

Commodities in the spotlight

Industry experts discuss the commodities market and how ETFs and ETCs can efficiently tap this asset class

Why are ETFs and exchange-traded commodities (ETCs) efficient vehicles for tapping the commodities sector? Are there any commodities that are otherwise hard to access?

Howard Atkinson: ETFs and ETCs offer several advantages over direct investing in physical commodities or futures. Investors can access ETFs and ETCs in a regular brokerage account. ETFs and ETCs have low minimums – they trade in broad lots of 100 shares, although just one share can be traded. Trading profits are generally taxed as capital gains in most jurisdictions. ETFs and ETCs are also marginable, but can be fully paid for in cash. Commodity ETFs and ETCs also trade whenever the equity market is open, have good liquidity and generally narrow bid/ask spreads.

Any commodity that is either difficult or costly for the average investor to store, such as perishables like wheat or popular energy plays like oil and natural gas, are hard to access outside of futures or ETFs and ETCs. Commodities with undeveloped or illiquid futures markets are also difficult to track.

Michael John Lytle: It was much easier for providers to create ETCs backed by physical precious metals – there are large and liquid centralised markets for physical precious metals and custodian banks typically hold the metal for the benefit of investors. It was much harder to create ETCs that tracked commodities such as oil, natural gas, base metals and agricultural commodities as it is very difficult to physically store these.

Underlying futures markets offer investors much needed liquidity. As a result, providers decided to create securities linked to the performance of indices tracking commodity futures where counterparty risk and exposure is managed together by the provider and swap counterparty. These products have become increasingly popular with investors, and ETCs have accumulated some of the largest inflows in the European ETP market.

In the last eight months of 2009, Source products alone captured US\$450m of new assets. Source believes the ETC market has further potential to evolve, and that improved product design, increased education about

product structures and index returns, and an enhanced trading environment are critical for future growth.

Scott Thompson: ETF Securities listed Gold Bullion Securities, the world's first Exchange Traded Commodity (ETC), in 2003. Today, the robust ETC structure provides investors with the most comprehensive commodities' platform in the world. Investors are able to take long, short and leveraged exposure to both individual commodities and commodity baskets. \$16.5bn is invested in our ETCs.

ETCs meet investor demand for commodities through an exchange traded product. Trading and settling like equities, they are low cost and transparent. Over 20 market makers compete for business. Their liquidity is derived from the underlying spot bullion or futures markets.

Owning and holding physical commodities is not easy. They are expensive to store and perishable in some cases. It is really only practical to store precious metals and therefore the majority of mainstream commodities are only accessible primarily via futures. An ETC removes all the operational complexity around managing exposure to futures.

Matthieu Guignard: ETFs and ETCs are indeed efficient vehicles for tapping the commodity sector that is otherwise very difficult to access for many investors (being professional or retail) for regulatory, risk or operational reasons.

Compared to other vehicles such as futures and swaps, ETFs and ETCs offer competitive assets to investors.

They are simpler as they are traded like a stock with no operational burden (ISDA documentation, margin call, roll over, etc...) and for a minimum amount of one unit (a few hundreds euro/USD). They are liquid: one or several market makers guarantee prices, volumes and spreads throughout the trading day on the stock exchange. And they are cost efficient, with low management fees and trading prices which can be compared amongst several brokers.

Moreover, ETFs enable investors to benefit from a regulated fund structure which respect strict diversification rules. It's also worth mentioning,

as we talk about physical commodities, that ETFs and ETCs avoid physical delivery risk.

How have commodities performed over the last year? Have ETFs and ETCs enabled investors to capture this performance effectively? What are your predictions for commodities this year?

Howard Atkinson: Many commodities performed extremely well in 2009. According to Bloomberg, the COMEX Gold index returned 22.6% and the COMEX Silver index returned 47.40% in terms of one year results to December 31, 2009. The ETFs on the respective indices returned 24% and 47.7% in the same time period.

Underlying commodity returns are generally linked to economic growth, investment supply and demand, and in the case of energy and agriculture, the impact of weather conditions on supply. If the US dollar continues to fall in 2010, commodities should perform well, as this is the base currency for most commodities. However if the greenback recovers, this would be a significant headwind for commodities, especially gold, which can be considered a hedge against the US dollar.

Michael John Lytle: 2009 was a strong year for commodities. The broad S&P GSCI total return index returned 13.5%, with 17 out of 24 commodities in the index posting significant gains. In particular, base metals outperformed other commodity sectors with copper (135.8%), lead (130.6%) and zinc (98.1%) leading the way.

Investors have been pleased with the tracking of physically-backed ETCs, for example physical gold ETCs that track the spot price of gold. The simplicity of the structure emanates from the ability to purchase gold on the investors' behalf and hold it for their benefit. As a result, physical structures tend to have limited counterparty risk and track the spot physical market quite closely. Unfortunately, this structure only works for a limited number of commodities, mainly the precious metals including gold, silver, platinum and palladium.

However, some investors may have made investment decisions without a clear explanation of the impact of



futures returns. An example of this is the oil market – the price of the NYMEX WTI front-month oil futures contract gained 76% in 2009, whereas the largest European oil ETC tracking WTI front-month futures returned only 3% for the same period. This 73% difference in performance is due to the current shape of the oil futures curve, or contango, which can be detrimental to returns as it leads to ‘negative roll yield,’ which is selling the front month contract and buying a two month contract at higher price.

To address the issues surrounding the shape of the oil futures curve – contango/backwardation – Source launched its Crude Oil Enhanced T-ETC. This new Source S&P GSCI Crude Oil Enhanced T-ETC has been designed to offer ‘dynamic’ index exposure and yield enhanced returns when the WTI crude oil futures curve is significantly positively sloped. The S&P GSCI Enhanced Oil index increased by 31% in 2009, compared to the gains of 3% and 76% mentioned above.

Scott Thompson: Investor appetite for commodities made 2009 a record breaking year for commodity ETFs and ETCs. Total net inflows into stock exchange traded commodity securities are estimated to have risen \$46bn to \$111bn worldwide.

Commodities were the second best performing major asset class in 2009 after equities and remained the best performing asset class on a 5 and 10 year basis based on the DJ-UBS All Commodities Sub-Index 3 Month Forward.

Industrial metals and precious metals with high industrial usage were the top performing commodities in 2009, all with gains in excess of 50%.

ETF Securities saw energy and precious metals attract the largest net inflows across the commodity platform in 2009. ETF Securities’ Physical gold and natural gas ETCs alone saw \$2bn and \$1bn of inflows respectively. Our gold ETCs have seen a more than doubling of gold holdings since the start of 2008 to \$9bn.

As we move into 2010, cyclically-gearred ETCs remain in favour as unprecedented monetary and fiscal expansion has boosted activity levels worldwide. This year strong inflows

have been into gold and agriculture, as well as short oil and short copper.

Matthieu Guignard: The overall commodity sector performed well last year: the S&P GSCI LE that gives an overall view of all commodities, has registered +15% in 2009. Amongst the best performers in 2009, we can mention industrial metals such as Lead (+143%) and Copper (+140%), as well as Crude Oil (+78%) or gold (+24%)

Have there been any issues or problems with ETFs or ETCs tracking commodities? For example, is there a need for structural awareness and an understanding of the difference between ETFs and ETCs? What about the issue of counterparty risk and the need for collateral?

Howard Atkinson: Three areas of concern for investors in 2009 included the shape of the futures curve. ETFs and ETCs, which can achieve their exposure to a commodity via the futures market, will be affected by the shape of the futures curve in the same manner as a direct investment in those futures.

For example, both oil and natural gas futures experienced steep contango curves during portions of 2009, whereby each subsequent futures contract out in time was at a substantially higher price. The bearish bias of a contango curve made it difficult during these time periods for the bullish investor to profit.

In the spring of 2009, investor demand for some commodity ETFs and ETCs exceeded the supply of shares in the market place and some products traded uncharacteristically at significant premiums to net asset value.

Also, the Commodity Futures Trading Commission’s (CFTC) review of position limits in the summer, which are out for public comment as we go to press, caused some ETF and ETC providers to shut down or not launch pending products. The uncertainty also kept many investors out of this space.

Generally speaking, commodity-related ETFs and ETCs are fully collateralized either by the physical commodity holdings or indirectly through a swap agreement which is backed by securities held by the fund.

Michael John Lytle The fall of Lehman



Howard Atkinson



Matthieu Guignard



Michael John Lytle



Scott Thompson

Howard is president of Horizons ETFs. He joined BetaPro Management, an affiliate of Horizons ETFs, as executive vice-president in 2006. Prior to this, he was responsible for iShares’ ETP business in Canada. He has also held positions with a national investment dealer and major mutual fund companies.



Matthieu Guignard is head of product development CASAM ETF, Amundi. Matthieu joined Amundi Investment Solutions, in June 2008 as head of Product Development for ETFs. He worked for 8 years at AXA Investment Managers and previously, held various positions at Société Générale in corporate sales.



Michael is director of marketing at Source. Prior to this, Michael was an executive director at Morgan Stanley in London, where he focused on the creation, marketing and distribution of multi-asset class retail structured products. During his eighteen years at Morgan Stanley, he had responsibility for a variety of investment banking roles.



Scott is co-head of European team. In 1997 Scott began his career at UBS straight from St Anne’s College, Oxford. In 2006 he moved to JP Morgan to run the risk program trading desk and set up the exchange traded funds business in Europe. Scott joined ETF Securities in May 2009 to co-head the sales effort across the UK and Europe.



Brothers and the near collapse of AIG in 2008 highlighted the issue of counterparty risk in certain ETC structures, and investors have increased their scrutiny of ETCs and demanded clear disclosure from product providers.

The notion of collateralisation was introduced by some ETC providers using a collateralised structured note, whereby the financial institution providing the commodities exposure placed collateral with a third party trustee that could be sold if the financial institution defaulted. This ETC structure has proven to be extremely popular.

Source opted for a different

and more robust structure when it launched its first commodities offering in Europe – the platform now includes 27 Treasury Bill Secured Exchange Traded Commodities (T-ETCs) listed on the Deutsche Boerse and one physical gold ETC (P-ETC) listed on the London Stock Exchange.

Each Source T-ETC is a certificate which is fully secured by US Treasury Bills and cash. These assets are placed in a special purpose vehicle and held for the benefit of the investors in a segregated account with Wells Fargo acting as collateral administrator and Deutsche Bank as trustee. The commodity index return is achieved through multiple swap providers – currently three, including Goldman Sachs, Morgan Stanley, BofA Merrill Lynch, and these swaps are collateralised and marked-to-market on a daily basis further reducing residual counterparty risk. Source T-ETCs are exchange traded certificates not funds; yet, they are Ucits eligible investments.

Scott Thompson: Our ETCs guarantee to track the benchmark less fees. For products based on futures, investors need to be comfortable with roll return. These are the returns derived from the sale and purchase of contracts.

ETCs, because they give the ability to achieve exposure to different part of the futures curve, enable investors to ‘optimise’ the roll return over time. An investor looking to minimise the impact of roll return and volatility will typically look to take a position further out on the futures curve

The majority of ETC/ETF issuers use collateral now to minimise any counterparty risk. The counterparty risk comes from a swap, which provides the performance. UCITS rules require at least 90% of the counterparty risk to be collateralised. Most of the industry, including ETF Securities, targets 100% collateralisation.

Apart from the collateral and counterparty exposure, clients focus on the systemic risk or probability of default/problems with the ETF/C. Clients look for independence between the ETF issuer, swap provider and main market maker. When they are all the same, there is more systemic risk and more need for higher quality collateral or a proven track record.

Matthieu Guignard: Yes, we believe that ETFs/ETCs have enabled investors to capture this performance effectively, even though the indices they track have been impacted by negative roll yields in 2009 (because the indices



track futures performances and not spot performances).

Does potential regulation pose a threat to commodity ETFs and ETCs? For example, what are the implications if the Commodity Futures Trading Commission (CFTC) imposes tighter position limits on commodities futures?

Michael John Lytle: Source has no unique insights into the activities of the CFTC as it is a regulatory body and does not disclose its decisions or decision making process ahead of issuing new regulations. However, the CFTC is looking generally at position limits and other factors potentially causing volatility in the commodity markets. Commodity ETF/ETC providers cannot preclude the possibility that a change in the regulatory structure might impact their ability to offer products, but Source is uniquely well-positioned to deal with any changes. This is because position limits are imposed on a bank-by-bank basis.

As Source uses multiple swap counterparties for its T-ETC platform, Source is able to access capacity wherever it can be found. Any change is likely to be implemented gradually, and allow for a transition period. Source would expect the CFTC to take a similar approach with respect to any further changes.

Finally, the ambit of the CFTC is to regulate commodity futures and options. Accordingly, they do not regulate the spot physical market and therefore we do not believe that the current review will result in any changes to physical metal products such as gold.

Howard Atkinson: Regulation is always a factor in the financial industry and changes from time to time should be expected and can affect the marketplace. For example, the current position on energy futures that the CFTC has out for public comment could result in limits and affect some very large commodity ETFs/ETCs in the future. Issuers of commodity ETFs/ETCs as a group have provided input to the CFTC during the current process and would likely be involved in any similar hearings in the future. Interested investors should monitor the CFTC and ETF/ETC issuer websites for the latest updates.

Scott Thompson: The current regulatory focus seems to be on the energy complex, which was been both a popular ETF investment theme in 2009 (Oil and Natural Gas) as well as a politically sensitive sector when trying to

stimulate economic recovery. Position limits have actually existed in Agriculture for some time, so this concept is not new. If the CFTC tightens the limits too much then there is the possibility that the market loses transparency by trading OTC or commodity futures trading gravitates outside of the US.

It is important to note that the CFTC regulates trading in futures. In the US market most Commodity ETFs actually trade futures and are therefore directly regulated by the CFTC. In Europe, ETF Securities does not hold US commodity futures directly; performance is delivered via a fully collateralised swap. Swaps are not currently regulated by the CFTC, although the US congress is considering expanding the CFTC powers. Nevertheless, we expect that commodity platforms that work with multiple swap providers and non-financial counterparties will continue to be able to offer passive commodities exposure to investors.

Matthieu Guignard: At Amundi, we’ve just launched four new ETFs that replicate various S&P GSCI indices, including S&P GSCI (Light Energy), S&P GSCI Non Energy, S&P GSCI Metals and S&P GSCI Agriculture. This new launch meets investors demand for commodity products that they can easily add to their asset allocation as a diversification tool to improve the risk return profile of their portfolios, or as a hedge against inflation.

This growing investors interest combined with positive market outlooks should indeed support asset growth on commodity products. For example, Crédit Agricole CIB’ commodities analysts, have positive views on metals with a forecast comprised between +30% and +50% and on soft-commodities (coffee, cacao, sugar...) that had good performance last year and may reproduce this year as a combination of higher demand and reduced production resulting from many factors among them climate effect.

In addition, structural drivers will support demand for most commodities, the most important being economic growth, demography, industrialization and mass consumption in emerging countries. On the other side, supply may not meet this extra demand due to factors such as scarcity and shortage of natural resources or production adjustment delays.

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