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Signs of Life for Commodity ETFs

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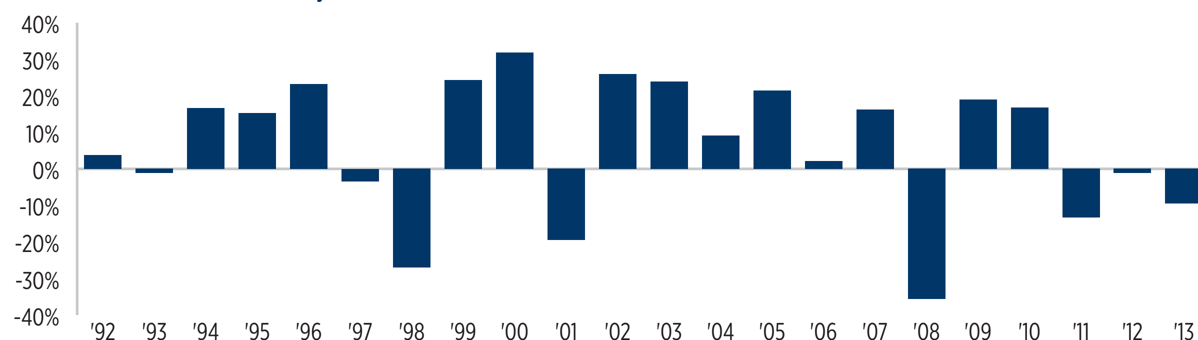
During the month of January 2014, broad commodity exchange-traded funds (ETFs) set a new record for single-month net outflows, which totaled approximately $612 million.[1,2] However, investor appetite seems to be shifting, as four straight months of net inflows totaled approximately $410 million, through the end of May.[2] Most likely, this trend is related to the encouraging relative returns provided by commodity indices so far this year. For example, the Dow Jones UBS Commodity Total Return Index posted a 6.45% return through the end of May, outperforming both the S&P 500 Index (+4.97%) and the Barclays Capital U.S. Aggregate Bond Index (+3.87%).

It's no secret that investors have a tendency to chase returns. Of course, the pertinent question is whether or not returns for commodity ETFs will continue this year's positive trend. In this newsletter, we will discuss three reasons for investors with underweight allocations to commodities to consider increasing exposure. First, following three straight calendar years of negative returns, the potential for mean reversion may provide a tailwind for commodities. Second, commodities may prove to be a hedge against inflation. And third, commodities historically have tended to provide the greatest benefit to a portfolio of stocks and bonds during the second half of economic expansions and the first half of economic recessions. We will then explore what characteristics may be of particular importance to investors when selecting a broad commodity ETF, highlighting the First Trust Global Tactical Commodity Strategy Fund (FTGC).

Commodities and Mean Reversion

One counterintuitive reason to be optimistic about the near term prospects for broad commodity ETFs is the poor performance of commodity indices over the past few years. The 3-year stretch of negative returns from 2011-2013 was unprecedented in the 22 year history of the Dow Jones UBS Commodity Total Return Index, which had previously posted only one 2-year period of negative returns (1997-1998). Interestingly, many of the best performing years for this index have followed periods of negative returns (see Chart 1 below). Of course, there can be no assurance that a similar rebound will occur in 2014.

Chart 1: Dow Jones-UBS Commodity Total Return Index



Source: Bloomberg. An index cannot be purchased directly by investors. Past performance is no guarantee of future results.

Preparing for the Unexpected (Inflation)

Many investors believe inflation will be relatively tame over the next several years. The median forecast of Bloomberg contributors for year-over-year US CPI growth, a common measure of inflation, is 1.7% for 2014 and 2.1% for 2015. First Trust's latest CPI growth forecasts are in-line with the composite for 2014 at 1.7% and only slightly higher for 2015 at 2.3%. Such low expectations have likely caused some investors to question the rationale for allocating to commodities, which are often considered to be a hedge against inflation. However, we believe low inflation expectations actually bolster the case for allocating to commodities, which may provide a hedge against unexpected inflation.

Unexpected inflation tends to impact stocks and bonds differently than expected inflation. For example, if a manufacturing company expects raw materials' prices to increase, it can effectively utilize futures contracts to lock-in costs. Absent such expectations, it's likely that manufacturers will less aggressively hedge future costs. Therefore, if raw materials' prices unexpectedly increase, profit margins may be compressed for companies that are unable to raise prices, which, in turn, tends to hurt stock values.

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 a bond's future cash flows is reduced, which also negatively impacts bond prices, as the market requires higher nominal yields.

Of course, it's impossible to predict when unexpected inflation may show up, which is ultimately what makes it "unexpected." However, this is a risk worth hedging, in our opinion, in light of several factors that could result in higher-than-expected inflation, such as an overly accommodative monetary policy from the US Federal Reserve, increasing global economic growth resulting in stronger-than-expected demand, and geopolitical events potentially causing tighter-than-expected supplies of raw materials.

Past performance is not a guarantee of future results and there is no assurance that the above mentioned events or improvements will continue.

Commodities and the Business Cycle

The historical relationship between commodity futures and the business cycle provides another compelling reason for investors to consider adding commodity ETFs to a diversified portfolio of stocks and bonds.

In 2006, Gary Gorton and K. Geert Rouwenhorst published a study which compared the average returns of U.S. stocks, U.S. bonds, and a diversified portfolio of commodity futures during four different phases of the U.S. economic business cycle, from 1959-2004.[3] The four phases in the study were determined by bisecting periods of "expansion" and "recession," as identified by the National Bureau of Economic Research (NBER). The data showed that both stocks and bonds tended to perform better during the first half of economic expansions than during the second half, while the opposite was true for commodity futures, which tended to outperform during the second half of expansions (see Table 1 below). Moreover, while stocks and bonds tended to produce negative returns during the first half of recessions, followed by positive returns during the second half, commodity futures tended to produce positive returns during the first half of recessions, followed by negative returns during the second half. Based on these observations, the study suggested that the long term diversification benefits offered by a portfolio of commodity futures were partly due to differences in performance during different phases of the business cycle.

Table 1: Average Returns by Stage of the Business Cycle, July 1959 - December 2004

Cycle Type	Stocks	Bonds	Commodity Futures
Expansion	13.3%	6.7%	11.8%
Early	16.3%	10.0%	6.8%
Late	10.4%	3.6%	16.7%
Recession	0.5%	12.6%	1.1%
Early	-18.6%	-3.9%	3.7%
Late	19.7%	29.1%	-1.6%

Gorton, G. and K. Geert Rouwenhorst (2006). "Facts and Fantasies about Commodity Futures." Financial Analysts Journal, vol. 62, no. 2: 47-68. Past performance is no guarantee of future results.

During the most recent NBER-identified full business cycle, which began in November 2001 and ended in June 2009, there were important similarities and differences compared to the longer-term averages published by Gorton and Rouwenhorst. The most obvious differences occurred during the early expansion phase, as returns for commodity futures far outpaced stocks and bonds, and during the late recession phase, as negative returns for commodity futures were more extreme than the longer-term average, even as returns for stocks were also negative (see Table 2 below).

Perhaps the most significant similarity between returns from the recent business cycle and the longer-term averages was the positive return provided by commodity futures during the first half of the recession, while stock returns were negative. Additionally, commodity futures outperformed stocks and bonds during the second half of the expansion phase, although the outperformance relative to stocks was less pronounced.

Table 2: Returns by Stage of the Business Cycle, November 2001 - June 2009

Cycle Type	Stocks	Bonds	Commodity Futures
Expansion *(10/31/01-11/30/07)*	55.8%	33.8%	131.5%
Early *(10/31/01-11/15/04)*	17.7%	16.7%	74.7%
Late *(11/15/04-11/30/07)*	32.4%	14.7%	32.5%
Recession *(11/30/07-5/30/09)*	-35.6%	6.9%	-28.2%
Early *(11/30/07-8/31/08)*	-12.0%	2.3%	8.8%
Late *(8/31/08-5/30/09)*	-26.8%	4.5%	-34.0%

Stocks are represented by the S&P 500 Index. Bonds are represented by the Barclays US Aggregate Bond Total Return Index. Commodity Futures are represented by the Dow Jones-UBS Commodity Total Return Index. Past performance is no guarantee of future results. An index cannot be purchased directly by investors.

Of course, a major problem arises for those interested in applying a trading strategy to this information (which was recognized by the study's authors): NBER identifies the beginnings and ends of recessions and expansions several months after the fact. This makes it impossible for investors to know when the economy has reached an inflection point between expansion and recession, or when a midpoint of either has been reached.

Nevertheless, we can make a reasonable approximation about the phase(s) to which the U.S. economy may currently be closest. With the trough of the last NBER recession identified as June of 2009, and in light of steadily declining unemployment and relatively steady GDP growth over several quarters (with the exception of negative GDP growth during the first quarter of 2014), one can reasonably assume that the U.S. economy is currently in a NBER expansion. If so, the current expansion is about 59 months old. According to NBER data, the average duration of the 11 expansions since 1945 (through the peak of the last expansion in December of 2007) was 58.4 months; the longest was 120 months (between March 1991 and March 2001). So, while it's not yet possible to identify the midpoint of the current NBER expansion, if it's anything like the previous eleven, there is a good chance the second half has already begun, or if it hasn't (and the next recession is more than 59 months away), the midpoint is likely drawing near.

If this inference proves correct, the U.S. economy may be in the midst of (or about to enter into) the two phases of the NBER business cycle during which commodity ETFs could provide the greatest benefit to a portfolio of stocks and bonds. The second half of NBER expansions produced the highest average returns for commodity futures, while the first half of NBER recessions produced positive average returns for commodity futures, during a stage in which average returns for stocks and bonds were both negative.

Considerations for Selecting a Broad Commodity ETF

Three important questions for investors to consider when selecting a broad commodity ETF are: First, how is the asset allocation determined? Second, what is the strategy for selecting/rolling futures contracts? And finally, what are the ETF's tax considerations and how are taxable gains/losses reported?

Asset Allocation

The vast majority of broad commodity ETFs are index-based. The methodology by which each index is constructed can result in significant differences in asset allocation. For example, the S&P GSCI is a broad commodity index whose constituents are weighted based on global production data. As a result, energy represents the largest sector allocation at 69.8%, followed by agriculture at 15.3% (as of 5/31/14). This is drastically different from the Dow Jones UBS Commodity Index, whose weightings are based on both production and liquidity, which results in a 32.6% allocation to energy and a 31.4% allocation to agriculture (as of 5/31/14). In contrast to these and other index-based approaches, the First Trust Global Tactical Commodity Strategy Fund (FTGC) is an actively managed ETF, whose asset allocation is determined based on risk-management principles, targeting a more narrow range of volatility. As such, the fund may adjust its asset allocation in response to increases or decreases in the volatility of its constituents. As of 5/31/14, FTGC's allocation to energy was 38.9% and its allocation to agriculture was 28.0%.

Implementation Strategy

The strategy by which a commodity ETF implements its asset allocation model can also have a meaningful impact on performance. Generally speaking, broad commodity ETFs utilize futures contracts for portfolio construction.[4] Because futures contracts expire on a monthly or quarterly basis, it's necessary to "roll" from one contract to another, in order to maintain a position. Depending on the difference between the price of the contract being acquired and the price of the contract being sold, this process may either add or subtract value from an ETF.

There are various strategies utilized by index-based ETFs for rolling futures contracts. Some ETFs systematically maintain and roll exposure to futures contracts nearest to expiration, irrespective of positive or negative roll returns. Others utilize optimization strategies designed to maximize returns from rolling futures contracts. As an actively managed ETF, FTGC employs a distinct roll strategy, which incorporates the idiosyncrasies of certain commodity futures, such as seasonality, liquidity, and geopolitical influences, in seeking to maximize total returns.

Tax Considerations/Reporting

Many broad commodity ETFs are structured as partnerships, which issue K-1 tax forms, rather than reporting taxable gains and losses on a Form 1099. Generally speaking, gains for these ETFs are taxed at a blended rate of 60% long-term capital gains/40% short-term capital gains. On the other hand, as a 1940 Act fund, FTGC reports taxable gains and losses on a Form 1099. The fund's distributions are taxable and will generally be taxed as ordinary income or capital gains.

Broad Commodity indices are off to a good start in 2014, and we believe there are compelling reasons to remain optimistic about the asset class. ETFs provide a low-cost, efficient tool for investors to gain exposure to commodities. However, there are significant differences among various commodity ETFs. Unlike most index-based ETFs, FTGC employs active management for portfolio construction and implementation, utilizing a fund structure that provides simplified tax reporting. As always, investors are encouraged to look "under the hood" at the various options to determine which ETF best meets their investment objectives.

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

[2]Morningstar Direct.

[3]Gorton, G. and K. Geert Rouwenhorst (2006). "Facts and Fantasies about Commodity Futures." Financial Analysts Journal, vol. 62, no. 2: 47-68.

[4]Commodity Exchange-traded notes (ETNs), which are unsecured debt instruments, generally track indices whose prices track futures contracts.

Past performance is not a guarantee of future results and there is no assurance that the events or improvements mentioned herein will continue.

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.

ETF Characteristics

The fund lists and principally trades its shares on The NASDAQ Stock Market LLC.

The fund may not be fully invested at times. Investors buying or selling fund 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.

Risk Considerations

The fund's shares will change in value and you could lose money by investing in the fund. The fund is subject to market risk. The trading prices of commodities futures, fixed income securities and other instruments fluctuate in response to a variety of factors. The fund's net asset value and market price may fluctuate significantly 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 the fund over short-term periods may be more volatile than other investment options because of the fund's significant use of financial instruments that have a leveraging effect. There is no guarantee that any leveraging strategy the fund employs will be successful.

Risk Considerations Cont'd

The value of commodities and commodity-linked instruments typically is based upon the price movements of a physical commodity or an economic variable linked to such price movements. The prices of commodities and commodities-linked instruments may fluctuate quickly and dramatically and may not correlate to price movements in other asset classes. An active trading market may not exist for certain commodities. Each of these factors and events could have a significant negative impact on the fund. All futures and futures-related products are highly volatile. Price movements are influenced by a variety of factors. The value of commodities, commodity-linked instruments, futures and futures-related products may be affected by changes in overall economic conditions, changes in interest rates, or factors affecting a particular commodity or industry, such as production, supply, demand, drought, floods, weather, political, economic and regulatory developments.

The fund does not invest directly in futures instruments. Rather, it invests in a wholly-owned subsidiary, which has the same investment objective as the fund, but unlike the fund, it may invest without limitation in futures instruments. The subsidiary is not registered under the 1940 Act and is not subject to all the investor protections of the 1940 Act. Thus, the fund, as an investor in the subsidiary, does not have all the protections offered to investors in registered investment companies.

The fund's strategy may frequently involve buying and selling portfolio securities to rebalance the fund's exposure to various market sectors. Higher portfolio turnover may result in the fund paying higher levels of transaction costs and generating greater tax liabilities for shareholders.

The fund is subject to management risk because it is an actively managed portfolio. The advisor will apply investment techniques and risk analyses that may not have the desired result.

The fund currently intends to effect most creations and redemptions, in whole or in part for cash, rather than in-kind securities. As a result, the fund may be less tax-efficient than if it were to sell and redeem its shares principally in-kind.

The fund, through the subsidiary, will engage in trading on commodity markets outside the United States. Trading on such markets is not regulated by any United States government agency and may involve certain risks not applicable to trading on United States exchanges. The fund holds investments that are denominated in non-U.S. currencies, or in securities that provide exposure to such currencies, currency exchange rates or interest rates denominated in such currencies. Changes in currency exchange rates and the relative value of non-U.S. currencies may affect the value of the fund's investments and the value of the fund's shares. Commodity futures contracts traded on non-U.S. exchanges or with non-U.S. counterparties present risks because they may not be subject to the same degree of regulation as their U.S. counterparts.

The fund may be subject to the forces of the "whipsaw" markets (as opposed to choppy or stable markets), in which significant price movements develop but then repeatedly reverse, which could cause substantial losses to the fund.

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.

First Trust Advisors L.P., the investment adviser of the fund, is registered as a commodity pool operator and commodity trading advisor and is also a member of the National Futures Association.

First Trust Advisors L.P. is the adviser to the fund. First Trust Advisors L.P. is an affiliate of First Trust Portfolios L.P., the fund's distributor.

Definitions

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.

The **Barclays Capital U.S. Aggregate Bond Index** covers the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass throughs), ABS, and CMBS.

The **S&P 500 Index** is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance.

This material is not intended to be relied upon as investment advice or recommendations.

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