

Investing with the S&P GSCI Commodity Indices

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Topics

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Commodities Aren't Stocks

- **Commodities include:**
 - Oil, gasoline and heating oil
 - Grains including corn, wheat and soybeans
 - Metals such as copper, silver and gold
 - Softs including coffee, sugar and cocoa
 - Agriculture including cattle, hogs and lumber
- **These are traded by futures contracts, not as stocks or bonds**
- **The discussion here excludes futures on stock indices, currencies or bonds**

What is a Futures Contract?

- **A futures contract is an agreement to buy or sell a set amount of a commodity at a specific future date at a price agreed to now, where:**
 - The transaction takes place on a futures exchange and is subject to exchange rules covering the definition of the contract, the trading, how the trade is cleared and what the margin requirements are.
 - Typically prices of futures contracts can rise or fall on any trading day.
 - Futures are “marked to market” daily – buyers and sellers settle up each day based on daily price changes.
 - All buyers and sellers must post margin as either cash or liquid securities like treasury bills.
 - “Spot prices” are the price for immediate delivery of a commodity, not future delivery.
- **Institutions and individuals can buy or sell futures contracts – the rules are different from stocks or bonds.**

S&P GSCI

- **The S&P GSCI is an index of 24 futures contracts traded on major commodities exchanges.**
- **The index was originally developed by Goldman Sachs in 1991 and is now owned and maintained by Standard & Poor's.**
- **Commodities are selected based on their importance in the global economy. The weight assigned to each commodity in the index reflects the importance of its production in the global economy.**
- **The index is reviewed annually to keep it up-to-date.**
- **It is a benchmark for commodity values and is also the basis of investment products including Exchange-Traded Funds (ETFs) and Exchange-Traded Notes (ETNs).**
- **There are futures contracts based on the S&P GSCI traded on the Chicago Mercantile Exchange (CME).**

S&P GSCI Total Return

- Anyone investing in futures, including someone investing in the futures contract on the S&P GSCI, must deposit funds in a margin account.
- A “fully collateralized” investment means that the margin deposit equals the total market value of the futures contract. Normally the deposit is invested in Treasury bills.
- The total return on the S&P GSCI is based on the sum of the change in the price of the futures contract and the interest earned on the margin account:

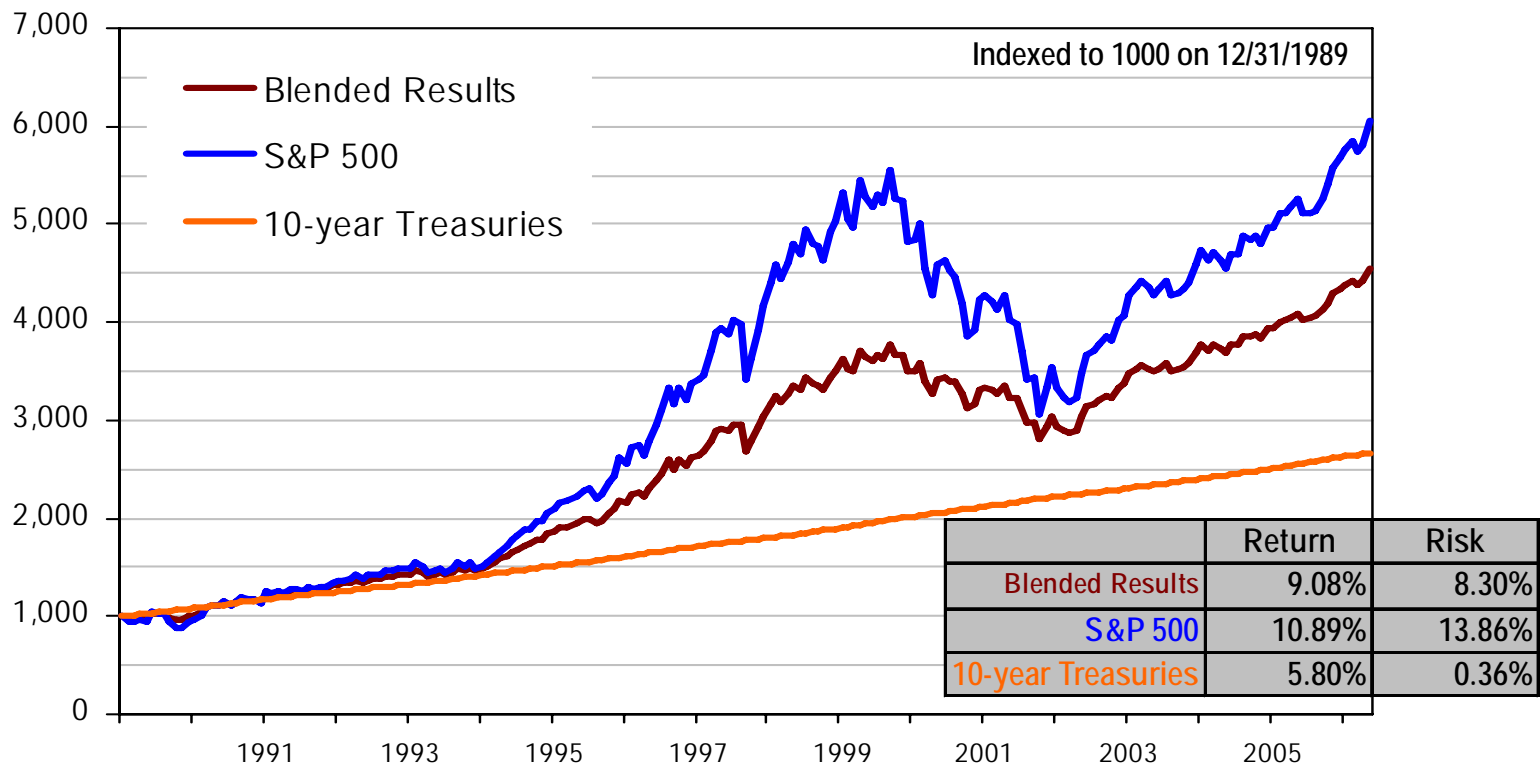
$$\text{S\&P GSCI Total Return} = \text{Price Change in Nearby Contract} + \text{Roll Yield} + \text{Interest on collateral}$$

Where the Commodities Return Comes From

- **There are three possible sources of returns in commodities:**
 - Spot prices can rise or fall.
 - Investors earn interest on their collateral.
 - Futures prices converge to spot prices.
- **Depending on market conditions, the futures prices may be higher or lower than the spot price.**
 - When the futures price is lower than the cash price and futures prices tend to increase as the delivery date approaches, the commodity is in “backwardation” and long investors earn money.
 - When the futures price is higher than the cash price and futures prices tend to fall as the delivery date approaches, the commodity is in “contango” and short investors earn money.
- **If an investor holds a futures position for some period of time, he may sell the contracts he owns as they approach maturity and buy the next dated contract. This is called “rolling the position” and the gain or loss is the “roll yield.”**

Stocks-Bonds Allocation Example

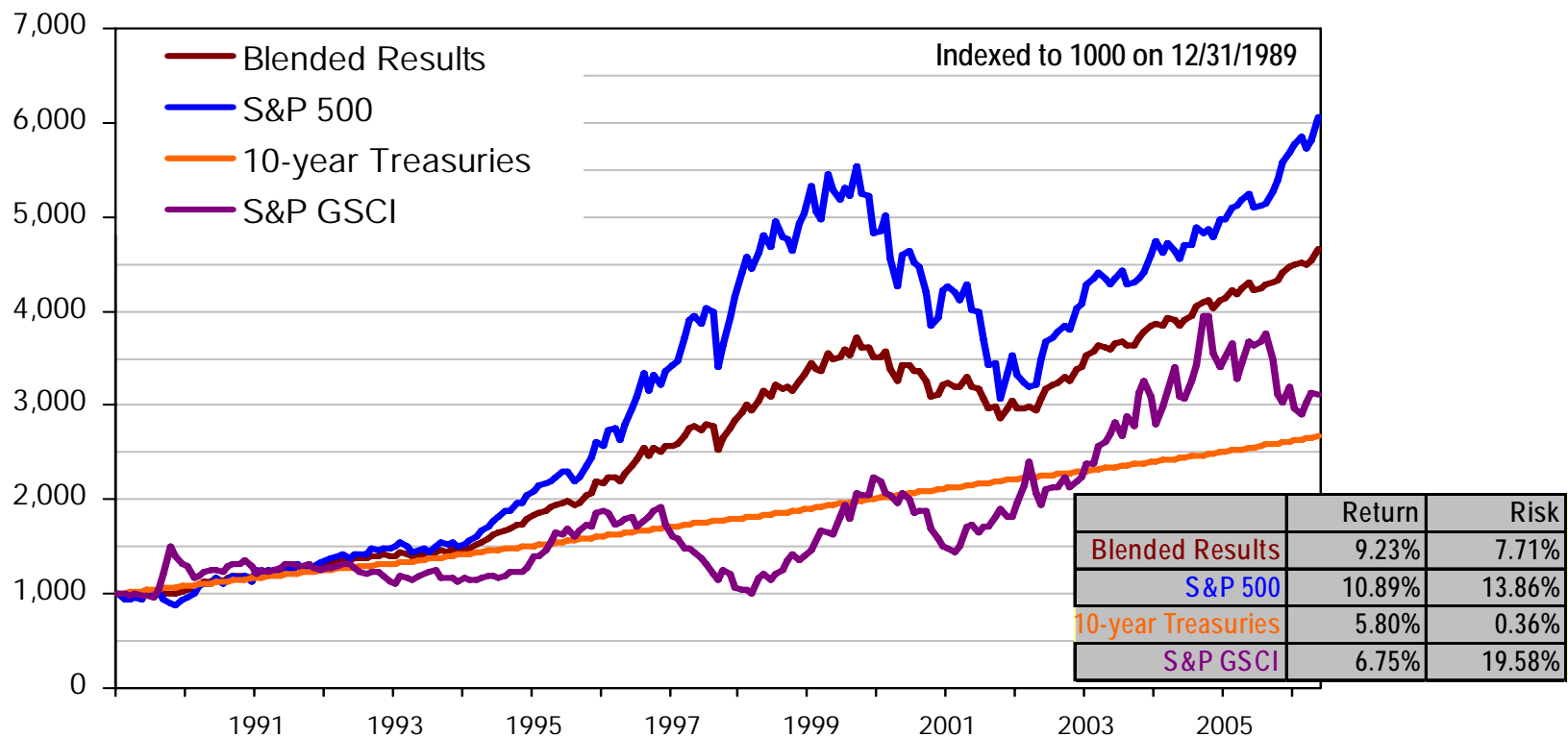
These results represent the hypothetical growth of US\$ 1,000 calculated using 60% S&P 500 and 40% 10-year U.S. Treasuries, assuming rebalancing at the start of each year from 1990 through April 2007.



Note: The results shown are for informational purposes only and are not results of any actual investment. See Footnote slide for explanations on terms and calculations.

Adding Commodities to Stocks and Bonds

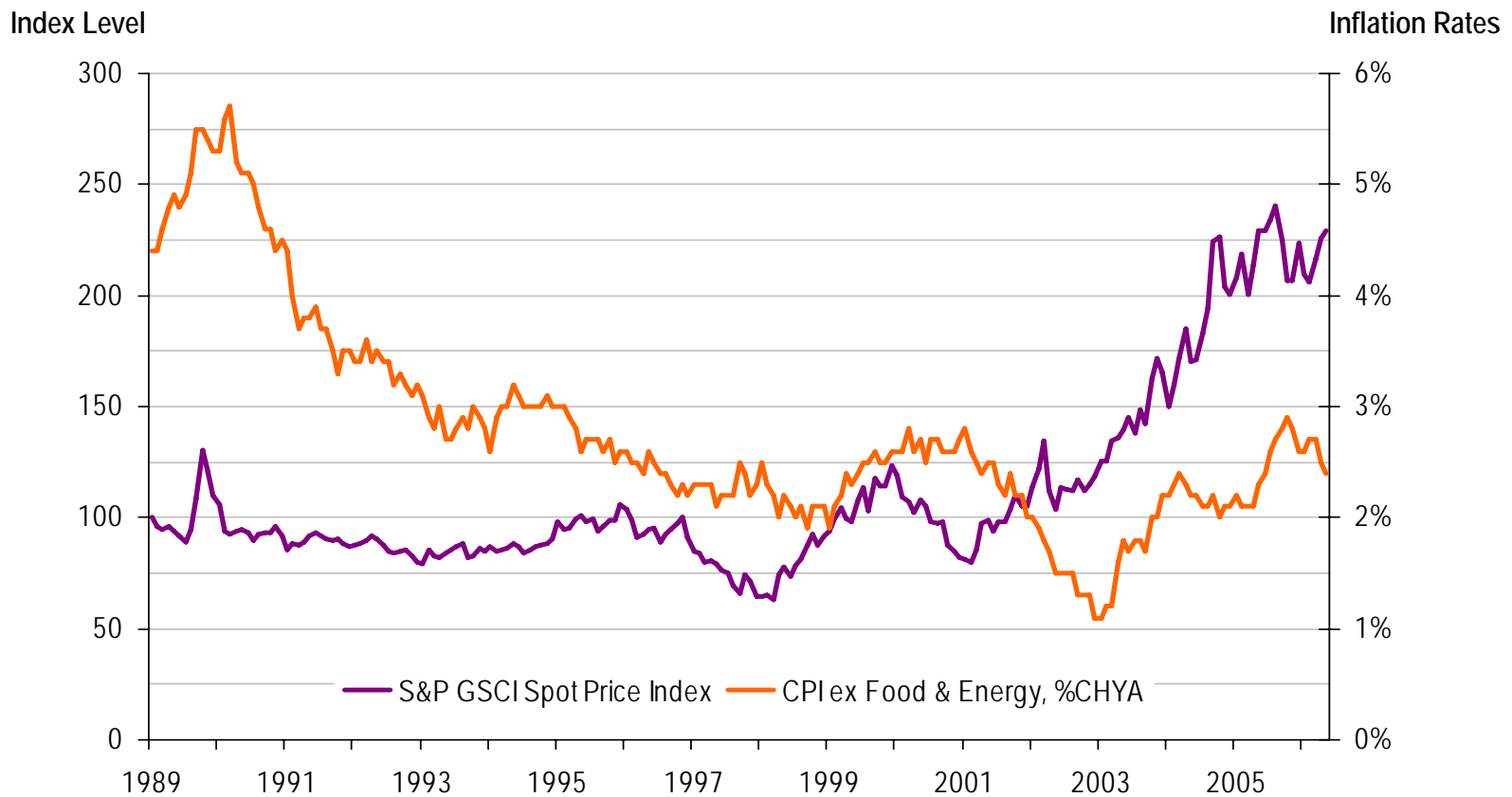
These results represent the hypothetical growth of US\$ 1,000 calculated using 10% S&P GSCI, 55% S&P 500 and 35% 10-year U.S. Treasuries, assuming rebalancing at the start of each year from 1990 through April 2007.



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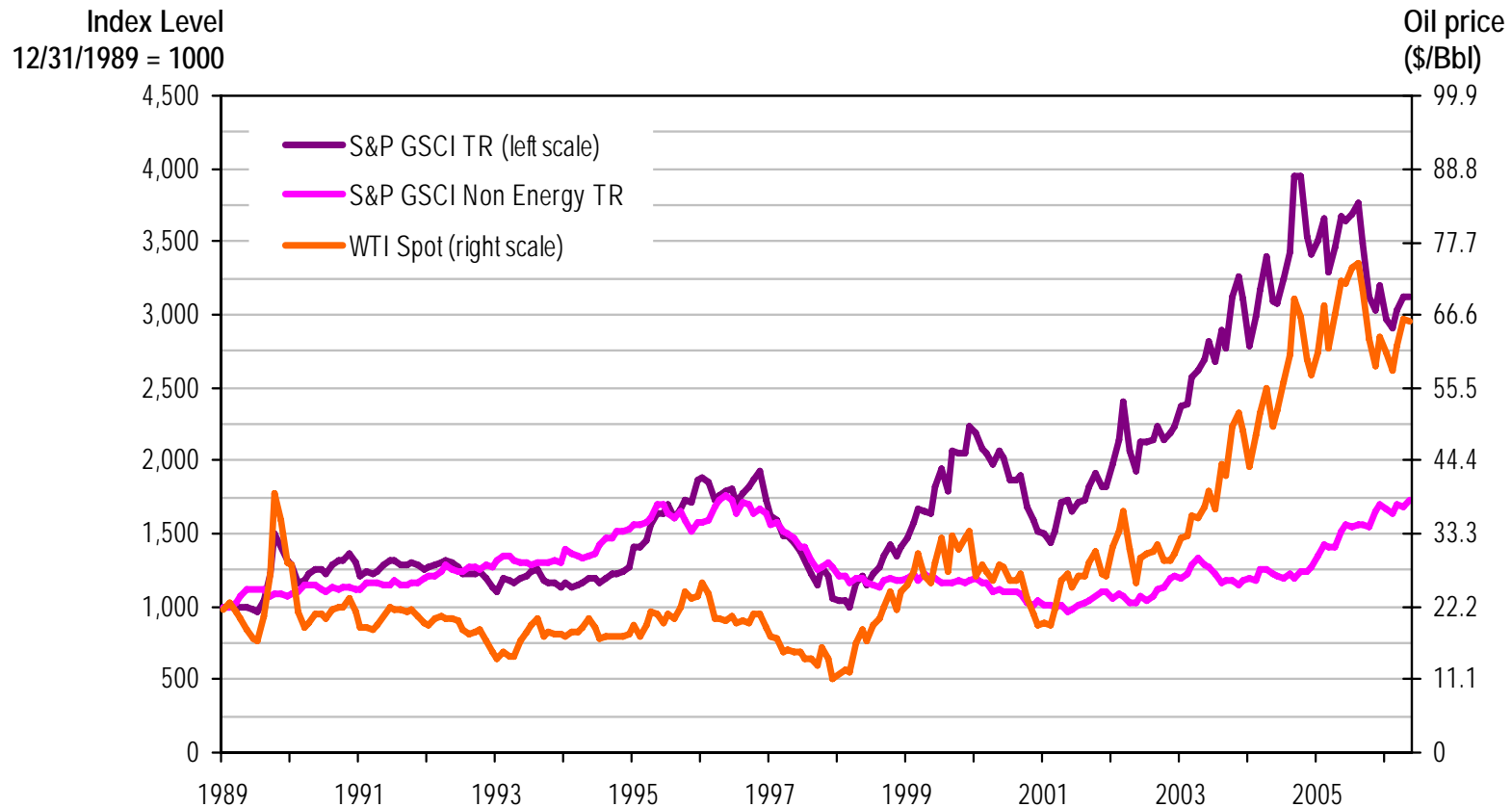
Commodities and Inflation

The chart compares inflation measured by the consumer price index excluding food and energy (the “core” rate) to the S&P GSCI Spot Commodity Price Index.



Commodities and Oil Prices

While the chart suggests that the S&P GSCI may be a way to “play” oil price movements, trading crude oil futures would be more direct.



Conclusion

- **Commodities aren't the same as stocks and investors need to understand how futures contracts work.**
- **There are three sources of return to trading commodities – interest on collateral, changes in commodity prices, and the roll yield.**
- **Shifting an allocation from stocks and bonds to stocks, bonds and commodities can reduce volatility, improve diversification and may increase returns.**
- **Commodities may appear to offer hedges against inflation or rising oil prices or surprises in oil or inflation, but there are probably better ways to meet these needs.**

Footnote

Risk-Return tables on Slides 8 and 9:

- Risk is the standard deviation of monthly returns stated as an annual rate.
- Return is the compound annual return based on monthly data.
- Time period is January 1990 through April 2007.
- 10-year Treasuries are an index based on monthly data on the yield of the 10-year constant maturity series sourced from the Federal Reserve Bank of St. Louis.

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