

Possible Hidden Dangers in ETFs – even GLD

There is Danger in Holding ETFs Long Term

by

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In my big picture assessment, I look at the world markets by looking at the performance of various ETFs that represent the markets. And I used to believe that ETFs were great trading vehicles to own long term. However, it's recently come to my attention that sometimes ETFs do not actually own what they are represented to own and that could be very dangerous to your wealth in this economic climate.

In fact, some of them might be a lot like derivatives. It's great if you own derivatives and they move in your direction, but it's worthless if the party that wrote the derivative in the first place cannot honor its end of the bargain.

The following warning, about ETFs in general and GLD in particular, falls under the heading of worst-case contingency planning. There are many traps in this economic climate that you need to be aware of. This one has only just come to my attention.

Let's look at the case for GLD as an example.¹ If you own this ETF, you probably know that it is somewhat like owning gold...and some people think it is the same as owning gold bullion. But there is a big difference. Theoretically the GLD Trust owns 850 tons of gold, but it might not really own that much gold. In fact, it might not have much real gold at all.

Why? Well, in the GLD Trust Prospectus (November 2004) you will find that it has no way of really guaranteeing how much gold it does own. In truth, GLD has no way of knowing whether the gold that is held in trust for it is actually there or not. It could be that the bank that is holding it already has it leased out. In other

words, banks could be playing the same game with gold that they do with your money. They hold your money on deposit, theoretically, but most of it is given out in loans. And what happens if the bank that is leasing out your gold fails? Do you think the government will bail them out so that you get your gold back? What if they actually tell you in the Prospectus that there is substantial risk involved and that it is much more substantial than a drop in the price of gold?

People have been worried about the government confiscating gold. But what would happen if 850 tons of gold (about \$25 billion worth) suddenly disappeared? I'm not sure, but the disappearance of \$25 billion worth of it would certainly be a blow to the financial system.

GLD, and I'm just using this as an example of what might be the case with other ETFs, has no way to legally determine if the gold being kept by the custodian (which is the European bank HSBC) is actually in the Custodian's vault. HSBC has the right to use other banks as "subcustodians" to keep the gold safe. And those subcustodians could actually use other subcustodians of their own.

The way GLD is set up, there is a series of legal barriers that prevent anyone from verifying if the gold is in the vault or leased out. Thus, GLD could have nothing to actually back up the 850 tons of gold it claims to have. Is GLD another financial Ponzi scheme, but with good intentions?

The Prospectus

The ability of the Trustee to monitor the performance of the Custodian may be limited because under the Custody Agreements the Trustee may, only up to twice a year, visit the premises of the Custodian for the purpose of examining the Trust's gold and certain related records maintained by the Custodian (p. 37).

The Trustee and auditor are not allowed to visit the Custodian "when no gold of the Trust is held in the Custodian's vault." (p. 48). And this could occur when it is being held by subcustodians. Thus, the Trustee of GLD has a limited ability to determine what the Custodian is doing and no ability to determine what the subcustodians (at any level) are doing. "The Custodian is not responsible for the actions or inactions of subcustodians." (p. 44) And the Trustee has no right to audit the gold or even any financial records about the gold of the subcustodians.

"In addition, the Trustee has no right to visit the premises of any subcustodian for the purposes of examining the Trust's gold or any records maintained by the subcustodian, and no subcustodian is obligated to cooperate in any review the Trustee may wish to conduct of the facilities, procedures, records or creditworthiness of such subcustodian." (p.37). Furthermore, the Prospectus states that "because neither the Trustee nor the Custodian oversees or monitors the activities of subcustodians who may hold the Trust's gold, failure by the subcustodians to exercise due care in the safekeeping of the Trust's gold could result in a loss to the Trust." (p. 12).

Current subcustodians appear to be one US bank: JP Morgan (which has \$US93 trillion in derivative exposure).

One Canadian Bank: The Bank of Nova Scotia.

And four European banks: the custodian, The Bank of England, Deutsche Bank AG, and UBSAG.

All of these banks actively lease gold.

However, it gets worse. The GLD trust does not insure its gold. According to the Prospectus, only the Custodian is responsible for insurance and "shareholders can not be assured that the Custodian will maintain adequate insurance" (p. 11). Furthermore, "Custodian and the Trustee will not require any direct or indirect subcustodians to be insured or bonded" with respect to gold held by the subcustodians on behalf of the Trust (p. 11). "Consequently, a loss may be

suffered with respect to the Trust's gold which is not covered by insurance and for which no person is liable in damages" (p. 11). If subcustodians are used outside of the U.S., it may be difficult or impossible to seek legal remedy against the subcustodians (p. 12). This is significant because the Custodian's primary vault is in London. The subcustodians' vaults can be anywhere in the world.

A further source of risk is the possible insolvency of the Custodian, HSBC.. How solvent do you think banks are these days? And if the subcustodians fail to return any gold that they have to the HSBC, there is no contractual obligations that can be enforced.

According to Tom Dyan in *Daily Wealth* on Monday Feb 23rd, the European banking system is about to collapse. And it is this banking system that holds the gold in the GLD Trust. The *Daily Telegraph* reports that European banks may have to write off \$25 trillion in comparison to the \$1.8 trillion written off by U.S. banks. This is because they have lent aggressively to Emerging Europe, which has imploded and been even more aggressively involved in the subprime debacle than their U.S. counterparts. Furthermore, they have no printing press like the Federal Reserve to print trillions of Euros to exchange for the junk debt like the U.S. has.

Lastly, banks and corporations have been geniuses at hiding what they are doing from the public.

Greenspan said, "I always believed that banks would police themselves to control risk." However, my impression of most banks is that they don't even understand risk. They've had rogue traders costing them a billion dollars a year. They've basically built up derivative exposures that equal many times the wealth of the world (only a small percentage of which has imploded so far). And, they've basically created much of the financial mess we are in today. They are also closely tied to the politics of most countries. For example, who was at the Swiss Conference at Davos to solve the world's financial problems? It was politicians,

bankers, and some of the world's richest people. So do you trust banks to look after your gold that you might have through GLD? I wouldn't.

GLD is probably fine for short term trading. However, for holding long term positions, it could become a disaster. And if one of the most well known ETFs is organized this way, it suggests that you should really look at the prospectus of any other ETF that you plan to hold for any length of time... especially under the current economic conditions.

1.. This information was first pointed out to me in an article written by Dave Kranzler posted in a blog: <http://www.rapidtrends.com>.

About Van Tharp: Trading coach, and author, Dr. Van K. Tharp is widely recognized for his best-selling book *Trade Your Way to Financial Freedom* and his outstanding Peak Performance Home Study program - a highly regarded classic that is suitable for all levels of traders and investors. You can learn more about Van Tharp at www.iitm.com