Mutual Funds Tap Into Commodities

By Neil O'Hara

It's no secret that commodities are hot. Whether it's energy, metals or agricultural products, most prices are either near record highs or at levels not seen for a generation. Now retail investors are clamoring to get in the game.

Most investors don't have a futures account, however, and in any case would rather get commodities exposure through a diversified pool. As a result, retail investors have piled into a new class of mutual funds that track commodity indices, a simple way to get a broad portfolio in a familiar format.

"People are first enticed by the high recent returns but when they dig a little deeper they realize it's generally uncorrelated with whatever they currently have," says Jim King, director of portfolio management at Baltimore-based Rydex Investments. "Risk mitigation through diversification is the real story."

Ironically, just as these funds are achieving broad recognition, a tax ruling from the Internal Revenue Service has forced them to change the way they obtain their exposure to the commodity indices and temporarily put their marketing efforts on pause. Instead of using commodity swaps, the funds are turning to commodity-linked structured notes, and in at least one case, going directly to the futures markets.

The trend first started in 1997, when Oppenheimer launched its Real Asset Fund. Pimco, one of the biggest names in bond investing, joined the trend in 2002, when it launched its Commodity RealReturn Strategy Fund. Today there are at least eight of these funds offered to retail investors by some of the largest names in the mutual fund business, with approximately $15 billion of assets under management. By way of comparison, that is more than 10% of the money invested in the managed futures business, which includes both institutional and retail money.

Except for the Oppenheimer fund, these funds generally do not invest directly in futures. Instead, they use over-the-counter derivatives based on commodity indices. These indices track a basket of futures on physical commodities, following rules set by the index providers that remain constant over time. The two most commonly used are the Goldman Sachs Commodity Index and the Dow-Jones AIG Commodity Index.

Unlike a commodity pool or a hedge fund, there is no trading strategy or active selection process. The basket may be adjusted from time to time to maintain the component weightings, but that is the job of the index provider. The funds simply buy and hold the index, much like the large number of funds based on equity indices such as the Standard & Poor's 500.

Oppenheimer's Real Asset Fund is a little different. Although it pays homage to the Goldman Sachs Commodity Index, it does not purport to track it precisely. The fund holds approximately a third of its assets in structured notes that are linked to the GSCI. These notes are typically leveraged three times, so the fund can get full portfolio exposure by putting up only one third of its assets. In addition, the portfolio includes substantial direct holdings of futures contracts and options on futures as well as structured notes and other commodity-linked derivatives. As

of March 31, 26% of the Real Asset Fund portfolio comprised energy futures–crude oil, natural gas and refined products–with another 5.7% in metals and agricultural futures.

Components of Return

The returns generated by these funds come from three sources. The first two come from the way that these indices are constructed. Not only do they increase in value when commodity prices rise, and vice versa, they also reflect the roll return, that is, the return from selling the futures contracts in the basket as they approach the expiration month and buying the same contracts in a deferred month. Each index has different rules for when and how the contracts are rolled forward, and this has an important impact on returns.

The third source of returns for these funds comes from cash and collateral. If one looks at the portfolios of these funds, one sees that the largest holdings have nothing to do with commodities. Instead, the bulk of the fund assets are money market instruments or short-term notes. Since these funds are using derivatives to obtain their exposure to the commodity indices, only a small amount of the customer funds are needed as collateral to support the investment strategy. The remainder can be invested in overnight repurchase agreements, treasury bills and the like.

This creates an opportunity to enhance the returns on the index. Oppenheimer's fund, for example, actively manages its collateral as a short-term bond portfolio (most mature within 12 months) that earns a higher yield than money-market instruments. Pimco leverages its bond expertise by investing the cash in its Commodity RealReturn fund into an actively managed portfolio of fixed income securities, including inflation-linked bonds issued by the U.S. Treasury. In this way, Pimco's fund makes investing in commodities even more attractive to retail investors concerned about rising inflation, although its "double real" strategy carries the risk that returns on the fixed income investments might fall below the returns on cash.

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Although the funds' exposure to commodities is indirect, their buying power still shows up in the futures markets. When the major derivatives dealers —Goldman Sachs, Barclays Capital and AIG Financial Products among them—sell over-the-counter commodity-linked derivatives to the mutual funds, the dealers end up short. To hedge their book, dealers turn around and buy enough futures to flatten their position. Everyone gets what they want: investors get diversification through a familiar vehicle, mutual fund companies increase their assets under management, derivatives dealers earn fees by replicating the index, and the futures industry benefits from higher trading volume.

The Move into Structured Notes

Last December, however, the Internal Revenue Service threw a monkey wrench into the operations of these funds. It ruled that income from commodity-linked swaps did not meet its test for "qualifying income" because the underlying instruments were not securities. As a result, a mutual fund that relied on commodity swaps for more than 10% of its gross income would lose its status as a registered investment company, and thereby become subject to an assessment on their taxable income and capital gains, rather than passing them through to their investors.

The ruling will not take effect until July 1, but it had an immediate impact. Pimco, whose fund relied primarily on commodity swaps, said in December that it was "both shocked and disappointed" by the ruling, and said it would "explore a range of legislative and regulatory alternatives that would expand the set of investment techniques" available to its portfolio manager.

In the meantime, the funds are scrambling for an acceptable alternative to swaps. The same IRS rules that disqualify commodity swaps as "qualifying income" also apply to commodity futures, so the funds can't just replicate the indices themselves with the component futures contracts. As a result, the most attractive alternative, according to investment industry experts and the funds themselves, are structured notes that deliver a return linked to a commodity index.

Like swaps, structured notes are over-the-counter instruments issued by investment banks and other counterparties. They tend to be slightly more expensive than swaps, but they can qualify as debt securities in the eyes of the IRS as long as they meet a "facts and circumstances" test, according to tax experts. There is no bright line standard, but they have to have a fixed term and offer some degree of principal protection, meaning that some portion of the principal is returned to the investor when the note comes due. In other words, if the notes look and feel like a debt instrument, they should pass muster.

Meanwhile, the IRS ruling has chilled asset inflows as the fund managers scramble to restructure their portfolios before July 1.

Assets Under Management

Fund Name	Assets $M
Pimco Commodity Real Return Strategy	11,818
Oppenheimer Real Asset	1,892
Fidelity Strategic Real Return	957
Credit Suisse Commodity Return Strategy	230
DWS Scudder Commodity Securities	190
Merrill Lynch Real Investment	111
Rydex Commodities	44
Potomac Commodity Bull	5
Total	**15,247**

Source: Publicly available reports

Pimco, for example, had obtained $5.4 billion of commodity index exposure through structured notes as of April 7, according to an update posted on its web site on April 11. Not all of the funds are facing this problem; the Oppenheimer fund, the second largest, relied primarily on structured notes even before the IRS issued its ruling. But even Oppenheimer has felt the effects. The fund closed its doors to new money effective April 28 "in order to preserve the benefits of the fund's strategy to current investors." When it announced the move, Oppenheimer hinted at capacity constraints in the structured notes market, blaming "the current availability and environment for commodity-linked instruments."

Rydex Ruling

The uncertainty hangs like a sword of Damocles over commodity mutual funds. "A lot of money has decided to sit on the sideline and let this whole thing work itself out," says Rydex's King. Like Pimco, his firm plans to switch from swaps to structured notes, relying on a private letter ruling it received from the IRS in April.

According to the letter, each note will have a term of a year and a day, but the fund has the right to put the note back to the issuer on one day's notice. The notes also have a "knockout" feature that requires the fund to repay the note one day after the reference index drops more than a predetermined percentage. The amount payable upon early redemption, knockout or at maturity equals the face amount of the note multiplied by the percentage change in the reference index through the payment date, plus a fixed-rate coupon amount, less an annualized fee. The index-related payment and the fee will both increase proportionately if the fund uses leverage. Rydex has not disclosed the knockout threshold, the coupon rate nor the fee, but the IRS ruled that the proposed note qualifies as "a hybrid instrument that is predominantly a security" not subject to the Commodity Exchange Act. Any income or gain a mutual fund receives from the note will therefore constitute qualifying income, which will preserve the fund's tax status.

Although the market for commodity-linked structured notes is not as mature as swaps, King expects that will change in short order. "I think a lot of the mutual fund industry will migrate to structured notes as their vehicle of choice," he says. "As a result, the pricing structure and liquidity will improve rapidly."

In effect, the switch to structured notes will be a triumph of form over substance. Keith Styrcula, chairman of the Structured Products Association, explains that one way a note issuer can hedge its commodity exposure is through a total return swap with either its own swaps desk or a third party. The counterparty will then lay off the risk in the futures market. "At the end of the day, much of the hedging winds up creating open interest and volume in the underlying futures contracts. All roads lead to enhanced liquidity on the futures exchanges."

An obscure tax ruling won't dampen investors' enthusiasm for commodities, anyway. Although mutual funds are convenient and familiar, investors do have other choices. In the last 18 months, exchange traded fund sponsors have moved into the commodities arena with ETFs that track the price of gold, oil and silver. Competition may pose a bigger threat to commodity mutual funds than the IRS as commodity-linked vehicles open to retail investors proliferate.

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