Gold as a Safe-Haven: Types of Exposure & Custody

Not all gold exposure is the same. The type of exposure, form of custody (legal responsibility) and reputation & location of the vault operator will impact its utility as a safe-haven asset.

What are the types of gold exposure?

Gold Bars (Physical)

Gold bars are commonly available in sizes of 1 kilogram, 500 grams, 250 grams, 100 grams and 50 grams. Gold bars should be accredited by the London Bullion Market Association (LBMA) to ensure widespread acceptance. However, even with LBMA-accreditation, the issuer or refiner of the gold bars also impact their desirability. Reputable issuers of gold bars such as UBS, Commerzbank, Perth Mint, Royal Canadian Mint and Valcambi may be more desirable than other brands.

Gold coins (Physical)

Gold coins mostly trade in sizes of 1 troy ounce (c. 31.1 grams) but there are smaller (less tradable) sizes as well. They trade at premiums to gold bars (per unit of weight) and these premium may vary significantly over time, not ideal for safe-haven purposes. Popular gold brands are American Eagle (91.67% purity), Canadian Maple Leaf (99.99%) and South African Krugerrand (91.67%).

"Currency" Gold

Currency gold (denoted by the symbol XAU) or "paper gold" can be viewed as a (indirect) claim on gold rather than its direct ownership. The acquirer of this claim is subject to the credit risk of the financial intermediary however small it may be. When an investor buys gold from their bank, unless otherwise stated, it is likely they are buying XAU gold. The aggregate amount of XAU gold held may be a multiple of physically available gold. In times of real or perceived crises, this could be an issue. Under normal circumstances, XAU gold may be converted to physical gold for a fee.

Derivative Exposure (Options & Futures)

If you add derivative exposure to XAU gold, the ratio of paper-to-physical gold is estimated to rise much above 100-to-1. The risk of trading derivatives on gold via an exchange, however, is probably safer than bank-issued XAU exposure, as the clearing house, or central counterparty (e.g. CME clearing) maintains variation margin requirements (in addition to own reserves) to safeguard against counterparty risk.

Gold Exchange-Traded Funds (Physical)

There are several ETFs backed fully by physical gold. The ZKB / Swisscanto Gold ETF (CH0047533549) is such a popular fund, available in various investment currencies.

Gold Exchange-Traded Funds (Non-Physical)

There are also contract-based (or "swap" agreement based) ETFs (also called exchange-traded commodities or exchange-traded notes). These are backed by the promise of a counterparty (and probably set-aside collateral set as well) and do involve an added element of risk. The WisdomTree Gold ETC (GB00B15KXX56) traded in London is an example.

What are the types of gold custody and /or storage?

Bank "Allocated" Gold

Gold bars stored in a bank's vault with the owner's identification stated on the bars. This is outside the bank's balance sheet. The client's portfolio should state the specific type of gold bar held.

Bank "Unallocated" Gold

This is gold held in a bank's vault without a specific investor allocation. Banks generally hold physical gold to back at least some of the gold claims purchased by their customers. In the client's portfolio statement, the gold position may display "metal account – gold".

Bank Safety Deposit Box

Investors may request their gold holdings be delivered to a safety deposit box in the same (or a different) bank. Reputable banks offer high security deposit boxes. In the event of a bank resoluton or insolvency, however, temporary suspension of acces is possible. Also authorities can seal or access boxes with a court order. Gold holdings here are not visible in a portfolio statement.

Private Vault Safety Deposit Box

No banking relationship needed. Lower data collection requirements. Access 24/7 may be possible. Lower access rights by authorities is expected. Be sure to keep an audit trail of gold purchases and delivery record (to facilitate any future sales).

Custody of Gold ETF Holdings

Gold bars owned by exchange-traded funds are generally held in custody (legal responsibility) of bullion banks such as UBS, Züricher Kantionabank (ZKB), HSBC and JP Morgan. The actual storage (vaulting) of this gold may, however, be outside a bank's own vaults through the use of external vault providers such as Brink's or Loomis, and may even be geographically diversified (e.g. UBS may store some gold in London as well as Zurich). The prospectus of the ZKB / Swisscanto Gold ETF (CH0047533549) states the physical gold is held in safekeeping exclusively in Switzerland with ZKB itself or with third-party vault providers.

ETF Trading Location

We spoke about the location of the custdodian (and vault operator). The location where an ETF trades is not a form of custody but it may nevertheless be of relevannce in times of crises. In extreme times, ETFs traded in the US may have different restrictions to those in Australia, Switzerland or the UK.

Opinion

There is much complexity and legal nuance the deeper one delves into the subject. In brief, if one's goal is protection in times of crises, it's desirable to confine holdings to physical gold only. How to allocate exposure within the physical gold spectrum will be influened by the size of the position and other considerations. For large exposures, a diversified allocation could be as follows: physically-backed gold ETFs (50%), bank-allocated gold bars (20%), bank safety deposit box (20%) and an independent vault operator (10%).

Some readers may view the above as much ado about nothing. Remember, our focus is protection against highly unlikely but also highly consequential events. If our efforts at gold diversification go to waste, as they likely will be, that itself is a positive outcome.

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