 tonnes per year to the supply from old jewelry, computers, and knick-knacks being re-smelted.

Most of that "new gold" is made into jewelry, with a little bit being identified as net demand from central bankers, exchange-traded funds, and newly minted gold coins and bars.

In any given year, supply and demand have to, by definition, exactly match. All other gold trading that happens is between existing owners of already mined gold. If people want to buy more bars, coins, or jewelry than the miners and recyclers can produce, the price will keep climbing until someone is willing to sell.

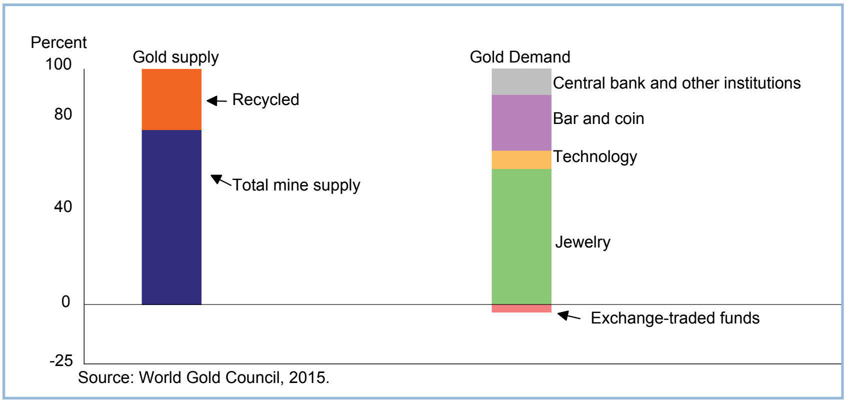

Chart 5. Gold supply is limited, so increased demand can raise prices.

It's a familiar refrain for gold investors. Over the long term, the constrained supply is on your side. In the short term, vagaries of psychology can create significant price swings.

This limited nature of supply makes gold highly susceptible to investor psychology. In many countries (notably India), gold jewelry is given as a gift not so much to wear, but for investment purposes—a sizable gold jewelry collection is seen as an asset that can be sold in hard times. If the price is too high or the economy is bad, jewelry demand can plummet. The same is true of essentially all of the sources of demand other than technology.

Central banks hold an interesting position in this mix. Historically, the world's governments have stockpiled enormous amounts of gold.

Despite the decline of the gold standard globally, the top five gold-holding central banks still have enormous remaining stockpiles—over 31,000 tonnes as of the end of 2015, or over 16 percent of all the above-ground gold on the planet, with a few countries owning the majority of that.

Gold Holdings by Central Banks

Central bank	Tonnes held (metric tons)
United States	8,133.5
Germany	3,381.0
IMF	2,814.0
Italy	2,451.8
France	2,435.7

Source: World Gold Council, May 2016

Each of these top five central banks owns enough gold to swamp the supply coming from gold miners in any given year. Because central banks have such large positions and the potential to massively over-supply if they choose to, over the past 100 years various multinational agreements have bound signatories to selling their reserves only according to an agreed-upon schedule, with an eye toward maintaining stability in gold's price vs. world currencies. These Central Bank Gold Agreements have been largely successful, especially since the late 1990s, and they continue to this day.

Buying Gold: Physical

Once you've decided that gold has a place in your long-term financial plan, you've actually just begun the decision process. How exactly are you going to take ownership of your yellow metal?

Physical gold can be fabricated into virtually any shape and size, and a vast amount of monetary wealth can be packed into a very small space—that's one of its main attractions. A carton of butter in your fridge weighs a pound, or about 14.5 troy ounces—the universal measurement of gold. A pound of gold fits into a cube less than an inch-and-a-half on a side—and was worth almost $20,000 at 2016 prices.

Pick a Format

The most common way small investors buy physical gold is coinage. Gold coins have been minted for thousands of years, and a modern gold coin is different from a Roman one only in its purity and consistency. While most people are familiar with the concept of "24-carat gold," that jewelry market unit is actually a very coarse way to measure purity. Twenty-four carat gold is 99 percent pure. The next lowest grade—22-carat gold—is about 91 percent pure.

Gold for investment is usually measured in "fineness" or parts per thousand. So 24-carat gold would have a fineness of 990—10 parts per thousand are some sort of alloy. Gold for investment can have a wide range of fineness, and differences will affect the price. A 400-ounce London Good Delivery bar used by banks has to have a minimum fineness of 995. The popular one-ounce American Eagle gold coin produced by the U.S. Mint has a fineness of just 916, as does the South African Krugerrand. A Canadian Maple Leaf coin has a fineness of 999.9 parts out of 1000.

Does this make one better than the other? Not really. Each coin is minted so that the content of pure gold is exactly one ounce. So while a Maple Leaf weighs 31.110 grams on a scale, an American Eagle weighs 33.931 grams.

Different weights, but the same actual amount of elemental gold inside. In any case, the act of taking gold and turning it into a coin or a small bar adds some cost. The headline price of gold might be $1,200, but an American Eagle coin might cost you $1,250. That fabrication cost means you generally want to buy the largest possible single item. Where the American Eagle might have a fabrication premium of 2 percent or so, a 10-ounce bar from the Perth Mint might only have a 1 percent premium.

In general, the larger the individual coin or bar, the closer to the advertised price of gold you'll pay.

Pick a Vendor

Of course, you still need to actually acquire your coins or bars. Once upon a time, you could go to your local bank and just buy gold. Now you generally need to either go to a specialized coin dealer or the main branch of a money-center bank. Increasingly, however, people take physical delivery of gold by ordering it online. Websites such as JMBullion.com and Kitco.com sell coins and bars and ship them right to your doorstep—signature required, of course. Online vendors will actually ship you tens of thousands of dollars of gold, completely insured. Like any other investment, the purchase price will always be more than the price you get for selling gold at the exact same moment—that's the spread, and it's just part of the cost of doing business.

Pros and Cons

The primary pro of owning gold physically is that if you are buying gold as a guns-and-butter asset, nothing stands between you and your investment. Nobody is holding on to it for you. You don't need access to a phone or a computer or a car in order to get your hands on it. For many, being able to literally put their hands on gold is important.

But physical ownership comes with its own risks, the largest being storage, or vaulting. A physical coin kept in your house is subject to theft, so some sort of security or a safe is prudent. Alternatively, you can store your gold in a local safe deposit box, but then you're at the mercy of the bank to get access to it. You can even pay large bullion dealers to store your gold in vaults from Canada to Asia to the Cayman Islands, with a promise to deliver it to you on demand—but again, this makes getting actual hands-on possession more difficult.

Each step in owning physical gold—the cost of fabrication, the spread charged by the dealer, vaulting, security, and perhaps insurance—is an expense. If you're planning on holding on to coins essentially forever, this may not matter. But if you're interested in a potential increase in value, there may be cheaper alternatives.

Buying Gold: Pooled Gold

If taking possession of physical gold seems risky, gold dealers have created an easy solution for you to still own bullion: gold pools.

In a gold pool, run by all the major gold dealers, you buy a share of a large pool of physical gold stored in the dealers' vaults. That gold may be a collection of London Good Delivery bars, coinage, and other easily traded physical gold.

The idea of investing in a pool is hardly new—German and Swiss Banks have issued gold-backed certificates to customers for hundreds of years, and gold certificates can be seen as the precursor to modern paper money. Currently, there's only one government-run certificate program: the Perth Mint certificates issued in Australia. Investors can buy certificates denominated in ounces of gold, which represent an obligation by the mint to deliver gold on demand or return a cash equivalent. In gold investor parlance, that's known as an "unallocated" ownership, because there's no vault you can walk into and point to a specific pile of gold and say, "That's mine."

More modern gold pools don't issue physical certificates. Instead, they look a bit more like an online bank account. Investors deposit money with the pooled gold program and purchase shares of a large pool of gold. These programs can be considered "unallocated," like the Perth program, or they can be "allocated," giving you legal ownership of a specific quantity of gold actually held in a vault.

In both, you can use the pool system to sell your gold and receive cash, or you can pay a fabrication fee and have your gold sent to you—say, $25 to take out an ounce as an American Eagle, or $2,000 to take a 400-ounce London Good Delivery bar. Unallocated programs generally don't charge for insuring your gold because, being unallocated, the gold is not actually yours; you're just a creditor of the pool. Allocated programs often charge a small fee to maintain insurance on your gold, costing around 0.10 percent to 0.15 percent a year.

Pros and Cons

The main advantages of pooled programs are convenience and cost. An unallocated gold account is generally the cheapest way to get access to gold, usually with no insurance costs and no fabrication premiums, and bid-and-ask prices that are very close to the advertised spot prices in New York or

London. Transactions can be very small or very large and can happen with high frequency, and the only cost is the spread advertised by the dealer. Allocated accounts often have commissions on transactions, ranging from almost nothing to 0.50 percent.

In either case, it's extremely important to do your homework before investing in a pooled gold account. Each dealer has terms and conditions. Some accounts are enormous, multi-billion-dollar pools used by institutions and high net-worth individuals around the world, and some are smaller upstarts with less of a track record.

The primary negative of pooled programs is that while you may have legal ownership of your gold—or at least a claim on the unallocated pool—you don't actually have it in your possession. If you're holding gold as an emergency asset to be used during some future breakdown in communications, commerce, or governance, gold vaulted in Zurich and accessed through the internet may not be for you.

Buying Gold: Miners

Before the advent of exchange-traded funds, one of the most popular ways for investors to participate in the gold market was to buy the shares of gold mining companies. The theory is that gold-mining stocks will do well when the price of gold rises, mirroring its price.

The idea has a lot of merit—after all, if a gold miner in Canada has a fixed cost of $500 an ounce to get gold out of the ground, it will make more money as pure profit if the price of gold rises from $1,250 an ounce to $1,500 an ounce. In fact, for decades many gold-miner investors have invested in the belief that miners acted as a kind of leveraged bet on gold—precisely because they were in such a windfall position should gold prices skyrocket.

There is something to that argument in the short term. Consider a 10-year investment in gold itself vs. the NYSE Arca Gold Miners Index.

You can see that during short periods—such as the rapid decline in gold in 2008 and the rapid increase in 2016—the gold-miners index moved far more on a percentage basis than a simple investment in gold would. The problem, unfortunately, is that gold miners are businesses just like any other, so as an investor, you have to be correct not only about the movement in the price of gold but in how those individual companies are run. A mining company can be well or poorly run. It can have windfalls (say, from an unexpected gold discovery) or mishaps (like a labor dispute).

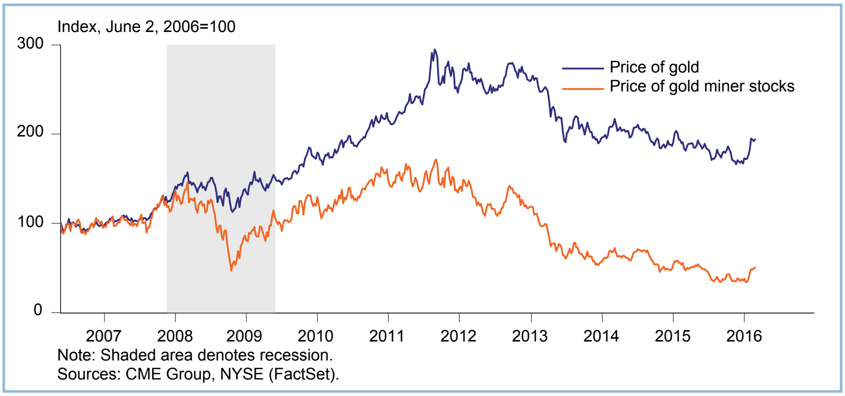

Chart 6. Stocks in gold mining companies have underperformed investments in bullion over 10 years.

Complicating matters is that mining companies have over the years tried to limit their exposure to the price of gold by using gold futures. Gold miners use futures much like a farmer who sees a high price for corn and decides to "pre-sell" his crop by promising to sell next year at today's prices. How well gold-mining CFOs manage these hedges can make a huge difference in the long-term profitability of any individual miner.

The track record over the past decade hasn't been great for gold miners—a 10-year investment in bullion has yielded a 94 percent return, while a 10-year investment in miners has lost around 37 percent.

Pros and Cons

The main advantage of investing in miners is that it's a way of making a simultaneous bet on both an industry and a commodity. It takes the return of gold and turns it into traditional equity returns, complete with rising and falling prices and dividends. Gold-mining stocks are also easily traded, like any stock, and there are numerous ETFs and mutual funds that can make buying them as a group easier and more convenient.

The downside is simple: Buying a miner stock is not the same as buying gold, any more than buying a farm is the same as buying milk. As an investor, you actually combine the risks of gold investing with the risks of the global equity markets.

Buying Gold: ETFs

If you're buying gold as a portfolio asset alongside stocks, bonds, and other investments, exchange-traded funds, or ETFs, provide an easy way to access gold that picks up where pooled gold leaves off.

An exchange-traded fund that owns gold is structured as a "grantor trust"—a legal structure where each shareholder has a unique claim on a single pool of assets. When you own a share of a popular gold ETF like the SPDR Gold Trust (Ticker: GLD), your share serves as a pro rata claim on gold actually held in vaults (in this case, in London) and verified by an independent auditor.

How you buy ETFs is different from buying pooled gold, however. With pooled gold you buy from the pool itself, but with ETFs, you buy shares from the market, just like you would a share of Microsoft or IBM. The price of the ETF will fluctuate during normal trading hours, just like a stock, and you'll have a small spread between what you can buy a share for and what you'll sell it for, also like a stock. All day long, the stock exchange publishes a fair-value estimate for each gold ETF, based on how gold itself is trading at that point in time—a figure called the intraday net asset value, or iNAV. At any point in time, you can look at the price of the ETF vs. that of the iNAV to ensure you're paying very close to the actual value per share of all the gold in the vault for that ETF.

In other words, ETFs combine the liquidity and convenience of stock-market access with the direct gold ownership of pooled gold. There are currently four ETFs that directly invest in gold bullion, with expense ratios ranging from 0.25 percent to 0.40 percent a year, making the costs very competitive with other forms of gold ownership. With over $40 billion in assets, gold ETFs are now used by some of the world's largest hedge funds and institutional investors to express their opinion on where gold is headed.

Pros and Cons

Most of the pros and cons of gold ETFs come from their presence on an exchange. Like a stock, you can theoretically buy a single share, often for less than $20. Like a stock, you can trade as often as you like, making an ETF ideal for speculating on how gold may react to the news cycle. It can be bought in any kind of brokerage account, including retirement accounts, and can even be bought on margin or shorted just like any other stock.

On the flip side, in order to own an ETF, you have to have a brokerage account, and you have to buy and sell it just like you would a stock. That means paying a spread on the transaction and likely a commission to your broker. These costs are generally still favorable compared with fabrication or storage costs, but they're not zero. It's also important to realize that the price of a gold ETF at any moment in time is determined by the buyers and sellers in the marketplace—it's not structurally pegged to the price of gold.

All ETFs—gold ETFs included—use the creation/redemption mechanism to help keep the traded price of an ETF close to its true value. Large institutions can deliver gold to the ETF in exchange for new shares or deliver shares of the ETF in exchange for gold. If the price of the ETF deviates very much from the fair-market value of the gold in the vault, they can buy or make new shares to sell (profiting a little from "selling high") or they can buy ETF shares and deliver them to the fund in exchange for gold (profiting a little from "buying low"). Since there are multiple firms competing for that arbitrage, it's rare to see any ETF trade far from its true value.

But that's not a guarantee—the purchase price is still ultimately the price you're willing to pay and that someone else is willing to sell for. For that reason, just as with any other kind of market trading, placing an order that can only be executed at a certain price or better (a limit order) is always the best practice, and setting that price so it's close to fair value by checking the iNAV is a good idea as well.

Last, as with any non-physical ownership, gold ETFs don't provide any kind of safety net should you be unable to access your brokerage account. Instead, they're a way of participating, as an investor, in the daily price fluctuations of gold in response to world events. (It's worth noting that a recent ETF entrant, the Van Eck Merk Gold Trust [OUNZ], allows investors to trade their ETF shares for gold coins or bars for a fee.)

Conclusion—and a Word on Taxes

For most investors, owning gold will either be a guns-and-butter decision or a portfolio decision.

As a practical matter, if you plan on using your gold reserve in actual transactions during a time of significant crisis, the form in which you have your gold matters a lot. It's unlikely the local farmer has change for a London gold bar, and he's certainly not going to take the promise of your Toronto-based gold account. For these reasons, most bullion holders buy smaller coin denominations and are primarily concerned with storage, safety, and cost.

For portfolio investors, some form of pooled vehicle will likely be the most cost efficient and convenient solution, sacrificing the hands-on nature of owning coins and bars for the security of a central bank vault.

But in either case, there's a final component that deserves special mention: taxation.

From the perspective of the Internal Revenue Service, gold is a collectible. It's not considered a financial asset of any kind. The IRS makes no distinction whether you own gold in coins, in a pool, or in an ETF. Gold is gold.

As a collectible, gold is taxed at a flat rate of 28 percent. Whether you hold gold for a day or a decade, any gain on your purchase and sale of gold will get 28 percent taken off the top. While this can be deferred by using an IRA or other tax-deferred account to shelter the gains, investors may find this a rather punitive amount.

By comparison, qualified dividends and long-term capital gains on equities are currently capped at 20 percent for those in the highest (39.6 percent) tax bracket, and 15 percent for those in the 25 percent to 35 percent bracket. Some investors choose to invest in gold miners precisely to avoid these tax issues.

The More You Know …

It's somewhat trite to say, "Know what you own, and know why you own it," when it comes to investing, but it's perhaps more true for gold than for stocks and bonds. The only way to be successful as a gold investor is to know what you expect to achieve with your gold investing dollar. With a solid understanding of that, you can take this guide as a first step—but not a concluding one. As with any investment, read the fine print, do the research to understand your true costs, and be skeptical of anything that seems too good to be true.

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