

WHAT ARE INDIVIDUAL INVESTMENTS THROUGH COMMODITY DERIVATIVES (COMMODITY TRACKERS USING FUTURES)?

Anyone who wants to invest in commodities (wheat, oil, etc.) or precious metals (gold, silver, etc.) can also do this via an **ETC**, or **exchange traded commodity**.

ETCs track the performance of a **commodity** (raw material) or of an index. The ETC usually does this by means of derivatives (**futures**). In practice, the manager of an ETC will buy futures on commodities: the manager then makes an agreement with a counterparty to take delivery of the commodities on a fixed future date at an agreed price.

Before the maturity date of the future contract is reached, the contract is rolled over, to avoid any physical delivery of the commodities. The manager does not normally own the large warehouses needed to actually store the ordered commodities. Rolling-over means that the manager sells a future contract with delivery in the near future and buys a contract with delivery further out, so that they never actually take delivery of the commodity. Roll-over also has a major impact on the returns that you can achieve; in financial jargon this is called the **roll yield**:

- If the contract with future delivery is more expensive, this means a cost to the manager – after all you are selling a contract at a fixed price and buying another at a higher price. In this context, that is also called a **contango**, the yield paid on an ETC will be less than the actual price change in the underlying commodities.

- Conversely, if the contract for delivery further out is cheaper than the contract with delivery in the near future, a situation referred to as **backwardation**, then you are buying at a lower price and selling at a higher price. This also means a profit for the manager; in this case the return on the ETC (before costs) will be higher than the actual price change in the underlying commodities.

Depending on the situation on the financial markets (futures are exchange-listed), the yield can therefore be lower or higher than the yield on the underlying commodities. In some cases your yield can in fact differ sharply from the movements in the price of the underlying commodities. In a contango market, your yield can fall sharply.

Before investing in an ETC, it is therefore necessary to know how commodity contracts work, and to understand the principles behind the futures markets.

Features

- ETCs are **listed** and can therefore also be traded on the financial markets.
- ETCs have no fixed **term**.
- These ETCs invest in underlying **commodity futures**, not directly in commodities. The underlying value is therefore fairly complex and the effects on the final returns are therefore not always clear or transparent.

Risks

Given that the prices of commodities are expressed on the world markets in US dollars, there is a **currency risk**.

The value of ETCs is very volatile: The price of commodities (and the value of ETCs) is determined by many factors, including climatic conditions (drought, failed harvests, etc.), the general economic climate and geopolitical unrest. Prices can fall and rise sharply in a short period.

ETCs use derivatives in order to achieve their objective (tracking the price changes in the commodity or the index). There is a **counterparty risk**: if the counterparty is not able to fulfil their obligations, you can lose (part of) your investment.

Even if the prices of the underlying commodities increase, the value of my ETC may still decrease precisely because an ETC invests in futures, and those futures are systematically **rolled over**. The reverse also applies: my ETC may also outperform the price development of the underlying value.



Costs and taxes

If you buy an ETC, then you also have to allow for the costs and taxes you need to pay. These will of course affect the return on your investment.

COSTS

Brokers' fees: banks charge their costs for executing your orders on the secondary market.

Custody fee: most banks will charge you fees to hold your ETCs on a custody account.

TAXES

Stamp duty on stock exchange transactions (TOB): if you buy or sell an ETC on a secondary market, you need to pay exchange stamp duty.

Withholding tax on dividends: withholding tax is owed on the dividends paid out by the ETC.

Speculation tax: ETCs are not subject to the speculation tax.

Would you like to know more about Exchange Traded Commodities?

Read our *Information brochure on financial instruments* at www.bnpparibasfortis.be.

