

New Commodities Vehicles: How Markets Responded to Rev. Rul. 2006-1

An investor can add substantial value by utilizing the commodities product that offers the best combination of low cost and positive tax treatment.

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At the end of last year, the IRS threw the commodities mutual fund market into turmoil. Revenue Ruling 2006-1,¹ issued to Pimco, stated that after June 30, 2006, mutual funds could not use income or gain from swaps on commodity indexes to meet the income test for mutual fund status. The same rules already applied to commodity futures.

The June 30 deadline was later extended, but the ruling had a chilling effect on new investments and prompted mutual funds to change the vehicles they used to gain exposure to commodities. On the positive side, the ruling also spurred the development of innovative financial products designed to offer exposure to the commodities sector.

Several new products may allow investors to approach commodities more cost-efficiently than ever.

A GROWING ARRAY OF PRODUCTS

The array of commodities products now includes physical commodities, companies that produce and own commodities, commodity futures, commodity-based mutual funds, commodity indexed exchange-traded funds (ETFs) that aren't really "funds" at all, and commodity indexed exchange-traded notes (ETNs).

ETFs and ETNs are the newest products. Early in 2006, Deutsche Bank launched a grantor trust of

futures as an ETF that tracks a commodities index. Later, Barclays Bank launched three innovative ETNs, and Barclays Global Investors issued a very clever commodity ETF that's really a commodity pool. Both Deutsche Bank and Barclays have filed with the SEC for the right to launch several additional sub-sector commodity ETFs. There has also been an explosion of filings and several launches of funds based on single commodities.

COMMODITY INDEXES

Beneath any sophisticated commodities product lies an index. In a 2005 paper for Cole Partners entitled "Commodities: A Case for Active Management,"² Rian Akey assesses correlations between the six existing indexes: Commodities Research Bureau-Reuters Total Return Index (CRBR), Deutsche Bank Liquid Commodity Index (DBLCI), Dow Jones-AIG Commodity Index (DJAIG), Goldman Sachs Commodity Index (GSCI), Rogers International Commodities Index (RICI), and Standard and Poors Commodities Index (SPCI). Over long time periods, correlations between these indexes are generally high even though the indexes have numerous construction differences. The chart in Figure 1 is from Akey's paper.³

All the indexes except the S&P have publicly traded commodity futures index contracts, and 86% of the open interest is in the GSCI.

¹ 2006-2 IRB 261.

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² May 11, 2005 (available at www.colepartners.com/articles.html).

³ Figure 6, p. 15.

Figure 1: Monthly Return Correlation, January 1991 – December 2004

	CRBR	DBLCI	DJAIG	GSCI	RICI	SPCI
CRBR	1.00					
DBLCI	0.59	1.00				
DJAIG	0.82	0.85	1.00			
GSCI	0.65	0.92	0.89	1.00		
RICI	0.72	0.96	0.90	0.92	1.00	
SPCI	0.81	0.75	0.91	0.88	0.82	1.00

INDEX TAX TREATMENT

Taxes can be quite friendly to investments in commodity index futures. Both individual commodity futures and index futures are Section 1256 contracts. Section 1256 contracts are automatically taxed as if 60% of the profits are long-term gains and the other 40% of the gains are short-term; this creates a blended tax rate of only 23%. The only downside is that these contracts are marked to market at the end of each year so profits cannot be deferred.

BARCLAYS I-PATH ETNS

The Barclays iPath product is the first exchange-traded note. The initial issue was linked to a commodities index, guaranteed by Barclays and due to mature in 2036. There are iPath notes on the GSCI Total Return Index, the Goldman Sachs Crude Oil Total Return Index, and the Dow Jones-AIG Commodity Index Total Return Index. Unlike mutual funds, iPath ETNs make no distributions, so investors retain control over when they realize their gains (or losses). Like ETFs, the notes have a redeeming mechanism for market makers and, so far, have traded decently against their underlying indexes. Management fees are 75 basis points and there are commissions to trade.

The author is advised that no tax is owed until the product is sold or matures. Theoretically, if the laws do not change, one could hold these notes without current taxation until they mature in 2036, and when profits would be treated as long-term capital gains. If the notes are held to death, the step-up in basis would eliminate the gains tax. If one goes short, the profits will always be taxed as short-term gains.

DEUTSCHE BANK AND BARCLAYS—RIVAL ETFS

The PowerShares Deutsche Bank Commodity Index Tracking Fund (DBC) is an ETF that invests in futures to track the Deutsche Bank Liquid Commodity Optimum Yield-Excess Return Index. Because it is a grantor trust that invests in futures, the “ETF” receives Section 1256 tax treatment, creating a

blended tax rate of 23% regardless of whether one is long or short and regardless of holding period. But these futures are marked to market at year-end, causing yearly taxable income. Total costs are 87 basis points plus commissions to trade.

A direct investment in futures would produce the same tax treatment and *no* management fees. Alternatively, there are commodity trading advisors that invest in futures to track one of the indexes.

Early in 2006, Deutsche Bank launched a grantor trust of futures as an ETF that tracks a commodities index.

The Barclays ETF is really a commodity pool—like the DBC, it is not a mutual fund. It follows the same Goldman Sachs Index as the first Barclays ETN. Unlike the Deutsche Bank fund, which invests in “regular” futures, the Barclays fund employs a commodity excess return futures (CERF) contract, which is a longer-dated futures contract on the Goldman Sachs Index. This vehicle has no trading history and thus might create tracking errors, but is expected to reduce transaction costs and taxes. The management fee for the fund is 75 basis points and there are commissions to trade. As a commodity pool, the fund will distribute realized income each year, like a mutual fund.

COMMODITY MUTUAL FUNDS

There are currently several commodity mutual funds on the market. The two most prominent are Pimco Commodity Real Return Fund, which tracks the Dow Jones Commodity Index, and Oppenheimer Real Asset Fund. Both funds employ structured notes like those “approved” in revenue ruling 2006-1. The Oppenheimer fund actually devotes a third of its assets to structured notes linked to the GSCI (the same

Goldman Sachs Commodity Index as the Barclays products). These notes are leveraged three times; the fund also holds other structured notes, futures contracts, options on futures, and other commodity derivatives. Both Pimco and Oppenheimer also employ active cash management techniques.

Rev. Rul. 2006-1 threw all the commodity mutual funds into confusion, and its ramifications are still playing out in the market. The ruling prompted Oppenheimer to close its commodity fund to new investors from the end of April until October of 2006.

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In April 2006, the Service issued PLR 200628001 approving the use of income and gain from commodity-linked structured notes to meet the income test.⁴ In response, many commodity funds converted to liquid notes, which essentially transformed them into completely new funds.

If a commodity mutual fund investment is held for more than one year, it will receive long-term capital treatment (as would any mutual fund held over one year). But any fund distributions are taxed currently.

COMMODITY INDEXES—WHEN TO BALANCE AND WHEN TO ROLL

For some large investors, the best approach to commodities may be direct participation in a commodity index. But these indexed portfolios need to be managed efficiently.

⁴ See "Commodities-Linked Notes Are Qualifying Income for Mutual Funds (How to Avoid Rev. Rul. 2006-1 Net)," 20(2) J. Taxation and Regulation of Financial Institutions 44 (November/December 2006).

In a working paper entitled "The Tactical and Strategic Value of Commodities Futures," Claude Erb and Campbell Harvey observe that indexes that rebalance annually become trend followers while those that rebalance each day stay closer to their original intent.⁵ Ranga Nathan finds that geometrically averaged indexes that require daily rebalancing (such as the S&P and CRB) exhibit lower volatility than other indexes.⁶ And Akey's Cole Partners paper concludes that geometrically weighted indexes may increase returns by more than 100 basis points.

Indexes must eventually roll from expiring futures into new ones. Typically this activity is spread out over five days; there have been instances where this has affected the futures prices. Index investors may achieve better returns if they hire a separate account manager to replicate a given index with the understanding that the manager would not be required to roll the contracts on the separate commodities on the same day the indexes are to roll.

TAILORED INVESTMENTS

Twenty-First Securities' research suggests that an investor can add substantial value by utilizing the commodities product that offers the best combination of low cost and positive tax treatment. The most important variables are the size of the investment and time frame.

For investments lasting more than one year, Barclays' ETN notes may emerge as the best vehicle for many individual investors. For investments lasting less than one year, the best approach may be the Deutsche Bank ETF or futures if one is comfortable with them. For substantial investors determined to squeeze the most profit from this investment, there are managers that can be hired to replicate (or maybe beat) the indexes with futures. ■

⁵ Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=650923.

⁶ Ranga Nathan, "A Review of Commodity Indexes" (2004) (available for download at www.indexuniverse.com).