Commodities as an Asset Class

From filling up your gas tank to eating corn at dinner, everyone is affected by commodities. Traditionally, a commodity is defined as a tangible asset that can be used as an input to produce another good or service. Commodities are uniform in quality, meet minimum standards and encompass a wide range of categories, including livestock, oil, grain, sugar, gold and cotton.

An exchange-traded fund (ETF) is a unique investment tool that combines some of the features of mutual funds with some of the features of individual stocks. Like a mutual fund, an ETF gives investors access to a group of securities through a single transaction. Like a stock, ETF shares are traded on exchanges at market-determined prices.

Before the existence of ETFs, investments in commodities were limited mostly to large, well-capitalized institutional traders. Now, because of the convenience and accessibility of ETFs, commodities are widely available, and many have advocated thinking of commodities as an independent asset class.

We see several potential benefits to owning commodities as an asset class. For example, the added diversification that can be achieved by allocating a portion of assets to commodities may reduce overall portfolio volatility. Also, commodities may provide a potential inflation hedge, as the prices of goods and services typically increase along with the prices of the commodities used to produce them. Ultimately, despite the potential risks, which may include weather, man-made or natural disasters, and political, economic and market conditions, some commodity ETFs may provide equity-like performance during economic booms.

Commodity ETFs come in three forms: futures, physical and equities, and each has its own potential risks and rewards. As more investors discover the benefits of owning at least some commodities, ETF providers are responding to make investing in the world’s natural resources easier than ever.
Types of commodity ETFs

Commodity ETFs come in several forms, ranging from broad, all-inclusive commodity funds all the way down to narrowly focused single-commodity funds. There are three common types: futures, physical and equities.

Futures. Most commodity ETFs receive exposure to commodities via futures contracts. In fact, futures are how most commodities are traded. A future is a promise to buy or sell a commodity for a set price at a set date in the future. A majority of the futures contracts traded on the exchange floor are settled or swapped for cash before the expiration date, meaning the owners of the contracts never take physical delivery.

Futures-based commodity ETFs come with a wrinkle that you should understand. Futures also add a time component to the price. When the next-to-expire contract is trading at a higher price than contracts expiring in later months, this is called contango. Backwardation is the opposite and occurs when the next-to-expire contract trades at a lower price than those expiring in later months. When contango is in play, futures-based commodity ETFs can lose money when they roll their contracts. Rolling a contract is the process of closing the current contract at expiration and initiating another contract.

Some futures-based ETFs, however, incorporate strategies that hold an optimal form of commodity exposure by holding positions in markets that are in backwardation, or markets that have the least amount of contango. Instead of automatically rolling into the next-month contract, optimum yield processes analyze the next 13 months and select the contract that seeks to generate the best “implied roll yield.” Essentially, the strategy seeks to minimize the negative effects of contango and maximize the positive effects of backwardation to produce optimal returns in futures-based ETFs.

Each share of a physically-backed ETF represents a fractional ownership of the physical commodity, such as gold metal bars owned by the ETF.

1 Roll yield is the return generated in a futures market that is in backwardation. Yield, which can be positive or negative, is achieved by rolling a shorter-term contract into a longer-term contract and profiting from the convergence toward a higher spot price.
Physical. An increasing number of commodity ETFs are also backed by the commodity itself, though this only pertains to precious metals ETFs. Physically backing an oil ETF or a wheat ETF would involve enormous amounts of storage, making it infeasible and very costly to do. Each share of a physically-backed ETF represents a fractional ownership of the physical commodity such as gold metal bars owned by the ETF. The bars are stored in secure vaults around the world. Small investors may consider physical ETFs over holding the physical commodity because of costs associated with commodity storage.

Equities. Lastly, you can get exposure to commodities via equity commodity ETFs, which typically hold companies such as miners and producers whose business is related to commodities. The catch with investing in equity commodity ETFs is that they do not always correlate with the underlying commodities price. While producers of commodities may see their profit margins increase if the commodity they produce rises in price, it doesn’t necessarily correlate with the spot price² of that commodity, since there are other factors in a company’s performance beyond the cost of the commodity it produces. The upside is that equity commodity ETFs may not see the wild day-to-day price swings that the commodity itself might.

A range of global influences

There are several macroeconomic factors to consider before diving into the commodities space, including global economic development, technological advances and market demand. All of these factors have a price impact, and supply and demand will typically dictate how much the commodities market will react to these forces.

As the inventory of a commodity diminishes below the level demanded, the market may experience a temporary front-month³ price spike. Some commodities are subject to surges or a dearth in demand as a result of current weather conditions, or they may be affected by disruptions to supply due to the weather, bureaucratic wrangling or simple maintenance problems.

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² Spot price is the cash price of a commodity when it is traded in the market for current delivery.
³ The front-month holds the contract that has the closest date of expiration compared to the current date.
Equities and bonds have historically performed well when the economy is at a low point in a business cycle since the potential for improvement is at its highest, and these assets may not perform well when an economy is at its strongest since the likelihood of a slowdown is that much greater. However, commodities are more connected with the current economic environment, which is why some commodities connected with expansion - such as copper, oil and livestock - may perform better during such periods.

- **Commodity risks can be hard to predict**

  The risk in commodities tends to be eventualities that are seemingly random or difficult to predict, such as unusual weather, natural disasters, epidemics or man-made problems. Sudden events can lead to rapid shifts in price almost overnight. While the prices of some commodities are closely linked (crude oil and gas, for example), not all commodities react to changing conditions in the same manner. For example, in most past market environments, crude oil prices were not directly related to platinum prices; likewise, copper prices were not affected by wheat prices.\(^4\)

  Seasons are also one major factor in deciding the prices of commodities. For many agricultural products such as livestock or crops, new crop yields or higher livestock numbers will come in during different months of the year. Energy-related commodities have historically experienced high demand during months when energy usage is at its peak or at times of extreme weather conditions.

  High volatility or a bearish mentality in equity stock markets may cause investors to start funneling money into precious metals that have historically been considered a safe-haven asset since they may be a good store of value.

  Global economic activity or disruptions in the supply of oil may lead to higher oil prices. Still, supply changes by the Organization of the Petroleum Exporting Countries,\(^5\) technological advances in alternative energy or economic downturns may suppress oil prices.

  Commodities used heavily in industrial production are more subject to the whims of economic growth. For example, copper and silver are used so much in building materials that a drop-off in industrial activity and/or economic weakness could send their prices tumbling.

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\(^5\) The Organization of the Petroleum Exporting Countries has a mission to coordinate and unify the petroleum policies of its Member Countries and ensure the stabilization of oil markets in order to secure an efficient, economic and regular supply of petroleum to consumers, a steady income to producers and a fair return on capital for those investing in the petroleum industry. opec.org.
Commodities: a key part of the global marketplace

Ignoring commodities as an asset class could mean ignoring a large part of the global marketplace. The United Nations recently sounded the alarm: A growing global population is expected to translate into increased demand for natural resources, particularly when it comes to agriculture, which may in turn lead to higher prices to the benefit of those investing in them.6

The benefits may include:

- Commodities have traditionally been negatively correlated with traditional bonds and equities, which can serve as a portfolio diversifier. A negative correlation7 implies that there is an inverse linear relationship between the commodities and that of traditional assets. By allocating a small proportion of your portfolio to commodities, you may be able to reduce overall portfolio volatility. There may typically be price dislocations between ETFs and commodities due to futures market speculation and commodity storage costs. However, we feel that to receive the underlying benefits and value of commodities, futures-based or physically-backed commodity ETFs can still be an efficient source of such value.

- Some commodity ETFs may provide equity-like returns and performance during economic booms when countries require greater raw materials for economic expansion.

- In that same vein, we believe commodities have the potential to benefit from the world’s population growth and the middle class growth in emerging markets. Growth in these areas means greater demand for food and other goods, which translates into greater demand for commodities.

- Commodities may be an effective hedge against inflation when prices of goods and services increase, since the prices of the commodities used to produce those goods and services typically increase as well. Having exposure to commodities before inflation is present, or in its earliest stages, may help you retain your purchasing power as prices rise up and the US dollar becomes weaker.

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7 Correlation indicates the degree to which two investments have historically moved in the same direction and magnitude.
Conclusion

Commodity ETFs may make it easier to invest in the world’s natural resources by eliminating the need to find storage for physical commodities, making the world of futures investing easier to understand, and giving investors convenient and simplified exposure to the world’s commodity markets.

Commodity indexes cover three major subsectors: agriculture, energy and metals. There are broad commodity ETFs, which include the three sub-sectors at different levels of exposure. Within each of those are sub-indexes with varying levels of exposure to individual commodities. The variations in the weightings implemented by fund providers may result in divergent performance numbers, so investors need to research weightings and act accordingly.

We believe there are possible flaws with all-inclusive commodity ETFs. Namely, they do not necessarily reflect the fact that each commodity within the ETF may react differently to underlying market forces and events. For instance, gold will react differently than cotton. For that reason, investors may also consider single-commodity ETFs, such as those focused on agriculture, metals or the energy sector. While this more narrow exposure may mean more volatility, it may also provide a more accurate reflection of the underlying fundamentals of each individual commodity.

There is a wide range of potential risks and benefits to owning commodity ETFs, and investors should weigh the influences that impact each one.
About risk

There are risks involved with investing in ETFs, including possible loss of money. Shares are not actively managed and are subject to risks including those regarding short selling and margin maintenance requirements. Ordinary brokerage commissions apply.

Commodities and futures generally are volatile and are not suitable for all investors.

Investments focused in a particular industry are subject to greater risk, and are more greatly impacted by market volatility than more diversified investments.

Foreign securities have additional risks, including exchange-rate changes, decreased market liquidity, political instability and taxation by foreign governments.

Shares are not individually redeemable and owners of the shares may acquire those shares from the Fund and tender those shares for redemption to the Fund in Creation Unit aggregations only, typically consisting of 50,000 shares.

Certain funds and portfolios, particularly the PowerShares ETFs, in and of themselves do not qualify as diversified investment strategies.

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