Pelagos Capital®

Commodities - See Spot Run, Index Crawl

> “While oil futures rose 78% in 2009, U.S. Oil Fund, an ETF that owns the "front month," or most actively traded, oil futures contracts, rose only about 19%.” *Wall Street Journal 1/6/2010*

John C. Pickart, CFA
Partner, Senior Portfolio Manager

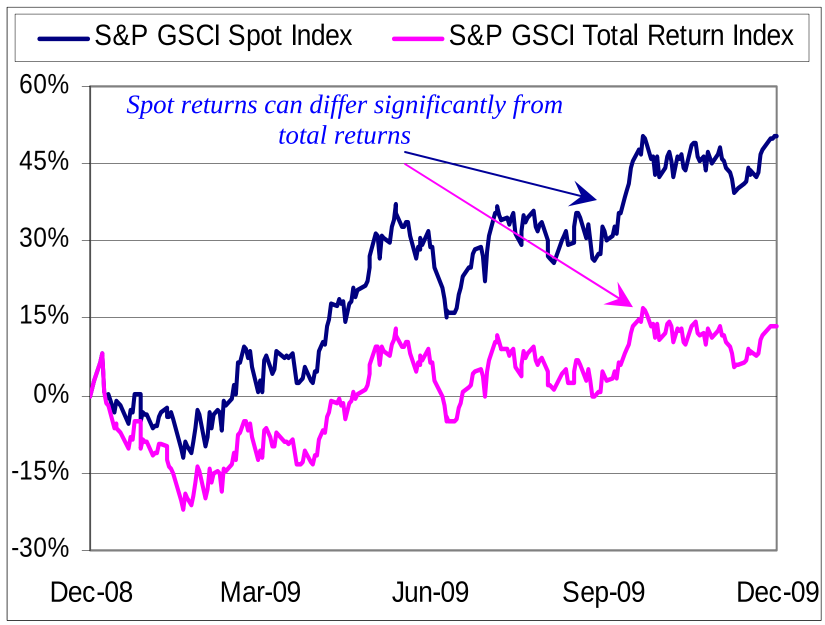
February 2010

Commodities – See Spot Run, Index Crawl

Commodities often top the list of asset classes that provide a high level of diversification to the more traditional asset classes of stocks and bonds. Although these diversification benefits are well documented, the nuances of obtaining commodities exposure through futures require active management of the asset class. As most investors cannot hold a majority of physical commodities and realize spot returns, the choice of futures contract, frequency of the roll, and even the ability to employ option strategies can have significant impact on returns.

Oil prices surged 77.9% during calendar 2009 yet some reports suggest more modest returns for the commodity in the single digits. The disparity arises as a result of whether returns are measured using spot prices (cash price of physical commodity) or the realistic return available to investors using futures contracts. Even broad-based commodities indices can exhibit this divergence. The S&P GSCI Spot Index increased 50.3% during 2009 yet the S&P GSCI Total Return Index increased a more modest 13.5%. Both S&P GSCI Indexes described are broad based commodities indexes composed of 24 individual commodities.

S&P GSCI Spot vs. S&P GSCI Total Return Commodity Index
2009 Performance



Source: Bloomberg, Pelagos Capital

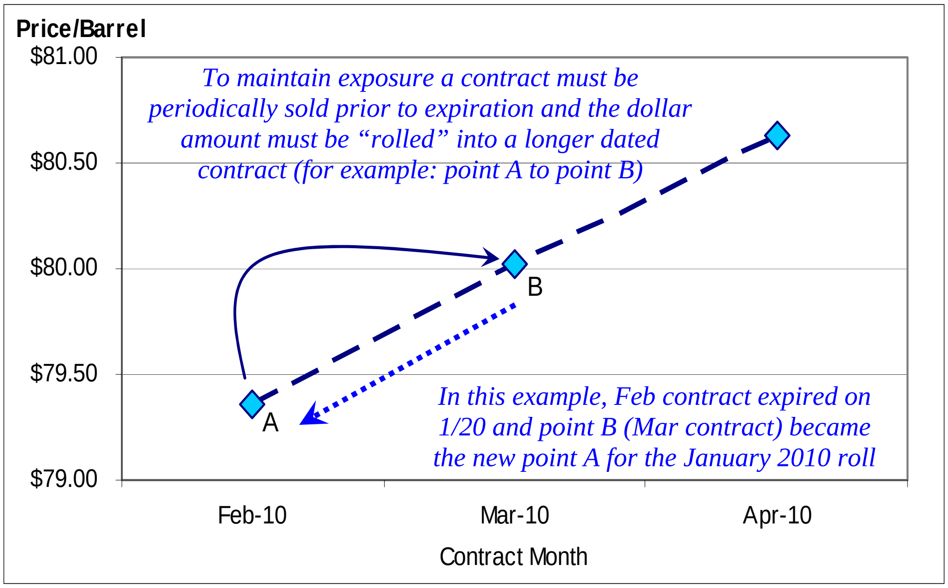
Spot Price versus Futures

Industrial users of commodities can buy, store, and insure barrels of oil, tons of copper, or thousands of bushels of grain and pay the spot price to producers in the market today. However, for an investor looking to obtain exposure to commodities, it’s not practical to physically hold most commodities. Futures contracts provide the underlying vehicle through which investors generally get exposure to commodities.

The difference in returns between spot and investor total returns stems from the structure of the futures market and how continuous exposure to commodities is more nuanced than the typical buy and hold scenario of securities investing. Each contract is priced independently and the various maturities can produce significantly different results from each other as well as with spot prices. The method by which an investor gains continuous exposure, also know as “rolling”, is the process the major commodities indexes employ to measure returns. Typically, the index methodology has a defined roll period in which contracts near expiration are sold and the next closest contract is purchased in order to maintain long exposure.

It is this roll and its magnitude that are the primary culprits behind the spot and total return divergence. When continuous long exposure rolls to the next contract, that price can be higher or lower than the price of the expiring contract. Contango, the environment when longer dated contract prices are higher than near term (upward sloping curve), can erode commodity returns as the roll buys higher priced contracts and sells lower priced contracts. The nearby chart illustrates the roll process and the potential drag to returns when in contango.

Dated WTI Crude Oil Futures Curve as of 12/31/2009



Source: Bloomberg, Pelagos Capital

The roll process is unavoidable for continual exposure. Fortunately, at times some commodities futures curves can slope downward (backwardation, the opposite of contango) where longer dated contracts are priced below near-term contracts. The roll in this scenario can boost returns as the roll buys "cheaper" longer dated contracts and sells "expensive" expiring contracts. The table below lists the commodities that had the highest percentage of periods in which they experienced backwardation or contango as measured at month end for the last five years using the two nearby futures contracts. WTI Crude Oil, the largest weight in the S&P GSCI Index at 36%, was in contango 80% of the months during this period.

S&P GSCI Commodity Index Component Curve Shapes

	Commodity	% of Months	GSCI Weight
Top 5 S&P GSCI commodity curves backwardated *2005-2009*	*Copper*	63%	3.9%
	Lead	53%	0.5%
	RBOB	49%	4.4%
	Feeder Cattle	47%	0.4%
	Nickel	38%	0.7%
Top 5 S&P GSCI commodity curves in contango *2005-2009*	*Gold*	100%	2.8%
	Silver	100%	0.4%
	Coffee	100%	0.7%
	Wheat	100%	3.0%
	Cotton	95%	1.1%

Source: Standard & Poor's, Bloomberg, Pelagos Capital

Managing the Roll

Given the ability of spot prices to run while investor total returns merely crawl, how can investors manage the nuances of the futures markets. The table on the next page offers several alternative methods of obtaining exposure to crude oil. As mentioned earlier, 2009 WTI Crude spot prices increased 77.9%, yet investor total returns using a methodology of buying and rolling crude oil contracts monthly returned only 7.2%. WTI Crude returns during 2008 were dramatic on the downside yet the difference between spot and total returns was only 2.0%.

"Active management of commodities is necessary"

Additional methodologies are available to investors as well. The table highlights the returns of two other long only strategies. An alternative to buying the near term contract and rolling every month is to buy a long dated contract that by definition can be held for longer periods. Bringing contango and backwardation back into the discussion is necessary, as futures curves often exhibit these shapes consistently across their curves. Therefore, long dated contracts can have significantly different prices than spot and near term contracts. Drivers of these longer contracts can differ from those in the front end of the futures curve so performance also can vary. The March 2010 WTI Crude Oil contract rose 31.3% in 2009 yet only declined 29.2% in 2008.

Evaluation of Unique Classifications of Crude Oil Return

	2008	2009
WTI Crude Spot - generic first future without roll *(CL1*)*	-53.5%	77.9%
WTI Crude Total Return Index *(S&P GSCI Crude Oil Index)*	-55.5%	7.2%
WTI Crude using long dated contract *(March 2010)*	-29.2%	31.3%
WTI Crude Total Return Index with option writing *(S&P GSCI Crude Oil Covered Call Index)*	-53.1%	32.7%

*__*Note__: The generic CL1 is always the nearest contract to expiration and the referenced dated contract changes sequentially at expiration. It is critical to understand that continuous exposure to CL1 is not possible beyond one month.*

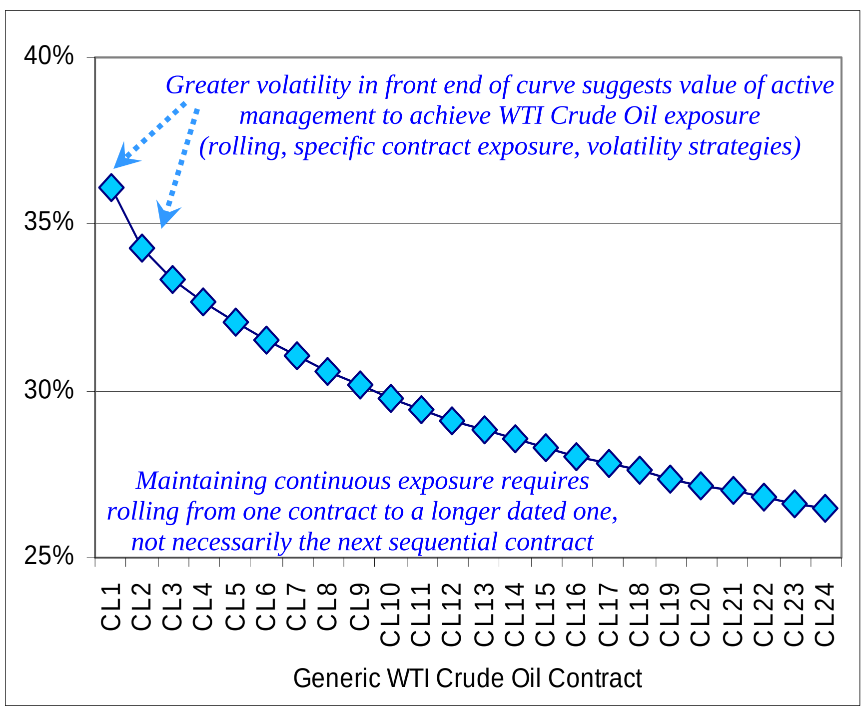
Source: Bloomberg, Pelagos Capital

The last alternative highlighted in the table is to write options on futures contracts. Standard & Poor's has created the S&P GSCI Crude Oil Covered Call Index which assumes a long position in near term oil contracts and sells call options against those futures. The futures and options are rolled every month. The options generate premiums that can augment returns in certain environments. Returns benefited from options in 2009; the option writing index returned 32.7%. However, 2008 returns were not significantly different than those of spot or total return indexes rolled monthly.

Summary

Active management of commodities is necessary to navigate the shifting landscape inherent in commodities investing. Simply buying and holding a broad basket of physical commodities is out of reach for most investors. Questions such as which contract to own, how much contango and backwardation will affect results and can these effects be mitigated, need to be addressed. Yet, the search for appropriate exposure to commodities is worth the journey, given the historical low correlation of the asset class to stocks and bonds.

Volatility of WTI Crude Oil Along the Generic Contract Curve as of 12/31/09



Source: Bloomberg, Pelagos Capital

Pelagos Capital®

DISCLOSURE

This article contains the current opinions of the author but not necessarily those of Pelagos Capital. The author's opinions are subject to change without notice. Pelagos Capital has no obligation to inform you of when opinions or information in this report change. Actual investments or investment decisions made by Pelagos Capital, its own account, or on behalf of clients will not necessarily reflect the views expressed in this report. This article is distributed for informational purposes only. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. There is neither representation nor warranty as to the current accuracy of, nor liability for, decisions based on such information. The information we provide does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Pelagos Capital is not responsible for any trading decisions, damages, or losses resulting from, or relating to the information, data, analysis, commentary or opinions in this report or their use.

FOR INFORMATIONAL PURPOSES ONLY. NOT A SOLICITATION.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

One International Place
Boston MA 02110
(Tel) 617.310.6530
www.pelagoscapital.com