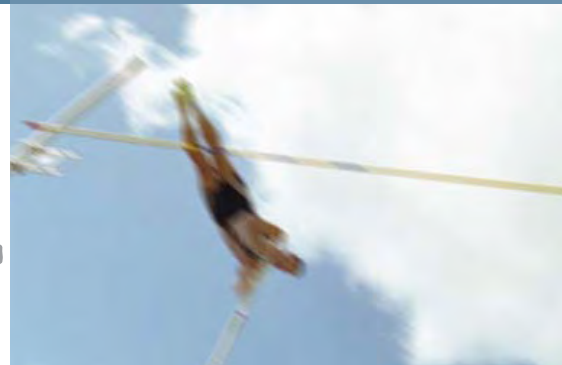


Making the Choice

Commodity Futures vs. ETFs



► It's paramount to know all the facts, no matter what you are investing in.



Making the Choice

Commodity Futures vs. ETFs

.....	
Introduction	4
.....	
Performance	4
.....	
Case-In-Point	5
.....	
Leveraged ETFs	6
.....	
Roll Yield	8
.....	
Tax Implications	10
.....	
Control	10
.....	
Short Positions	11
.....	
Capital Efficiency	12
.....	

Commodity Futures vs. ETFs

Exchange-traded funds (ETFs) have been a popular vehicle to gain exposure to the commodities markets. Many investors choose commodity-based ETFs over futures because of perceptions that they are less risky, and are less complicated to understand.

However, investors who assume they are getting diversification through an ETF may find that's not the case. And, ETFs have other potential downsides for investors:

- **Potentially higher taxes on earnings**
- **Less control over their investments**
- **Lower returns than trading futures contracts directly**

Performance

The idea behind investing in commodity-based ETFs is that they mirror commodity price trends, and thus offer investors diversification. That might be true some of the time, but it doesn't always work out that way. Commodity ETFs based on shares of companies in a particular sector, such as mining or refiners, are subject to issues affecting the individual companies, such as management, production, or even corporate malfeasance. These ETFs may move with the tide of stock market sentiment in general, irrespective of commodity prices. So when you invest in a stock-based ETF, you will have to not only be right about the fundamentals of the industry you are investing in, but also be a good stock picker.

Commodity-based ETFs backed by physical commodities, futures and/or swaps are another option for investors. They can be easily bought or sold through an existing securities account. However, they also do not always directly track the price of the underlying commodity, and returns may vary significantly. Investor demand for shares of a particular ETF, management issues, and regulatory constraints can all impact performance.

**Futures
Provide the
Purest Play**

Chart 1 Crude Oil Futures



Chart 2 USO ETF



“What the stock market is doing is of no concern to you—only the price of gold itself.”

For example, consider the USO, a popular oil-based ETF, which was trading at about \$37 in early December 2009, far below the spot price for NYMEX crude oil futures at \$76 a barrel. If you had bought USO at \$32 in January 2009, your year-to-date return would be just over 15 percent (net of fees/commissions). If you had bought NYMEX crude oil futures in January 2009 at \$47, your year-to-date return would be over 60 percent (net of fees/commissions). That doesn't even consider leverage, which individual investors are free to employ—or not—by trading commodity futures directly.

Investors who choose to participate in the commodity markets directly by buying or selling commodity futures contracts get the purest price play. A futures contract is simply an obligation to buy or sell a commodity at some time in the future, at a price agreed upon today. So in simple terms, if you think the price of gold is going to go up, you would buy (go long) a gold futures contract. If you think the price of gold is going to go down, you would sell (go short) a gold futures contract. If gold rises and you have a long position, you profit and the holders of short positions lose. If gold falls, holders of long positions lose and the shorts profit. What the stock market is doing is of no concern to you—only the price of gold itself.



“Rebalancing a leveraged ETF systematically erodes the net asset value.”

You may have heard of leveraged ETFs, which may seem like a way to gain access to the futures markets and achieve superior performance versus other types of ETFs. However, these funds carry some pitfalls for long-term investors. They typically provide \$1 of debt for each \$1 of investor equity, and are often marketed as “2X” funds. The premise is that when a commodity or index returns 10 percent in a given period, the leveraged ETF should return 20 percent. However, that typically has not been the case.

ETFs with “2x,” “ultra,” “bull/bear” or “leveraged” in their name are typically leveraged funds that are rebalanced daily. The purpose of this rebalancing is for the fund to achieve a leveraged return that mirrors the daily movement of the underlying asset. However, rebalancing systematically erodes the net asset value underpinning the units by purchasing futures when the price rises, and selling futures when the price has fallen on the day (buy high, sell low). The opposite of good market timing!

Here’s an example. An underlying asset and its respective “2X Daily Returns” ETF each start with a value of \$100. The ETF’s price change is two times greater the daily change in the underlying.

	Daily Return	Underlying Asset	2x Daily Return ETF
Start	---	100	100
Day 1	20%	120	140
Day 2	-20%	96	84
Day 3	20%	115.2	117.6
Day 4	-20%	92.16	70.56
Day 5	20%	110.59	98.78
Total Returns		10.59%	-1.22%

Table 1 Return on Assets

After Day 5, the ETF's value is lower than the underlying, and is even lower than its own starting value. The price erosion is catalyzed by volatility; the greater the volatility the greater the erosion. In this example, the volatilities have been exaggerated to dramatize their effect. However, in reality, on a longer-term schedule the same type of erosion can be expected. The figures haven't even taken into account the management fees and brokerage fees which would further erode the value of the ETF. It is for these reasons that the prospectuses of leveraged ETFs clearly state that the units are meant for day trading and should not be used for position trading.

In addition, some of these leveraged vehicles have run into position limits in the futures markets as they have grown in size. That has forced some them to stop issuing shares, and/or to restructure holdings to include swaps or other unregulated vehicles you as an investor might have wanted to avoid.



Positive and Negative Roll Yield

Futures contracts have expiration dates and are subject to “roll yield,” something long-term investors in commodity futures should consider. If you don’t intend to take delivery of the actual physical commodity, you must close (offset) your position at expiration and take your profit or loss, or “roll” your position to the next contract month to maintain it. The rolling of contracts can produce what’s called “roll yield,” and it can be positive or negative. Often commodities contracts are in a state called “backwardation,” whereby the nearby contract months are priced higher than farther-dated contracts. When this is the case, you gain a positive roll yield at expiration, because you will be rolling your old contract into a slightly cheaper one.

An example of backwardation can be seen in a snapshot of the sugar market, taken on December 11, 2009. You can see how the January 2010 contract is higher than the May and July 2010 contracts.

Product	M/Y	Exch	Open	High	Low	Last
Sugar #11	Jan 10	ICE	2273	2314	2273	2314
Sugar #11	May 10	ICE	2248	2279	2239	2246
Sugar #11	Jul 10	ICE	2140	2163	2126	2130

Table 2 Sugar #11 Futures



*“Control
the roll with
futures”*

On the flip side, a market in a state of contango, where nearby contracts are priced lower than those dated farther out in time, can create negative roll yield, because you will be rolling into a higher-priced contract. Here you can see an example in gold taken on December 11, 2009. The January 2010 contract is lower than the April and June 2010 contracts.

Product	M/Y	Exch	Open	High	Low	Last
Gold (Globex)	Jan 10	COMEX	11329	11430	11200	11204
Gold (Globex)	Apr 10	COMEX	11344	11445	11216	11223
Gold (Globex)	Jun 10	COMEX	11370	11454	11232	11232

Table 3 COMEX Gold Futures

As you can see, this “roll yield” can be a negative or a positive—depending on the state of the market at any given time. This roll-yield can also affect returns in commodity-based ETFs that utilize the futures markets. The difference is that with futures, you can control whether you’d like to roll your positions and when. No matter which investment you chose, it’s important to work with a professional if you don’t have a clear understanding of the mechanics involved.



Tax Rates

It is important to know the tax consequences of your investments. If you are a stock investor in the United States, you are probably already familiar with long-term and short-term capital gains treatment, which taxes your investment based on your holding period. You might not know that some metals ETFs backed by physical gold or silver can be subject to “collectibles” tax treatment, putting them in the 28 percent bracket even if you hold them long-term.

In the United States, futures are lumped together and reported on a single Form 1099 at year-end, and any profits in commodity based futures (regardless of the holding period) are taxed at the “60/40” rate – 60 percent taxed at the favorable long-term capital gains rate and 40 percent taxed at the short-term rate. Of course, tax laws change, but this has been the rule. We encourage all investors to speak to a qualified accountant to discuss the particulars of your situation, as each is unique.

In Canada, any profit or loss can be treated as an income or capital item depending on your situation, so please check with a tax professional for more information.

Controlling Your Investment

Investors have more control over the day-to-day decisions in regard to their futures positions, and are not reliant on the capability of the ETF manager(s) to achieve a return comparable to that of the actual commodity. You also have the flexibility of trading options on futures contracts for further control over your strategy, including hedging mechanisms.

Because shares of ETFs are traded on stock exchanges, their trading hours are very similar to those of regular share trades. On the other hand, futures can be traded nearly 24 hours a day, providing more opportunities.

Keep in mind, futures contracts represent an obligation to buy or sell the underlying commodity. This is not the case with an ETF. For this reason, some investors avoid trading commodity futures because they fear they will unwittingly wind up with a herd of cattle or barrels of oil at their doorstep. As mentioned, if you don't intend to take delivery of the commodity, all you need to do is either roll your position to the next contract month to maintain it, or close it before expiration day. In fact, the vast majority of participants in the futures markets don't make or take delivery at all.

That being said, some investors of precious metals futures contracts (gold or silver in particular) do choose to take physical delivery of graded bars at wholesale market prices, and store them. You can learn more about how the gold delivery process works in this video:

<http://www.letstalkfutures.com/2008/11/20/how-the-gold-delivery-process-works/>

Short Positions

Sell First Buy Second

This may seem obvious but prices don't always go up. Sometimes they fall. With futures it's just as easy to sell (take a short position) as it is to buy (take a long position). There are no special forms to fill out, no "uptick rule" and no higher financial requirements to meet. The money required to sell short is exactly the same as to buy long. You can think of short selling futures as simply "betting on abundance." High supplies will put pressure on prices, which would be good news for some (end-users) and bad news for others (producers). Selling first and then buying to offset is a perfectly reasonable strategy, and is easy to execute in your futures account. It's easy to get in and out of these positions in popular and liquid futures markets.

**Leverage:
A Powerful
Investment
Dynamic**

*“You can
choose how
much leverage
to use when
trading
futures.”*

Futures offer a highly capital efficient investment vehicle. By utilizing leverage, you can essentially make a larger investment with a smaller amount of upfront capital. Futures contracts typically require an investor to deposit roughly 5 – 15 percent of the full contract value to hold a position. That frees up extra capital you can use for some other purpose. For example, suppose you want to buy one gold contract. You would be required to deposit \$4,500 (margin as of December 2009, subject to change). One COMEX gold contract represents 100 troy ounces, so if gold is trading at \$1,000 an ounce, your investment is actually worth \$100,000.

To get a better understanding of how leverage works, consider home ownership. Say you buy a \$300,000 home with 20 percent down (\$60,000). In five years, if your home appreciated to \$360,000, you would have a \$60,000 gain, or a 100 percent return on your initial \$60,000 down payment. If however, your home falls in value to \$200,000, you would be facing a loss in excess of your down payment—and if you sold your home, you’d owe the bank an additional \$40,000 to cover the full mortgage value. You actually lost more than your initial investment (your \$60,000 down payment). Futures work the same way.



Continuing our gold example, as a holder of a long gold futures position, if the price of gold rises, leverage magnifies your gains, and when it falls, it magnifies your losses. This can be a positive or negative aspect of trading any type of futures contract. However, investors who have heard you can “lose your shirt” trading futures may not know you don’t have to utilize leverage at all. You can simply deposit the full contract value. The most you can lose is your initial investment, and that’s only if gold (or any other commodity you are trading) falls to zero. It is unlikely anyone will be giving away gold for free, so that’s an unlikely scenario. One reason many investors like trading commodities directly is that they always have some value—unlike shares of many companies that no longer exist.

That’s not to say futures are the right investment for every individual. Like any investment, one needs a thorough understanding of the risks. Investors who wish to employ leverage can lose more than their initial investment. That is why it’s paramount to know all the facts, no matter what you are investing in.



Futures trading involves the substantial risk of loss and is not suitable for all investors.

LIND | WALDOCK®
Your vision. Our expertise.

Chicago Board of Trade Building
141 West Jackson Boulevard
Suite 1400-A
Chicago, Illinois 60604

800-445-2000
lind-waldock.com

Lind-Waldock, a division of
MF Global Canada Co. Member CIPF
123 Front Street West, Suite 1601
Toronto, ON M5J 2M2

877-501-5463
lind-waldock.ca