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Commodity ETF: An Alternative Investment Option

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The exchange-traded fund (ETF) industry has grown strongly in a relatively short period of time, with the industry attracting greater attention as it grows in size. The original appeal to investors of these products was their simplicity, low-cost diversification benefits and ability to trade intraday. While this is still broadly the case, the evolution of the industry has yet not resulted in a greater variety of ETFs becoming available to investors and improved accessibility to different asset classes. This paper examines a relatively recent innovation in financial markets, exchange-traded funds (ETFs). ETFs are investment vehicles that are listed on a stock exchange and provide investors with the return of some benchmark, such as an equity index. They also offer investors the ability to invest in a range of asset classes which may otherwise be inaccessible or prohibitively expensive, including emerging market equities and commodities. Gold ETF has been fairly doing well in Indian markets. However, as it seems it will still take a while for other commodities to enter exchange-traded funds (ETF) in India. The paper examines the success of Gold ETFs in India. It also attempts to find out the possibility of other commodity ETF as investment options and find out what restricts the regulators to introduce ETFs in commodities other than gold.

Key words: ETF, Investment Vehicle.

Introduction

There are many savings and investment options available in India. One of the options is gold. Gold is one of the most valuable and universally accepted metals, its price movements are keenly watched in global economics. Even today, after gold has been officially delinked from currencies, it has a huge role to play in the global economy. Gold is widely considered to be an asset whose intrinsic value and purchasing power will not be widely subjected to the fluctuations of inflation. It is widely respected as a store of value. Gold has been popular in India because it acted as a good hedge against inflation. There is so much uncertainty in the world in terms of economic growth and geopolitics, it is no surprise that many investors, big and small have chosen to hedge their investments through gold.

The purpose of the paper is to have in-depth knowledge of hyped topic of Gold and its Exchange Traded Fund (ETF)-an alternate investment options. After the success of Gold ETFs in India, the time has come to explore the same opportunity with other commodities. However Indian regulatory bodies seem to be a little conservative in this regard. What stops SEBI to start commodity based ETF? Which commodities should first enter the pool of commodity ETF? The paper aims at throwing some light on such issues.

Objectives of the Study

1. To examine the success of Gold ETF in India.
2. To understand the impact of Gold ETF on physical price of Gold (if any).
3. To find out feasibility of other commodities to be traded on ETF.

Methodology

The methodology followed of the paper is as follows:

- Movement of gold prices in the past years is studied. In depth analysis is done mentioning the proper reasoning of the movement of price in past years linking it introduction of ETF. For analysis the data is collected from Ace equity software .The data available for this analysis is from 2005-2006 (pre ETF) to 2007-2012(post ETF).
- Movement of some major commodities like silver, copper, crude oil are studied for past few years for understanding their viability to enter the commodity pool of ETF.

Exchange Traded Fund

An exchange-traded fund (or ETF) is an investment vehicle traded on stock exchanges, much like stocks. An ETF holds assets such as stocks or bonds and trades at approximately the same price as the net asset value of its underlying assets over the course of the trading day. Most ETFs track an index, such as the Dow Jones Industrial Average or

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the S&P 500. ETFs may be attractive as investments because of their low costs, tax efficiency, and stock like features. An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be purchased or redeemed at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be substantially more or less than its net asset value.

History

Exchange Traded Funds came into existence in 1993 when, State Street Global Advisors, together with the American Stock Exchange, developed and launched the ETF market. The name of the product was SPDRS. SPDR, which is benchmarked against the S&P 500 Index, continues to be the most successful product with over $102 billion of Assets under Management. In 1999, AMEX introduced the first ETF in Asia and currently they are doing the same in other major markets around the globe.

Features of ETF

- Exchange Traded Funds (ETFs) are open ended mutual funds which means an investors can enter or exit the trade at any time
- ETFs represent a fractional ownership in the underlying securities in a particular index.
- ETFs can be traded like stock on the major stock exchanges.
- Intraday portfolio values are calculated every fifteen seconds. ETFs range in style, sector, country ranging from value, growth, international equity, commodity, and domestic to equity and fixed income

Creation of ETF

ETFs are different from Mutual funds in the sense that ETF units are not sold to the public for cash. Instead, the Asset Management Company that sponsors the ETF (Fund) takes the shares of companies comprising the index from various categories of investors like authorized participants, large investors and institutions. In turn, it issues them a large block of ETF units. Since dividend may have accumulated for the stocks at any point in time, a cash component to that extent is also taken from such investors. In other words, a large block of ETF units called a "Creation Unit" is exchanged for a "Portfolio Deposit" of stock and "Cash Component".

The number of outstanding ETF units is not limited, as with traditional mutual funds. It may increase if investors deposit shares to create ETF units; or it may reduce on a day if some ETF holders redeem their ETF units for the underlying shares. These transactions are conducted by sending creation / redemption instructions to the Fund. The Portfolio Deposit closely approximates the proportion of the stocks in the index together with a specified amount of Cash Component. This "in-kind" creation / redemption facility ensures that ETFs trade close to their fair value at any given time.

Some investors may prefer to hold the creation units in their portfolios. While others may break-up the creation units and sell on the exchanges, where individual investors may purchase them just like any other shares.

Redemption

ETF units are continuously created and redeemed based on investor demand. Investors may use ETFs for investment, trading or arbitrage. The price of the ETF tracks the value of the underlying index. This provides an opportunity to investors to compare the value of underlying index against the price of the ETF units prevailing on the Exchange. If the value of the underlying index is higher than the price of the ETF, the investors may redeem the units to the Sponsor in exchange for the higher priced securities. Conversely, if the price of the underlying securities is lower than the ETF, the investors may create ETF units by depositing the lower-priced securities. This arbitrage mechanism eliminates the problem associated with closed-end mutual funds viz. the premium or discount to the NAV.

Advantages and Disadvantages of Investing in ETF

Benefits

- Can easily be bought / sold like any other stock on the exchange through terminals across the country.
- Can be bought / sold anytime during market hours at a price close to the actual NAV of the Scheme.
- No separate form filling. Just a phone call to your broker or a click on the net
- Ability to put limit orders
- Minimum investment is one unit.

- Enjoy flexibility of a stock and diversification of index fund
- Expense Ratio is lower. Hence low cost invest, even lower than the index funds
- Provides arbitrage between Futures and Cash Market

Disadvantages

- Underlying volatility - ETFs passively track other financial instruments, which can be liquid or volatile. Usually market indexes are less volatile than specific sectors or industries. Similarly international ETFs which track indexes of countries / regions with strong fundamentals are less
- ETF liquidity - Although the liquidity of ETFs match liquidity of tracking index, their own trading volume is also a factor worth noticing. With coming of new types of ETFs to the market, now there are quite a few not-so-liquid ETFs having large differences between ask and bid prices.
- Capital gains distribution - most ETF firms invest capital gains to the market, which is often the right thing to do. ETFs which distribute capital gains to ETF holders are making the shareholders qualify for capital gains tax.
- Dollar cost averaging - DCA is a simple but effective way of building a big portfolio. But the costs involved in ETF trading makes DCA less-effective (unless trading through a discount broker).
- SIP investing - SIP in ETF is not convenient as you have to place a fresh order every month
- Also SIP may prove expensive as compared to a no-load, low-expense index funds as you have to pay brokerage every time you buy & sell
- Because ETFs are conveniently tradable, people tend to trade more in ETFs as compared to conventional funds. This unnecessarily pushes up the costs.
- Dividend reinvestment - You can't automatically re-invest your dividends. Secondly, you may have to pay brokerage to reinvest dividends in ETF, whereas dividend reinvestment in MFs is automatic and with no entry-load
- Comparatively lower liquidity as the market has still not caught up on the concept

Gold ETF in india

History

Gold has played a pivotal role in the Indian social fabric for as far back as man's memory will stretch. In India, gold has a religious significance. Gold was acquired in India in Roman times as part of the silk and spice trade, and the first gold ducats struck by the Venice Mint in 1285 went into the Levant (i.e. the countries bordering the eastern Mediterranean) and into India. In the seventeenth century the Dutch and English East India companies paid for goods with gold and silver and during the American Civil war India received gold from the US in return for the cotton that it supplied to make up for the lost crops in America. Indian people are renowned for saving for the future and the financial savings ratio is strong, with a ratio of financial assets-to-GDP of 93%.

According to World Gold Council, India is world's largest consumer of gold accounting to some 20% of worlds demand. In India gold is historically and culturally tied to the concepts of wealth and prosperity. Consumer demand still remains high as Indians believe gold offers the best protection against inflation. To quote few facts:

- Gold jewellery demand in India, the world's largest gold jewellery market, rose 67 percent year-on-year to 272 tons in the first half of 2010, despite the higher gold price.
- Over the past decade, gold demand in India has increased at an average rate of 13 percent per year, outpacing the country's real GDP, inflation and population growth by 6 percent, 8 percent and 12 percent respectively.
- Currently, the country has one of the highest saving rates in the world; estimated at around 30 percent of total income, of which 10 percent is invested in gold. Continued rapid economic growth and urbanization will create greater wealth but also inflationary pressures stimulating gold demand.

The World Gold Council reports: "In the longer term, we are confident that India's favorable demographic trends, the growing affluent middle class and declining age profile, should ensure a buoyant consumption growth."

Growth of Gold ETFs in India

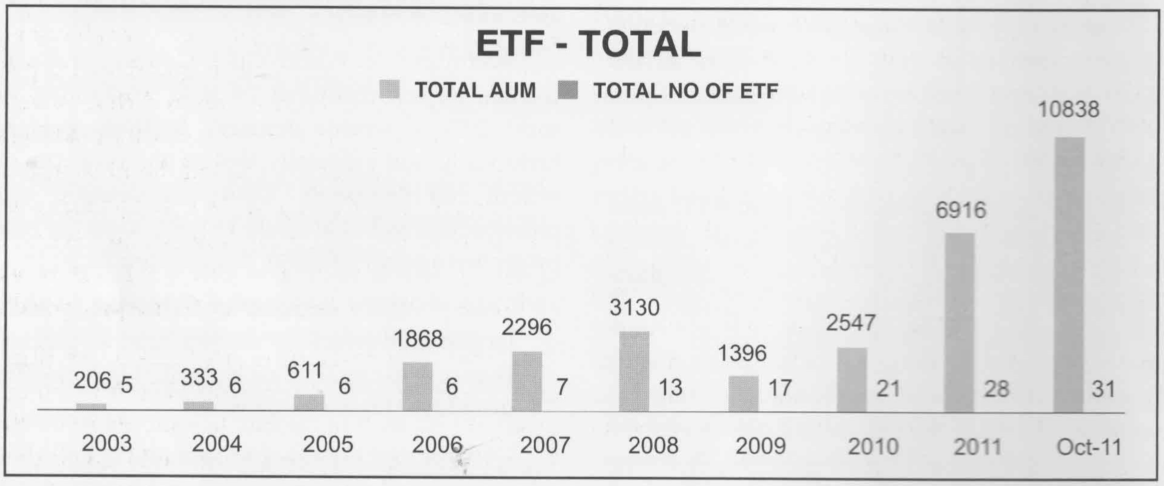
Around seven years ago, exchange-traded funds specialist Benchmark Mutual Fund (now

Goldman Sachs India Mutual Fund) was the first to have submitted to the capital market regulator, Securities and Exchange Board of India (SEBI), a draft offer document for a gold ETF. It took SEBI around two years to give it the green signal. Benchmark Gold BeES, the first Gold ETF in the country, was launched successfully in March 2007, and since then there has been no looking back for gold ETFs as mutual fund after mutual fund launched their own gold ETFs over these years.

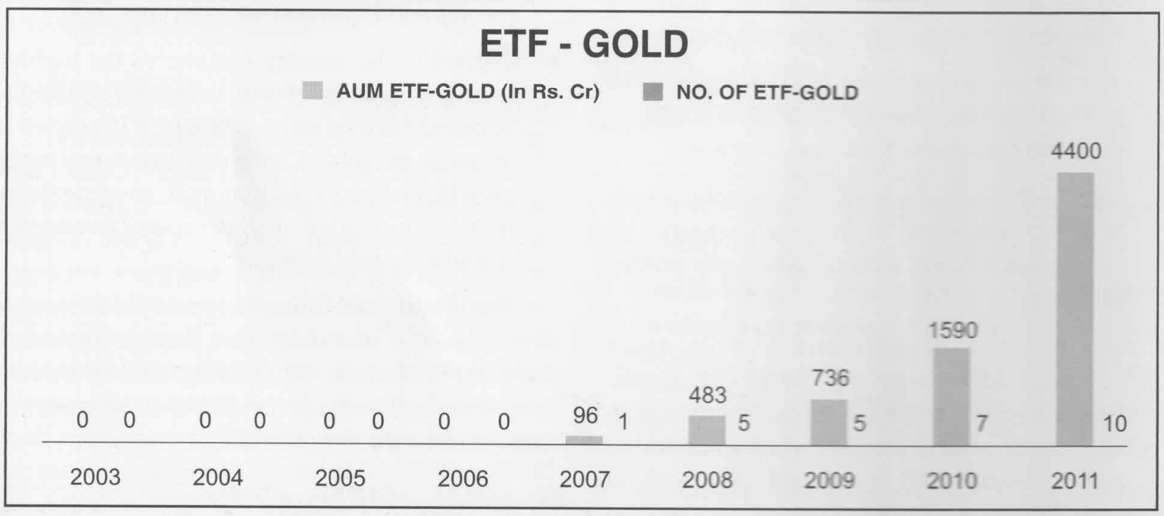
The growth of the gold ETF market in India was not rapid in the first few years. From a total corpus of just Rs 475 crore in January 2008, making up for a tiny 0.09 per cent of the total corpus of the mutual fund industry, gold ETFs' total corpus went up to Rs 767 crore in January 2009 (0.16 per cent of the total), and then to Rs 1,425 crore in January 2010 (0.19 per cent of the total). Gold ETFs began gathering momentum in 2010 and between January 2010 and January 2011, their total corpus stood at Rs 3,581 crore, making up for 0.52 per cent of the total corpus of the industry.

The past one year has seen sustained high growth in the total corpus of gold ETFs which stood at a collective total of Rs 9,614 crore (January 2011-January 12), accounting for a decent 1.49 per cent of the total industry corpus, which is usually dominated by liquid funds, debt funds and equity funds in that order.

Overall Growth of ETF in India, as of October 2011



Overall Growth of ETF-Gold in India, as of March 2011



Source: http://www.infosys.com/finacle/solutions/thought-papers/Documents/exchange-traded-funds.pdf working paper "Exchange Traded Funds - Its Growth & Challenges in India", Data source: AMFI

Charts above show how gold ETFs have had a humble start but roaring success in just few years of inception. It is clearly visible that Gold ETFs had a phenomenal growth. The latest report of The Association of Mutual Funds of India (AMFI), states that the investment under gold exchange traded funds (ETFs) has registered more than 100% growth in the first two months of 2012. During the last one year, where Sensex has shown a drop of 10% in the benchmark gold ETF's proved to be a wise investment with 34.74% returns.

Gold ETF and Boom in Gold Prices

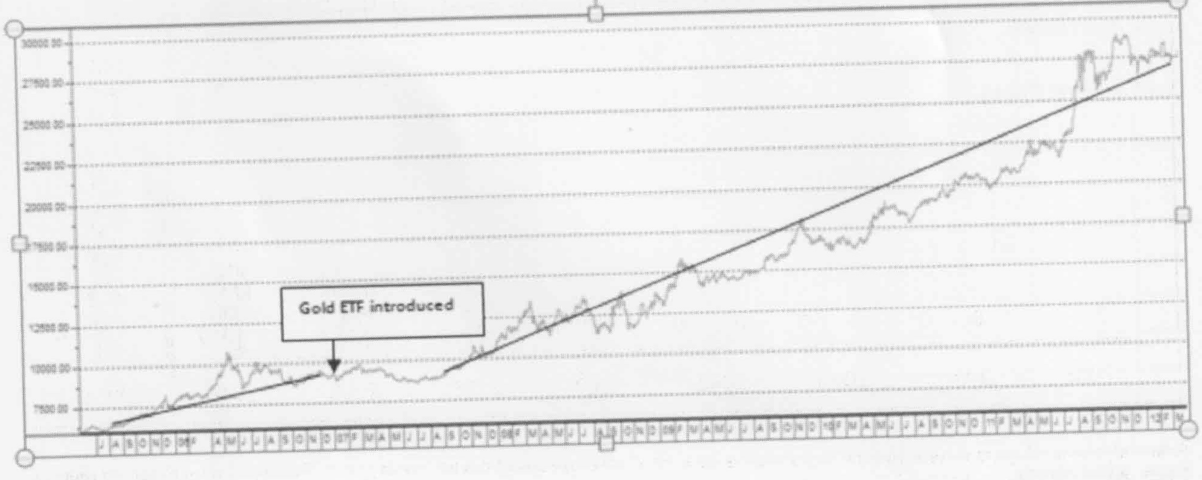
The introduction of gold ETFs, and the ease with which the average investor can now invest in gold, has made gold much more accessible and, in turn, much more speculative than ever before.

The more widespread an investment becomes, the greater its chances of forming a bubble. Perhaps nothing has helped gold prices soar more than the introduction of Gold Exchange-Traded Funds (ETFs). Before ETFs, the main ways to invest in gold were limited to buying physical gold, jewelry, or through real commodity trading. The introduction of gold ETFs, most notably the GLD (the largest gold holding ETF in the US), has made it much easier, more accessible, and liquid to invest in gold. With gold now traded similarly to stocks, the number of investors and degree of speculation has increased exponentially. With the proper tools for investment now at the disposal of gold investors, a speculative bubble has become drastically more likely. A multitude of gold ETFs have since emerged, and continue to ignite speculative interest in the precious metal. Though the speculative interest in gold has coincided with the growth of the gold ETF industry, and is not necessarily caused by the ETF, it is still easy to see how the introduction and availability of the gold ETFs has tremendously supported the rise in gold prices, and may have even acted as a multiplier. Just take a look at how far gold prices have gone since the introduction of gold ETFs

The chart below clearly shows that how steep is the slope of gold spot prices curve post ETF introduction than the pre ETF. There had been a drastic change in the growth rates and that is obviously because of increase in demand. However the growth of gold returns can not only be contributed to ETFs. There is variety of other macroeconomic variables playing a role here but yes even ETF played a significant role. After all even if ETF is a security, it eventually is gold-based paper, which affects demand and supply and, thus, pricing of the commodity. The introduction of the gold ETFs has increased awareness, created the illusion that investing in gold through ETFs is sound and safe, and has encouraged many investors who were once afraid of gold investing to buy gold and hence contribute to the "upward thrust" of the gold prices.

The price of gold is up nearly Rs 23000 per 10 gm since the introduction of the gold ETFs. And though it is hard, if not impossible, to truly measure the effect of ETFs on investment demand it could very well be argued that ETFs have sparked a lot of interest in gold.

Chart 1: Gold prices



Source: Accord Infotech

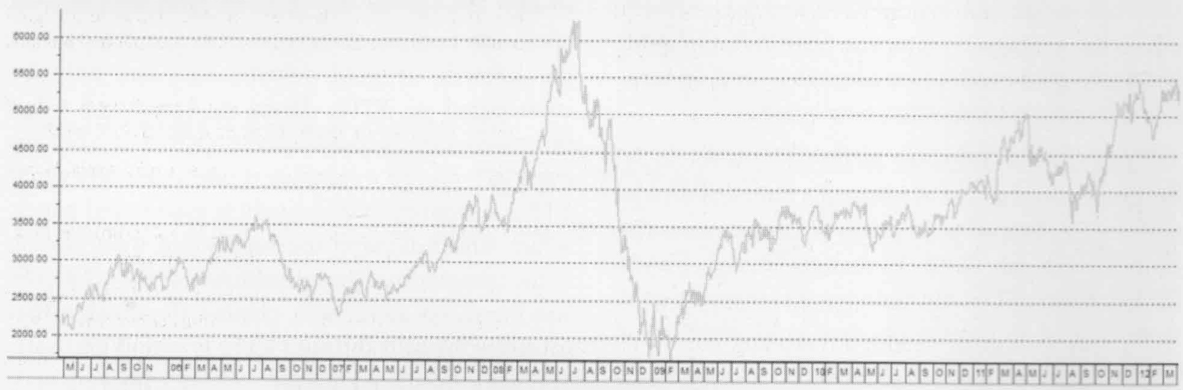
ETF- Possibility of other Commodities to join the Commodity Pool

There has been a robust growth in assets under management in the ETF industry in the last four years. One of the primary contributors to this growth has been the gold ETF and the financial crisis, which made gold a more favourable investment than ever. After the roaring success of Gold ETF in India it is now the time to introduce few more commodities in ETF pool. We have tried to find out few such commodities which could prove profitable if traded on ETF.

The charts below show the performance of some other commodities like Crude Oil, Copper, Silver and over last seven years. The charts are self explanoratory and very well depict that these commodities have been doing fairly well despite of a major meltdown in 2008.

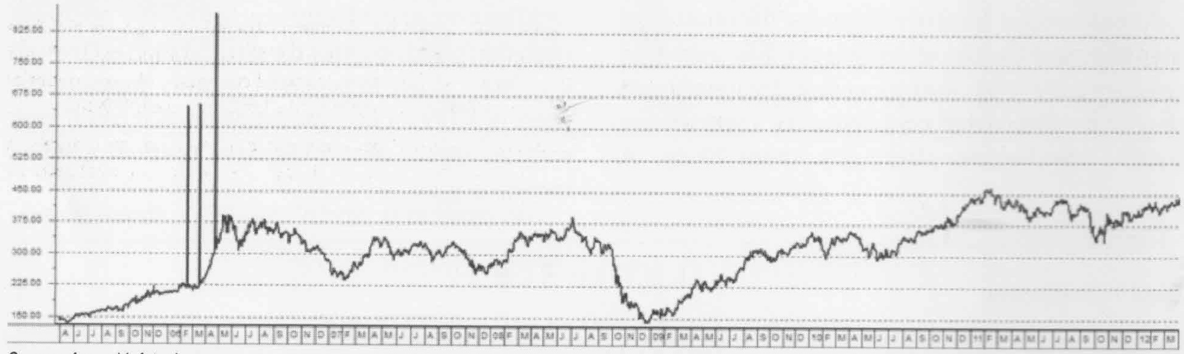
Silver has shown a trend very similar to that of Gold and hence silver fairly stable commodity to be introduced on ETFs.

Chart 2: Crude oil Prices



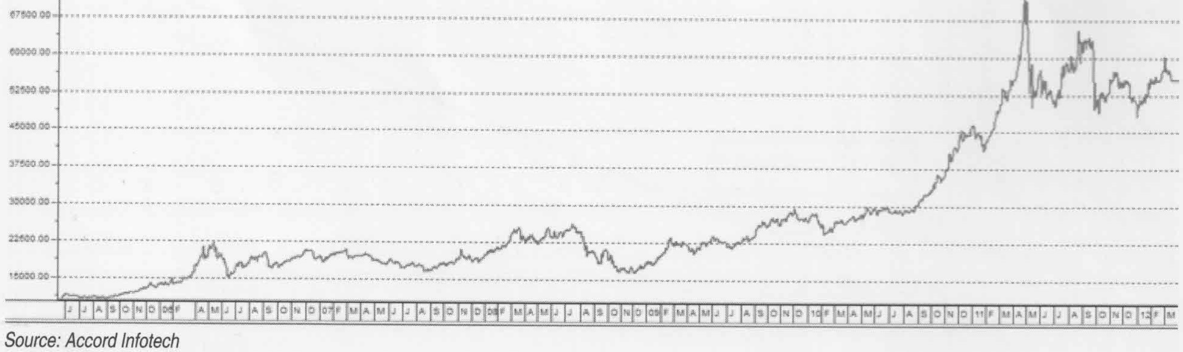
Source: Accord Infotech

Chart 3: Copper Prices



Source: Accord Infotech

Chart 4: Silver Prices



Source: Accord Infotech

There is a huge potential for other commodities too in the ETF market. The regulatory bodies are having a cautious approach right now but in future some more commodities should join the ETF pool.

Conclusion

ETF has definitely made a mark on the Indian Investment panorama and has introduced a new investment opportunity for the investor. As the market matures, we are going to see a lot of action on the ETF horizon, for sure. Indian ETF industry has seen a tremendous growth in just few years of inception and it has proved to be a good investment alternative. Despite of few disadvantages it does give a good diversification advantage to the investors. To add to the glory of ETFs in India Gold ETFs have shown a remarkable presence. The success of Gold ETF and increasing investor interest in these instruments have shown that markets are ready for more commodity ETFs. However no marked evidence is there to blame Gold ETFs for the increased speculation in the spot market prices of gold in Indian market but then yes the impact of same can not be totally neglected. In good regulated markets where close watch is kept on the excessive speculative activities, other commodities especially precious metal, crude oil and some agri products can prove to be good addition to the commodity pool of ETF.

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