

BULLSEYE

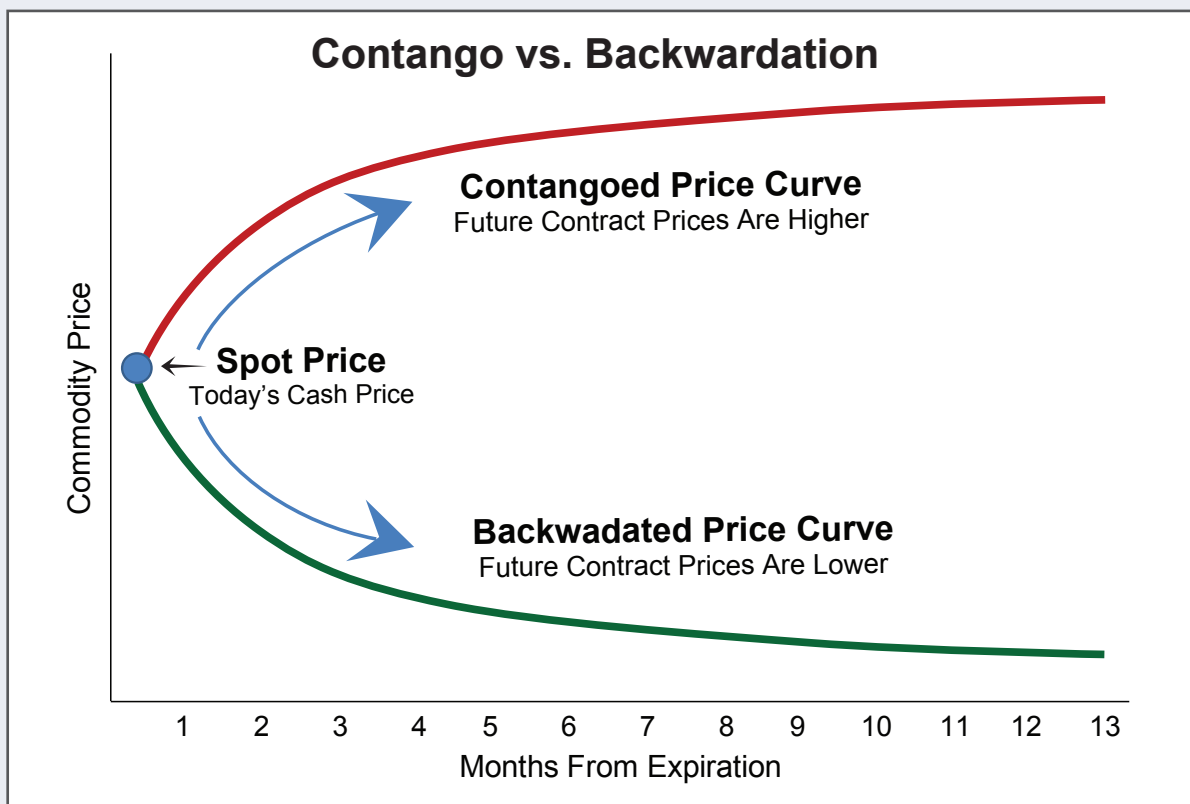
Highlights

Contango & Cash

The current cash value of a commodity is referred to as the spot price. If a buyer wants to own the physical commodity, they can pay the current spot price and take immediate delivery of actual bars of gold, barrels of oil, or bushels of wheat. For commercial producers, that is just a cost of doing business. For example, a bread company needs wheat and would have a storage and delivery process in place. But unlike commercial producers, commodity investors rarely want the actual commodity. Instead, they often gain their exposure through mutual funds and ETFs that follow indexes that are tied to commodity futures contracts.

A futures contract locks in the price for a set amount of a commodity at a future date. When that future date arrives, in order to maintain constant exposure, the contract must be sold before the expiration date, and the proceeds are rolled into a different contract with a later expiration date. This contract rolling process is the most common form of commodity portfolio exposure, but it comes with a cost.

If you plot out the prices of a commodity's monthly future contracts, a curve begins to form. If the commodity curve slopes upward, it is said to be in contango. If it slopes downward, it is called backwardated.



Hypothetical illustration.

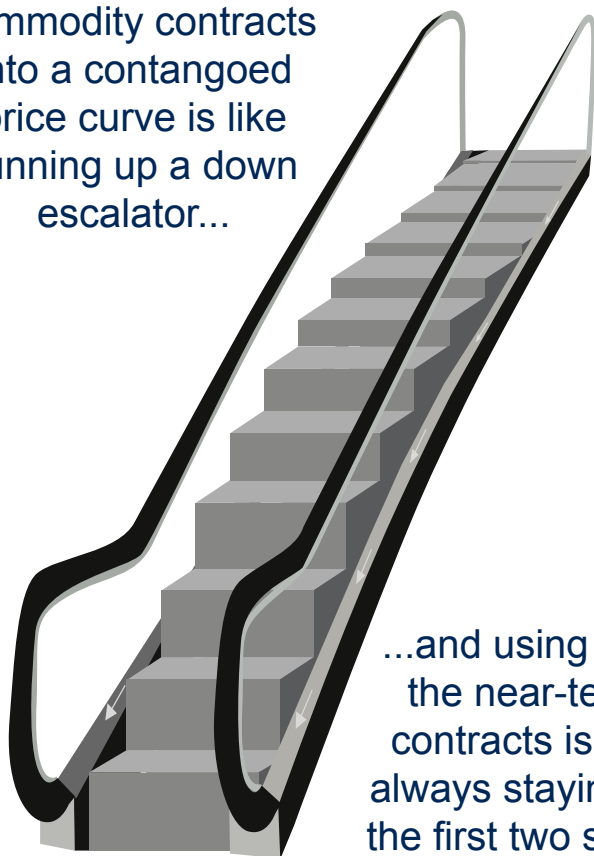
The futures curve can be in contango, backwardated, or a combination at any given time. But generally speaking, when commodity prices are depressed, and the market expects prices to be higher in the future, the tendency is for the curve to be upward sloping in contango. And when commodities seem to be overpriced, with the expectation of declining prices, the curve tends to be downward sloping in backwardation. In the post-financial crisis period following 2008, many commodity prices have declined for some time, so many of the futures price curves are in contango.

Commodity mutual funds and ETFs often follow indexes that require exposure to near-term contracts that are set to expire within a month or two. Each time the contracts get close to expiration, they must sell the current contract and buy the next closest monthly contract. Every one of these frequent rolls comes with trading expenses, which can add up, creating quite a drag on performance. Aside from trading expenses, there is the cost of selling cheaper near-term contracts and using the proceeds to buy more expensive contracts. When the curve is in contango, frequently rolling into new contracts is like running up a down escalator because each contract “step” is priced higher than the previous month. Every time that contract nears the bottom, you have to step up to the next month.

All too often in the case of contango, the step up from the first month to the next month is often the largest and most costly roll. The farther out the curve, the price difference between the later months tends to be less steep as the curve flattens out. So the problem with rolling frequently in the near-term months is not only like running up a down escalator, but one where the first few steps are the steepest to climb.

Another approach would be to do less frequent rolls, go farther out on the curve, and hold each contract longer between rolls. This “long-dated” approach is better suited for a buy-and-hold investor from both practical and philosophical perspectives. For example, a long-dated approach would buy a contract 12-15 months from expiration, hold it for almost an entire year, and roll out when it gets within two to three months from expiration. If the steps were equal, it wouldn’t make a difference. But when the curve is steeper in the near term, making 12 steep monthly rolls in the near term can create a far greater performance drag than simply making one or two rolls per year farther out on the less steep part of curve.

Frequently rolling commodity contracts into a contangoed price curve is like running up a down escalator...



...and using only the near-term contracts is like always staying on the first two steps.

Near-term indexes benefit commodity trading desks due to their frequent trading. Long-dated indexes are designed to align with commodity producers, and ultimately, with long-term investors. Perhaps buy-and-hold investors should consider using a commodity strategy that is more aligned with their investing goals.

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