THE RISK-RETURN SPECTRUM IN GOLD

A primer on Monetary Metals' Gold Investments and how to think about the Interest Rate in Gold

August 2021

The Risk-Return Spectrum in Gold

Every investor has questions about interest rates. The purpose of this document is to help gold owners think about gold interest rates. Gold is different from the dollar. The dollar's manager (the Federal Reserve) states its official policy is 2% annual debasement. But gold, of course, cannot be debased. An interest rate of 3% in dollars is not directly comparable to an interest rate of 3% in gold (though it is not so simple as subtracting 2% from the dollar rate).

Monetary Metals has completed enough gold-paying deals, with sufficient variety of circumstances and rates, that we can offer some perspective.

How Are Rates Set in the Gold Yield Marketplace™?

We do not wish to bias the preferences of investors, in an attempt to try to suggest the *right* rate. We believe that the *right* rate is the one set by investors without interference. The right rate benefits everyone. Investors can participate according to their risk and rate preferences. Lessees and borrowers are attracted to a transparent market that meets their rate preferences also.

Freedom from interference is a radical idea. To hold a dollar—even a paper dollar bill—is to be a creditor. There is no choice to lend or not to lend. There is only the choice to lend to the Federal Reserve itself, to the Treasury, to a bank, or to another borrower. As a consequence, investors cannot express an absolute rate preference. At best, they can express a preference for one debt instrument over another. For example, an investor may prefer to hold short term Treasurys over a bank balance.

Monetary Metals uses an auction process to set rates. That is, each investor decides how much metal to offer, and at what rate. We believe that **no one is better qualified to make these decisions, than the investors who own the gold.** Our auction is a true free market. Investors have the choice to keep their metal, with zero storage cost, or to offer it at a rate acceptable to them.

Risks and Returns

In a developed monetary system, there are many different kinds of investment opportunities. These can be sorted by risk, with higher risk generally earning higher returns. This is only natural, as no one would choose the higher-risk investment unless it paid better than the lower-risk.

In the dollar system, there are many investments and risk levels, including cash, Treasurys, investment-grade corporate bonds, public equities, junk bonds, private equity, and even triple-leveraged exchange traded funds. Cash pays nothing, but incurs no risk in nominal terms. At the opposite extreme, the 3X leveraged ETF is risky but may pay a high return.

Gold is different. For four decades, it was illegal to hold. And for five more, it has been officially severed from the monetary system.

There are few choices on the gold risk-return spectrum. The metal itself has no risk and pays no return, in gold terms. Owning shares of mining companies is the other main option.

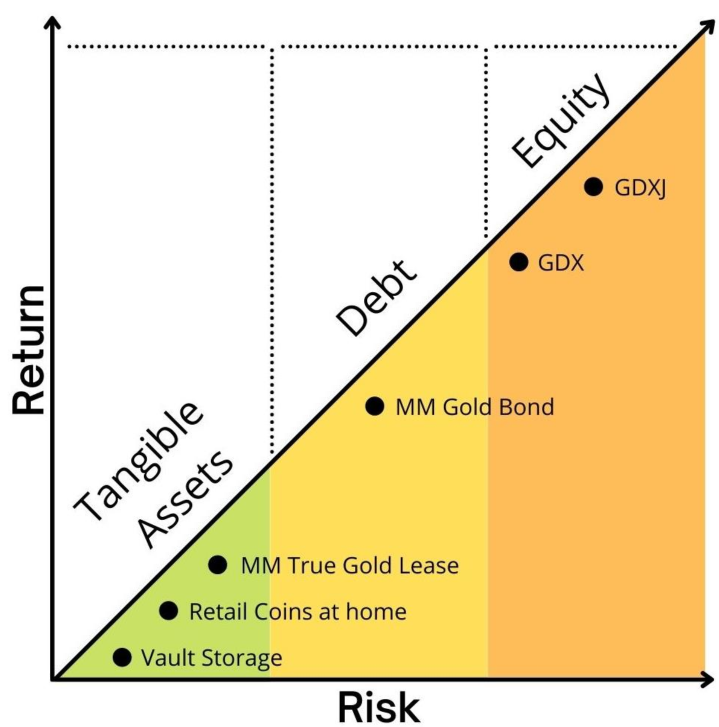
Before Monetary Metals, that is. We have developed two new options for gold owners.

The **True Gold Lease** offers ownership of the metal plus a return. The investor retains title, but allows his gold to be placed with a productive business who pays for the privilege of using it as inventory or work-in-progress (the metal is insured). Monetary Metals looks after the metal to make sure it is counted, audited, and monitored frequently. This is the lowest-risk point on the risk-return spectrum which pays a return.

The **Gold Bond** is lending directly in gold. The purpose is to finance creation or expansion of a gold-income-producing asset, such as a gold mine. The bond's return is higher than the return on a lease, as there is credit risk to a borrower. The borrower has a gold income, which amortizes the gold debt.

Illustrating the Risk-Return Spectrum of Gold Assets

Plotting the historical returns of different assets is easy enough. But illustrating the risk of those opportunities is difficult. Nevertheless, there are a few key points to note. Knowing the nature of the asset class you're investing in is an important first step to analyzing the risk, and potential returns, of your investment.



Naturally, there is more risk in equity, than in debt. And there is less risk in owning tangible assets than in debt. This is true for gold investments as well. A Monetary Metals Gold Bond is debt, while a True Gold Lease is physical gold.

The above chart illustrates one dimension of risk and return for gold investments. However, there is more to say about the specific risks of each gold investment.

- Vault Storage in a Depository: Assuming a reputable depository, the risk is as close to zero as one can get. Physical security is excellent, they have strong internal controls, and carry insurance. But this comes at a cost (0.75% per year is typical).
- Retail Coins at Home: There are no storage costs, but there is a risk of burglary, home invasion, fire, flood, etc. It is difficult to insure gold at home.
- MM True Gold Lease: The lease pays interest, unlike coins, and vault storage. The investor retains title to the gold, and the metal is insured, but there is no such thing as a return without risk, and the risk is that the lessee loses or takes the gold. MM seeks to control, mitigate, and monitor this risk, but some risk remains.
- MM Gold Bond: The bond extends credit to the borrower, and the gold becomes an asset on the borrower's balance sheet. MM performs due diligence, but the risk is generally higher than a lease. And the interest rate is accordingly higher.
- Gold Mining Stocks – Majors (GDX): This is the conventional approach to gold investing to seek a yield. Since this is an equity investment, it is higher risk than the bond (and most investors do not perform the same diligence that MM performs). The return may be much higher, though there are long periods of time when miners do not outperform physical gold
- Junior Gold Mining Stocks (GDXJ): These are often speculative companies, which promise great returns and incur great risks.

Gold Leases

Monetary Metals has a track record of leases since 2016. We can offer some perspective on the risk factors in leases, and their corresponding returns.

Leases have paid rates of 2% to 4.5%. This is a wide range, and the reason is that some risk factors are present in some leases but not in others. These include:

- industry
- jurisdiction
- where the metal is held (lessee's premises, a bank, or Brinks)
- track record with Monetary Metals
- kind and amount of insurance coverage
- lessee's financial condition
- whether there are audits of the lessee's books
- physical security, operational, and financial controls of the business
- kind and frequency of stock-takes, reporting, and monitoring

- collateral, and other considerations such as personal guarantee
- reputation of the company and management
- unique circumstances that create or mitigate risk

Gold Bonds

Bonds may have a greater range of rates than leases, owing to a greater diversity of risks including most of the above factors and others, including:

- borrower's business stage
- quality of the financial model
- projected ROI of the project
- financial depth of equity backers
- duration
- jurisdiction risk, including rule-of-law concerns
- for mining companies:
    - geology, mine engineering, and metallurgical risks
    - project plan
    - project managers
    - land use and permitting risks
    - contractors, milling plant operators, etc.

The Monetary Metals Approach to Risk Management

Monetary Metals conducts an extensive due diligence process on all companies who want to lease or borrow gold. And we reject many deals. There are two common reasons. One is when we discover a risk that we deem to be unacceptable. Two is when we propose a control to mitigate a risk, and the other party does not wish to comply with it.

When we present a lease or bond opportunity, we disclose the risks we identify and the steps we have taken to mitigate them. Our discussion of risks and controls is qualitative. We can identify the possibility that investors will lose gold via a particular lapse. But we cannot state it in terms of a precise statistic. If we believed that there was a significant probability of loss—if there were risks that should be eliminated or mitigated, or if the people were not trustworthy, for example—then we would not offer the deal and risk anyone's gold.

How to Think About the Interest Rate

A version of the Golden Rule states: he who has the gold, makes the rules. This is especially true for our Gold Yield Marketplace™. Investors are empowered to compare each new opportunity to prior Monetary Metals deals, assessing the presence, absence, or degree of each risk factor. Every gold owner knows what rate will motivate him to part with his gold for a day, a month, a year, or years. Those who want to earn gold on their gold, and in so doing incur the risks, decide how much return to demand in exchange for that risk.

Each gold owner offers gold at a rate that adequately compensates him, which he determines, in his sole discretion. This decision must balance, on the one side time preference plus risk, and on the other side the desire to earn a return and not miss an opportunity.

The MM auction process is not a negotiation. Each investor decides what rate he will accept, and then the process determines whether to accept his gold. Every investor wants a higher rate, but that is not the question being asked or answered by the auction. The question is where is the investor's minimum, the line at which he will walk away? Suppose John offers gold at 25% (a rate that is far above the rate cleared by the market). His gold will not be accepted. Would he have been happy to put his gold at 24.95%? If so, he may want to consider that. Investors are advised to think about what rate they would prefer to keep their gold, and set their offer rate just above that.

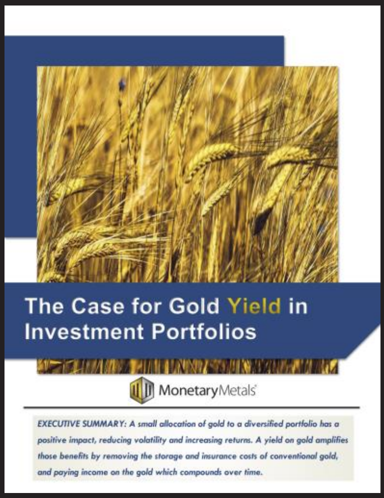
All actors in the market have to consider the alternatives to the transaction. In dollar investments, this is the next-most attractive dollar deal. In gold, the alternative is storage at negative yield, or another gold investment—a Monetary Metals gold investment or otherwise.

Disclosures

MonetaryMetals®

Unlocking the Productivity of Gold™

If you found this paper helpful, you may be interested in our other white papers

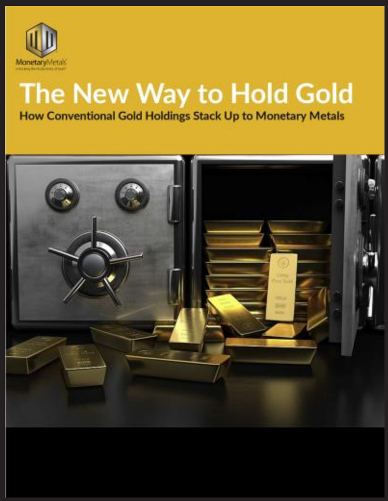


The Case for Gold Yield in Investment Portfolios

Adding gold to a diversified portfolio of assets reduces volatility and increases returns. But how much and what about the ongoing costs? What changes when gold pays a yield? This paper answers those questions using data going back to 1972.

The New Way to Hold Gold

In this paper we look at how conventional gold holdings stack up to Monetary Metals Investments, which offer a Yield on Gold, Paid in Gold®. We compare retail coins, vault storage, the popular ETF - GLD, and mining stocks against Monetary Metals' True Gold Leases.



We cover a wider variety of research topics on our website, including The Gold Standard, Yield Purchasing Power, Bitcoin and more.

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