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# Commodity Exchange Traded Products

Advantages, Disadvantages and Trade-offs

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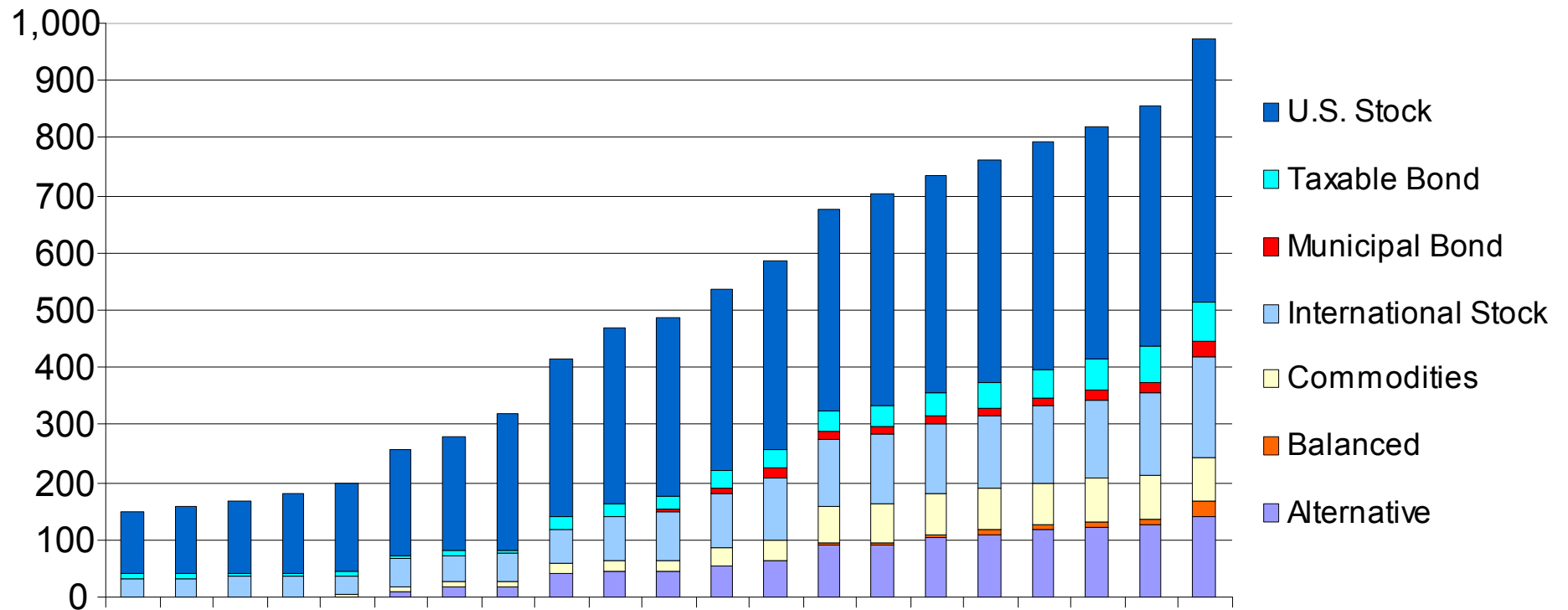
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## Total Net Assets by Asset Class, Quarterly

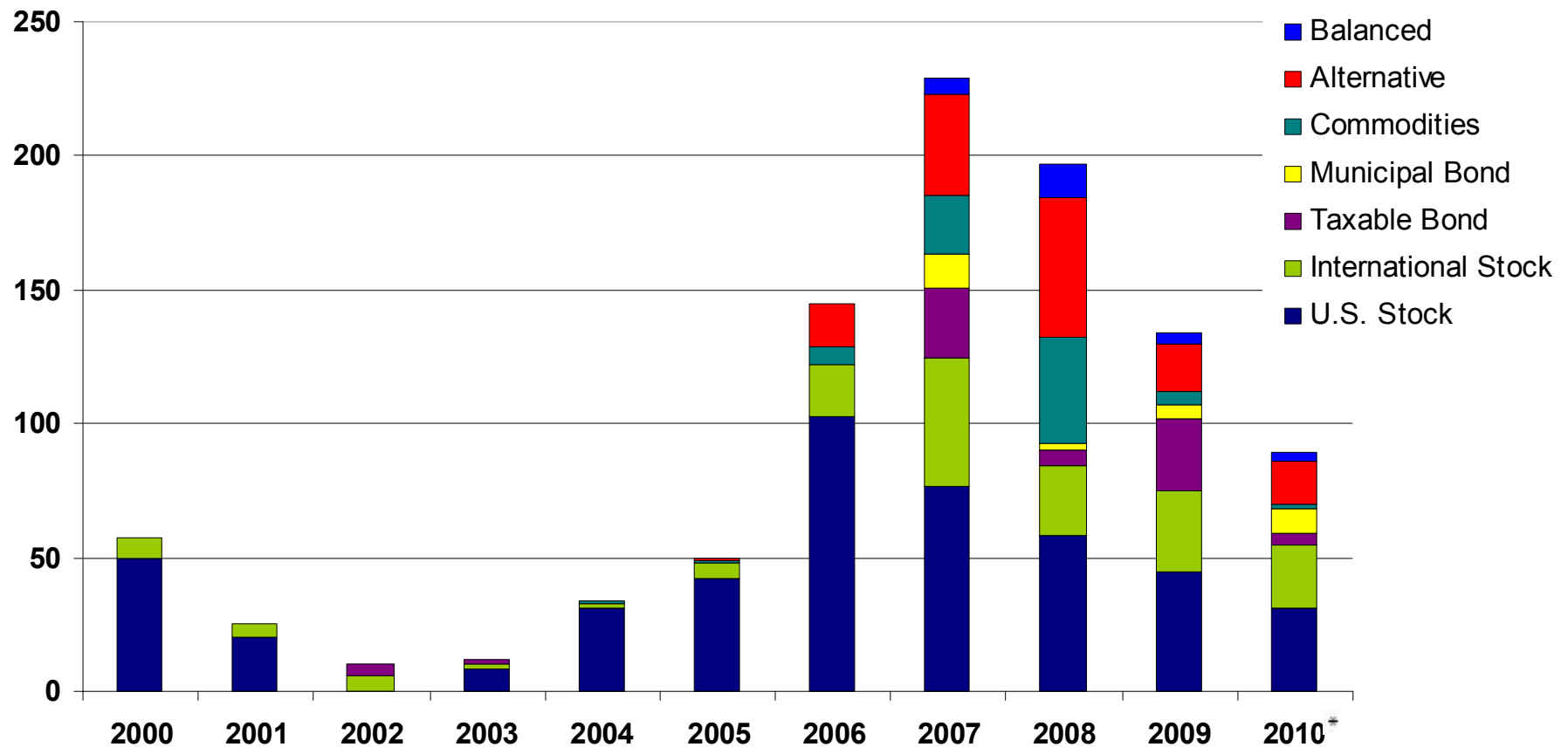
- ▶ Industry evolving beyond domestic equity
- ▶ Democratization of “difficult-to-access” asset classes



## ETF Proliferation Since 2005, Quarterly



## ETF Launches by Asset Class



\* Data for 2010 through May 14, 2010

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## Commodity ETNs – Basics

- ▶ ETNs are actually promissory notes that in effect give an investor a “swap” return for their investment
  - ▶ i.e. in exchange for an investor’s capital, the underlying bank promises to pay the return of the underlying index.
  - ▶ The underlying bank hedges the exposure as necessary
- ▶ In this structure, owners of ETNs are creditors of the bank pari passu with other senior secured lenders
- ▶ Because of the swap nature, ETNs have better tracking error to the index than ETF products that must actually buy and sell the underlying securities
- ▶ ETNs are more tax-efficient than ETFs that hold futures and forwards because they are taxed as fixed-income with long-term capital gains available to investors holding the fund longer than a year
  - ▶ Neither Commodity ETFs or ETNs pay dividends

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## Commodity Futures ETFs – Basics

- ▶ Commodity ETFs using futures are generally structured as limited partnerships (LPs) and actually hold, manage and roll futures positions on the underlying index.
- ▶ Because commodity ETFs hold the securities underlying in the partnership, there is no credit risk associated with the funds
- ▶ The need to actually buy and sell the contracts of the underlying index causes these products to often be limited in breadth (number of commodities) and to also have increased tracking error caused by transaction expenses
- ▶ ETFs are “look through” delivery vehicles for tax purposes
  - ▶ This means that a fund that holds commodity futures is subject to 60/40 long-term/short-term capital gains treatment and that gains and losses must be marked to market at the end of every year.
  - ▶ Because they are structured as LPs, investors also receive K-1 statements in the mail—although none have posted non-qualified income to date.

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## Commodity Physical ETFs – Basics

- ▶ Commodity ETFs holding physical assets are generally structured as investment trusts and actually hold and warehouse the underlying commodities
- ▶ Because commodity ETFs hold the commodities “in trust”, there is no credit risk associated with the funds
- ▶ The need to actually buy and store the commodities generally limits these structures to precious metals.
- ▶ ETFs are “look through” delivery vehicles for tax purposes
  - ▶ This means that a fund that holds precious metals is taxed as if the investor held precious metals themselves.
  - ▶ Gains on collectibles are taxed at ordinary income with a cap of 28% on the rate

## Commodity Physical ETFs – Why can't all ETFs Deliver Spot?

- ▶ Outside of precious metals, the physical storage requirements are absurdly large
- ▶ Take United States Natural Gas UNG at its peak for example:



\$4.5 billion

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### Hubert H. Humphrey Metrodome



21,150 Stadiums



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## Morningstar's Take on Commodity ETFs vs. ETNs

- ▶ In a taxable account, an investor should prefer to use a commodity ETN over a commodity ETF
  - ▶ The tax advantages are too large to ignore--lower tracking error is a plus
- ▶ We are not that concerned with credit risk—generally
  - ▶ Most are backed by large, well capitalized banks, but....
  - ▶ ....Not all banks are created equal and we due diligence the bank as much as we due diligence the ETN before recommending
- ▶ In a tax deferred account, we feel that investors can use either ETFs or ETNs
  - ▶ Without the tax advantage, there is no need to take on the credit risk, so absent massive tracking error, an ETF is fine and perhaps preferred

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## The “Market’s” Take on Commodity ETFs vs. ETNs

- ▶ Prior to the financial meltdown of 2008, ETNs were the clear leaders in asset gathering
- ▶ During the two months when banks were most in peril—November 2008 and March 2009—we saw massive fund outflows from ETNs
  - ▶ At that time, CDS spreads on many of the backing banks spiked to over 500 bps as default concerns soared
  - ▶ Lehman also filed bankruptcy and was the backing bank on 4 ETN products (it should be noted that none of those had investor assets in them at the time of bankruptcy)

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## The “Market’s” Take on Commodity ETFs vs. ETNs cont.

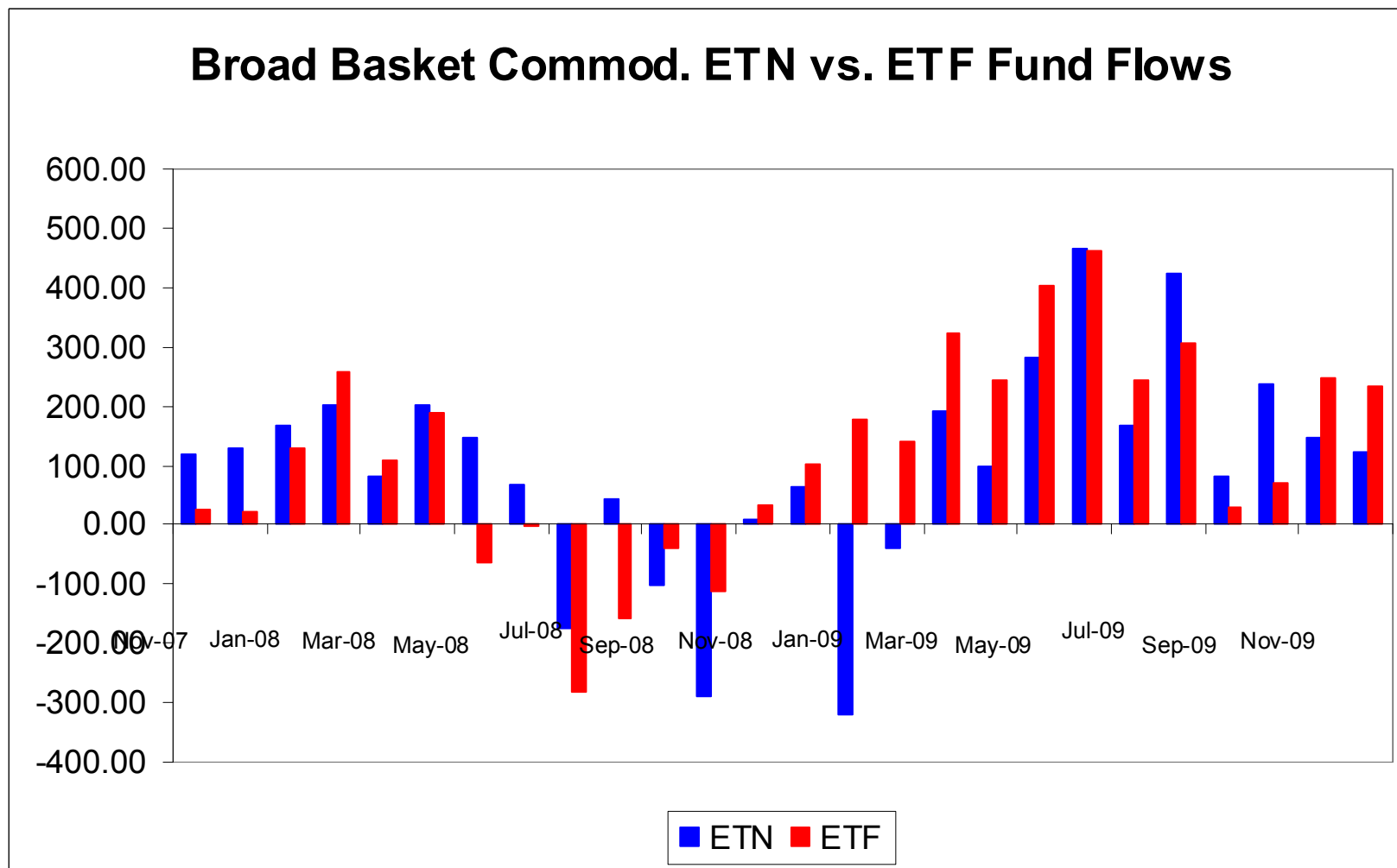
- ▶ Around April of 2009, we began receiving hundreds of e-mails from disgruntled investors who were not pleased with the tax situation they had encountered after switching from commodity ETNs to commodity ETFs
  - ▶ On its face, these may have seemed petty complaints, but there was perceived cost to the investor. Many complained that their tax accountant fees had doubled as a result of having to deal with the futures taxation issue and late K-1s caused them to file amended returns.

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## The “Market’s” Take on Commodity ETFs vs. ETNs, cont.

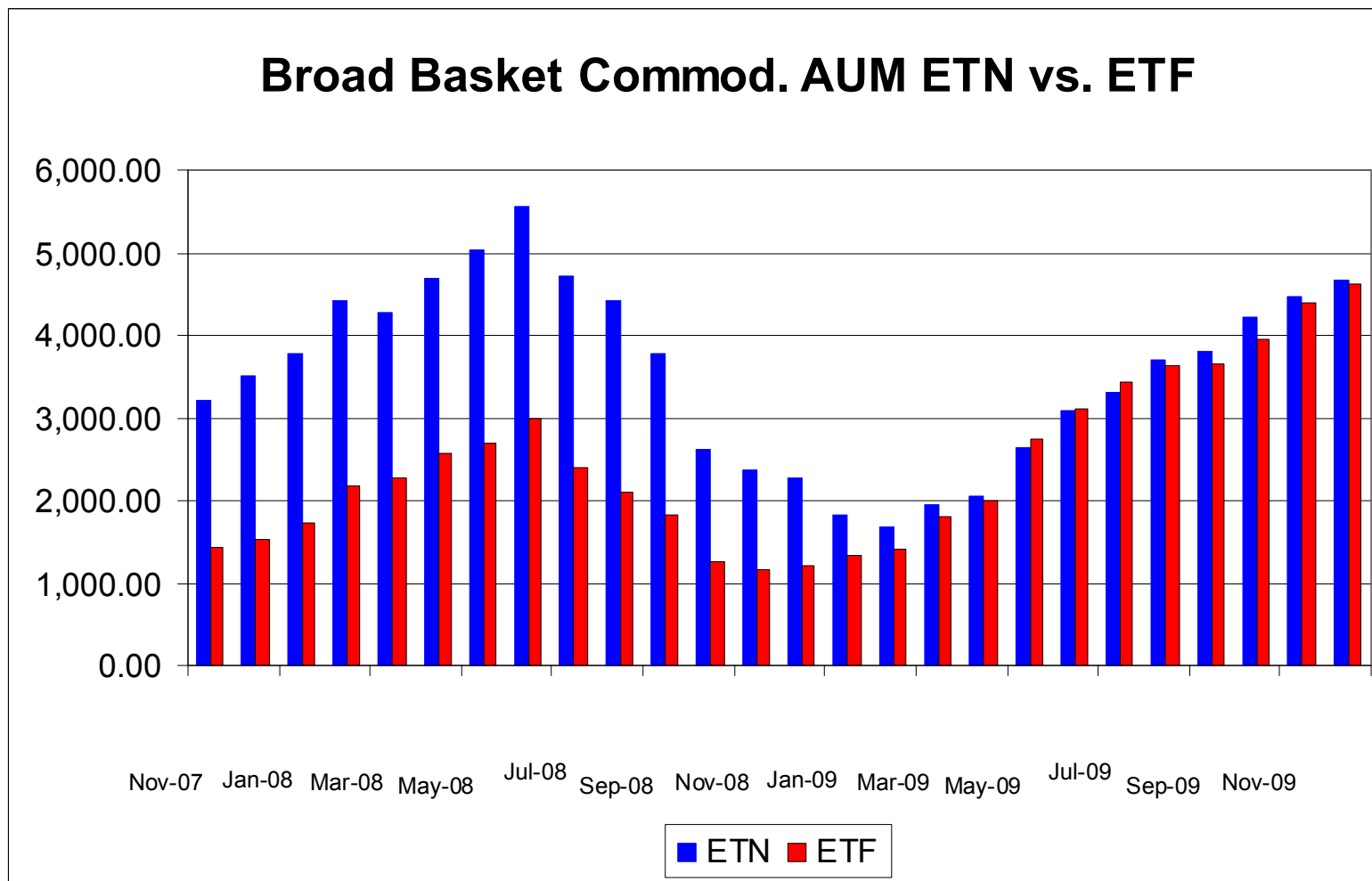
- ▶ So, the market is of multiple minds about this debate
- ▶ In periods of benign credit risk at banks, the market clearly appears to favor ETNs
  - ▶ As the banking crisis wound down, we’ve seen ETNs begin to grow again, although they have ceded market share to ETFs
- ▶ However, for some investors, no credit risk is good credit risk and they will never use ETNs
  - ▶ We have anecdotal evidence that entire platforms banned the use of ETNs during the height of the credit crisis and have yet to rescind those orders

## Commodity ETN vs. ETF Data



*dollars in millions*

## Commodity ETN vs. ETF Data



*dollars in millions*

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