




London
Stock Exchange

Exchange Traded Commodities

Redefining the commodities marketplace



London
Stock Exchange Group



“ETCs – removing
the difficulties of
gaining exposure
to commodities.”



Introduction

Exchange Traded Commodities

Redefining the commodities marketplace

Commodities are an integral part of retail and institutional investment portfolios the world over. For many, gaining efficient and quick exposure to this asset class has traditionally been fraught with difficulties, namely contingent liability, margining requirements, mandate restrictions, connectivity issues and access to international derivatives exchanges.

As a result many investors are left unable to invest in commodities or paying dearly for the privilege.

This is why the London Stock Exchange has worked closely with issuers to make commodities more accessible through Exchange Traded Commodities (ETCs) and created the world's very first committed and distinct ETC trading platform.

Previously the preserve of a select few, commodities exposure can now be gained via ETCs using the same brokers and systems currently used to trade UK equities without having to play the futures markets or risk taking delivery of the underlying itself. ETCs trade just like shares, are simple and efficient and provide exposure to an ever-increasing range of commodities and commodity indices, including energy, metals, softs and agriculture.

It is no wonder that more and more investors seeking commodities exposure are turning to ETCs and that this increasingly mainstream alternative asset class has experienced exponential growth since its inception.

What are ETCs?

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stamp duty

Exchange Traded Commodities (ETCs) are investment vehicles (asset backed bonds) that track the performance of an underlying commodity index including total return indices based on a single commodity.

Similar to Exchange Traded Funds (ETFs) and traded and settled exactly like normal shares on their own dedicated sector, ETCs have dedicated market maker support, enabling investors to gain exposure to commodities, on-Exchange, during London hours.

They are open-ended securities, created and redeemed on demand by the issuer, (as with ETFs) and come in two broad forms:

Single commodity

Investors can buy single-commodity ETCs like gold and oil or more exotic variants such as zinc and lean hogs.

Index tracking

Investors can invest in index tracking ETCs giving exposure to a range of underlyings from broad indices to specific sub-indices such as energy or livestock, and all in one trade. See diagram opposite as an example.

Sources of return

Generally, both single commodity and index-tracking ETCs track a total-return index, meaning there are three sources of return (it is critical that the precise details of individual products are inspected before investing):

- The change in price of the future – largely affected by changes in the spot commodity price
- The roll – as the front month future is 'rolled' into the near month, there is usually a price difference between the two, which is reflected in the price of the ETC
- Interest on collateral – since futures are margined instruments, interest is earned on the cash value of the initial investment.

Tax

ETCs can generally be traded within SIPPS and ISA accounts. Additionally, current advice suggests that no stamp duty is payable on trades in those ETCs which were available as this brochure went to print. However, it is important to take your own tax advice.

Individual securities	Index securities			
Natural gas	All commodities	Energy		
Crude oil			Petroleum	
Gasoline			Natural gas	
Heating oil			Carbon	
Aluminium		Ex-energy	Industrial metals	
Copper				
Zinc			Precious metals	
Nickel				
Gold			Livestock	
Silver				
Live cattle			Agriculture	Grains
Lean hogs				Softs
Wheat				
Corn				
Soybeans				
Sugar				
Cotton				
Coffee				
Soybean oil				

Benefits and features

The benefits of commodities investment are well known: they bring balance to a portfolio, can be used as an inflation hedge, have low correlation to equities and bonds which, according to modern portfolio theory, should result in reduced risk without necessarily reducing returns.

ETCs are one of several vehicles which can be used to gain commodities exposure, and the table below sets out the relative merits of this innovative product.

Features

Low tracking error – the open-ended nature of these securities ensures tracking error is minimised and creates an arbitrage opportunity should the price drift away from the NAV

Open-ended – price not subject to supply and demand forces

Liquid – ETCs are open-ended and can be created on demand. Additionally, market makers are committed to provide on-book liquidity all day

Traded and settled on a regulated exchange, the same as any share – familiarity, regulated, no mandate barrier, protection of CCP, settles T+3* through Euroclear UK & Ireland Limited (formerly CRESTCo)

No management of physical or futures positions – hassle-free – reduces back-office costs

Ability to go long or short – potential for positive returns in bull and bear markets

Lendable and marginable – flexibility – potential to recoup management fee through lending

Market access – all types of investors can gain exposure and are charged the same fees

Transparency – no hidden fees, accurate pricing.

* T+2 from 6 October 2014

Who are they for?

ETCs are very flexible products and can be used by all types of investors for a number of different purposes: whether you are an institutional investor looking for liquid, quick and easy commodity exposure during London hours; a hedge fund manager with a view on a commodity sub-index; a private wealth manager with clients crying out for exposure to 'alternatives'; or a private investor looking to participate in commodity markets using an existing stockbroker account, ETCs are redefining commodities trading for all types of investors.

Strategic uses

Gaining market exposure

ETCs provide investors with an easy opportunity to gain exposure to commodities.

Asset allocation strategies

Investors can use ETCs to diversify their portfolios.

One-trade index exposure

Index and sub-index ETCs extend an investor's capabilities to include whole index-exposure, in one trade.

Cash 'equitisation'

Investors can eliminate cash drag quickly and efficiently whilst deciding where to invest the capital.

Hedging

Investors can go long or short an ETC, giving the investor ultimate flexibility to quickly and efficiently hedge existing or future exposure to the price of commodities.

Lending

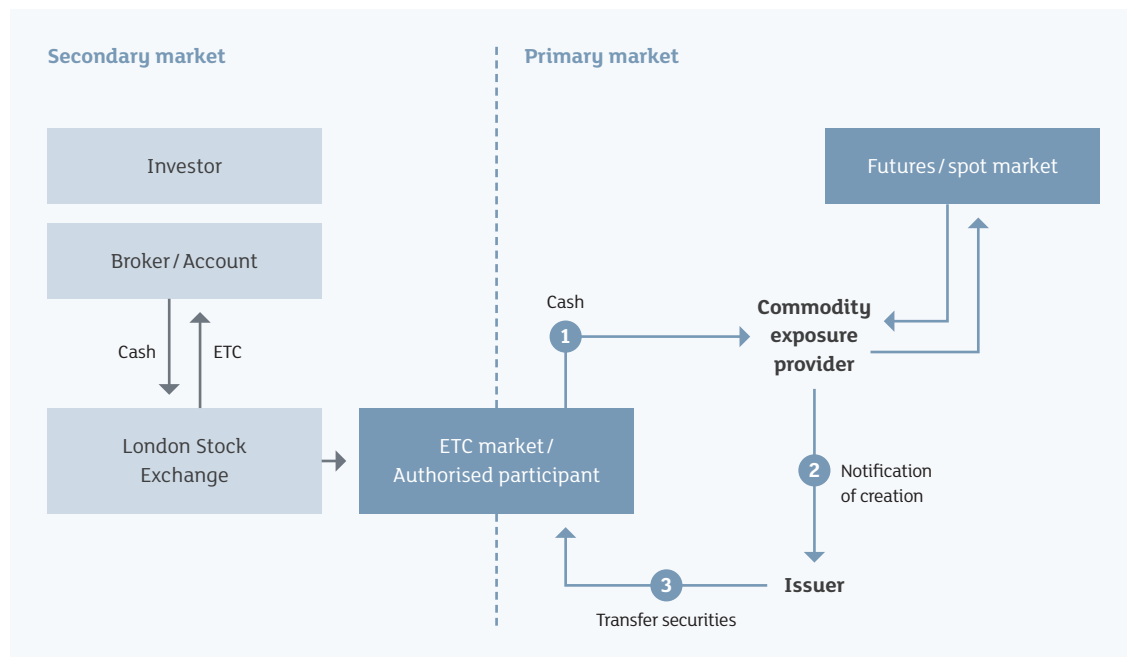
Investors can maximise returns from their long ETC position by lending them, often easily recouping the management fee.

Pairs trading

There are many opportunities for pairs trades, whether going long an index and shorting one of the constituents, or combining with an equity trade to reduce the impact commodities prices have on that equity. The possibilities are endless (examples are for illustration only).

How do ETCs work?

Cost-effective
commodity
exposure



ETCs are notes which provide the owner of the security with exposure to the actual underlying commodity future or spot price.

As described in the diagram above, ETCs are created through an authorised participant. The issuer then enters into a contract with the 'commodity exposure provider', the fulfilment of which results in the price of the security tracking the relevant commodity/ies. This means the monthly roll, custodianship, and management are effectively 'outsourced' to the issuer and 'commodity exposure provider', in return for the annual management fee. However, because these are passive investments, the management fee is typically very low.

Creation

- 1a** The authorised participant (often the market maker) pays cash to the commodity exposure provider – the amount paid is based on the current creation price, set by the issuer.
- 1b** The commodity exposure provider then invests the money in the appropriate underlying commodity market/s.
- 2** The commodity exposure provider notifies the issuer that cash has been received and confirms correct amount.
- 3** The issuer asks Euroclear UK & Ireland Limited to create securities and transfer them into the account of the authorised participant. These securities are then available for the authorised participant to trade in the secondary market.

Redemption

Redemption is the process of creation in reverse. The authorised participant transfers securities to the issuer, who cancels them and notifies the commodity exposure provider to pay in cash the relevant amount to the authorised participant.

Redefining the commodities marketplace

Through its dedicated Exchange Traded Commodity platform the London Stock Exchange, along with issuers, provides investors with both simple and sophisticated commodity trading opportunities.

No other single market offers investors such a wide range of commodities, with one set of trading rules, one connection and in one time zone.

ETCs enable investors to gain exposure to this asset class quickly, simply and most importantly efficiently, on-Exchange and during London hours.

For further information

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