

Surfing the contango

With a commodity index that fixes roll-yield problems



When long-term futures prices rise above short-term and spot

Reflecting weak demand and generous supply, most commodities are trading in contango at the time of writing. That is, longer-term futures prices exceed the shorter-term futures prices, which is the normal state of affairs in most commodities markets. This hits the pockets of investors in any indices or exchange-traded funds that are based on short-dated futures contracts, where so-called roll losses are highest (see box).

This problem is specifically addressed by the UBS Bloomberg Constant-Maturity Commodity Index, which is based on longer-dated futures contracts that allow for improved roll yields. By diversifying across all liquid futures maturities, the CMCI also better reflects the full futures spectrum and thus constitutes a more representative benchmark than traditional indices.

Since its launch in January 2007, CMCI has outperformed the three major commodities benchmarks, namely the S&P

GSCI Index, the DJ-UBS Commodity Index and the Rogers International Commodity Index (see chart). It has also exhibited less volatility.

The advantages of the methodology become even more apparent on a single commodity level, where CMCI sub-indices have provided higher returns than traditional vehicles for 24 out of 26 commodities over the past two years. The CMCI Crude Oil Index, for example, has outperformed the United States Oil Fund (USO), the world's largest crude oil ETF, by approximately 30% (as at 26 May 2009, since CMCI launch on 29 Jan 2007).

A wide array of products and investment styles based on the CMCI is available to both private and professional investors, including index trackers, such as Exchange Traded Commodities (ETC), a UCITS III-compliant investment fund, and certificates reflecting different risk profiles. In addition, tailor-made over-the-counter

transactions have notched up a notional total of several billion dollars.

As contango widens to record levels in many commodity markets, many investors have discovered the advantages of market-neutral strategies that exploit the CMCI's outperformance without taking a directional view on commodity price levels. Institutional investors have also looked to bespoke indices that apply CMCI methodology to each underlying commodity within, say, the S&P GSCI Index. This allows them to use the traditional index as their benchmark while benefiting from the methodology of the CMCI.

At present, the arguments for and against commodity investments are complex. On one hand, rising inventories, falling industrial output and weak consumption have undercut prices. On the other, those very factors will discourage investment in exploration and production. In time, this will likely aggravate the very supply bottlenecks that gave rise to the commodity super-cycle of the past seven years. Whatever happens to commodity prices, though, the CMCI methodology will continue to provide would-be investors with a handy tool for expressing their views.

Fabian Schlederer UBS Investment Bank, Equity and Commodity Risk Management
fabian.schlederer@ubs.com

On a roll

To maintain an investment position over a period of time, commodity futures contracts need to be sold some time before expiry (in order to avoid physical delivery), and replaced with new ones with a later expiry date. The difference between the sale and purchase price is known as the roll yield. The roll yield is positive if the price of shorter-dated futures is higher than for longer-dated futures (when the market is in backwardation). The opposite condition is known as contango and results in a loss for investors, especially when market pressures raise the cost of roll-overs. To address this problem, UBS launched the UBS Bloomberg Constant Maturity Commodity Index (CMCI), a joint-venture with Bloomberg, two years ago. Since then, the CMCI has evolved into a comprehensive family of commodity-related indices and sub-indices that cover all the major commodity classes.

Chart: Rollercoaster ride

