ticker

Bullion Mutual Fund, Alternative to ETF

Gold is familiar to investors for its rare qualities and preferred as a store of value, but investors have been limited in replicating gold bullion returns through financial instruments. Investors have embraced gold exchange traded funds but they come with inherent operating costs, higher capital gains tax cost and limitations for retirement accounts.

What is the history of the company and the fund?

I have been in the separately managed account management business for more than three decades and in 1981 started Flexible Plan Investments, an asset management company that focuses on active management.

We believe that an investor should hold investments in multiple strategies. Buy-and-hold can be one of them, but there are lots of different strategies that are available for investors. We've found that the best protection against unexpected events is to have a diversified portfolio, not just among different asset classes, but also among actively managed strategies.

I have been in the money management business for over 30 years, and over those years I have noticed that one asset class that has been missing in the retail mutual fund industry has been a gold bullion fund, so we set out a little over a year ago to remedy that.

Since no one had ever brought out a gold bullion mutual fund as opposed to an Exchange Traded Fund, we thought the time was ripe to do that. We certainly had strategies that we wanted to use for our investors and thousands of registered reps at the over 600 broker-dealer firms we work with.

We wanted to be able to bring out strategies that would include gold in people's portfolios.

We have four other mutual funds in our sub-advised und family called The Quantified Funds, all of which moved over from the Direxion Fund family and were named the Evolution Managed Funds. These funds have been in operation since 2004 and manage about $180 million in assets.

Our firm is known for separately managed accounts, and we currently have more than $1.5 billion in managed accounts with access to more than a hundred different strategies on about forty different platforms.

Why should investors consider a mutual fund that invests in gold bullion when there are at least ten exchange traded funds available?

Historically the only way to bring gold into a mutual fund portfolio as opposed to an ETF portfolio has been to use gold mining shares, so-called precious metals funds that own shares of gold or silver production companies. We all know after tracking them that they haven't done a good job of tracking the price of gold bullion, and yet it is gold bullion that can offer diversification characteristics.

For example, if you compare the performance of GLD, the gold ETF that tracks the price of gold bullion, with the fund that trades gold mining shares, GDX, you will see a dramatic divergence in results.

Since the inception of GDX (through 12/13/2013), GLD has advanced about 80%, but GDX has dropped approximately 40%. So if you are looking to invest in gold, investing in mining shares is not going to give you the same portfolio effect as investing in gold bullion.

So when we set out to create a gold bullion fund, we were trying to remedy that situation.

Second, we wanted to do it in a manner that was attractive to investors rather than having some of the problems that existing gold and commodity ETFs and funds have, namely reporting and tax considerations.

Third, we wanted to set up the fund in a manner that had the best chance of offsetting all of the costs that are associated with holding gold bullion. Whether you hold it in a mutual fund or an ETF, there are costs associated with that and we wanted to come up with what we believed to be the most cost-efficient way of participating in the daily percent change of gold bullion.

Jerry C. Wagner has been President, Director and majority shareholder of Flexible Plan Investments, Ltd. since its formation in February 1981. He formed a hedge fund and managed its assets in the early seventies. He has been active in market analysis, designing methodologies and management of personal investment portfolios since 1969. A graduate of Michigan State University and the University of Michigan Law School , Mr. Wagner practiced law for twenty years and was a shareholder and head of the tax and securities law department of a law firm in Birmingham, Michigan. In addition to his management duties at The Gold Bullion Strategy Fund, Mr. Wagner is also a portfolio manager, acting as a sub-advisor of the four Quantified Funds also offered by Advisors Preferred.

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So those three goals guided us and I think we have achieved all of the goals that we set out to do.

We started the fund on July 8, 2013 and the marketing of the fund began about a month ago. We have about $12 million in the fund at the moment.

What role has gold played for investors and what kind of diversification can the precious metals offer in portfolios?

That is a great question that goes to the heart of what we believe in and what we practice in this strategy.

Gold can deal with different market scenarios in a more versatile manner than just about any other asset class. Gold is closest to the bond asset class in terms of having great versatility, but since bonds and gold behave differently, having both of them in a portfolio may allow you protection, at least based on history, in an incredible number of scenarios. Although, I should add that past performance does not guarantee future results.

We just finished a white paper tracing gold versus traditional commodities, equities, bonds, and the dollar over the last 40 years, right back to the time when President Nixon unlocked gold from its fixed asset price of $35 per ounce. From 1973 to 2013, one thing that stands out (even though there was quite a prolonged bear market in gold in the midst of that time period); gold still came out with the second best return among all asset classes.

It always helps to start with a decent rate of return, but more importantly than that is when you isolate different types of economic scenarios, gold does very well.

In the paper, we discussed seven different economic scenarios to start with and of those seven economic scenarios, gold's return in each was either the best or the second best rate of return. These scenarios covered a wide variety of scenarios like negative real interest rates; bear markets in equities; the U.S. dollar and commodities; inflation rising and market volatility rising.

So in all of those scenarios, gold was either the best place to be invested or the second-best. That is a remarkable versatility. To be clear, I am referring to the performance of Gold, the commodity, and not The Gold Bullion Strategy Fund.

So having gold in a portfolio and being able to deal with that regardless of the short-term implications for gold is a real plus for a firm that prides itself on constructing portfolios for investors, whether it is an active investor like us or passive managers.

You can look at it in another way. What are called all-weather portfolios are portfolios that are meant to deal with four different economic scenarios: rising growth, rising inflation; rising growth, declining inflation; declining growth and rising inflation; and declining growth and declining inflation, the last one being the deflation scenario.

If you look at those four and break the last 40 years down, you'll find that each of them has occurred over a given percentage of time and that gold has a positive return in the scenarios that the economy experiences 98% of the time.

So again, if portfolio managers are looking to create all-weather portfolios, you just cannot do it without gold when it is a positive contributor in the studied scenarios that existed 98% of the time.

How can gold impact portfolio returns?

Most investors simply have their portfolios in balanced portfolios. These portfolios allocate 60% to stocks and 40% to bonds. This approach in asset allocation has a good track record in dealing with market ups and downs. But, again, past performance is not always indicative of future results.

We decided to add gold to these portfolios and we found that adding gold to the asset allocation mix increased risk-adjusted returns. No matter what percent you added over the 40-year study up to 45%, your risk-adjusted return was better. In other words, on a Sharpe ratio basis you were always better at adding some percent of gold all the way up to 45%, and for the optimal risk reward, the peak in the curve occurs at 20%.

That is a far cry from the traditional rule of thumb I think we've all been brought up on: "If you are going to have gold in the portfolio, put in 5%." 20% is a pretty amazing figure, and yet that is what the numbers tell us using Modern Portfolio Theory statistics to determine where the optimal contribution gold should have in a portfolio.

Just to put the previous conversation in a little context, the reason why you have those great results in different economic scenarios is two-fold.

One is the second-best return over the 40-year period for the asset class. That certainly is important, but the other is that when you do a cross-correlation analysis between all the major asset classes, gold only moves 12% of the time with the other asset classes.

I have never seen the cross correlation against the major assets determined before, and this is a 40-year number. And to say there is only a 12% correlation against the other major asset classes tells you why it is so helpful in diversifying a portfolio.

How have gold investing options evolved in the last three decades?

Since I opened up the firm over 30 years ago, the gold marketplace has changed dramatically. Back then you might have been able to buy some collector coins at a coin dealer and then bullion coins and bullion bars came out. Physical coins or bars cost money to store and are not easy to transport in bulk, and you have insurance issues. It can be a costly option and tied up in an asset class that doesn't yield anything.

So that is where we were until the ETFs came out, other than those precious metals stock funds that I talked about with inherent performance deficiencies that have failed to capture the true essence of gold bullion.

Finally, with the advent of ETFs investors had better choices, but the same type of option never appeared in the mutual fund arena.

It is important to have it in that arena because there are trillions of dollars still tied up in the mutual fund industry. Many 401(k) and 403(b) plan accounts have no access to ETFs. Variable annuities and variable universal life policies also have no access to ETFs.

Yes, investors can own gold bullion, or invest in an ETF, but within the mutual fund marketplace there really was no alternative. Our mutual fund is the only one in the marketplace that permits investors to track gold bullion price movement.

What are the limitations of investing in gold through retirement accounts?

Well, there are lots of different reasons for the limitations. Within the 401(k), 403(b) market place it is a question of the ability to have a partial ownership of the ETFs and divide those up among the participants in a plan in a cost effective manner. In addition, there are also the transaction costs in an environment in which most of the products out there are done on a no-load basis. Both of those are being addressed in different ways.

Some providers are in a sense unitizing the ETF exposure so that you can break it up. Others are looking at the gold ETFs and putting them into new investment vehicles or forgoing the transaction costs on some of the investment platforms.

Within the variable annuity structure, it is simply a matter of the size of the market and the regulatory structure that requires a separate registration to make it available. We have now registered a variable investment trust that mirrors The Gold Bullion Strategy Fund.

In fact, a few weeks ago we started trading our VIT on the Jefferson National Monument Advisor platform so variable annuity owners can have access to a similarly managed portfolios on a tax-deferred basis.

What is your investment strategy?

We invest 25% of our total assets in gold ETFs and futures and take advantage of the inherent leverage in the futures contract to re-create the daily price changes in the price of gold at the fund level.

The other 75% of our assets do not have to be used for that purpose and we invest that in short-term bonds. We are currently using short-term bond ETFs and we do not put more than 4.75% in any one ETF. So we are quite diversified in that 75% of assets and everything is very short-term – nothing is longer than a three-year maturity; either floating rate loans or very short-term bond ETFs – and by doing that it accomplishes a couple of objectives.

One, it can help reduce the volatility a little bit, but more importantly, it can help generate an income stream that can offset much of the cost of running the fund and in a rising interest rate environment, it could actually generate a profit.

So if you were to track our fund against gold futures or GLD, the chart looks almost identical, which is what we want to do, but so far we have tended to come out just a bit better than both of those alternatives. The estimated fund expense ratio is 1.55% per year, while GLD's is just a fraction of that number. Yet since inception 7/9/2013 through 12/16/2013, The Gold Bullion Strategy Fund (QGLDX) has a total return of +0.40% versus the ETF (GLD) return of +0.15% over the same time period, and that's after both funds' expenses.

Thus, we think this structure has the potential to be the most cost efficient way of participating in the daily percent changes in gold bullion. In addition, there are other cost advantages in that there are no storage or insurance costs. It is a no-load, no-transaction fee mutual fund, so there are no commissions like the investors in ETFs often have to pay, which aren't even included in their expense ratio.

Secondly, by structuring the fund as I have described (limiting the amount of gold and limiting it to futures), we get better tax treatment. By virtue of the fact that GLD owns gold, it is treated as an investment in a "collectible." It actually owns the physical gold. As a result, on long-term capital gains you have to pay at a 28% rate instead of the 15% to 20% that everyone else pays on traditional long-term capital gains.

Also, our sub-advised fund is not considered a pure commodity fund because of the low percentage of assets invested in commodity futures. A commodity fund is taxed at 60% long-term capital gains and 40% short-term capital gains, regardless of your holding period. We are not subject to that. If we have short-term gains they are taxed as short-term gains, if they are long-term gains they are taxed at the long-term gain rates. That is a perceived advantage of our structure over the others.

Lastly, commodity funds typically have to report at year end using a form called a K-1. K-1's are looked down on by investors because they have a history of taking a long time to be generated. They are not available typically in January, but later in February. In addition, they are a much more complicated disclosure form and often force investors to go to a professional to prepare tax returns.

The preferred method for most mutual funds if they are not a commodity fund is to generate much simpler 1099s, which are available by the end of January, and our fund does just that.

Of course, dividends and capital gains received from the Fund, whether invested or received in cash, are taxable to investors at either ordinary or capital gains tax rates unless in a tax-deferred account. Taxes may be applicable on money withdrawn from tax-deferred retirement accounts, including a 10% tax penalty for money withdrawn prior to age 59 ½.

Are you investing in near-term or long-term futures contracts?

We are always in the near-term futures, and one of the things you have to manage is the rollover between the two contracts and actively manage the rollover whether at a premium or at a discount.

Similar investment strategies have not worked well in oil futures investing market.

Gold and oil are two different markets with different characteristics. We all think of gold as a volatile market, but when you look at oil, it is much more volatile, and the frequencies of the shifts from premium to discount seem to be greater in that market and that may be the reason for the difference.

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All we can really look at is when we tested backwards using an extensive futures database that goes back to the 70's on the forward market in gold, and it seems to work well. Again, past performance does not guarantee results in the future, and our study was on historic performance of gold, the commodity, not The Gold Bullion Strategy Fund.

How do you minimize the impact of volatility in the gold futures market?

It is really monitoring the price of gold futures with our trading partners and working with them to minimize the impact of it, and so far that has worked well. We have a wide window of when we consider the rollover and we know what we are focusing on and just try to minimize it in the process.

The other thing that helps, too, is the bond portfolio, because you are earning income there and that is offsetting to some extent the impact of the rollovers. Also, the trading cost in the futures market is very small.

In your bullion strategy do you also invest in other precious metals?

No, we were really looking to take the non-diversifying asset class that was missing, i.e., gold, and put it back on the table for portfolio constructors. The other precious metals tend to be more volatile than gold or have less of a following. We think the biggest market is the gold area and we have done a lot of study on gold and investing in gold and what it can do within a portfolio.

What risk controls do you practice at the strategy and at the fund level?

The trading is based upon an algorithm spreadsheet that we created. We have multiple people running it each day to make sure that the trades themselves are correct. Rick Andrews developed the algorithm and has a patent pending on the investment approach.

I think the structure of the fund itself is our greatest risk management tool. When you have a substantial portion of the fund in bonds, that does have a volatility dampening effect and it does generate an income stream to help overcome additional expenses. That is something that a pure commodity fund cannot do.

Also, when you talk about the bond portfolio, we have only a limited investment, 4.75% in any one position. Second, each one of them are diversified ETFs themselves, so they are holding multiple bond positions. That additional diversification helps. Lastly, bond ETFs that we are focus on are either short-term bond maturities or floating rates so that the risk to principle is minimized.

It is important to add that an investment in any mutual fund involves risk, including loss of principal.

What goes into deciding what percentage of the assets you put in the futures contracts (5% or 25%)?

Our prospectus limits us to committing 25% of all assets to futures contracts and currently we are at 20% in the fund.

It is also a function of what best tracks the daily price change of gold bullion in the futures markets, the Comex gold bullion price that is our benchmark. (In fact, our fund close time matches the closing time in the gold futures trading market, 1:30 pm E.S.T.) To the extent that we use less than 25% in futures, we can place the unused balance of the 25% in gold ETFs to give us a stake in physical gold.

What would you say to advisors who think your fund is a bond fund with a gold futures exposure?

That would reflect what the mutual fund structure is, but I think you have to look at the goal we are holding ourselves to, and we are holding ourselves out as being a tracking fund against gold.

What we are trying to accomplish as closely as possible is to deliver the daily price changes in gold bullion, and to the extent we have bond ETFs in there, it has a lot of advantages but the goal of the fund is to track that daily price change.

Can you summarize the advantages of investing in your mutual fund compared to Exchange Traded Funds from an advisor perspective?

Advisors should review the advantages and disadvantages of both ETFs and The Gold Bullion Strategy Fund prior to investing to ensure that any recommendation is suitable for their client's profile, needs, and objectives.

As an advisor, especially as an active advisor (but even if I was holding for the long-term), I would look at it from the standpoint of, one, I want to make sure I secure the price changes in the gold bullion market, which is the objective of both ETFs and the mutual fund.

Next I want to look at what my tax situation would be upon sale as well as how I am going to report each year. I am also going to want to look at how the investment is structured. A mutual fund has a big advantage over the presently available ETFs in my mind in terms of the taxes.

A gold mutual fund is not deemed collectible by tax authorities so you are not getting hit with the 28% tax rate and you can benefit from the lower 15% to 20% capital gains tax rates. The fund is not treated like a futures or commodity fund so you don't have that 60/40 split in terms of taxation. And you receive 1099 reporting instead of the K-1 reporting.

Finally, there's another more subtle difference in the operations of our fund and the ETFs holding the physical commodity. When you are running a gold ETF, you have to have the cost of sale. You actually have to sell the commodity, the physical commodity, under two circumstances. One, to pay expenses of the fund, or two, to meet redemptions, and when you take a look at what the gold funds have gone through to meet redemptions this year, you can see the potential for these expenses. T

An investor should consider the investment objectives, risks, charges and expenses of The Gold Bullion Strategy Fund before investing. This and other information can be found in the Fund's prospectus, which can be obtained by calling 1-855-650-7453. The prospectus should be read carefully prior to investing in The Gold Bullion Strategy Fund.

There is no guarantee that The Gold Bullion Strategy Fund will achieve its investment objectives.

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The opinions expressed are those of Mr. Wagner and do not necessarily reflect the opinions of Ceros Financial Services, Inc., its employees or affiliates.

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