Opinion: Investors would be wise to use caution in this gold rush

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BlackRock's $8 billion iShares Gold Trust ran out of shares as worried investors piled in

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(Updates story originally published March 4 to say BlackRock expedited the issuance of new shares.)

Demand for gold has been so hot lately that it actually broke a gold exchange-traded product Friday.

The circumstances are, if nothing else, weird, but for anyone looking to follow the crowd into gold, there's a lesson in what happened that reminds investors that there a lot of options when it comes to putting something glittery in a portfolio, and that all types of funds are not created equal.

That's proven by the curious notice issued Friday morning that the $8 billion iShares Gold Trust **IAU, +0.05%** from BlackRock **BLK, -0.78%** had effectively run out of shares and would need to register new ones with the Securities and Exchange Commission before it could sell any more.

The situation was resolved by the opening bell on Monday, but it should not be ignored.

The suspension of new shares did not affect the ability of investors to trade the IAU on stock exchanges, but had the potential to alter what the shares were worth, at least for the day. That's because if an ordinary fund stops issuing new shares, it basically starts acting like a closed-end fund; rather than trading at the net asset value of what the underlying holdings are worth, a closed-end fund can trade at a premium or discount.

The cause, apparently, was a combination of administrative oversight and booming demand for gold; the rising push for gold — futures hit a three-month high on Friday — gave IAU the potential to trade at a premium, good news for any shareholders who could sell out for a quick profit, bad news for investors looking to buy IAU because they'd have to pay an inflated price. A widening spread between the quoted price of offers to buy and sell shares can mean heightened trading costs.

Market observers did not see abnormal trading activity or any significant premium arise in Friday's trading.

The situation might have lasted for several business days — the time regulatory officials say normally is required for approval of share-issuance requests — but iShares expedited the process to minimize the trouble.

Where most gold ETFs hold gold-mining stocks and gold-related investments, IAU holds physical gold. Technically, that makes it an "exchange-traded commodity," and means it is covered by different rules than most funds.

The standard fund or exchange-traded fund operates under the Investment Company Act of 1940, which allows for the continuous creation of shares. An exchange-traded commodity would operate under the Investment Company Act of 1933, meaning a fund company has to file additional registrations to issue more shares.

While the IAU was taking in $1.4 billion in new money this year, someone at the company apparently didn't get the new registrations handled in time, and the fund ran out of shares.

Todd Rosenbluth, director of ETF and mutual fund research for S&P Global Market Intelligence, said BlackRock "should have been prepared for the persistent demand for commodity ETFs. IAU was a top-10 asset gatherer in February."

That said, with the status of IAU uncertain, investors might gravitate toward its rival, the SPDR Gold Shares **GLD, +0.14%** despite a higher expense ratio.

These kinds of situational imbalances happen at times with exchange-traded funds and exchange-traded notes. In January, Barclays notified investors that the iPath S&P Crude Oil Total Return Index ETN **OIL, +0.92%** had developed "a material premium." Instead of trading at net-asset value, the ETN was trading at premiums as high as 50%. The flip side — a discount — occurred in SPDR Barclays High-Yield Bond **JNK, -0.19%**and iShares iBoxx High Yield Corporate Bond **HYG, -0.23%** last November when investors were nervous about liquidity in junk bonds.

The situation with IAU should not have investors reconsidering gold, but they shouldn't buy the fund until new shares are created and prices normalize.

Meanwhile, investors should be thinking about what they want when it comes to gold holdings.

While owning the precious metal directly or in the IAU or GLD is an option, a gold fund is an alternative; anyone late to the current run on precious metals should know that the metal typically rises in price before mining companies do, so someone coming late to the current rally might prefer a traditional gold fund.

"It's a very volatile sector and typically in the second quarter we see retracements, step backs from gains that happen at the start of the year," said Thomas Winmill, manager of the Midas Fund **MIDSX, -2.27%** "At this level, with this kind of run-up and volatile movement, investors want to be careful, and probably should be allocating less than 5% [of their holdings] in gold. … There will be opportunities to buy gold at better prices, but right now investors want to be careful."

Somehow, with the flood of money breaking a big player in the sector, however temporarily, it doesn't seem like investors are using that restraint.

They should at least be careful about the kind of fund they're getting and know how it's being affected by the gold rush before they buy it.