Preparing for the Unexpected with Commodity Futures ETFs

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Three straight years of negative returns for broad commodity benchmark indices, such as the Dow Jones-UBS Commodity Total Return Index, have led some investment advisors (and their clients) to begin questioning the rationale for including commodity futures ETFs[1] in their asset allocation models. Relatively tame inflation expectations seem to support these doubts, as commodities are often thought of as a hedge against inflation. However, the fact that inflation expectations are so low may actually highlight one of the most important reasons for maintaining (or adding) a strategic allocation to commodity futures ETFs: in order to hedge against *unexpected* inflation.

Unexpected inflation is a risk worth hedging, in our opinion, because it tends to have a negative impact on both stocks and bonds. For example, when inflation is accurately forecasted, manufacturing companies can utilize futures contracts to lock in their future costs for certain raw materials, in order to manage their profit margins. However, when input costs rise unexpectedly, profit margins may be compressed for companies that have difficulty passing these cost increases along to their customers, which, in turn, tends to hurt stock prices.

Bondholders are negatively impacted by unexpected inflation as well, since bond yields are set by the market with an embedded inflation expectation. When inflation increases unexpectedly, the real value of bond interest payments is reduced, which may also negatively impact bond prices, as the market requires higher nominal yields.

Similar to stocks and bonds, the prices of commodity futures also have embedded inflation expectations, but unlike stocks and bonds, commodity futures prices tend to be positively impacted by unexpected inflation increases.[2] This relationship enables investors to potentially utilize commodity futures and related ETFs as an effective hedge against unexpected inflation.

Of course, it's difficult to make a strong case for *when* unexpected inflation may show up, which is ultimately what makes it *unexpected*. While there are certainly conditions in place that could eventually lead to higher levels of inflation, First Trust's forecast for year-over-year US CPI growth of 1.8% in 2014 and 2.3% in 2015 is only slightly higher than the median forecast among Bloomberg contributors (1.6% for 2014 and 2.0% for 2015). But this underscores why we believe it makes sense to include a strategic allocation to commodity futures ETFs in an asset allocation model: not as a tactical play based on our expectation of unexpected inflation, but as a tool to manage the risk of unexpected inflation, which, by definition, you don't see coming.

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. You can download a prospectus or summary prospectus, or contact First Trust Portfolios L.P. at 1-800-621-1675 to request 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.

The Dow Jones-UBS Commodity Index is made up of exchange-traded futures on physical commodities and represents 20 commodities, which are weighted to account for economic significance and market liquidity. Indexes are unmanaged and an investor cannot invest directly in an index.

Investors buying or selling ETF shares on the secondary market may incur customary brokerage commissions. Market prices may differ to some degree from the net asset value of the shares. 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, unlike mutual funds, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units. A fund's shares will change in value, and you could lose money by investing in a fund. One of the principal risks of investing in a fund is market risk. Market risk is the risk that a particular security owned by a fund, fund shares or the market in general may fall in value.

The trading prices of commodities futures fluctuate in response to a variety of factors which will cause a fund's net asset value and market price to fluctuate in response to these factors. As a result, an investor could lose money over short or long periods of time. In addition, the net asset value of a fund over short-term periods may be more volatile than other investment options because of a fund's significant use of financial instruments that have a leveraging effect. Futures instruments may be less liquid than other types of investments. The prices of futures instruments may fluctuate quickly and dramatically and may not correlate to price movements in other asset classes.

All opinions expressed constitute judgments as of the date of release, and are subject to change without notice. There can be no assurance forecasts will be achieved. The information is taken from sources that we believe to be reliable but we do not guarantee its accuracy or completeness.

[1] For the sake of clarity, the term "ETF" is used to refer to all exchange-traded products (1940 Act exchange-traded funds, exchange-traded notes, commodity exchange-traded securities, etc.).

[2] Gary Gorton and K. Geert Rouwenhorst. 2006. "Facts and Fantasies about Commodity Futures." *Financial Analysts Journal*, vol. 62, no. 2 (March/April 2006):47–68.

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