Gold Exchange Traded Funds: Current Developments and Future Prospects in China

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Abstract

The gold exchange traded fund is a burgeoning product to invest in gold. It has very positive significance as foreign exchange, financial safety and avoiding inflation to a country. At the same time, it is convenient to invest in gold exchange traded funds for small and medium-sized investors and extremely welcomed by market. However, most of the investors don't understand gold exchange traded funds. This study was designed to clarify this understanding with the help of literature and analyze the developments of gold exchange traded funds and future prospects, specifically in China.

Keywords: Gold, China, Gold ETF, Development, Yellow metal

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1. Introduction

In today's financial markets exchange traded funds (ETFs) are considered a highly valuable mean of investment. The ETFs has emerged as most successful innovation and ETFs industry shown rapid growth in last decade, with a 5-year average annual growth rate of 33 percent (Schuster, 2008). Fuhr (2001) described that almost two or three ETFs are on the list of the top five most actively traded stocks in the AMEX. ETFs are an extremely successful form of basket securities, which enable investors to trade a portfolio easily and quickly in a single transaction. Further, exchange traded funds permit investors to obtain the benefits of portfolio diversification and track the performances of underlying indexes without incurring high transaction costs (Lin et al, 2006).

Exchange Traded funds (ETFs) are open ended index funds that are listed and traded on exchanges like stock equity based on the price of metal. Ferri (2007) defined ETFs as "ETFs are baskets of securities that are traded, like individual stocks, through a brokerage firm on a stock exchange." The first bonafide ETF was launched in US in 1993, a tradable depositary receipt for a portfolio of index stocks held in a unit investment trust. It was called the S&P Depositary Receipt, and it also tracked the S&P 500 Stock Index (Lofton, 2007).

However in China the first ETF was launched in 2004. Since then ETFs have become a key innovation in the Chinese exchange based markets (Hsu et al, 2009). Presently, there are five ETF listings, and assets under management for the five ETFs are USD 5.2 billion (Hsu et al, 2009). ETF are mainly in Gold, Silver, Platinum and Palladium. However, the focus of this study was Gold ETFs.

Gold ETFs have gained greater significance as successful mean of investment in the last decade. The recent global financial crisis increased the demand for gold hedge. The value of gold holdings with trading exchanges has continued to increase since last decade. The major data of the world seven largest gold ETFs indicates that, the total holdings of the world's seven largest golden ETFs are 1383.8 tons. At the same time in order to hedge

the stock market turmoil, the housing market problems are constantly emerging, and other credit crunch in the area, due to which the demand for gold gradually increased. The gold ETF (exchange-traded index funds) provides a convenient way to the investors to intervene in the gold market.

The purpose of this study was to analyze the development of ETFs in Chinese financial market, particularly the development of Gold ETFs. The study is designed to serve as a tool for investors searching the opportunities in ETFs. Further, the study also helps in realizing the level of competition other actively managed mutual funds will face due to these ETFs in the years ahead.

The rest of the paper is organized as follows. Section 2 introduces the gold ETFs and current status of gold ETFs in world. Section 3 analyzes the economic significance and prospects of gold ETFs in China. Section 4 presents some inherent advantages for Chinese investors to invest in gold ETFs. Section 5 discusses important obstacles to gold ETFs development in China and final section concludes the paper.

2. Literature Review

2.1 Gold ETF Overview

Gold ETFs are defined in several ways. According to Bang (2009) gold ETF is basically an open-ended mutual fund that invests in standard gold bullion as its underlying asset. It is also known as paper gold. These instruments are listed on the stock exchanges and, hence, can be bought and sold just like buying and selling of shares.The first gold exchange-traded fund was launched in March 2003 on the Australian Stock Exchange (Bloomenthal, 2008). In U.S. the Gold ETF trading began on the New York Stock Exchange (NYSE) in 2004. These ETFs are traded under the symbol “GLD”. Different people define and perceive GLDs differently. Some people perceive that they will own physical gold by investing in the shares of Gold ETFs. However, it’s not the right perception. The objective of GLDs is not to provide investors with the opportunity to own gold bullion by investing in the shares of gold ETF. Rather, gold ETFs are designed to track the price of gold.

Gold ETF Index Fund is a kind of gold-based assets. It tracks the gold price and each share represents one-tenth of an ounce of gold. With transaction convenience, storage security, transaction costs and low liquidity, transparency of transactions and many other investment advantages, gold ETF has become widely accepted.

Jill Leyland Economic Advisers to World Gold Council said that the unlimited potential of gold ETF is of high interest for those countries who have not yet introduced such products. He further pointed out that, in addition to insurance funds, other agencies such as public funds, sovereign wealth funds, investment to gold ETF's also raise the demand for gold. Nedeljkovic (2005) described that Gold ETFs, compared to some other structured products, are very simple structures. He further, described that there is no credit risk and investment in Gold ETFs is accessible and simple. Gold ETFs are listed on a stock exchange, quoted in local currency, with no minimum investment. The other considerable characteristics of Gold ETFs are their cost effectiveness, security, and high liquidity (Nedeljkovic, 2005).

Several studies have been conducted about ETFs, their trading characteristics and benefits (Gallagher and Segara, 2005; Jares and Lavin, 2004 and Kostovetsky, 2003). Milonas and Rompotis (2006) conducted a study on the performance and the trading characteristics of the ETFs. Gastineau (2001) described the origin, main types and the benefits of ETFs. Carty (2001) confers several characteristics of ETFs like flexibility, convenience, risk diversification, tax efficiency and cost advantages. However, the current study concerns the Chinese Gold ETFs and the prospectus of Gold ETFs development in China.

2.2 The Status of the Global Gold ETF

Currently, ETF demand for gold has become the fastest growing area; its growth rate is higher than jewellery and industrial consumption. The demand for gold ETFs and similar products is rapidly increasing over the time; t able 1 indicates this increase. ETF demand in 2009, at 594.7 tonnes, was 85 percent higher than in 2008.

Insert Table 1 here

According to statistics, the first gold ETF since its inception in March 2003, approximately attracted 180 billion U.S. dollars investment, which is equivalent to 650 metric tons of gold, accounting for 10 percent of the world's total demand. During this period, the price of gold also rose to almost double. Before the introduction of the gold ETF there was no direct involvement in commodity markets to hedge the risk of the stock and bond markets. At that time the main investment was through the purchase of gold stocks and funds to hedge risk, but such ways that lacks transparency, liquidity, and also bear gold mine operations and the risk of mismanagement. Ross Norman (2010) an internationally known gold analyst at The Bullion Desk, said gold ETF market has greatly improved its availability in a short time. The first gold ETF listed on the Australian Stock Exchange (ASX)

launched under the symbol "GOLD", has made a very good introduction to the sales, just in June raised on 340 million ounces of gold, this also attracted the international community to the gold ETF. As the New York Stock Exchange's successful listing Street TRACKS Gold Shares, gold ETF open a prelude to a rapid development. Since then, the United Kingdom, South Africa, Switzerland, India and other countries also have launched similar products; table 2 indicates the major gold ETFs traded in the world. Gold ETF trading gold on the widened channels, one hand improved the international market gold demand, and on the other also expands the market capacity.

Insert Table 2 here

3. Gold ETF Market Prospects in China

China is the world's largest gold producer and second largest consumer. Gold production in China is mainly concentrated in Shandong, Henan, Fujian, Liaoning, Hunan, Shaanxi and other places. At present the prices in China's gold market, are gradually align with the international gold market. In 2007 China's output of 276 tonnes of gold, made it the world's largest for the first time following South Africa which produced 272 tonnes (Mathews, 2008). With the continuous improvement of people's living standard, China's gold consumption maintains sustained growth, in 2008-09. China is the world's second-largest consumer of gold after India with last year's consumption of 427.5 tonnes (Subramani, 2010). China's gold reserves also show an increasing trend and reach to 1054 tonnes in 2009. However the gold share of national foreign exchange is still very small at 1.5 percent and US dollar and securities reserves are quite high as indicated by the table 3.

Insert Table 3 here

According to the above table statistics China is sorely short in gold reserves as percent of its total foreign reserves. All other four main industrial countries have almost 65 percent of their reserves in gold. This data also reflect the need of more investment in gold and gold related products like ETFs in China. However, while launching gold ETF China has to consider some of the micro and macro-environment factors.

Gold ETF is a kind of gold investment, so like gold market related factors also affect the gold ETF investments. China's micro environment factors arte highly feasible for launching Gold ETFs. Financing the supply side, China's household savings is higher than other countries, and has sufficient capital supply. In addition, the structural imbalances of China's economic growth lead increase in foreign exchange reserves. This significant increase in reserves, causing excess liquidity into the stock market and real estate market, and increase in stock prices and real estate prices. Finally, this has enabled long-silent household savings. This caused presence of ample funds in market. Gold prices in China and world are increasing continuously. This continuous increase in gold prices attracted domestic investors, who are keen to take advantage of favorable conditions.

Chinese government policy-makers need to consider the question of how monetary policy in line with international standards, and how to link China's currency with gold to avoid risks associated with access dollar reserves. We may refer to US dollars and Euro at the global level linked to the gold. The issue of how China should learn from international experience and can it separates itself from gold is underpinning. China's highest foreign exchange reserves in world and recent financial crisis in US heave the question how to avoid risks. These economic situations have placed in front of decision-makers a great problem. In this severe situation when China needs to increase its gold reserves as well as to decrease portion of US dollar reserves in comparison with gold. Gold ETFs can provide a better solution to such crisis situations. Therefore, the introduction of gold ETF in China is principally significant. Another important factor highlighting the significance of Gold ETFs in China is threat of inflation. The investors are always cautious about inflation so Gold ETFs are an improved alternate to such investors.

4. Benefits of Investing in Gold ETFs

Gold ETF is like a bank wherein an investor can store his gold in an electronic format to thwart the threat of all forms of hazards and hassles that arise out of holding physical gold. Gold ETFs have several benefits as compared to physical gold. Some of them are as follow:

- Investing in Gold ETFs has no risk like cheating, mixing, physical and chemical impurities. In gold ETF, the problem of quality concern does not arise because the gold is in its purest form. Whereas, in buying physical gold such impurity dangers are always present.
- Storage is a key issue in case of buying physical gold. Bank lockers have emerged as an alternate to home storage to safe gold from the danger of theft. However, investing in gold ETFs is quite safe, as the gold in this case is stored electronically.

- The investors in physical gold lose a significant portion of their gold as making charge, during sale and purchase of gold. However, gold ETFs are in electronic form and no making charges are involved, so there is no such risk of losing money.
- Another great advantage of gold ETF is for small investors as with the introduction of gold ETFs it is possible to buy gold in small quantities, even to 1 gram. However, buying gold at such a small scale was not easier, from the physical market.
- Another important benefit of gold ETFs is uniformity in pricing. Whereas, the prices of physical gold varies from market to market and sometimes from vendor to vendor.
- Since producing more gold is far more difficult than issuing new currency and its value does not rely on any particular government's health, it is used in times of high inflation to protect wealth.
- Cost efficiency – No holding cost or other cost
- Liquidity- can be sold anywhere.
- Tax Efficiency

5. Obstacles in Development of Gold ETFs

The ETF offerings in China are not so diversified and are mainly concentrating on traditional large-cap activities. The current ETF offerings are unable to meet the needs of investor, due to lack of innovation and diversification. The development of gold ETF in China is little compared to its capacity. The gold ETF growth faces certain obstacles; some of them are as follow:

- Lack of knowledge about gold and gold related securities is the major problem in growth of gold ETFs in China. Particularly, at retail level knowledge regarding ETFs is quite limited. An important cause of this is lack of analysts covering gold and gold related products.
- Another important obstacle caused by lack of related products' knowledge is, it lower downs market involvement, which prevent assets' managers to launch new products to the market.
- A usual perception that gold is a marginal and speculative asset with no real intrinsic value is also a hindrance in the way of gold ETFs development.
- Regulatory obstacles are also considered important.
- Investors' low participation in gold ETFs is also causing problem in its growth.
- Technical challenges like single market limitation also obstruct the gold ETF development in china.
- Most people perceive ETFs and Open-End funds in the same way, while inherent differences exist between the two, which are given in table 4. This misperception is also causing problem in growth of ETFs.

Insert Table 4 here

6. Conclusions

China's has significant need of gold ETF as national security strategy, as well as also individuals and institutional need to maximize their profitability. Hence, we can forecast gold ETF in China will have extensive prospects for development. China needs to reconsider its policy regarding Gold ETFs. The Chinese government needs to encourage and facilitate gold buying by the Chinese public. Past trend in China also indicate that Chinese have a long-term love for gold. According to Reuters, in last quarter of 2009, China had surpassed India as the world's largest gold buyer, for the first time in recorded history. Though India retained its position quickly, but Chinese consumption still is encouraging. The savings in china are also high. The circumstances in China are favorable for Gold ETFs. If only one ounce purchased by each of the 80 million middle-class Chinese would equate to 2,500 tonnes of gold. This will lead an increase in Chinese gold reserves as well as more opportunities for investors. Concluding the arguments, investments in Gold ETFs in China are significant. The launch of Gold ETFs will improve the China's ability to deal with problems such as diversification, inflation protection, currency hedging. Due to time and resource constraints, and lack of prior research in the area the study lacks empirical investigation. Future researches can investigate it empirically.

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Table 1. Identifiable gold demand (tonnes)

	2007	**2008**	**2009**
ETFs & Similar Products	**253.3**	**320.9**	594.7
Jewelry consumption	**2,404.8**	**2,186.7**	1,747.3
Industrial consumption	461.7	435.5	367.6

Source: World Gold Council, 2010

Table 2. The Major Gold ETFs Traded in the World

Name of Gold ETFs	**Exchange Traded on**
Gold Bullion Securities(GOLD)	Australia
Street TRACKS Gold Shares ETF(GLD)	New York/ Singapore
iSHARES COMEX Gold Trust(IAU)	America
Market Vector TR Gold Miners(GDX)	America
LyxOR Gold Bullion Securities(LyxOR GBS)	London/Europe
New Gold Debentures	Johannesburg, South Africa
ZKB	Switzerland
GOLDIST	Turkey
Benchmark gold ETF	India
UTI Mutual Fund	India

Source: Bloomberg

Table 3. Comparison of China's foreign reserves with highly industrialized countries

Country	Total foreign exchange reserves	Percent gold reserves	**Tonnes gold**
USA	**$83,000,000,000**	**68.7%**	8,134
Germany	**$189,000,000,000**	**64.6%**	3,408
Italy	**$129,000,000,000**	**63.4%**	2,452
France	**$126,000,000,000**	**64.2%**	2,435
China	$2273,000,000,000	1.5%	1,054

Source: Vronsky, 2009

Table 4. Major Differences between ETFs and Open-End Funds

ETFs	**Open-End Funds**
Priced and traded continuously throughout the day.	Priced and traded at NAV and the end of the trading day.
Investors buy and sell shares on an exchange with other shareholders.	Individual redemptions with the fund company at the end of the trading day.
Purchase and sale of shares has no tax effect for other shareholders.	Large redemptions may result in a capital gains tax distribution for non-redeeming shareholders.
The in-kind redemption process reduces the tax liabilities of shareholders.	Fund managers have limited ability to manage taxes because of cash redemptions.
Like stocks, can be traded with limit orders, stop limits, and can be sold short.	Limit order pricing and short selling not available. Transactions are completed at NAV at the end of the trading day.
Can be bought and sold on margin.	Funds cannot be bought and sold on margin.
Low to moderate expense ratios as most client services are shifted to the brokerage firms.	Low to high expense ratios depending on client service costs' possible sales loads.
Can be bought and sold through any brokerage account.	Availability through brokers depends on negotiated selling agreements. Not all funds are available through brokerage firms and must be purchased from the fund company.
Normal brokerage account commissions apply.	No-load funds bought directly with a fund company have no transaction charges. Load funds and no-load funds bought through a broker usually charge a sales load or a commission charge.

Source: Ferri (2007)