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Investment Road Test

BetaShares Gold ETF

By Tony Rumble

PORTFOLIO POINT: Without the cross risk of the exchange rate, the BetaShares Gold ETF delivers what Australian DIY investors crave most: control.

I've been reading a lot of Scandinavian crime thrillers lately and since it's hard to avoid skipping to the ending to see "whodunit", this week it's appropriate to give eager readers the ending first. That's because this is the first investment product reviewed in this column that scores a perfect 5: a great product, giving clean exposure to an asset that should be in everyone's portfolio.

The new Betashares Gold ETF (ASX: QAU) is a low-cost way to buy physical, allocated gold without the currency risk that has destroyed Australian dollar investment returns on this valuable asset class.

Gold is an asset that many investors misunderstand. That's because it has the character both of an asset in its own right, as well as behaving like a currency. When denominated in US dollars, its price moves in line with exchange rates – making its volatility and correlation with other assets harder to understand than some other assets. But it also performs a valuable role in markets experiencing rising inflation: because of gold's scarcity (and portability), the value of gold tends to rise in times of inflation. Because of its tendency to hold value and appreciate during inflationary periods, gold is also attractive to sovereign investors.

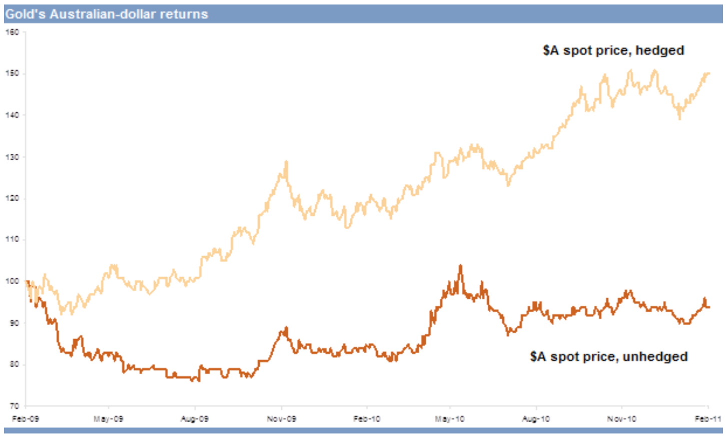
Many countries that 20 years ago were in economic and financial turmoil, now find themselves holding net surpluses (China, Russia and many emerging economies) – and apart from buying US Treasury bonds, these nations have been steadily buying gold for at least the past decade. Add this to the demand for gold coming from OPEC members, and it's easy to see why gold is appreciating in value (and is expected to continue to do so for some time).

The Australian dollar-hedged price of gold has beaten the local sharemarket returns over the last one, three, five and 10-year periods. During that time it has also beaten the returns of international equities, as well as domestic bonds. Gold is also relatively uncorrelated with shares and bonds, making it a good way to add diversification to portfolios.

There are a number of ways for Australian investors to buy gold. They can buy it physically, holding it themselves or through custody services offered by the likes of the Perth Mint. Self-storage is risky and using a bank security box is relatively expensive. Perth Mint facilities are useful but somewhat cumbersome (more paperwork, less than instant access, relatively high minimum costs).

The other gold ETF available in Australia has been a useful way for investors to buy smaller parcels of gold exposure. The ASX listed ETF "GOLD" is a relatively low-cost mechanism providing the liquidity of ASX shares, but with the exchange rate risk entrenched (GOLD trades in Australian dollars but references the US dollar price of gold).

It's the currency exposure that has undermined Australian returns for typical gold investors since the end of the GFC: while the Australian/US dollar hedged price of gold has risen by 50% since 2009, the un-hedged return is –6%. No wonder investors here are confused about this important asset class!



Source: Bloomberg, BetaShares

The BetaShares Gold ETF uses a managed investment scheme structure to hold physical gold for investors. (And for investors spooked by the words "managed investment scheme" – even though these were the vehicles through which many failed agribusiness investments were issued – this is a simple vehicle in which your assets are held on trust by an ASIC-licensed "responsible entity," and is the dominant way that most traditional managed funds are issued).

BetaShares Capital Ltd is the responsible entity for all the ETFs issued by BetaShares, and for its Gold ETF, JPMorgan Chase has been appointed as the custodian of the physical gold held within the fund. Physical gold is transacted for the fund using Royal Bank of Canada. The cost for these custodial arrangements is 0.10% pa – a small price for the security provided.

BetaShares provides data showing the serial numbers, purity, etc for each of the gold bars held by the fund.

The ASX listing of the Betashares Gold ETF means that it is accessible to any investor with a broking account – and can be purchased in small amounts sizes, suitable for smaller investors.

The base cost of the BetaShares gold ETF is 0.49% pa (ie, total costs including custody are 0.59% pa). This buys the ETF units and covers the costs of issuing and managing the investment – including the currency hedging in place. This hedging uses a simple mechanism, where the exchange rate is hedged each month. At the end of each month's hedging contract, the hedging "forward" contract is rolled over, buying cover for the following month.

This hedging mechanism is not without risk, but understanding this risk is simple and discloses one of the intrinsic values of this investment.

Forward contracts simply mean that an investor buys the right to sell a currency for settlement at the maturity date of the contract; in this case, one month from inception. When the forward involves a high exchange rate currency being hedged against a low exchange rate currency, the forward rate pays a positive return from the low rate currency to the high rate currency. This means, in lay terms, that in current market conditions, the BetaShares gold ETF receives a positive return (estimated at about 4% pa) from its currency hedging activities. This is in addition to the underlying price movements in the gold price.

This illustrates the risk involved in currency hedging. "Rolling" one month currency forwards expose the investor to "rolling risk"; eg, the risk that market conditions change when the position needs to be renewed. But since the positive carry in the actual hedging used by BetaShares is linked to the gap between Australian and US dollar interest rates, investors can be confident that this isn't going to change anytime soon (and as it does, investors will certainly be able to see it happening!).

The other "risk" (and potential detriment) for holders of the BetaShares Gold ETF in comparison to buying unhedged gold, is that as and when the US dollar starts to appreciate against the Australian dollar, unhedged US dollar assets will gain in value for investors that bought those assets using Australian dollars.

But this turnaround in exchange rates may not happen for some time yet. High interest rates (linked to the commodity super cycle) are with us in Australia for some time yet (read the RBA website if you don't think so). And intrinsic demand for Australian assets compounds the strength of our dollar. Compare that to the massively devalued US dollar and you can see how slow the journey back up will be for the US dollar.

In fact, this shows the utility of the BetaShares Gold ETF. If you want to add currency exposure into the mix in your portfolio, there are plenty of ways of doing so. (For example, BetaShares also offers its own US dollar currency ETF). But by providing specific exposure to the price of gold in Australian dollars – the currency you consume when you spend your investment returns – without the cross-risk of the exchange rate, the BetaShares Gold ETF delivers the key investment attribute that Australian DIY investors crave the most: control.

Because the data tells us that gold is an asset that most investors will benefit from holding, and because the currency risk is a severe dampener of returns to Australian investors, the BetaShares Gold ETF provides a valuable investment mechanism to an important asset – and deserves the first 5/5 rating awarded by this column for Eureka Report readers. ◆

The score: 5 stars

1.0 Ease of understanding/transparency
1.0 Fees
1.0 Performance/durability/volatility/relevance of underlying asset
1.0 Regulatory profile/risks
1.0 Innovation

Tony Rumble is the founder of the ASX-listed products course LPAC Online. He provides asset consulting and financial product services with Alpha Invest but does not receive any benefit in relation to the product reviewed.