INVESTOR ALERT

INVESTING IN COINS

Rare coins are no longer the domain of hobbyists interested only in the beauty, numismatic heritage and intrinsic value of their holdings. Lured by claims of high profit potential, the ranks of coin investors in the United States has swelled dramatically.

Investing in coins involves unique and unusually high risks for the novice investor. The coin market is not as highly regulated as the stock and bond markets and many unscrupulous brokers who have been barred from selling stocks and bonds turn to selling coins. As a result, investing in coins is not appropriate for investors who either lack the sophistication or the time to acquire it.

Recent Problems in the Coin World

State securities divisions around the nation are beginning to move against fraudulent coin dealers. Even though coin dealers traditionally have gone unregulated, state securities administrators are arming themselves with the legal theory that certain representations made by companies in connection with the sale of rare coins form an investment contract, which would trigger the securities laws of many states. A review of state securities divisions and Council of Better Business Bureaus (CBBB) files turned up a number of recent cases highlighting the new concern about fraud and misrepresentation in the coin market:

A Better Business Bureau (BBB) study of coin advertising in New York found that six out of ten ads incorrectly implied a guaranteed return to investors. The BBB recommended that the six firms incorporate a statement in the ads detailing the risks inherent to coin investing. The ads of five coin dealing firms also were criticized by the BBB for suggesting an affiliation with the U.S. Government. Despite names like “Federal Coin Registry,” and “National Gold Mint,” the private firms had no ties to the Mint or any other government agency, the BBB pointed out.

The New York Attorney General indicted six coin brokers and five coin companies subsequent to 21 other brokers pleading guilty to Felonies. The brokers made misrepresentations concerning the value, the provenance, and future market value of the coins. The brokers targeted gullible investors looking to make money in coins.

Background: How Coins Moved from Hobby to Investment

Until the 1950s, there was little or no concept of “investing” in coins. Coins were collected by hobbyists, who traded among themselves and through a number of scattered and largely unconnected coin dealers. From a few hundred major dealers and fewer than one million collectors in the late 1950s, the rare coin business has evolved into a major American business sector, complete with more than 5,000 coin firms which service between 15-20 million investors.

Today, many coins are traded in a system that involves a national network of publications and firms posting “bid” and “ask” prices for specific coins. The “bid” price is a guide to the prices dealers are willing to pay for an average coin of that grade, which the “ask” price is a guide to the prices that dealers are asking for an average coin of that grade. (As is explained below, there is typically a minimum 20 percent "spread" - - dealer markup - - between "bid" and "ask".) It is important to keep in mind that these are dealer-to-dealer prices. There is no assurance that an individual investor will be able to find anyone willing to pay the published prices.

These prices are made known nationally through telephone link-ups, on-line computer services and a number of publications, including Coin World, Numismatic News, CoinAge, and Coin Dealer Newsletter, Blue and Grey Sheets which serve much the same function as the "pink sheets" listing trading information about over-the-counter stocks.

Some rare coins have appreciated in value, while others have not. Promoters of rare coins as an investment often tout studies, including one by Salomon Brothers, which purport to show coins as a lucrative investment opportunity. Potential investors should keep in mind that such studies may completely ignore the dealer markups added to the cost of the coins and may involve only a small fraction of the types of coins traded. If an investor held a coin other than those studied, it may not have undergone the same price rise.

The Lack of Consumer Protection in the Coin World

Though it has been years since speculation fever swept through and changed the face of the rare coin world, there is little government regulation if the coins are sold as collectibles. However, if the brokers promote the coins as an investment, the government can take action.

Some coin companies have shown signs that they perceive the danger of failing to disclose excessive markups and improper grading of coins. If the (rare coin) market continues to be abused, regulation will only be deserving down the line," comments Richard Montgomery, certification service director for the American Numismatic Association.

Risks and Pitfalls of the Coin Market

Novice coin investors need to spend time studying the unique aspects of the coin market. Just as an understanding of stocks and bonds requires detailed study. There are at least four major factors that investors should weigh carefully before investing a single penny in coins: inaccurate coin grading, lack of liquidity, suitability and expenses. In particular, the investor should try to determine whether they are paying front-loaded fees.

RISK: INACCURATE COIN GRADING

The value of a rare coin depends on its condition, supply and demand, and the value of the underlying metal (Gold, Silver, Copper, etc.) Grading is the shorthand method that firms use to describe the condition of coins. In recent years there has been improvement in the uniformity of evaluation methods that dealers use in coin grading. Differences in the grades of otherwise identical coins can correspond to substantial variations in coin value. Mastery of coin grading takes years of research and training and an inexperienced investor cannot distinguish between different grades. For this reason, incorrect grading poses one of the greatest risks to an unwary coin investor.

This risk is multiplied many times when an unsuspecting investor is duped by an unscrupulous coin dealer who has graded the coin. Investors should always purchase coins that have been graded by NGC or PCGS, two independent 3rd party grading services. The practice of "overgrading" by fraudulent coin dealers, gives the investor the impression that the coin is more valuable than it is and allows the dealer to charge a much higher price than is merited. The investor is literally left holding the bag when he or she attempts to sell the coin, and finds that there is no market for it at or near the inflated price.

RISK: LIQUIDITY

The marketplace for coins is also sometimes troubled by liquidity problems. A coin is illiquid if an investor has difficulty finding a buyer, making it impossible to convert the coin into cash. The price of some coins, such as U.S. $20 gold pieces with .9675 troy ounce of gold, changes on a daily basis. But other rarer coins, such as the Double Eagle, are not likely to change dramatically in price even over an extended period of time.

Factors other than the supply of the coin also pay a major role in the liquidity of a coin investment. Coin dealers are not held to honor the "bid/ask" prices listed in coin publications. Unlike over-the-counter stock dealers, coin brokers are not required to "make a market" in a coin. As a result, a dealer may refuse to purchase a coin from an investor at a quoted price. This high-pressure practice is frequently resorted to by dealers eager to get investors to part with their coins for a below market price.

For those reasons, coins are not considered the most appropriate choice for investors who need the assurance that they can secure a fair price for their investment in a short period of time.

RISK: SUITABILITY

Unlike some other investments, coins do not pay interest or dividends to investors. Some coin dealers caution their customers that rare coins must be held as an investment for three to seven years. Therefore, rare coins may be an unsuitable investment for investors who desire regular income, easy convertibility to cash, or quick profits. For these reasons and because of the high risk associated with coin investing, some firms that promote their services directly to the public advise against placing more than 5-10 percent of an individual's total portfolio in rare coins.

PITFALL: DEALER MARKUPS

In some coin purchases, purchasers may typically incur an initial loss of at least 20 percent of their investment. This is because each deal involves a dealer markup, also known as the spread of difference between listed "bid" and "ask" prices of at least 20 percent. This spread can easily offset or exceed the past or future increase in the valuation of a coin. Potential investors should consider carefully the fact that this up-front cost is much higher than that associated with any other major type of investment. To make matters worse, unscrupulous coin dealers may charge a spread of well over 20 percent. Remember you will have to see the value of the coin rise more than the markup – 20 percent or more – before you see any real increase in the value of the coin.

Some dealers do not even disclose the existence of their markup. If the coin is being sold as an investment coin dealers are required to disclose the amount of the markup. Others may speak of "paying your dues or "overcoming the load", that is, the need to stay with an investment long enough for a price rise to cover the markup. In real terms, the value of the specific coin investment does not begin to accrue to the investor's benefit until the initial price, <u>including</u> the spread is surpassed. Thus, "overcoming the load" can easily take a long time or, more importantly, <u>it may never happen at all</u>.

<u>HOW NOT TO BE LEFT HOLDING THE BAG: TIPS TO AVOID FRAUD</u>

Investors who want to add coins to their portfolios can take basic steps to protect their investment. The following guidelines should be observed by newcomers to the world of investing in coins:

<u>1. Determine your investment goals and risk/return requirements.</u>

Coins are an extremely risky investment in a lightly regulated market, which is strewn with obstacles standing between the new investor and profits. Coins may not be appropriate for your investment strategy.

<u>2. Before you invest, spend a considerable amount of time learning about coins, the coin market and grading</u>.

Take advantage of experts in your community, your local library, and available publications. Attend coin shows and auctions. Ask questions and get answers that you can understand.

<u>3. Choose your dealer</u>.

Consult other collectors, numismatic organizations, the local Better Business Bureau, or state securities offices about the background and reputation of the coin dealer with whom you are considering doing business. Do not be impressed by the size of the coin company. A coin company with sales topping $100 million (making the firm one of the 10 largest in the nation) has been shut down for abusive practices.

Caution: do not assume a company is honest solely because agencies do not have evidence of prior wrongdoing or the coin dealer advertises in reputable publications or on radio or television. There is no substitute for your own investigation, analysis and judgment.

<u>4. Ask for full disclosure in writing – in advance</u>.

Get everything in writing from the coin dealer. Ask for information in advance and read it in detail before investing a penny in coins. Ask the dealer to state the amount you could get for the coin if you decided to sell it immediately. Ask for a specific explanation on paper of the dealer's markup – the spread between the "bid" and "ask" prices. Ask questions and insist on getting the answers in writing. If the dealer offers a guaranteed buy-back program, ask for a separate document detailing the firm's financial condition and assets. Satisfy yourself that the dealer actually has the resources to honor its guarantee.

5. Remember that you have little consumer protection under the law if you are purchasing the coin as a collectible.

That means your best chance to protect yourself is in advance. There is little or no chance of recovering your money from a bad coin deal. As the old expression goes, once the horse is out of the barn, it is too late.

6. Be extremely wary of high-pressure telephone and direct mail sales pitches.

As is true with any other investment, the rule is simple: Deal with people you know and trust. Promises of sky-high returns are meaningless if the broker possesses no coins and is simply manning a boiler room telephone.

7. Reject promises of guaranteed profits.

This is a clear sign that you are dealing with a questionable dealer. Coin investment profits cannot be guaranteed. As is true of stocks and bonds, past performance is no guarantee of future performance. There is no such thing as a certain thing in coins.

8. Be suspicious of claims or hints of official government ties or protections.

No commercial coin dealer has ties to the U.S. Mint, which is responsible for the production of coins and the safeguarding of the nation's gold and silver assets. Be wary of firms that operate with names sounding as though they are official government agencies. The official-sounding United States Coin Reserve, was a Texas-based mail order firm, which claimed that it was a depository for federal government owned coins, and that the offer or sale of Kennedy half dollars by the company had been directed or authorized by officials of the U.S. government. The truth is that coin dealers and retail establishments which sell coins are not agents of the U.S. Mint or Treasury Department.

9. Make sure that your coins are graded by an independent party.

If you are planning on having an ongoing business relationship with a coin dealer, take the time to get an independent appraisal of coins you have already purchased from that dealer. Determine whether or not you are comfortable with the grading and pricing the coin dealer is offering you. Make sure that all the coins that you purchased have been graded by NGC or PCGS.

10. Exercise caution in using a financial planner for coin investments.

Make sure that if you are going to rely on someone else's decision in selecting coins that you are comfortable with his or her degree of expertise. Keep in mind that if you discover that your coins are overgraded and/or overpriced, the financial planner and coin dealer may point fingers at each other, leaving you with little or no possibility of recovering your funds.

Moreover, in addition to the dealer's markup on the coins, the financial planner may also get a substantial commission. You are entitled to know both the dealer markup and the planner's commission.

11. Avoid using credit cards to buy coins over the phone.

Some unscrupulous coin dealers use customer credit card numbers and send the investors additional coins.

SPECIAL CAUTION: DEFERRED PAYMENT PROGRAMS

Some coin brokers offer a program in which the customer initially pays only a fraction of the price of the coins involved in the sale. Under this arrangement, most often termed a deferred payment program or leverage contract, the balance of the coin purchase price is financed by a loan from a bank. As is true of buying stocks, options or futures on margin, leveraged coin deals increase the potential for profits – but also sharply escalate the risk of loss in the event the coins drop in value. It is possible under a deferred payment or leverage contract arrangement to lose substantially more than the amount of the initial investment.

Extra caution is advisable in these arrangements. Investors must determine all costs, including the markup, commission, loan origination fees, storage costs, insurance, and interest on the loan. Only after these facts are ascertained will it be possible to determine how long you will have to "pay your dues" before just breaking even. Also the investor must make certain that the coins actually arrive at the bank. Many banks feel no obligation to check out the coin and metal brokers involved in these programs. Smart investors will avoid coin brokers who use a bank's name to lend credibility to their pitches. Keep in mind that leverage contracts involve an extremely high degree of risk and are normally unsuitable for average investors.