GOLD EXCHANGE TRADED FUNDS AND ITS USEFULNESS AS AN INVESTMENT OPTION OVER GOLD

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Abstract

Gold Exchange Traded Funds are basically one type of derivative instruments which are backed by Gold and are traded in the Stock Exchange. They are basically mutual funds issued by the Fund Houses but instead of buying and selling through Fund Houses based on their NAV they are bought and sold through the stock exchanges. The main objective of this paper is to explain the relevance of Gold Exchange Traded Funds as an investment option as compared to the physical gold. This paper also explains the working mechanisms of the Gold Exchange Traded Funds and also explains the positive features of the Gold ETFs.

Key words: Gold, Gold Exchange Traded Fund, Mutual Fund, Investment Alternative

Introduction

The objective of investment is twofold. One is to beat the inflation so that the rupee value is maintained and the other one is to make some gain so that the investment objective is fulfilled. Keeping these things in mind an investor looks for investment avenues where his objectives can be fulfilled. There are various avenues for investment. An investor can go for risk-free securities like treasury bonds or can look for other investment options like stocks, shares, Post office deposits, Debentures, Bank Fixed Deposits etc.The rate of return of these deposits and their riskiness also vary. Investing in alternative sources of investment depends on the risk appetite and time horizon of the investor. The general rule applicable to investments is that higher the return higher is the risk and lower the return lower should be the risk. However most investors want to reduce risk in their investment. For ages gold has been the most preferred investment for Indians. Indians love to wear gold jewellery. They also prefer to invest their money in gold coin and bullion. Because it is a known fact that gold never loses its shine and unlike other mediums of investment never depreciate in value as gold is the most preferred commodity traded and exchanged all over the world .India is the second largest consumer of gold in the world after China.Figure 1 shows the top consumers of gold in the world as on 31st October 2020.

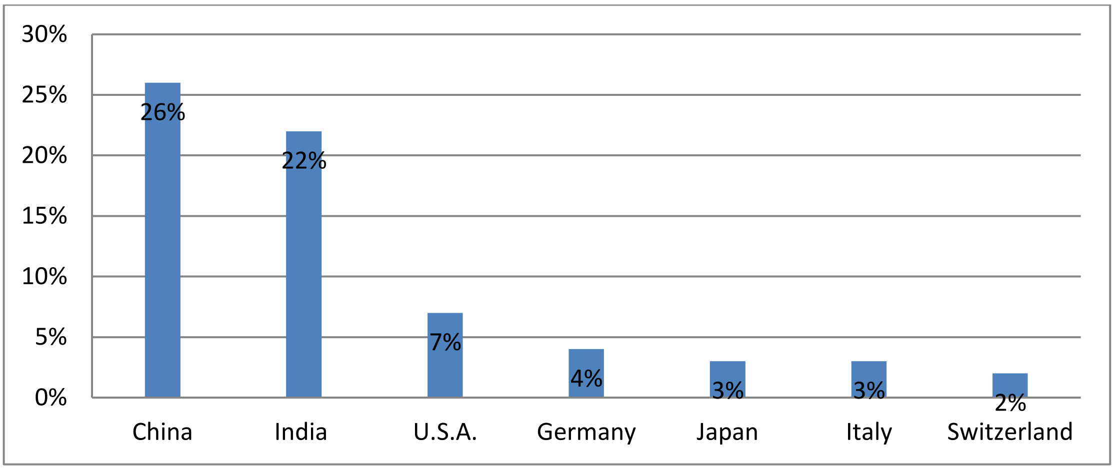


Fig.1. 10 Year Average Consumer and Investment Demand for Gold ending 2019

(Source: World Gold Council)

Fig.1 shows that Indians consume 22% of the world Gold. It includes gold jewellery, Gold Bullion and Gold Exchange Traded Funds.

Though investment in gold is rewarding but it is not risk free. The main risk associated with the physical gold is the risk of theft .Another important thing associated with physical gold is that it is not possible to buy it in smaller quantities. If one has to invest in gold then one must invest a higher sum which is not always possible on the part of the small investor. The answer to these problems lies in investing in Gold Exchange Traded Funds. Gold Exchange Traded Funds are theft proof and can be invested by putting smaller amounts of money. Over a period of time one can build a bigger portfolio by investing smaller amounts over time.

Review of Literature

Mishra Susanta Kumar, Das Arka Kumar Mohapatra (2020) in his article titled "Investment Analysis of Gold Exchange Traded Funds in India" has concluded that Gold ETFs are indeed the best investment options available to investors. They provide high returns and always reflect the market trend of gold. They also provide high return when the stock market is bearish. Further according to them the risks associated with investment in Gold ETF are low in comparison to Stock Market. Investors can invest on Gold ETF without the worry of risk .This is an innovative investment option introduced in Indian investment market that helps investors to maximize their wealth and also helps the asset management companies to widen their product and customer base.

Baur (2013) has claimed that the volatility of gold has been increased because of the ease of trading facilitated by gold ETFs.

Kim (2011) stated that just like any commodity the price of gold depends on the dynamics of its demand and supply. The special feature with regard to gold is that the price of gold is determined not only by its consumption demand but also based on its holdings. From a long time in the past, gold has been held by individuals and central banks as a reserve and the price of gold is more influenced by the demand and change in gold reserves rather than the supply from gold mines.

Method Of Subscribing To Gold Exchange Traded Funds

Gold ETFs invest only in gold and gold based securities. Thus if one Gold ETF is equivalent to one gram of gold then by buying one gold ETF one is investing in one gm of gold. Hence one can gradually build a portfolio over a period of time.

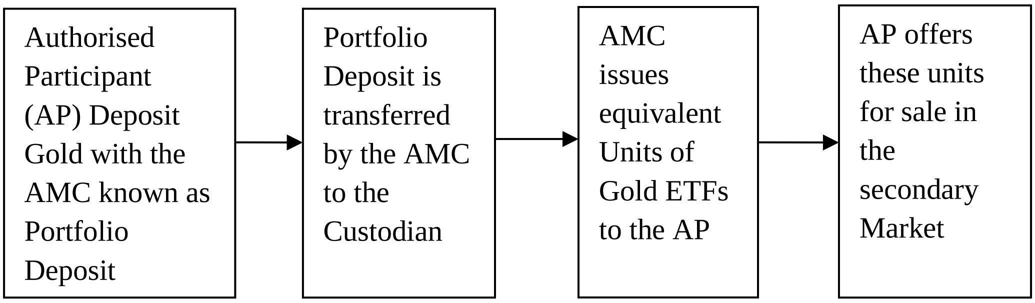
An investor can subscribe to a Gold Exchange Traded Fund either through subscribing to the New Fund Offerings or through authorised participants.

In case of New Fund Offerings Investors subscribe to the fund and the Asset Management Company invests in the same quality gold as specified in the prospectus at the rate prevailing in the market.

In the second method Authorized Participants (APs) deposit money or gold with the Asset Management Company known as portfolio deposit which is transferred by the AMC to the custodian, who is responsible for the safe keeping of the gold. In exchange AMC issues equivalent units of Gold ETFs to the Authorized participants (APs) .APs offer these units for sale in the secondary market. APs continuously offer two way quotes, known as bid-ask rate and earn on the difference. For example if the bid-ask rate is 576 -579, then the buying rate is 576 and the selling rate is 579. The difference of Rs. 3 is the earnings of AP.

The custodian maintains a record of the gold deposited or withdrawn under a scheme through an account known as allocated account. At the end of each trading day the custodian prepares a summary report of the allocated account and submits it to the AMC not later than the following trading day.

Fig.2.Diagram for Creation of Gold Exchange Traded Funds



Tracking Error of the Scheme

The tracking error in case of ETFs occurs due to transaction costs. In case of gold ETFs the custodian has to pay insurance premium for the gold held by them. This premium is treated as the transaction cost which is allowed as an expense by SEBI. The difference between the return from the gold and that of the scheme due to the expenses involved in the maintenance of the gold is referred to as the tracking error. Tracking error is defined as the variance between the daily returns of the gold and the NAV of the scheme for any given time period. For the purpose of the valuation of the gold a specific formula is used by taking into account various factors like the price of gold in US$ / ounce quoted at London Bullion Markets Association, the conversion factor for ounce to kg, the US$/INR exchange rate, customs duty etc.

Advantages Of Investing In Gold Exchange Traded Funds

Gold Exchange Traded Funds have the following advantages over the physical gold

a) In case of Gold ETFs since the certificates are backed by equal amount of Gold as stated in the Certificate and kept with the Custodian hence there is no doubt about the quality and the purity of Gold.

b) Gold ETFs can be bought and sold online through Demat account and there is no hidden cost .

c) Gold Exchange Traded Funds do not attract Wealth tax.

d) As the Gold is held in electronic form hence there is no fear of theft. The gold remains in the safe custody of the Custodian of the Asset Management Company.

e) Gold Exchange Traded Funds can be converted into physical gold. The buyer or the holder of the Gold ETF has two options. He can either convert his holdings into physical units of Gold or he can sale it at the Market price of the Fund and collect his money to be credited into his account.

Table.2.Comparative Analysis of Gold ETF with Physical Gold

Criteria	Gold ETF	Physical Gold
Sale/Purchase	Through DEMAT Account	Jewellery,Coins
Security of the Asset	Not the Concern of the Investor	Responsibility of the Holder
Transparency	Very High	Moderate
Impurity Risk	Nil	Moderate to High
Pricing	Transparent	Varies from Seller to Seller
Denomination	One Gram or in Multiples thereof	Not Standardised
Wealth Tax	Nil	Applicable
Long-Term Capital Gains Tax	Applicable after One Year	Applicable after Three Years

Conclusion

Due to continuous rise in the price of Gold has made the investment in Gold and Gold backed Assets an attractive option. During the COVID-19 Pandemic when the Global economic outlook does not provide a clear picture regarding various economic indicators like GDP, Employment the stable rise in the price of the gold has made everyone to think of Gold as an strategic investment alternative. During the last one year though there has been constant rise in the price of the Gold but people's investment orientation has been more towards the Gold ETFs all over the world rather than Gold. Various reasons could be attributed to it like restriction in the movement of the people, declaration of lock-down and shut down resulting in the non-opening of the business and jewellery houses etc. Thus Gold Exchange Traded Funds should be considered as a part of investment plan in the overall portfolio of any individual in order to avoid risk and to gain higher returns .

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