

# INVESTMENT RISKS AND INSURANCE IN THE GOLD MARKET

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## ABSTRACT

In this article we investigated the causes and features of investment risks in the gold market, studied the components of investment risks in this market, and analyzed the main methods of insuring those investment risks. In addition, we presented the methods and financial investment instruments used in gold operations and provided the conceptual analyses of investment risk in the gold market.

**Keywords:** investment risk, methods of investing in gold, gold market, financial instruments, insurance investment risks in the gold

## PROBLEM DEFINITION

The ways in which the modern market economy operates and often clashes with sound risk management, is a threat to any bank. Not only is the bank, as a commercial institution, but also each of the participants in the gold market who are seeking to make a profit is exposed to risks. The terms of transition in the market, political changes, increased competition, fluctuations in inflation, and economic crisis increase the risk functioning of the gold market. Those who participate in the gold market: investors, insurers, other financial institutions are exposed to many types of risks. These risks include market transitions, political changes, increased competition, rates of inflation, and economic crises.

## ANALYSIS OF RECENT RESEARCH AND PUBLICATIONS

Certain aspects of the theoretical and methodological substantiation of the essence of the gold market are considered in the works of economic experts such as P. Bulanovych, M. O'Byrne, P. R. Chitwood, D. Frisby, M. Krantz, V. Myhalskiy, A. Steel, O. Ustenko, S. Varfolomeyev, and N. Werner.

In the Ukrainian domestic economic literature; however, most of the theoretical and practical aspects of the problem of insurance investment risks in the gold market are not yet determined. First of all, it is focused on the effect of investment risk in the development of the gold market. And second, the mechanisms of investing in gold are not fully analyzed. It is the opinion

of the authors that a comprehensive study of these issues will contribute to the development of practical recommendations to enhance the development of the domestic gold market.

## THE PURPOSE OF THE ARTICLE AND MAJOR ISSUES

The purpose of this article is to review and analyze the methodological approaches to the definitions and characteristics of the insurance investment risks in the gold market.

To achieve this goal the following major issues are raised and resolved:

- exploration of the concept of "investment risk in the gold market"
- analysis of the methods of investing in gold;
- description of the types of investment risks in the gold market;
- identification of insurance investment risks in the gold market.

## PRESENTATION OF KEY RESEARCH FINDINGS

There are different definitions of the term "risk" in the works of domestic and foreign banking experts. In general, the term risk estimates future threats or uncertainty. Risk is defined as the expression of probabilistic events that can lead to losses as a result of the economic, organizational, or technical solutions from adverse environmental exposure: including

changes in market conditions, major forces, etc. (Business Week.com). The National Bank of Ukraine defines risk as the probability of a negative impact on its capital or income. Also, the bank defines risk as being associated with the possible loss of the profit of the bank as a financial intermediary (National Bank of Ukraine no. 104, 2004). It includes all possible risks in the bank's activities. While, due to competitive pressures, companies often consciously accept projects that have a certain degree of risk because it knows that not all risks can be subjected to analysis and control by the company. A situation where the probability of an event (such as the burning down of a building) is known but where the fire will occur at a particular property is not. A risk is not an uncertainty (where neither the probability of the occurrence nor mode is known), a peril (cause of loss), or a hazard (something that makes the occurrence of a peril more likely or more severe).

There are many examples of the classification of risk in the modern scientific and educational/methodical literature. Analysis shows that modern economic theories present different approaches to classifying economic risk; but as a rule they complement each other.

International investments are not limited to investments in securities or real production activities. Markets allow an investor to allocate free money to other assets, such as gold (gold bars), precious stones, real estate, antiques, stamps, etc. Gold, as opposed to other alternatives; however, has a number of significant advantages. These benefits include the objective properties of gold and the subjective attitude of government agencies, private investors, and citizens about investing in gold.

Gold is seldom mentioned in the list of the major asset classes within recent investment practices; it is viewed as part of a wider asset class. This role in the last 30-40 years has significantly changed. Investment advisors had previously recommended keeping gold at 10-15% of a portfolio (Varfolomyeyev, 2003). Modern research shows that a 5-10% investment in gold significantly improves the risk-return ratio for long-term portfolios. An important characteristic of gold as an asset class is that it is not owed anything (like all debt securities) and does not affect the rights on some company assets (such as stocks).

Investment in the global gold market takes two forms, foreign and domestic. In the first case, the investor will directly have an account in a foreign bank using dealers or brokers. In the second case, the investor must buy physical gold or precious metals in the domestic or foreign market and then import them into the country. The investor must open an account with gold in intermediary banks, which in turn will have an account in a foreign bank that is a direct participant in the gold market.

## GOLD INVESTMENTS

The different investment methods that will be examined are direct, indirect and mixed. 1) Direct investment methods include investing in bullion, coins, and medallions. 2) Indirect methods include investing in financial instruments such as gold savings plans, gold bonds, gold stocks, derivatives, gold and gold investment funds. 3) Mixed investment methods include investing in jewelry design and metal accounts with and without the physical delivery of gold (Table 1).

### Investing in gold

There are several ways in which investors can invest in gold: investing in gold bullion, buying coins, metal accounts, gold savings plans, purchasing 'gold bonds', acquiring shares of gold in mining companies, purchasing derivatives based on gold, gold funds, and jewelry. Each of these is described below.

1. *Investing in gold bullion.* Investing in gold is the most common and convenient form of transactions on the regulated market. There are two international bullion types: large bars weighing 12.5kg and 90kg; and small bars weighing 990g and 1,005g. The trading in physical delivery of the metal is refined gold bullion of a certain size. These bars are often called bank bullion. The best known standard is the "London Good Delivery". The bar should not have any pores or depressions and it should be comfortable for carrying and storage. Settlement for 1 troy ounce (31.1034807 grams) of pure gold is held in U.S. dollars. The number of delivered gold bars should be expressed in whole numbers that correspond to the physical quantity of gold bullion. Because the specifications of bullion are standardized, in transactions all bullion appears in standard forms.

Renewal of investment demand for gold is usually associated with the devaluation of money. The bulk of "investment" metal is bought up by large institutional structures - banks, gold trading firms, pension funds and other funds. In times of financial uncertainty and inflation there are small customers investing in precious metals. These investors can cause an increase in the demand for gold coins and precious metals; thereby increasing the buying price.

2. *Buying coins.* Gold coins and small bars offer private investors one of the fastest ways to invest in relatively small amounts of gold. In many countries (including all European Union countries) gold purchased for investment purposes are not subject to the value added tax (VAT). The gold market includes gold market coins, which are used almost exclusively for accumulation (sometimes called hoarding) due to their high liquidity. Leading markets for gold coins are found in Zurich, London, Paris, New York, and Brussels. Central banks tend to favor wholesale suppliers for coins.

**Table 1.** Basic methods and instruments for investing in gold: Advantages and disadvantages

Methods	Investment instruments	Advantages	Disadvantages
Direct	Bullion	Small initial investment, quick convertibility into cash, international recognition, ubiquitous and laundry quotes	Should be kept in a safe place, subject to analysis in transactions, not very attractive in terms of profitability
	Bullion coins	Relatively inexpensive, convenient for storage and transportation, quickly converted into cash, international recognition, ubiquitous and laundry quotes	Should be kept in a safe place, not very interesting in terms of yield, sold at a premium to the metal bars
	Medallions	Ability to select more or less expensive options, convenient for storage and transportation	Similar to coins, but they are not always easy to monetize if they have no marks from a recognized manufacturer
Indirect	Shares of companies that produce gold	Possibility of increasing the value of savings from increased market value and dividends	Requires a large volume of investments and specific knowledge about the stock market
	Mutual funds focused on investments in gold	Having to choose between funds, diversification of investments among many tools	
	Certificates	High liquidity, no risk of storage, no taxes, and the presence of quotation prices	A few days delay in the issuance of the metal, no physical possession of the metal
	Special plans of accumulation	Investing small amounts, high liquidity, no taxes, no costs of storage; averaging dollar price, low cost	No ownership of physical metal
	Futures	Speculative appeal, liquidity, availability of quotation prices, no-risk storage	A large number of trade restrictions, high risk, unlimited losses, the presence of special knowledge about the market
	Options	Speculative appeal, liquidity, no risk of storage, and the presence of distinct limits risk	Trade restrictions, high risk, less liquid than futures, the presence of specific knowledge about the market
Mixed	Metal accounts	No risk of storage, no taxes, the presence of quotation prices, and interest income from a deposit account	A few days delay in the issuance of the metal, no ownership of physical metal, investments in gold are not provided by the Fund Deposit Guarantee
	Jewelry	Speculative appeal, the value of an art product that may eventually turn into an antique	Deterioration during the period of use, low cost stones if the product is not used gems

Note: Adapted from: O'Byrne, M. (2009, November 27). *A beginner's guide to investing in gold*. Retrieved from <http://www.moneyweek.com/investments/precious-metals-and-gems/a-beginners-guide-to-investing-in-gold>  
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*The Five Most Commonly-used Investment Risk Tolerance Categories*, Retrieved from [http://toolsformoney.com/investment\\_risk\\_tolerance.htm](http://toolsformoney.com/investment_risk_tolerance.htm)

Table 2 describes the different types of coins that are traded on international markets. Small unit cost and

popularity among small investors creates opportunities for organizations to bid on an

institutional basis. The price of coins is determined by the value of the gold content (based on grams and premium), which is added to the cost of the gold coin

itself. Scratches and other damage reduce a coin's value.

**Table 2.** Traded coins on organized markets

Name of coin	Gold content, grams	Premium, %
American Double Eagle	30.093	53.1
Austrian Coronae	30.488	2.0
Chervonez	7.742	6.7
Krugerrand	31.103	2.1
Maple Leaf	31.103	4.2
Mexican Peso	37.500	2.0
Napoleon	5.807	32.5
Sovereign	7.322	5.7
Vreneli	5.807	26.2

*Note:* Adapted from: *Gold bullion coins*, Retrieved from <http://www.certifiedmint.com/gold-bullion-coins.htm>.  
*Information on gold investments*, Retrieved from <http://www.cmi-gold-silver.com/buy-gold-bullion-coins/>

3. *Metal accounts.* There are two types of metal accounts: 1) physical delivery of the metal and 2) without physical delivery. A metal account with physical delivery is similar to storing it in a deposit box or safe. There are precisely defined bars (numbered stamp marked with the symbol weights and samples) allocated for each individual investor, and the investor has to pay a custodian for storage and insurance. Gold accounts without physical delivery, which many investors prefer, is conceptually similar to conventional currency accounts. In this case, the investor does not own any fixed bars; however, investors may require the supply of gold (in standard bullion) to be delivered and held by the bank or dealer. The delivery usually takes place within two days. The advantage of these types of accounts is that an investor does not bear the costs of storage and insurance, although there is a risk associated with the credibility of the bank or dealer providing the service.

4. *Gold savings plans (Gold Accumulation Plans - GAP).* These are similar to regular savings plans because they are based on the principle of investing a fixed amount of money each month. Gold accumulation plans differ from regular savings plans because a fixed amount of money is invested exclusively in gold. The advantage of the GAP plan over other ways of investing in gold is that by investing small amounts of money over a long time, one avoids the possibility of investing a large sum of money at an inopportune time. Gold savings plans originated and exist only in Japan, and these plans have accumulated more than 200 tons of gold.

5. *Purchasing "gold bonds".* The purchase of gold bonds can be structured in different ways, depending on market conditions and investor preferences. While sometimes the structure is very complex, it is rather simple for large issues. In large issues nominal bonds are indexed to the price of gold, and the coupon rate is represented by a fixed percentage of an indexed value. These bonds have a fixed yield "in gold" the same as gold deposits. In addition, they can be bought and sold. The fundamental difference between "gold" bonds and deposits in gold is that bonds usually are long term (sometimes 10-20 years). Gold deposits, on the other hand, are short-term bank liabilities. It is clear that long-term gold bonds are very risky. One of the most famous enterprises using "gold bonds" was an American and Canadian Refinement International Las Minerals, Ltd. For example, Refinement International in 1981 released the 11-year bonds with a face value of 10 ounces and an annual coupon of 0.35 ounces.

6. *Acquiring shares of gold mining companies.* The crux of investing in this form of assets is that the investor evaluates the profitability of gold mining companies' shares as being closely tied to the price dynamics of gold itself. That is, the rising cost of gold leads to an increase in production and supply of gold on the market, raising the incomes (and possibly dividends) of gold mining companies, and the growth rate of their shares. As in the case of "gold bonds", the cost associated with the transportation and storage of gold is avoided.

7. *Purchasing of derivatives based on gold.* Buying

derivatives is popular because it allows the investor to hedge price fluctuations in gold indirectly. The investment is protected because the cost derivation partially reflects the real value of gold as an asset and does not include the risk of hoarding and transportation. Three common forms of derivatives are forward contracts, swap contracts, and options.

Forward contracts on gold are agreements between two counterparties that allow the seller to deliver in the future a fixed amount of gold at an agreed upon price on a specified date. Investors may call or put gold that is underlying the asset of the contract, but in practice this is rare (Myhalskyj, 2007). Forward contracts optimally are used when interest rates are quite high but are not expected to increase (and may even decrease) during the life of the contract. The most optimal time is when interest rates on gold are low and it is unlikely that they will fall further, but they can grow within the contract.

Swap contracts agreements with gold hold the same interest rate on the contract. The buyer is a part of swap agreements that wants to pay a fixed interest rate and receive a floating rate. Rate swaps have positive and negative sides. The advantages of it include: minimizing losses after a short period of crediting, coverage of any bank transactions, maintaining gold on deposit and long term, and when the investors want to insure themselves against mining companies poor performances. The disadvantages of using agreements with gold are the capacity to incur losses if the credit rate moves up against the swap bid for the contract. It is not impossible for borrowers and lenders to get benefits favorable to them with changing interest rates.

Options are the right (but not the obligation) to sell or buy a certain quantity of gold at a certain price on a certain date (European option) or throughout a specified date (American option). The seller sells the option to a counterparty, which gives the right to perform the transaction or abandon it, and the option buyer pays a premium. If the investor intends to hedge against the risk of higher gold prices in the future, he can buy a call option or sell a put option. If there is a decrease in the market price of gold it is more rational to buy put options and sell call options. In practice, the National Bank of Ukraine uses structured products - a combination of deposit operations and options where the option premium is included in the total amount of interest on deposits.

8. *Gold funds.* There are many mutual funds in the world that specialize in investing in the shares of gold-mining companies. These "golden" shares are characterized by volatility that is 3-4 times higher than the volatility of the price of gold. This is because, in addition to the factors that affect the change in the price of gold, these shares are subject to a number of the same factors that affect the price of

a company's stock (for example, changes in leadership). Shares of many Australian and South African gold mining companies are traded in the U.S. market in the form of ADRs (American Depositary Receipts) (*The Five Most Commonly-used Investment Risk Tolerance Categories*, 2014).

9. *Jewelry.* The main purpose of purchasing jewelry is for aesthetic pleasure, regardless of the investment intent. Jewelry serves to satisfy desires and needs. It is not an indicator of social status. The idea about investing in gold jewelry (chains, earrings) is the investment in gold. Gold quotations on exchanges are unrelated to the precious metal itself. Banks sell gold, and transfer to the client the value of gold at the moment. The market for gems and precious metals is a different phenomenon. Investing in stones or jewelry is a personal choice.

In our opinion, the main motives of investment activity in the gold market should include efforts to preserve value and hedge against certain types of risk. This is especially important for investment activities in countries with high levels of non-economic risks. Political instability and social conflicts cause investors to invest in gold, which does not lose its value during various crises. Inflation, stock market crashes, defaults, and nationalization of foreign property induce investors to consider gold as an alternative investment because the price of gold increases during crises and political turmoil. A core feature of investing in gold; however, is that regardless of the level of profitability, the level of risk (standard deviation) is always high.

With respect to diversification, it should be noted that, as in the case of equity instruments, its effectiveness depends on the degree of correlation between gold and other securities, including inflation. Most researchers note a positive correlation between inflation and gold prices. Strengthening inflationary trends and uncertainty in market actors affects the growth in the price of gold. Increased demand for gold during inflation demonstrates the relevance of the interest to invest in gold. Accordingly, such market behavior allows gold to be used in portfolio management. If the return and risk of the portfolio as a whole, or its individual components, tend to react negatively to inflation, (for example, when funds are invested in those sectors or individual firms that are most plagued by inflation or suffered unexpected losses from inflation), then the inclusion of gold in a portfolio tends to stabilize it. If during a period of low inflation gold will increase the standard deviation and reduce the yield of the portfolio (because investments in gold have a higher standard deviation and lower returns than stock investments), then a period of high inflation will increase the profitability of the portfolio and reduce the risk. As a result, over a long period, the portfolio will look more attractive due to mutual compensation from fluctuations in the gold and stock components of the

portfolio.

### Investment risks

*Investment risk* is the main characteristic risk of the gold market. Investment risk can be defined as a shortfall in planned profit during the implementation of investment projects (Chitworth, 2007). The theory of market efficiency indicates if a business structure in its work avoids all risks, it can count only on income which is comparable in size to the yield of government securities superior reliability or the rate of Libor (in short time). There are two fundamental forms of investment risk, systematic and unsystematic. 1) Systematic risk is the risk associated with general economic and political conditions in a country. 2) Unsystematic risk is associated with the financial condition of specific entities.

Investment risks should be divided into two groups, depending on the scope of investing:

- Investment risks in the manufacturing and non-manufacturing sectors of the economy
- Investment bank risks in the financial market

The first of these risk groups is a collection of all the risks that affect an investor while investing in businesses not associated with the activities of the financial market.

Investment risks associated with financial market activities, in turn, can be divided into two groups:

- Risks of lost opportunities
- Risks reducing yield

The risk of lost opportunity has its source in the probability of indirect (side) financial losses, which appear in the profit shortfall due to the failure of a measure that would have given an investor the opportunity to receive more income. A special case of this risk is a risk due to falling general market prices, often associated with the fall in gold prices traded in the market at the same time. For example, by reducing the overall investment activity when there are falling market prices (Ustenko, 1997). Most of the risks of lost opportunities are irregular and can be prevented by taking special measures.

There is another type of investment in the gold market. This is when investors invest in gold mining companies or gold deposits. An investor investing in the field does not have a claim to the gold, but can take a share of profits from the sale of the metal based on the size of the stake. Luck plays a big part in this type of investment. The first mining survey shows only statistical the quantity of gold in the bulk rock mass. An additional exploration may show that there is gold. The amount of gold varies dramatically. It is desirable to have a yield of a pound of gold per ton during the mining of bulk rock. But, the quantity of gold cannot be truly determined until actual mining takes place. Therefore, the investor is exposed to significant risk if

funds are invested in this industry. The investor calculates the income and expenses of 10-15 years. Medium gold deposits should have a production of 10-50 tons of gold per year. This is the internal rate of return (IRR). For mining projects the IRR should not be lower than 15% (Werner, 2007).

Co-owner of one of the largest gold deposits in the Ukraine, Muzhyivske, is a foreign investor. Muzhyivske owns 93.67% of the fund company "Zakarpatpolimetal", which was founded in 1996 for the development of this field. The field belongs to the State Joint Stock Company "Ukrainian Polymetal". Muzhyivske also purchased a 6.33% share in 2003 in the company Zakar Recourses (Australia) (Werner, 2007). Muzhyivskyy also owns the rights to Eurogold exploration of deposit.

### Investment risks using insurance and credit to minimize risk

A separate group of investment risks are risks reducing yield. The existence of these risks is the result of the probability of reducing the amount of interest and dividends from portfolio investments as well as contributions and loans. Risks reducing yield can be divided into two types: interest rate risk and credit risk (Steel, 2011).

Investment risk in the gold market can be minimized by applying the method of insurance. Insurance is one of the methods of transferring risk through a contract to an insurance company. Of all the ways to optimize risk, insurance best meets the ideal conditions for the transfer of risk. It was a means of business protection and protection for the welfare of people. The other the kind of investment risk generates income.

The main functions performed by insurance in the gold market are insurance and investment protection. The essence of the function of insurance coverage is to protect participants in the gold market from the negative impact of risks in this segment of the financial market.

There are often cases when insurance companies invest some of their capital in gold. This method can allow the insurance company to act as a client of the bank, investing in gold and gaining income from interest on deposits.

At present, the efficiency of the insurance business in the Ukraine remains quite low. The share of insurance premiums that may be considered as a source of potential economic investment is about 1% of GDP. In the European Union (EU) insurance investment is 8.53%. In the Ukraine only 10% of GDP is used in investment risk in gold. Whereas in developed countries there is a 90-95% investment rate in gold insurance. This factor indicates an inadequate insurance coverage risk investment in the gold market in the EU and in the Ukraine. The shares of investment of the Ukraine in the European insurance market are only 0.05%, while the

population of the Ukraine is 7% of the population of Europe. The volume of insurance services in Ukraine is 600 times lower than Germany and France. The volume of insurance services in the Ukraine is 20 times lower than in Russia and Poland (Bulanovych, 2004).

Theoretically, to justify and develop practical recommendations for insurance firms to protect market participants in the gold trade and to minimize the risks of gold traders, markets must offer insurance firms the ability to participate in investments.

The buyers of insurance investments in the gold market are funds that invest in certain sectors such as mining, manufacturing and others. Insurers are individuals and legal entities - investors who invest their money in a particular industry (e.g., exploration, deposits in banks and gold) for profit. Insured events can prevent revenue shortfall during the implementation of investment projects, in particular due to the decline in gold prices, which is dictated by the market. In addition, insuring these events could reduce the impact of lower amounts paid on the interest on investments and loans to reduce the effect of incorrect data after the prospecting of gold deposits (*Gold as an inflation hedge*). The insured amount is the amount of money invested and planned income.

In our opinion, the following suggestions are among the ways insurance companies can offer protection for those who invest in gold:

- Insure annual income at a level that will provide risk-free investments in gold
- Insure not only the risk of losing the money spent on the purchase of gold, but also lost profit of income from risk-free investments

The amount of insurance premium is calculated by multiplying the amount of insurance coverage based on an interest rate for this type of risk. The insurance rate depends on a number of factors: the price of gold, the amount of reinsurance for this type of risk, the size of the franchise (part of uncompensated loss

## CONCLUSIONS AND RECOMMENDATIONS

There is a direct link between the level of risk and financial performance of gold market participants. For higher incomes, a higher level of risk must be taken. Conversely, a low level of risk allows an investor to get a small but steady income.

The main method of minimizing investment risk in the gold market is the method of buying insurance. There are two main varieties: 1) an annual income investor who buys insurance at a level that will provide risk-free investments in gold, 2) and an insurance investor who is willing to lose profits by having risk-free investments. Insurance investment risk in the gold market acts as a means of protecting the business from investment losses.

Methods and tools of investing in gold are divided into three types: 1) direct (investing in bullion, coins, medallions), 2) indirect (investment in gold savings plans, gold bonds, gold stocks, derivatives, gold, gold investment funds), 3) mixed (investments in jewelry and metal accounts of physical delivery and without physical delivery of gold).

The main motive for investing activities in the gold market is the hedge against certain types of risk and the preservation of the value of gold, because it allows for avoiding the devaluation of investments. Volatile stock and real estate markets have encouraged investors to consider gold as an alternative to other financial instruments.

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