Exchange Traded Commodities

Led by Gold, ETCs Opened the World of Commodities to Investors

By Nik Bienkowski, Head of Listings and Research, ETF Securities

The introduction of Exchange Traded Funds – ETFs – in the early 1990s revolutionised the mutual funds industry. Now Exchange Traded Commodities – ETCs, a part of that revolution – are transforming the way investors think about the commodities markets.

Commodities – along with real estate and hedge funds – have attracted increased interest as investors seek non-correlated assets to improve portfolio diversification. Around 2000, commodity markets went through some fundamental changes. Tight supply, caused by falling capex and record low inventories for some commodities, coupled with increasing demand for raw materials from emerging markets such as China and India, provided the foundations of the current bull market.

ETCs were designed to tap into that pool of increasing demand, and they have experienced spectacular growth. Global ETC assets have grown to over $28 billion since March 2003, and products are now available to suit most commodity investment strategies.

ETFs: Providing Investors with New Asset Classes

ETFs are similar to mutual funds, but trade on an exchange. Since their inception, ETFs have made a huge impact on investment and portfolio management. Currently almost $700 billion of assets is held in 950 ETFs globally across 41 different exchanges – this amount is expected to reach $2 trillion by 2011 (source: Morgan Stanley, *ETF Report*, August 2007). ETFs cover the traditional asset classes of equities and fixed income as well as the alternative asset classes of real estate and commodities. With these various asset classes covered by a wide variety of ETFs, a diversified portfolio can be constructed in as little as four or five easy transactions.

The primary advantage of ETFs was to provide easy, real-time access to mutual funds, which in turn provide portfolio diversification benefits in a single trade. By trading intra-day and not at day-end prices – as mutual funds do – ETFs could be used to take advantage of daily market movements and for hedging. New ETFs are continually being listed to provide all investor types with access to new investments that were previously barred to many, and certainly were not available through domestic brokerage accounts – for example, emerging markets.

The major common features of ETFs include:

- An exchange listing with the ability to trade continually
- A predetermined, transparent index-linked structure
- The ability to handle cash or physical creation in exchange for ETF units
- Redemptions by market participants, called 'Authorised Participants'
- Competitive pricing provided by multiple market makers.

A further benefit is that ETFs now provide the ordinary investor cost-effective access to new markets not previously accessible.

Opening Up Commodities Markets

Commodities markets are some of the oldest in the world, yet some of the last to be broadly available to investors. Gold has existed as a currency and an asset for thousands of years, and even though it was the first commodity to be securitised through an ETF structure, it was not available until 13 years after the first equity ETF was created.

Until the advent of ETCs in 2003, commodity markets were the exclusive realm of 'sophisticated' institutional investors – through purchasing the physical metal, trading in futures contracts or negotiating bespoke long-term agreements. Although these markets were viewed as less liquid, commodities now trade in the realm of $100 billion per day. And whereas originally commodity markets were heterogeneous, opaque and small, today they have become regulated, transparent and liquid. These characteristics have helped make commodities suitable for securitising and investment by a broader group of investors.

Investor appetite increased when commodity markets experienced a surge in interest around 2000. This led to the development of a wide range of structured products on commodities that provided investors with direct exposure to commodities without the need to take on equity market risk through mining companies. The resulting increased demand from a wider investor base in turn led to the development of the ETC, providing investors with a legal structure that was secure, listed and, perhaps most importantly, investable (many institutional investors are prevented from buying physical commodities, or even commodity derivatives). Thus the ETC was the only structure that could allow the broadest range of investor groups to access the commodities market.

Although the ETC market is only four years old, it has experienced tremendous growth. Figure 1 shows the growth of the global ETC market, initiated in 2003 by the first gold product, Gold Bullion Securities.

Fig 1 Growth of Gold ETCs & Other Commodity ETCs

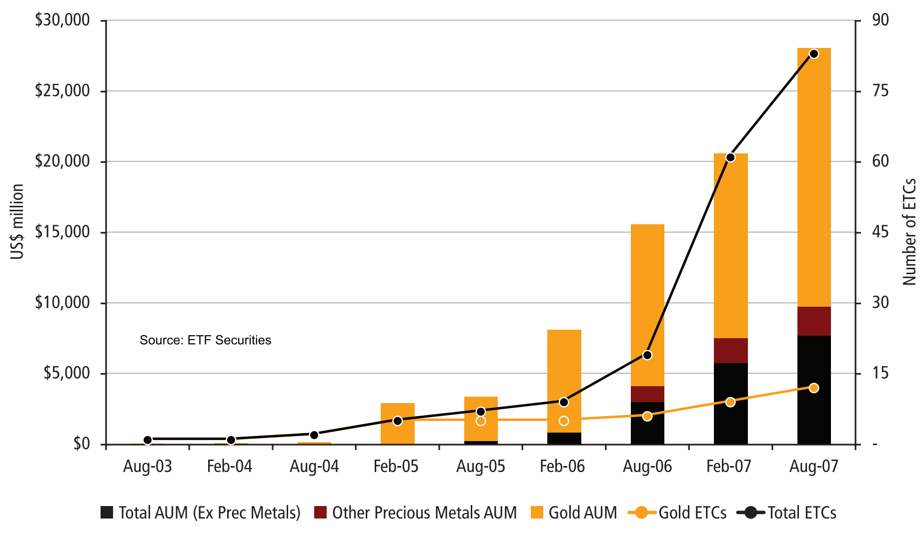
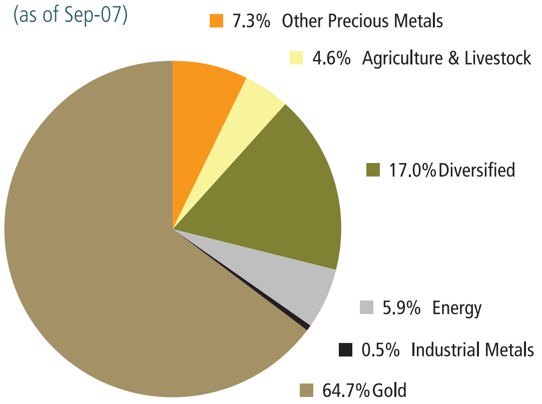


Fig 2 Breakdown of Global ETC Assets

(as of Sep-07)



Source: ETF Securities

In the past two years alone, global ETC assets have grown by over 1000%, with the number of products increasing from around 10 to over 80. ETCs have been listed on most of the world's major stock exchanges and now cover every major commodity group. At current growth rates, global ETC assets are likely to exceed $45 billion by December 2008.

Introducing the First ETC

After the introduction of ETFs in 1990, it took 13 years for the first ETC to be created. Figure 2 shows that approximately 65% of all ETCs are exposed to gold, with the remaining 35% exposed to other commodities. Gold's dominance is partly due to the fact that it was the first ETC to be created – gold's characteristics make it one of the easiest commodities to be securitised.

ETFs are generally created by physically delivering a portfolio of shares – e.g. 500 shares in the case of the S&P 500 – and issuing securities from the fund. Gold bullion is easy to purchase, does not decay and can be physically delivered to the fund's account. Furthermore, unlike most other commodities, it is relatively easy to define a homogeneous type of bar – for example, London Good Delivery bars. Another helping factor was that gold has been considered insurance for a diversified portfolio for many years.

Despite gold's helpful physical characteristics, securitising gold was not an easy task. Complications inevitably arise when markets originally designed for equities are combined with those for commodities. Each market has its own separate rules, regulations, supervision, jargon and participants. In addition, many equity funds are prevented from buying physical metals and commodities. The solution to the introduction of the gold ETC required a legal structure that would allow investors who had been previously prevented from purchasing bullion to invest in ETFs. Gold Bullion Securities were the result, and from there, a global industry of ETCs was spawned – and whose market acceptance is increasing day by day.

Recent Developments in Commodities Investing

ETF Securities has over 40 ETCs, covering all major commodities and commodity sectors. Figure 3 shows the progression of demand across the various commodity groups for ETF Securities' ETCs. I use ETF Securities' platform as an example as it offers the widest range of products, thus it is easier to highlight any trends. A few interesting factors can be noted from the chart.

Agriculture and livestock make up a large portion of assets – approximately 40% – for a number of reasons, including the fact that agriculture and livestock are commodities that are typically hard to access, particularly through equities – a problem which ETCs were designed to solve – and due to the

Quick Study ETCs – Et Cetera

Exchange Traded Commodities – ETCs – are listed securities backed by a commodity – either physical commodities or commodity futures. They enable ordinary investors to buy and sell commodities through regular brokerage accounts, providing cheap and easy access to an asset class (or sector) that has previously been difficult to access.

The steady growth in ETCs over the past few years is a result of the many benefits they provide to investors:

Exchange listed – commodities can now be held in ordinary brokerage accounts and self-managed pension funds

Broad appeal – because many investors were prevented from investing in commodities, particularly in physical form, ETCs provide access to new types of investors

A single market – in the case of the numerous ETC platforms being created on Europe's stock exchanges, the world's major commodities can now be traded in one time zone and on the same exchange. Previously some commodities were only traded on certain continents across a range of time zones and on multiple exchanges

Independent – ETCs can be created, accessed and traded by anyone

Increased availability – ETCs have brought the wholesale market to smaller investors. While minimum investment sizes were out of the reach of some investors, ETCs can be purchased in amounts ranging from $2.00 to $130.00, depending on the commodity

Safe – ETCs are regulated, and since they are backed by an asset (either physical or futures), there is generally little or no financial or credit risk

Simple – ETCs do not require any daily operational management – such as managing futures positions, rolling or margin calls

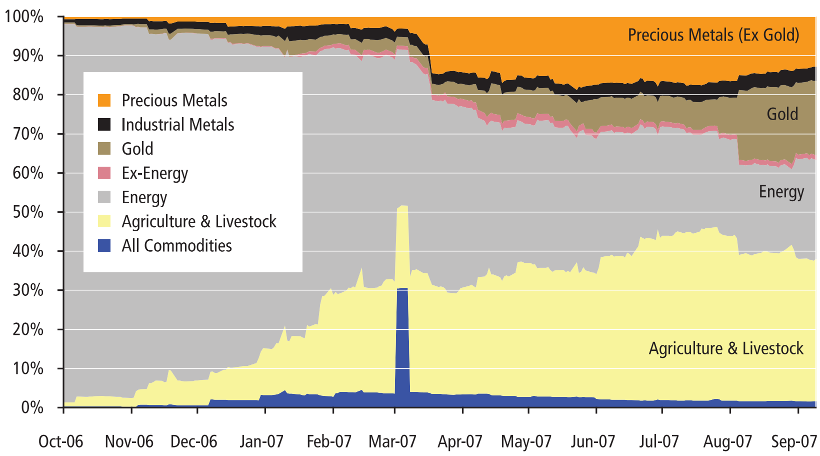
Cost effective – due to their passive and simple nature, costs are low and transparent, making wholesale prices accessible to all investor groups

Liquid – Like ETFs, ETCs are as liquid as the underlying asset and are not limited to on-exchange volumes

High correlation – ETCs provide near-perfect correlation to the underlying commodity – something not achievable through the purchase shares in commodity companies – providing an additional tool for managing portfolios

Portfolio management – ETCs can be used for asset allocation, core/satellite approach, cash equitisation, sector and style allocation/rotation, and risk management.

Fig 3 Development of ETF Securities' Asset Growth



current agriculture boom, which is in turn caused by two factors: the alternative fuel story and the combination of record-low inventories in most agriculture commodities and increasing demand from a growing world population

Gold and other precious metals are the second largest group. ETF Securities' precious metals ETCs are the newest addition to their stable of ETCs, yet due to gold's long history as an investment, it has captured 20% of total assets in around four months; the other ETCs have been listed for over 12 months.

As global ETC growth continues, we would expect the allocation of other commodities to increase, and consequently gold's share will fall from 65% of total global ETC assets. However, we expect that gold's share will remain significantly above the 2% to 7% allocation gold currently commands in the major commodity benchmarks such as the S&P GSCI™ Commodity Index and the Dow-Jones AIG Commodity Index℠.

The ETF market has come a long way in the past seventeen years and now covers a vast range of assets, including many that had been difficult to invest in, such as emerging markets, commodities and other alternative investments. The development of ETCs has opened up some of the oldest markets in the world to ordinary investors, providing additional sources of diversification that can improve portfolio performance. Given the wide range of ETCs, investors can simply choose their preferred commodity for investment.

The growth in number of ETFs and assets invested is likely to continue, as markets around the world develop and as investors' knowledge of commodities increases. ■

Nik Bienkowski *helped create Gold Bullion Securities, the world's first gold ETC. Following on that success, he co-founded ETF Securities Limited, which created the world's first oil ETC and then in September 2006 launched an entire platform of commodity ETCs. This platform now includes over 50 ETCs and is listed on five European Exchanges.*

As Chief Operating Officer at ETF Securities, Nik's responsibilities have included running the investment research team and product development. Prior to his work on ETCs, he spent five years working in the mining finance and pension consulting industries.