A Practical Guide for Investors

How to Buy Gold and Silver Today

Jerry White

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A Practical Guide to a Balanced Portfolio

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2014 Edition

TradersGame.com Gold & Silver Series

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Introduction & Background

How to acquire the four main precious metals (gold, silver, platinum and palladium) for long-term investment is the subject of this book. It is a guide addressed to individual investors and to their financial advisors who are familiar with investing in stocks and bonds but have little experience with precious metals.

Liquidity and insolvency in a world of debt

Entitlements and debt

The spending that produces annual budget deficits in the US and other developed countries pays for the public benefits that keep politicians in power. The deficits are financed by borrowing, which advances consumption (*Buy now – Pay later!*) at the expense of future generations, who will be left with the debt and the interest cost to carry it. But US public debt has grown so large – and is still growing – that it is doubtful that our children and their children can ever repay it.

With an aging population in the US, the future costs of Medicare, Medicaid and Social Security will continue to rise. Adding to entitlement costs, layoffs and lack of new hiring in a weak economy has led to a massive increase in families receiving food stamps, individuals on disability, and ex-students with loans they can't pay.

In the long run, entitlement costs must either be reduced by cutting benefits or paid for by increasing tax revenues or financed by more debt. Each of these paths is problematic. Not surprisingly, politicans refuse to cause pain to their constituents by reducing government programs. An increase in tax revenues requires either robust economic growth or higher tax rates. The US government's "growth policies" (including uneconomic clean energy and expanding entitlements) and Obamacare's disincentives have been ineffective at stimulating hiring, resulting in relatively few small-business starts, a general curtailing of new business investment, and reduced consumer spending. Immigration has led to increased competition for jobs at the lower end of the job market, just where new hiring is concentrated – in low-paid and part-time jobs in food-service and retail. That leaves the default solution of financing entitlements with more debt.

Growing debt typically leads to rising interest rates, which would balloon the Treasury's debt-servicing costs. To keep debt service costs low, to stimulate housing-market recovery by keeping mortgage financing costs low, to promote rising equities prices for their "wealth effect", and to maintain liquidity in the shadow banking system involving rehypothecation of collateral and interbank lending in the face of deleveraging (due to falling trust among money-center banks themselves), the Fed through its policy of *quantitative easing* has been buying Treasury bonds, thus both enabling the government's deficit spending and inflating the money supply. As the Fed cuts back on the quantity of bonds it buys, other buyers will have to be induced to buy Treasuries, likely only at higher interest rates.

When interest rates inevitably rise, debt-servicing costs will take an increasing share of the Federal budget, eventually ushering in confiscatory tax rates and impacting the entitlements that politicians have committed to pay out.

Financial system stresses are global – and growingl

Stresses in the US financial system are consequences of the housing bubble, when Americans were encouraged to buy homes they couldn't afford and to finance the purchases by borrowing, and in which US banks securitized the homeowners' risky mortgages through issuance of trillions of dollars of derivatives.

Major European banks – traditional buyers of their governments' bonds and, in several countries, lenders in the recent real estate boom and bust – have inadequate capital to support their outstanding loans. Many are probably insolvent. To hide their insolvency they are permitted to value their assets (private loans and government debt) at fantasy prices.

Borrowing costs of several European governments have reached unsustainable levels leading them to come begging to special-purpose bailout funds set up by European governments for this purpose, to bail them out – that is, to lend them money so they can provide liquidity to their insolvent banks, which can then use the funds to buy more government bonds, thus increasing the governments' debt further.

Liquidity, however, cannot solve the banks' *insolvency* and therefore fails to restore confidence. Governments that are heavily in debt have done little to reduce their need for borrowing, citing an aversion to *austerity* (that is, living within their means). Meanwhile, the special-purpose bailout vehicles, funded largely by promises of insolvent countries who themselves will eventually need bailouts, are grossly inadequate. Thus, the debt and insolvency problems have not been solved, and quiet times are temporary.

As borrowing continues, there is a growing shortage of high-quality assets (that is, collateral), so default risk is rising. With banks overly leveraged, a relatively small loss could trigger a bank run and require a bank to be nationalized like Dexia was, or liquidated, resulting in losses both to depositors (as in the Cyprus "bail-in") and to other banks, possibly triggering a global cascade of bank failures. Bank depositors have started to withdraw their money from local banks, thus further reducing the banks' working funds.

The problem is not limited to the West. For many years China's outsized economic growth was financed by easy money policies, enabling a building boom on a massive scale. Today, China's four biggest banks are saddled with huge quantities of non-performing loans. The government is engaged in a tightrope-walking policy of discouraging new borrowing while hoping to stimulate enough economic growth to maintain a high level of employment. As banks and their customers deleverage, the big banks risk the same contagion of failures seen throughout the global banking system. The Chinese public, with a very high proportion of their wealth deposited in banks, have reacted to the potential risk of bank failures by converting some of their cash into gold.

Consequences of money supply expansion

The increasing supplies of *liquidity* that are being pumped into the economies of developed countries to try to solve the *insolvency* problems of the banks and governments not only will be ineffective but also will eventually cause prices to rise. Higher food, energy and other commodities prices will choke off economic growth.

The Fed's money supply expansion will also pressure the value of the dollar, risking the loss of its reserve status as foreign central banks sell their Treasury bonds and make arrangements to finance regional trade in local currencies, as the BRICS countries are doing. Some will also diversify their dollar reserves by buying gold.

An investment portfolio of physical precious metals offers some protection

While there is no solution to the massive quantities of debt accumulated over many years by the US government's living beyond its means – other than the painful one of creating annual surpluses by reducing entitlements, removing regulatory impediments to doing business, reducing uncertainty with respect to future costs, and substantially reducing the size and scope of government itself – an investor can find some protection against the fallout from the coming crisis by converting financial assets and cash into a portfolio of physical precious metals in various forms.

Precious metals offer protection against the eroding purchasing power of the dollar and other fiat currencies as well as offering a safe haven in the face of a banking system collapse. Regardless of whether you believe there is a high or low probability of such a scenario coming to pass, the risk is substantially greater than zero. It is to hedge this risk that many investors have created a semi-diversified precious metals investment portfolio. In a later section we will expand on why investors own gold and other precious metals.

Right off, let's address a question that you might have in the back of your mind.

Do you need a guide? Why not just buy an ETF?

A guide to buying precious metals is useful for a number of reasons. Because gold and other precious metals are available for investment in several forms, each of which entails costs and risks, deciding which form to buy makes the basic buying decision more complicated than buying stocks or bonds — not least of all because investors' motivations in buying them are more complex.

While buying precious metals may be as easy as calling your stockbroker or going online to place an order to buy an exchange-traded fund, an ETF may not be the best solution for investors who are looking for a safe haven and store of value.

In their physical forms precious metals are heavy, valuable and need to be kept somewhere safe. How many pounds does a silver bar weigh? Is it safe to ship precious metals?

Terminology is unfamiliar and arcane. Precious metals are priced by *bullion dealers*, at *fixing sessions* and on *futures exchanges*, in *troy ounces*. Isn't fixing prices illegal?

Nearly all forms of gold and other precious metals for investment sell at premiums to the reference prices of the metals themselves as traded in London and on Comex — and unaware investors may be encouraged by some sellers to pay high premiums to satisfy their investment needs. What is a fair premium?

While buying physical metals and taking delivery can solve the crucial problem of counterparty risk, when it comes to selling back what you bought, the buyer may need to verify that your material is genuine. Yet if you did not take physical possession from the vendor, you take the credit risk of the counterparty that owes it to you, like buying a bond or keeping money in a bank. What's the best way to hold physical gold?

You may discover only after you sell that the tax consequences of your investment depend on the form you bought — and only sometimes on how long you owned it.

A guide is useful too because there is no one profession called "gold seller" that handles all forms and can help you select the right form *for you* without bias. Rather, there are commodity brokers and securities brokers, numismatists and bullion coin dealers, fund managers and jewelers, all of whom offer legitimate ways to buy precious metals, competing with one another but with different products, different cost structures, and differing degrees of regulation. Add to the population of serious sellers those who are looking to make a fast buck — especially the tv advertisers and telemarketers who make exaggerated, misleading or false claims. Because their prospective customers don't have the experience to challenge them, the emotional appeals they make can cost customers dearly who fall for them.

Lastly, there are several myths and misconceptions floating around — some even coming from gold sellers of various stripes looking for a competitive advantage, but more coming from the mainstream press whose misinformation or biased views echo the limited asset allocation spectrum of the financial industry it serves (in which "diversification" is conceptually good, yet diversification beyond stocks and bonds is somehow suspect). Investors will benefit from the guidance of a precious metals specialist who is not a gold seller and has no axe to grind.

Buying gold with confidence

It seems odd that an asset whose price has risen substantially over a decade or so (from under $260 in 2001 to around 1300 in mid-2014) is owned by fewer than 2% of American investors. Many more have looked at the possibility of buying precious metals for crisis protection but gave up because they were unsure how to go about it or were discouraged by their stockbroker. Yet, with a guide, buying precious metals does not need to be difficult. And owning gold and other precious metals can provide security and opportunities not available with other investments. European and Asian investors have been buying gold for centuries, just for these reasons.

American individual investors are not alone in avoiding precious metals. The average holdings of gold by pension funds and insurance companies are said to be under 2%, reflecting the lack of familiarity with the gold market by most institutional fund managers. Despite several confirming academic studies, gold is still not generally accepted as an asset that can provide the benefits of diversification to institutional investors. Perhaps institutional interest will increase if the gold price rises over the next ten years and fund managers are motivated to read the studies.

In this guide we will look at the various ways that individuals can acquire precious metals, and we will analyze the benefits and risks of each. The presentation here is modeled more or less after the work of a generation ago by the eminent and irascible economist and monetery expert Dr. Franz Pick, who wrote that ***"devaluations are inevitable. They can be effected only by increasing the gold price. To devalue via peanuts, onions or paper is simply not possible."***

Disclaimer

Will precious metals prices rise this year or next? Perhaps. There is a discussion of the bull case and bear case for gold later in this guide. But the motivation to have a portfolio of precious metals that is supported in this guide is not primarily based on the notion that prices will rise, but rather on the protection they would offer in case of inflation and hyperinflation and as a store of value in a global economic crisis.

This commentary is for information purposes and does not represent a recommendation to buy precious metals, nor is it a representation of their suitability for a particular investor. Precious metals are risky investments whose prices can fall as well as rise. If you act on the information presented, you should do so based on your own evaluation and at your own risk.

If you are contemplating the idea of including precious metals in your investment portfolio, this guide will inform you about the benefits and pitfalls of various ways to do that. The markets and the global economy are dynamic, so some of the information presented in this guide may become out of date. Yet the principles that govern investment and risk have been relevant for centuries, and that is a reason that investors continue to buy gold and silver today.

Market prices of precious metals

What is fineness?

Simply, fineness is a measure of the quality of a sample of a precious metal. It represents the purity of the precious metal in an alloy as determined by assaying the bar, expressed in parts per thousand. Each precious metal has a minimum standard of purity set by the market. London good delivery gold bars (weighing approximately 400 ounces each) must assay at least 99.5% pure gold; that is, 995 parts of gold per thousand parts of metal, or "995 fine". Some gold coins and small gold ingots are made from gold that was refined up to 99.99% pure gold; that is, 999.9 parts per thousand, generally stated as .9999, or "four nines".

While investors often prefer .9999 gold for psychological reasons and may be willing to pay a premium for it, it was not created for their benefit. Four nines gold and even higher-purity six nines gold (99.9999%) are made for electronics uses by further refining of .995 gold. The purpose of the extra refining step is to eliminate impurities that impede electrical conductivity. The additional refining cost is part of the premium that an investor will pay for the higher quality gold.

Gold is sold by its fine weight, so a customer who buys a 400-ounce .995 bar that weighs exactly 400.000 troy ounces will pay for only the fine gold content (the fineness times the gross weight of the bar): 400.000 x .995 = 398.000 troy ounces. Each good delivery bar will be stamped with the refiner's mark, its year of manufacture, purity, gross and fine weignt, and a unique bar number.

It is unlikely that an internationally recognized gold refiner would scam the London bullion market by marking a bar with an inaccurate fineness. Some gold bars find their way into manufacturing processes, and the refiner of a fraudulent bar would be quickly outed, never to be allowed back to the market.

Silver bars must be at least 999 fine (99.9% silver) and are sold by gross weight of the bar rather than fine weight of silver contained. Platinum and palladium ingots and plate must be at least 999.5 fine and, like gold, are sold by fine weight of precious metal contained.

What is a troy ounce?

Precious metals (gold, silver and platinum-group metals) are measured and priced in *troy ounces* (from the medieval fair town of Troyes in northern France), and large quantities are sometimes measured in *metric tons*.

Historically, one troy ounce was $1/12^{th}$ of a troy pound (a measure no longer used), 480 grains (sometimes used to define weights of coins), or 20 pennyweights (still used by jewelers and jewelry scrap buyers).

Today, *by definition*, one troy ounce is equivalent to 31.1034768 grams.

There are 32.1507466 troy ounces in a kilo (1000 grams) and 32,150.7466 troy ounces in a metric ton (1000 kilos), typically rounded in the trade to 32,150 troy ounces. Metric tons are used to estimate quantities of gold or silver produced or stored, not for pricing.

Trivia: Troy ounces are often written (but not pronounced) in the trade as *troz*. Prices are quoted as currency units "*per* ounce" or "*an* ounce", never "*the* ounce", an affectation reserved for perfume. In the London bullion market, silver was traditionally traded in quantities of *lakhs* (or *lacs*) of troy ounces, the term for 100,000 in Hindi, Bengali and other south Asian languages. Thus, 200,000 troz is two lacs, while 50,000 troz is a half-lac.

There are 14.58333 troy ounces in a familiar avoirdupois pound, which comprises 16 avoirdupois ounces; thus a troy ounce is about 9 percent *heavier* than an avoirdupois ounce. This is useful to determine how much a gold or silver bar weighs: a 400-troy-ounce bar (a rough standard for gold) weighs about 27 ½ pounds (400 / 14.58333 = 27.43), while a 1000-troy-ounce bar (a rough standard for silver) weighs about 68 ½ pounds (1000 / 14.58333 = 68.57).

24-hour global trading

The most abundant precious metals (gold, silver, platinum and palladium) trade freely on and off exchanges around the world. Their market prices are based on supply and demand as reflected by bids and offers and by thousands of daily transactions. The London gold and silver bullion markets and Comex exchange futures market are the most liquid precious metals trading forums. They are kept closely in line with each other through dealer arbitrage. Prices of all other forms of gold, silver, platinum and palladium are based on these markets, including coins, ingots, certificates, and growing physicals and futures markets in Asia. Whether a market is designed primarily for speculation and hedging (so-called "paper markets') or for physical delivery, all prices reflect supply and demand for the metal, adjusted for costs associated with that particular market.

Bullion dealers/banks, whether in London, New York, Zurich, Hong Kong, Singapore, Sydney, Dubai, or another financial center, quote competitive bid and asked prices to other market participants and to their own customers throughout their day, thus collectively making for a 24-hour market around the world (Monday through Friday) for London spot delivery (that is, physical metal for 2-day settlement). Their realtime prices for spot gold, silver, platinum and palladium are published continuously on various websites, including *kitco.com, goldprice.org* and *thebulliondesk.com*.

Local sellers and coin dealers generally base their prices for bullion coins and small bars on the bullion dealers' London delivery spot prices, translated into the local currency, and will add a premium representing the mint fabrication cost, shipping costs, local taxes, overhead and profit. Local markets may or may not be government-regulated.

The London fixings

The so-called *London fixings* of gold, silver, platinum and palladium are not collusive anti-trust violations. Rather, they are auction markets that take place at a specific time each day. The mechanism of the fixings is to find the single price for spot (that is, physical for 2-day settlement) at which all market and limit orders of buyers and sellers (primarily bullion dealers/banks and their largest customers) are matched. This gives producers and fabricators a single price each day which they can use to average over the course of a month. The bullion dealers who are members of the fixings act as brokers and charge a small commission on business transacted at the fixings.

In May 2014, Deutsche Bank, which was a member of both the 5-member London Gold Fixing (which operates through conference calls starting at 10:30am and 3pm London time daily) and the 3-member London Silver Fixing (daily at noon), announced their resignation as part of a retrenchment from commodities dealing. This left the silver fixing in a non-viable situation. With a 117-year tradition, the silver fixing will be conducted electronically by CME and Reuters Thomson from mid-August 2014.

With just four members and amid charges of potential collusion between fixing participants and their trading desks, and payment of a substantial fine by Barclays for failure to supervise a trader who manipulated the gold fixing price on June 28, 2012, to avoid payment for an option contract with a customer, the London Gold Fixing is under regulatory and market pressure to increase transparency as well. Some changes are likely in its procedures.

Platinum and palladium are fixed daily at 9:45am and 2pm by the four fixing members of the London Platinum & Palladium Market. Daily fixing prices for precious metals are set in dollars, euros and sterling and are published on many websites, including those noted above.

While the amount of metal that is bought/sold at the fixings varies greatly in quantity from day to day, it represents just a small fraction of the transactions that take place based on the fixing prices among non-participants. Because a fixing price is trusted as a truly representative market price at the time of the fixing, it is used as a reference for pricing contracts between dealers, mining companies, refineries and fabricators throughout the world, especially for contracts based on the *average fixing price* for a given month. For example, a gold mining company that sent doré bars to a refinery to be refined will plan to sell the gold when the refinery finishes processing and notifies the miner of the quantity refined. The miner will then contract with a bullion dealer to sell the refined gold at the average morning or afternoon fixing price of the following month.

Comex futures and options contracts

The Comex division of the CME Group trades gold futures and options contracts of 100 ounces minimum .995 fine during the New York day and electronically on Globex, plus mini contracts of 50 ounces and micro contracts of 10 ounces on Globex; and silver futures and options contracts of 5,000 ounces minimum .999 fine during the New York day and electronically on Globex, plus mini contracts of 2,500 ounces and 1000 ounces on Globex.

Shanghai gold

The Shanghai Gold Exchange trades physical gold, in quantities of kilos (32.15 troy ounces). With demand for gold increasing in China, gold delivered in Shanghai may have been sourced from vaults in London as 400-ounce bars or in New York as 100-ounce bars, transported to a refiner in Switzerland or in South Asia where it was melted into kilobars, and then delivered to Shanghai via Hong Kong. Prices for Shanghai gold reflect the supply and demand for gold in that market, based on the London bullion price, and taking into account the costs of transportation and melting/refining. Prices are quoted in yuan per gram. Gold and silver are also traded as *futures contracts* onthe Shanghai Futures Exchange. Soon, foreign investors will be able to trade gold priced in yuan per gram on a new exchange expected to open in Shanghai in late 2014. This is seen by China as a step toward internationalization of the yuan.

Pitfalls: How not to buy gold

Before we look at how to buy gold, here are some warnings about pitfalls. There are many competent and legitimate sellers. There are also a few scam artists and unscrupulous dealers. TV advertising and telemarketing have proven to be immensely profitable ways for dealers to make pitches directly to investors worried about their future well-being, and the buyer will pay for the promotions and commissions.

Hopefully we will always have the freedom to make stupid decisions, to make fools of ourselves, and to be parted from our money. That freedom puts a burden on the buyer to analyze a proposed transaction thoroughly before buying. High prices attract nefarious characters who actively try to convince unsophisticated investors into buying at outrageous premiums. Here are a few simple rules to help keep you out of trouble:

1. Know whom you are dealing with. We have listed several legitimate gold sellers in this guide and also give you criteria for determining whether others are worthy of your trust. The guy who calls you unsolicited on the phone, pitches you on cable tv, or has just set up a website to sell you a “rare coin” (real or fake), may have been selling used cars yesterday. A cable tv seller or a telemarketer may not be your best gold source.

2. Some gold coin dealers you may find on the web, even those who have been in business for a long time, have salesmen whose commission is based on premium over the reference gold price. They may steer you away from inexpensive bullion coins to so-called “pre-1933 rare coins” like US Double Eagles (more properly called “pre-1933 *common* coins” because they are not rare). They will tell you that

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About the Author

While not a coin dealer, broker or clairvoyant, Jerry White has a rich background in precious metals trading, investing and consulting.

As former trading manager of a major bullion dealer, he has bought and sold millions of ounces of physical precious metals of all types as well as futures and options. Having worked in New York, London and Hong Kong, he knows the precious metals market and its participants (banks, exchanges, brokers, miners, refiners, fabricators and traders).

He was chief executive officer of a Comex-registered precious metals warehouse that stored gold and silver, processed bags of silver coins, and shipped precious metals by courier, armored car and tractor trailer. He gave his name to a well-known international commodities brokerage firm (Brody, White & Co.) and was involved in the over-stimulated silver market of 1979-80.

As a consultant, White has advised major refiners, wholesale coin dealers, and Comex, and he developed derivatives trading software for some of the largest international banks as well as a risk management system for JP Morgan's Treasury department. He also combined his experience in precious metals, software and marketing to set up a large-scale gold-jewelry buying firm.

White believes that the US economy and particularly the US dollar are in trouble due to decades of government policies that favor international banks, big business and big labor over entrepreneurs and free markets, and that there will be no practical way to correct the resulting misallocations of resources until the present Fed-led system collapses and is replaced.

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