Inside First Trust ETFs
April 2011 ■ Vol. 3

Commodity ETFs in 2011

Author:

Ryan Issakainen
Senior Vice President
Exchange Traded Fund Strategist
First Trust Advisors L.P.

The ETF industry has experienced explosive growth in the US over the last decade, with assets now exceeding $1 trillion. One of the many factors fueling this increase is the fact that ETFs have effectively democratized certain asset classes that had previously been much more difficult or expensive for most investors to access. Today, in addition to traditional equity index ETFs, investors can gain exposure to commodities, foreign currencies and fixed-income securities as well as a growing number of more sophisticated investment strategies. Along with the benefits of having more options from which to choose comes a renewed responsibility for investors to scrutinize and understand the strategy by which an ETF provides exposure to its specific asset class.

With fears of inflation looming amidst volatile energy prices, there has been a groundswell of interest in commodity-related ETFs. In this newsletter, we will explore some of the more significant differences between ETFs[1] that provide exposure to a given commodity via the popular strategy of rolling futures contracts versus ETFs that invest in commodity-related equities, considering the example of natural gas ETFs. As we'll discover, these differences have had a significant impact on the relative performance of commodity-related ETFs in recent years, with implications extending into the future.

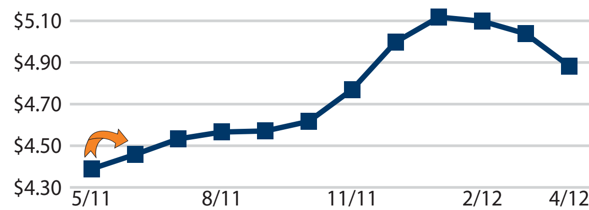
Commodity Futures-Related ETFs

One popular approach taken by commodity ETFs is to systematically maintain a position in the near month futures contract for a specific commodity or basket of commodities. This not only sidesteps the costs associated with physical storage, which in many instances would be prohibitive, it also provides a relatively close proxy for short-term spot price fluctuations, to which near-month futures contracts are highly sensitive. However, this strategy also requires the ETF to roll futures contracts periodically, introducing an additional layer of complexity that has had a significant impact on performance.

The challenge faced by ETFs that follow a strategy of rolling near-month futures contracts is observed most acutely during periods of time in which futures contracts for later months are more expensive than their shorter-dated counterparts, a condition referred to as "contango". This is problematic because the fund is forced to sell near-month futures contracts approaching expiration at prices that are lower than the fund's cost for purchasing an equivalent quantity of subsequent month's contracts, as illustrated in Chart 1 (above). If contango persists over time, as it has in recent years for certain commodities such as natural gas, the fund systematically realizes a negative "roll yield" during that period of time.[2] This has resulted in significant underperformance of many commodity ETFs relative to their respective spot prices over time.

Additionally, investors should be aware that, because many ETFs that invest in commodity futures are organized as limited partnerships (as opposed to traditional mutual funds), they must issue a schedule K-1 each year rather than a form 1099.

Chart 1: NYMEX Natural Gas Futures as of 3/31/11



Source: First Trust; Bloomberg.

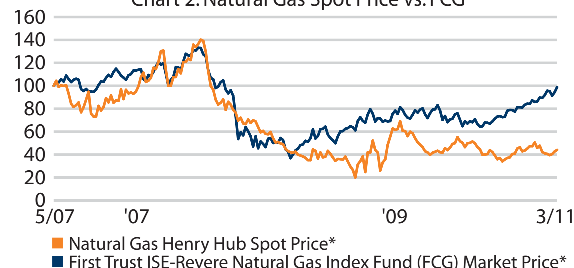
Past performance is no guarantee of future results. This information is for illustrative purposes only and is not intended to be indicative of the performance of any First Trust portfolio. The performance shown does not reflect any fees, transaction costs or expenses.

Commodity-Related Equity ETFs

ETFs that invest in equities related to specific commodities, such as energy exploration & production companies or metals mining companies, have emerged as another alternative for investors. In this case, exposure to commodities is provided indirectly, via the earnings of those companies. Because a large proportion of a company's cost for producing a commodity is fixed, the variable price it receives for selling that commodity is an important driver for its earnings. In other words, corporate earnings are leveraged to price movements of the underlying commodity.

Of course, commodity spot price movements are not the only factor that impacts a related company's earnings. For example, commodity producers often seek to smooth out the variability of spot price movements by selling future production in the commodity futures market. Additionally, many producers have the ability to temporarily shift production to other commodities that may be more profitable in the short term. For example, many energy E&P companies produce both natural gas and crude oil. Depending on the relative cost of production and market price of each, these companies may shift the balance of production to maximize profits. Companies may also invest in new technologies that lower the cost of production, further impacting their ability to deliver earnings to shareholders. Each of these elements of "business risk" can impact the performance of commodity-related equities beyond fluctuations in the related commodity's spot price (See Chart 2 below).

Chart 2: Natural Gas Spot Price vs. FCG



Source: Bloomberg.
*Indexed to 100 as of 5/31/07.

First Trust

How does my investment thesis match my ETF?

One of the most important questions investors should consider when evaluating the many options available within any segment of the ETF market, including commodity ETFs, is how well each ETF matches up with his or her investment thesis. For example, an investor interested in speculating on the potential for short-term price gains for natural gas during hurricane season due to storm-induced production shut downs may be well-served by choosing an ETF that maintains exposure to the near month natural gas futures contract. Such an ETF will generally be more sensitive to short-term natural gas price movements than an ETF that invests in natural gas-related equities would be.

On the other hand, an investor who is more interested in the long-term case for the natural gas industry may find an ETF that invests in natural gas-related equities more appropriate for his or her investment thesis. While both methodologies may benefit from increasing natural gas prices, natural gas companies may operate quite profitably even when prices are stable. Furthermore, while new discoveries of natural gas supply may negatively impact the price of the commodity in the near-term, these discoveries are generally viewed positively from the standpoint of companies increasing their reserves. In the case of natural gas, the abundance of recently discovered domestic supply provides a net benefit for the industry because it enables long-term structural changes to the ways in which natural gas can be used. As the long-term outlook for the natural gas industry continues to improve, the potential for natural gas-related equities to be acquired by large integrated oil companies grows as well. While many of these long-term factors may have a profound impact on natural gas companies, their impact on the near-term price of the commodity is much smaller.

Conclusion

As we've stated in previous ETF publications, all ETFs are not created equal. In no category is this assessment more critical than for commodity ETFs. While their introduction has expanded the average investor's toolkit beyond that which was previously economical, the nuances associated with different types of commodity exposure must not be overlooked. As each approach serves slightly different purposes, commodity ETFs should ultimately be selected based on how well each fits an investor's rationale for owning the asset class

[1] While recognizing that many commodity-related ETFs are not organized under the Investment Company Act of 1940, we will refer to all exchange-traded products discussed in this newsletter as ETFs for the sake of continuity.

[2] A strategy of rolling near month futures contracts may also experience a positive "roll yield" during periods of time in which subsequent month futures contracts are less expensive than the current month's contract, a condition known as "backwardization". In either case, the implementation of a strategy in which near month futures contracts are rolled introduces tracking error between the ETF and the spot price of a commodity.

RISKS

The fund's shares will change in value, and you could lose money by investing in the fund. One of the principal risks of investing in the fund is market risk. Market risk is the risk that a particular stock owned by the fund, fund shares or stocks in general may fall in value.

The fund's return may not match the return of the ISE-REVERE Natural Gas Index™. The fund may not be fully invested at times. Securities held by the fund will generally not be bought or sold in response to market fluctuations. The fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Investors who sell fund shares may receive less than the share's net asset value. Shares may be sold throughout the day on the exchange through any brokerage account. However, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units.

You should be aware that an investment that is concentrated in stocks in the natural gas industry involves additional risks, including limited diversification. The companies engaged in the natural gas industry are subject to certain risks, including price and supply fluctuations, increased interest rates, and fuel prices which will vary with supply and demand factors including weather and general economic and political conditions.

An investment in commodities involves risks as the price of commodities can fluctuate widely. Several factors may affect the prices of commodities, including but not limited to: global supply and demand, excess capacity, production costs, economic recession, domestic and international politics, currency exchange rates, government regulations, volatile interest rates, consumer spending trends and overall capital spending levels. In addition, commodity prices may be affected by import controls, worldwide competition, inflation, investment and trading activities of hedge funds and commodity funds, and depletion of natural resources.

The fund is classified as "non-diversified." A non-diversified fund generally may invest a larger percentage of its assets in the securities of a smaller number of issuers. As a result, the fund may be more susceptible to the risks associated with these particular companies, or to a single economic, political or regulatory occurrence affecting these companies.

The First Trust ISE-Revere Natural Gas Index Fund is not sponsored, endorsed, sold or promoted by the International Securities Exchange (ISE). ISE makes no representation or warranty, express or implied, to the owners of the fund or any member of the public regarding the advisability of trading in the fund. ISE's only relationship to First Trust is the licensing of certain trademarks and trade names of the ISE and of the ISE-REVERE Natural Gas Index™ which is determined, composed and calculated by ISE without regard to First Trust or the fund.

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit www.ftportfolios.com to obtain a prospectus or summary prospectus which contains this and other information about a fund. The prospectus or summary prospectus should be read carefully before investing.

Not FDIC Insured • Not Bank Guaranteed • May Lose Value