GOLD ETFS: AN EMERGING INVESTMENT OPTION

DR.PRASHANTA ATHMA
Professor, Dept. of Commerce,
Osmania University College for Women, Hyderabad, A.P.
Email id: prashantaathma@gmail.com

Ms SUCHITRA K.
Research Scholar, Osmania University, Hyderabad, A.P.
Email id: konkaboina_s2004@yahoo.co.in

Abstract

An investor has numerous investment options to choose from, depending on his risk profile and expectation of returns. Different investment options represent a different risk-reward trade off. Of the various types of investment options in Stock market, ***Gold Exchange Traded Funds (GOLD ETFs)*** *happens to be one of the best options to be included in the portfolio for diversification of risk.*

The first ***Gold Exchange-Traded Fund*** *was actually launched in March 2003 on the Australian Stock Exchange under Gold Bullion Securities (ticker symbol "GOLD"). Graham Tuckwell, the founder and major shareholder of ETF Securities, was behind the launch of this fund.*
Not much research work has been done on "Gold ETFs". The studies related mainly to conceptual knowledge of gold ETFs. Hence the study is undertaken to fill the research gap with the objectives to focus the Gold ETF as a strong asset class; to stress upon the inclusion of Gold ETF in a portfolio for risk diversification; to assist the investor in the selection of best Gold ETF option and to analyze the tax implications of Gold ETF.

The investment in the Gold ETF is low due to the low awareness among the investors and the sentimental attachment of the investors towards holding gold in physical form.
If the uncertainty over the global economies and volatility in the equity markets are to continue for some more time, Gold ETFs are bound to find not only more number of investors, but also more number of Mutual Fund Players to launch them in the coming future.
However, initiatives are to be taken by the Mutual Funds offering Gold ETFs, Govt. SEBI and Members of the Stock Exchanges for creating awareness among the investors.

Introduction

Investment is the commitment of funds in an asset or financial instruments with the aim of generating future returns in the form of interest, dividend or appreciation in the value of the instrument. Investment is involved in many areas of the economy, such as, business management and finance no matter from households, firms, or Governments.

An investor has numerous investment options to choose from, depending on his risk profile and expectation of returns. Different investment options represent a different risk-reward trade off. Low risk investments are those that offer assured, but lower returns, while high risk investments provide the potential to earn greater returns. Hence, an investor's risk tolerance plays a key role in choosing the most suitable investment. Various investment options available are Bank Deposits, Commodities like Gold, Silver etc., Post Office Savings Schemes, Public Provident Fund, Company Fixed Deposits and Stock Market options like Bonds and Debentures, Mutual Funds, Equity Shares etc., Of the various types of investment options in the Stock Market, Gold Exchange Traded Funds (Gold ETFs) happens to be one of the best options to be included in the portfolio for diversification of risk.

The idea of Gold ETF was first conceptualized by Benchmark Asset Management Company Private Ltd. in India, when they filed a proposal with the SEBI in May 2002. However, there was no regulatory approval then and later it was launched in March 2007.

The first Gold Exchange-Traded Fund was actually launched in March 2003 on the Australian Stock Exchange under *Gold Bullion Securities* (ticker symbol "GOLD"). Graham Tuckwell, the founder and major shareholder of ETF Securities, was behind the launch of this fund.
The emergence of Gold ETF's in India is tabulated in Table 1.
In this context, the study is undertaken to assess the importance of Gold ETFs in India.

Review Of Literature

1. Bakul Chugani Tongia[1] in his article has pointed out that, in the month of May 2010 alone, Gold ETFs have clocked in about 8.7% gains, strengthening its role as a hedge against inflation as well as equity markets as Sensex has declined by about -5.6% during the same period. He also pointed out that, since the launch of gold ETFs in early 2007, they have emerged as a strong asset class, generating more than 27% returns (CAGR) in the past three years against the Sensex returns of just about 4% CAGR during this period.

He further corroborated that the increasing demand for gold is evident from the growth in the

Table 1
Emergence Of Gold Etfs In India

Sl. No	Fund	LAUNCH DATE	UNIT SIZE (1 unit equals)	SYMBOL AT NSE
1	Benchmark Asset Management Company Pvt. Ltd.	15-Feb-2007	Approx. 1 gram	GOLDBEES
2	UTI Mutual Fund	01-Mar-2007	Approx. 1 gram	GOLDSHARE
3	Kotak Mutual Fund	20-Jun-2007	Approx. 1 gram	KOTAKGC
4	Reliance Mutual Fund	15-Oct-2007	Approx. 1 gram	RELGOLD
5	Quantum Mutual Fund	24-Jan-2008	Approx. 1/2 gram	QGOLDHALF
6	SBI Mutual Fund	30-Mar-2009	Approx. 1 gram	SBIGETS
7	Religare Mutual Fund	28-Jan-2010	Approx. 1 gram	RELIGAREGO
8	HDFC Mutual Fund	25-Jun-2010	Approx. 1 gram	Not Yet Listed
9	ICICI Prudential Mutual Fund	28-Jun-2010	Approx. 1 gram	Not Yet listed

Source: Computed from the data given in www.onemint.com, www.moneycontrol.com, www.nse-india.com,

Assets under Management (AUM) of gold ETFs. During the period Apr 2010-May 2010, the AUM of gold ETFs has surged by nearly 10% from Rs 1,650 crore to Rs 1,815 crore. In fact, the AUM has risen by more than 100% in the past one year — the highest annual growth witnessed by gold ETFs since their launch three years ago.

2. Dipak Mondal[2] suggested that investors should take exposure in gold by buying either physical gold, Gold Exchange-Traded Funds or even units of mutual funds, which invest in the stocks of gold mining companies. He also added that due to the crisis in the European Union, most currencies are witnessing high volatility and unless world currencies reach some kind of equilibrium, prices of gold would continue to go up. In the very short-term, there are possibilities

of a correction but gold, either in physical form or in mutual fund units, continues to be a very good investment tool.

3. Fisher[3] lists five reasons why the yellow metal remains the most universally accepted and time-tested asset class. The reasons are Effective Portfolio Diversifier, Thrives under worst conditions, Hedge against inflation, Linkage with oil and US Dollar and Widening demand and supply Gap. He suggested that gold must be made a part of the asset allocation because it is a great risk diversifier and considered as a safe haven during times of economic uncertainty, political strife, high inflation and wars.

4. Fisher[4] in his article mentioned that Gold Exchange-Traded Funds (ETFs) have made investing in the yellow metal very convenient and inexpensive. He expressed that they offer a way of participating in the gold bullion market without the necessity of physical delivery of gold. He listed out six reasons why gold ETFs are considered as the best way to invest in the gold. The reasons mentioned are Wealth tax exemption, Income tax benefit, Investment in small denominations, Hedging, Convenience and better holding of ETFs as compared to physical gold holdings.

Research Gap

The survey of Literature indicates that not much research work has been done on "Gold ETFs". The studies related mainly to the conceptual knowledge of Gold ETFs. Hence the study is undertaken to fill the research gap with the following objectives.

Objectives Of The Study

The objectives of the study are to:

- Focus the Gold ETF as a strong asset class
- Stress upon the inclusion of Gold ETF in a portfolio for risk diversification
- Assist the investor in the selection of the best Gold ETF option
- Analyze the tax implications of Gold ETF

Scope Of The Study

The most actively traded securities in NSE and S&P CNX NIFTY Indices are only taken as Gold ETFs were initially launched on National Stock Exchange of India.

Methodology

The period of study is for three years starting from the inception of Gold ETFs in India i.e. 2007-08 to 2009-10.

The study is based on secondary data. The sources of data include websites and journals.
Simple statistical tools like Averages, Standard Deviation and Co-efficient of Variation are used.
For the construction of portfolios, three most actively traded securities namely Reliance Industries Ltd, ICICI Bank Ltd and State Bank of India (SBI) are taken as one portfolio and the other portfolio includes Gold ETF and top two actively traded securities in order to reflect upon the effect of inclusion of Gold ETF in a portfolio.

Gold ETF of Benchmark Asset Management Company Private Ltd (Gold BeES) is included in the portfolio as its expense ratio is the lowest as compared to the other Mutual Funds offering ETFs.

Gold Etf: Concept

India is one of the largest consumers of gold. Nearly 800 tonne of gold is imported every year. Indians account for 23% of the world's total annual demand for gold. While conventional investment options like jewellery, gold bars and coins still exist, Gold ETFs are another effective way to invest in the yellow metal.

Exchange-Traded Fund (ETF) is a security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange at approximately the same price as the net asset value of its underlying assets/commodity over the course of the trading day. Gold ETF is an open ended exchange traded fund, listed on the stock exchange, available for trading with an intention to offer investors a means of participating in the gold bullion market without the necessity of taking physical delivery of gold. A Gold ETF is designed to provide returns that, before expenses, closely correspond to the returns provided by domestic price of Gold. However, the performance of the scheme may differ from that of the domestic prices of Gold due to the expenses and/or the other related factors. All gold bullion held in the scheme's allocated account with the custodian shall be of fineness (or purity) of 995 parts per 1000(99.5%) or higher.

An Individual who is a resident of India, Non Resident Indian, Foreign Institutional Investor registered with SEBI, Banks and Financial Institutions, Companies, Trusts and Cooperative Societies, Partnership Firms, a HUF, Mutual Fund registered with SEBI, etc., can invest in Gold ETFs. A Demat account and registration with the broker (member of NSE) is mandatory for the investors willing to invest in Gold ETFs.

An investor can either invest in these ETFs during New Fund Offer (NFO) periods, when the scheme is launched or buy Gold ETF units from Stock Exchange. Investing during the NFO period would attract entry load, which differs from one Mutual Fund to the other, and have a minimum investment amount. Post NFO, however, would not attract entry charge, but a brokerage charge of as low as 0.4-0.5% would be levied by the stock broker.

The advantage of Gold ETF, firstly, is that, it can be easily sold in the secondary market on a real-time basis (i.e. at the prevailing market price) whereas, while selling physical gold, the

jeweller will deduct some charges. The second advantage is storing. Investors do not have to worry about the storage and security aspects that are typically associated with investing in physical gold. Thirdly, it is ideal for retail investor as minimum lot size to trade is one unit on secondary market. Fourthly, ETFs have a transparent pricing mechanism. Finally, Gold ETFs assure purity of gold. As per SEBI regulations, the purity of underlying gold in Gold ETFs should be 0.995 fineness and above.

As a coin has two sides, Gold ETFs also suffer from a few limitations like, the returns on Gold ETFs may be hampered, due to factors such as entry loads and annual fund management charges levied by the fund house on the fund's NAV and Gold ETFs are made up of gold contracts and derivatives and can only be redeemed for cash, never for gold itself.

Gold Etf: A Strong Asset Class

In the times of growing uncertainty about the global economy, volatility in the equity markets and the weakening of Indian Rupee against the US Dollar has set the gold prices soaring to record highs, hugely benefiting the investors of Gold Exchange Traded Funds (ETFs). The graphs 1 and 2 show the five year movements of S&P CNX NIFTY and Gold prices during 2006-10.

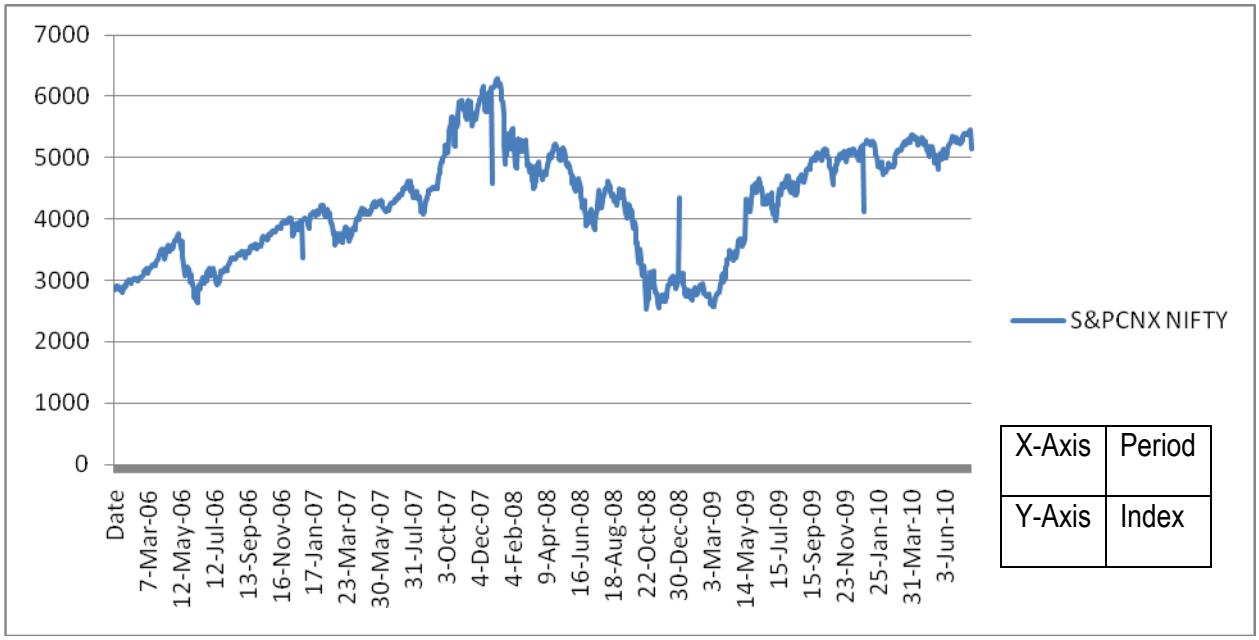
It is clear from graphs 1 and 2 that there exists a lot of volatility in the equity market as compared to the prices of gold. In the light of the persistent volatility in the equity markets, gold, as an asset class, has once again started to gain the investor's admiration vis-à-vis the equities.

The increasing demand for gold is also evident from the growth in the Assets Under Management (AUM) of Gold ETFs. During the period April 2010-May 2010, the AUM of Gold ETFs has surged by nearly 10% from Rs 1,650 crore to Rs 1,815 crore. In fact , the AUM has risen by more than 100% in the past one year — the highest annual growth witnessed by Gold ETFs since their launch three years ago.[1]

---

1. Bakul Chugani Tongia., "Gold ETFs: Craze for safety adds to popularity", www.moneycontrol.com, June 3, 2010.

Graph 1
Five Year Movements Of S & P Cnx Nifty During 2006-10



Source: Computed from the data given in www.nse-india.com

Graph 2
Five Year Movements Of Gold Prices In Usd/Oz During 2006-10

Source: Computed from the data given in www.goldprice.org

While the rising valuation of gold has definitely added to these AUM figures, the mutual fund houses have also admitted to witnessing an increase in the number of investors for this product. In the last few years, the gold price showed an increasing trend and has touched Rs. 20,000 per 10 gms. The Volatility in gold prices is very less as compared to equities market instilling confidence in the minds of investors to possess gold as an asset.

Gold Etf: Risk Diversifier

Investment in gold is considered as a best way to mitigate the risk and hedge the portfolio. Small allocation (5 - 15%) of gold improves the consistency of portfolio performance.

The purpose of diversification is not to increase the returns, but to reduce the risk. The aim is to protect the value of portfolio against the fluctuations in any class of asset and this purpose is achieved when the different asset classes in a portfolio have either low or negative correlation with each other. Gold serves this purpose well by diversifying and stabilizing the portfolio and protecting it against the stock market fluctuations. Two portfolios are constructed one without Gold ETF(Portfolio A) and the other with Gold ETF (Portfolio B).

Table 2 shows the average daily return and risk of select securities namely Reliance Industries ltd., ICICI Bank Ltd, SBI and Gold BeES. All the select securities are the most actively traded

securities listed on NSE. In terms of average return, ICICI Bank Ltd. stood first followed by SBI, Reliance Industries Ltd. and Gold BeES. Whereas in terms of risk, it is observed that the lowest risk is in case of Gold BeES followed by Reliance Industries Ltd., SBI and ICICI Bank Ltd., exactly the reverse order compared to the average return. This shows that higher the risk, higher the return and lower the risk, lower the return.

The construction of the Portfolio A with Reliance Industries Ltd, ICICI Bank Ltd., SBI and Portfolio B with Reliance Industries Ltd., ICICI Bank Ltd. and Gold BeES and their risk-return is shown in Table 3. The selection of securities in the Portfolio is based on their active trading on NSE.

From the table, it can be observed that Portfolio A's (without Gold ETF) average return is high (33.02%) compared to Portfolio B's (with Gold ETF) average return (28.88%). At the same time, it can be observed that in terms of risk, Portfolio B is better compared to Portfolio A with a low risk of 21.16% as compared to 37% of the Portfolio B.

The Co-efficient of Variation is calculated to select the best portfolio which diversifies the risk. The co-efficient of variation of Portfolio B is low i.e., 0.73 compared to Portfolio A i.e., 1.12 suggesting the option of Portfolio B consisting of Gold ETF. This shows that allocation of a portion of investment in Gold ETF would diversify the Portfolio risk.

Table 2
Average Daily Return And Risk Of Select Securities

YEAR	Reliance Industries Ltd. (%)	ICICI Bank Ltd (%)	SBI (%)	GOLDBeES (%)
2007-08	66.24	-8.55	30.26	28.5
2008-09	-32.13	-55.32	-31.5	22.57
2009-10	41.83	189.81	96.63	7.82
Average Return	**25.313**	**41.98**	**31.8**	**19.63**
Risk (σ)	**41.83**	**106.26**	**52.32**	**8.69**

Source: Computed from the data given in www.nse-india.com

Table 3
Portfolios Risk-Return Analysis

	Portfolio A (%)	Portfolio B (%)
Average Return	33.02	28.88
Risk(σ)	37	21.16
Co-efficient of Variation	1.12	0.73

Source: Computed from Table 2

Gold Etf: Best Option

Having convinced about the inclusion of Gold ETF in the portfolio, the investor will be in a dilemma as to the selection of the best Gold ETF from the available Gold ETFs in the stock market. From graph 3, it can be observed that the closing prices of all the existing 7 ETFs (viz., Benchmark Asset Management Company Private Ltd., UTI Mutual Fund, Kotak Mutual Fund, Reliance Mutual Fund, Quantum Mutual Fund, SBI Mutual Fund and Religare Mutual Fund), since their inception, moved quite closely together and hardly any difference between the ETFs can be noticed. However, the low price indicated in case of Quantum ETF is due to the fact that the unit is approximately 0.5 grams whereas for other Gold ETFs it is one gram.

Earlier, the difference in the returns of Gold ETFs existed mainly due to the difference in the expense ratio. Therefore, the selection of Gold ETFs was based on lower expense ratio, as the closing prices of Gold ETFs were more or less the same. However, now in case of all Gold ETFs, the expense ratio is 1% of net average assets. Therefore, the return in case of all Gold ETFs is more or less the same as reflected in Table 4. Hence, inclusion of any Gold ETF in the portfolio of assets would diversify the risk.

Gold Etf: Tax Implication

There will definitely be a specific tax implication on an investment in a Gold ETF, which is similar to those on Debt Mutual Funds .

- The first step in understanding the taxation process is to determine the nature of the gains of the investor, which depends on the investment's holding period. A unit of a Gold ETF that is held for less than twelve months is treated as a short-term capital asset. Short-term capital gains will be added to income and taxed at the marginal income tax rate. Units held for more than twelve months are treated as long-term capital assets. Long-term capital gains are taxed at 20% (after allowing for indexation benefit) or 10% (without indexation benefit), whichever is less,thus, benefitting the investor in terms of lower incidence of tax.
- There would be no wealth tax.

- There is no security transaction tax (STT) because this is a non-equity scheme. STT is applicable only when shares are bought or sold.
- As far as the Dividend Distribution Tax (DDT) is concerned, it will be taxable in the hands of the investors if and when these Gold ETFs declare dividends.

Graph 3
Gold Etfs: Movement Of Closing Prices

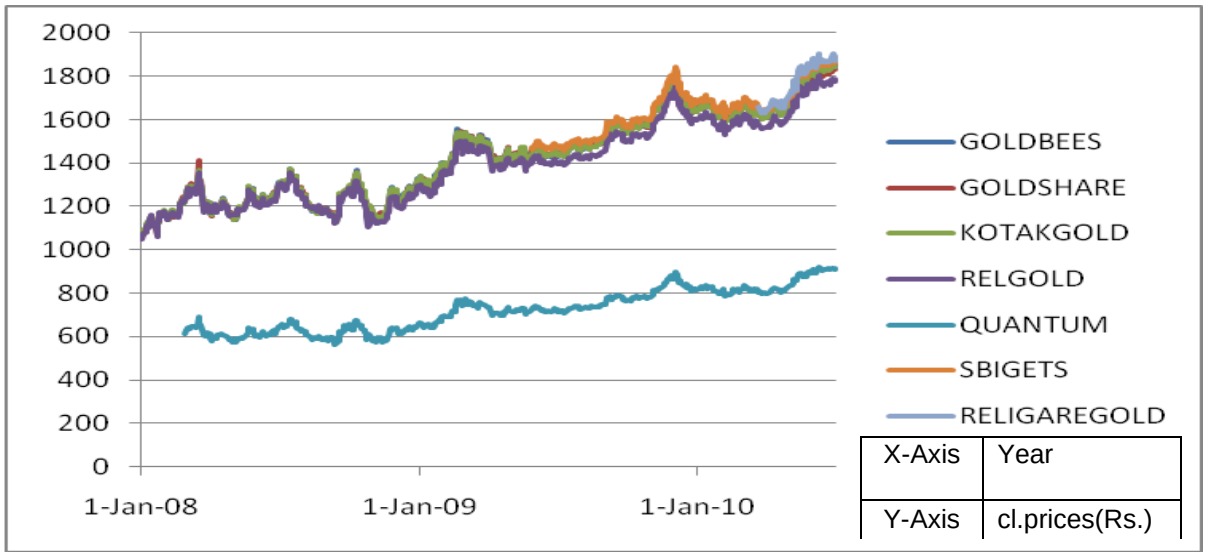


Table 4
Expense Ratio And Return Of Gold Etfs

Scheme	Expense Ratio (%)	6 Months Abs Return (%)	1 Year Return CAGR (%)	2 Yrs Return CAGR (%)
Gold BeES	1.00	11.84	27.82	22.84
Kotak GOLD ETF	1.00	11.84	27.42	22.62
Quantum Gold Fund	1.00	11.81	27.37	22.66
Reliance Gold ETF	1.00	11.84	27.37	21.76
Religare Gold ETF	1.00	-	-	-
SBI Gold ETF	1.00	11.57	26.49	-
UTI-Gold ETF	1.00	11.86	27.50	22.67

Source: Computed from the data given in HDFC New Fund Analysis offer document.

Findings

The findings of the study are:-

- The Volatility in gold prices is very less as compared to the equities market instilling confidence in the minds of the investors to possess gold proving it to be a strong asset class.
- Investment in gold is considered as a best way to mitigate the risk and hedge the portfolio. Allocation of a portion of investment in Gold ETF would diversify the Portfolio risk.
- As the return in case of all Gold ETFs is more or less the same, inclusion of any Gold ETF in the portfolio of assets would diversify the risk.

Suggestion

Initiatives are to be taken by the Mutual Funds offering Gold ETFs, Govt., SEBI and the Members of the Stock Exchanges for creating awareness among the investors.

Conclusion

Gold ETF is an emerging option of the various investment alternatives available to the investor. The low volatility of gold prices as compared to equity market, weakening of Indian Rupee against US Dollar and growing uncertainity about global economy resulted in the emergence of Gold ETF as a strong asset class. Allocation of a small portion of investment in Gold ETF would diversify the portfolio risk. The stabilisation of Expense Ratio made the task of selection of the best Gold ETF option easy. Inclusion of any Gold ETF in the portfolio of assets would diversify the risk. Gold ETFs also offer the benefit of lower incidence of tax. Inspite of the merits of holding Gold ETFs, the investment in the same is low due to the low awareness among the investors and the sentimental attachment of the investors towards holding gold in the physical form.

If the uncertainty over the global economies and volatility in the equity markets are to continue for some more time, Gold ETFs are bound to find not only more number of investors, but also more number of Mutual Fund players to launch them in the coming future.

References

Bakul Chugani Tongia., 2010 , “Gold ETFs: Craze for safety adds to popularity”, [online] Available at http://economictimes.indiatimes.com/markets/bullion/Gold-ETFs-Craze-for-safety-adds-to-popularity/articleshow/6005498.cms

Dipak Mondal, 2010, “Despite rising prices, gold ETFs look strong”, [online] Available at http://www.mydigitalfc.com/news-analysis/despite-rising-prices-gold-etfs-look-strong-755

Fisher, "Gold As An Alternative Asset Class: 5 Reasons to Invest", [online] Available at http://www.themoneyquest.com/2008/11/gold-as-alternative-asset-class-5.html

Fisher, "Gold ETFs: The Best Way to Invest in Gold", [online] Available at http://www.themoneyquest.com/2008/11/gold-etfs-best-way-to-invest-in-gold.html