ETFplus
Borsa Italiana

A NEW WAY OF INVESTING IN COMMODITIES

ETC - Exchange Traded Commodities

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Introduction

Diversification and protection of capital from inflationary phenomena represent two fundamental objectives in building a portfolio. From this standpoint, commodities have always been valued for their low correlation with traditional investment classes (typically stocks and bonds) and for their structural revaluation in periods of general price increase.

Thanks to these characteristics, commodities have represented and even now represent an indispensable component in the definition of both institutional and retail investors' portfolios.

Except for precious metals (e.g. gold, silver, platinum and palladium) of which material possession is technically possible despite some operational risks (for example, custody costs), for other commodities such as energy, agriculture and industrial metals, problems of perishability and difficulties of storage do not allow for direct physical investment. Exposure to these goods can be achieved only through standardised derivative financial instruments - futures - a contract in which two parties agree to exchange, at a future date, a certain amount of particular commodity for a predetermined price. For these reasons, historically the use of commodities has been the exclusive remit of institutional investors, who were the only ones able to access international derivative markets and manage positions in futures. This management required high minimum lots, maintenance of margins, and repositioning of consecutive futures contracts in order to maintain exposure to relevant commodity (technically defined as "rolling").

“Operating in a similar way to stocks, they allow investors to obtain the performance of a commodity or of commodity indices”

Access to the commodities market was therefore unavailable to retail investors until the introduction of instruments like the Exchange Traded Commodities. Operating in a similar way to stocks, they allow investors to obtain the performance of a commodity or of commodity indices without the need for rolling, without any margin requirement and without the expense of managing expiring derivative contracts - these activities are incorporated into the ETC itself.

ETCs are instruments conceived and created very recently. The listing of the first ETC was in March 2003, when the Australian Stock Exchange began trading Gold Bullion Securities. Even more recent is their entry into the Italian market, which first occurred in April 2007 with the opening of the ETFplus market of Borsa Italiana in which a dedicated segment was provided for ETCs.

ETCs benefit from clearly defined investment objectives, low management commissions, no expiry date, a minimum lot of just one ETC and low cost access to commodies otherwise difficult to obtain. These factors, together with the simplicity, flexibility and transparency characteristic of ETCs, combine to create a unique financial instrument. Although simple and flexible to use, ETCs are complex and innovative instruments whose characteristics need to be understood in detail in order to understand the potential ETCs offer and their limitations. The information on the following pages describes the features of ETCs and potential methods of investment, and may assist towards making an informed investment in the world of commodities.

Exchange Traded Commodities

ETCs are financial instruments fungible with the commodity or the basket of commodities they refer to since firstly they are issued against a direct investment by the issuer in those commodities and secondly they can be created and redeemed on continuous basis and intermediaries can take advantage of arbitrage opportunities against the underlying commodities.

What they are

Exchange Traded Commodities (ETCs) are financial instruments issued against a direct investment by the issuer in commodities or commodities derivative contracts. The price of an ETC is, therefore, directly or indirectly linked to the performance of the underlying. ETCs:

- are traded on the stock exchange like shares
- passively track the performance of the commodity or commodity indices to which they refer, thus are fully entitled to be referred to as "passive instruments".

Using ETCs the investor may take a position on one single commodity (eg. gold, oil, natural gas, sugar, soybean, zinc), while ETFs can't do because they must ensure a certain degree of diversification to compy with UCITS III (Directive on Undertakings for Collective Investments of Savings).

ETCs are not UCITS; they are securities without maturity issued by an investment vehicle in relation to an investment in the commodity to which they refer, or an investment in commodities derivative contracts entered into by the issuer with intermediaries operating in the commodities market.

The ETCs are created in the primary market, accessible only to authorised participants, where the creation and redemption of the securities takes place on a daily basis at the price of the official reference market of the underlying commodity (it is also possible for certain ETCs to subscribe in kind, i.e. delivering to the issuer directly the commodity). The secondary market is held on the stock exchange, where other investors may trade the ETCs at a price determined by the best bid and ask orders on the trading book.

The creation and redemption process on the primary market allows authorised participants to take advantage of arbitrage opportunities, which ensures that the price of ETCs on the secondary market is always aligned to the market value of the underlying commodity.

“The range of commodities replicated by ETCs is very broad and is not limited to single commodities, but extends to their indices, sub-indices and forward indices. This allows the investor, depending on his expectations and risk profile, to take a position on the performance of an individual commodity or to maintain a well diversified position on a basket of commodities”

Main features

Commodities represent an important asset class for both institutional and retail investors, and make it possible:

- to protect one’s own investments against the risk of inflation
- to improve the risk-return ratio and therefore the efficiency of the portfolio, given the low historical correlation between commodities and the equity/bond markets.

ETCs can trade continuously throughout the day, and the ETFplus market makes it possible for all investors to access a highly liquid commodities market in a simple and transparent manner. Overall, an ETC permits investors:

- **to access the commodities market directly.** ETCs replicate the performance of a single commodity or a commodities index, as they are issued against a direct investment by the issuer in the relevant commodity or commodity derivative contracts. In the latter case, ETCs enable investors to gain an exposure similar to that which would be obtained through a long position in a futures contract without leverage
- **to remain constantly aligned to the performance of commodities.** Unlike positions in futures, ETCs do not need to ‘roll’ from one futures contract to another, require no margin, and do not entail the brokerage/replacement expenses of derivative contracts approaching maturity because these activities are already incorporated within the instrument. Finally, physically backed ETCs enable investors to avoid the charges and the risks linked to commodities storage
- **to obtain exposure to a total return.** ETCs linked to the price of commodity futures contracts provide the investor access to a total return comprising three different components:
  - spot return: this is the return derived from the fluctuation of the price of the underlying commodity
  - roll return (positive or negative): this is the return associated with selling near month futures contracts prior to expiry and reinvesting the proceeds in next month futures contracts, in order to maintain the position on the underlying. The roll return can be negative (contango) when the front month futures contract price is lower than the next month futures contract price, or positive (backwardation) in the opposite event

– return of the collateral: this is the interest that is obtained from the investment of the collateral (the purchase of a future does not require any investment other than the maintenance of a margin, which is also remunerated).

Finally, as a large part of commodities are handled in dollars, the value of investment will be positively or negatively affected by the performance of the EUR/USD exchange rate

- **access to the commodities market at a low cost.** The investor is charged no "entry", "exit" or "performance" fees, management fees are low and are applied in proportion to the time during which the ETC was held. Finally, like for the purchase of any other security, trading fees applied by one's own bank/broker must be considered.

Investment modalities

The range of commodities replicated by ETCs is very broad and is not limited to single commodities, but extends to their indices, sub-indices and forward indices. This allows the investor, depending on his expectations and risk profile, to take a position on the performance of an individual commodity or to create a well diversified position on a basket of commodities purchasing:

- ETCs on individual commodities (Aluminium, Coffee, Copper, Corn, Cotton, Gasoline, Gold, Heating Oil, Brent Oil, WTI Oil, Lean Pork, Live Cattle, Natural Gas, Nickel, Silver, Soybean Oil, Soybeans, Sugar, Wheat and Zinc)
- ETCs on indices linked to homogeneous baskets of goods (Agricultural Products, Energy, Cereals, Industrial Metals, Cattle, Oil, Precious Metals, etc.)
- ETCs on global commodities indices
- ETCs on forward commodities indices.

As they trade on the stock exchange, ETCs are flexible instruments suitable for taking advantage of expectations on the evolution of the markets or for other investment strategies. They may be used for short-term trading, for taking advantage of the movements of an individual session, or for long term investments, as ETCs have no maturity. Finally, if available through your bank/broker, they may be short-sold in order to profit from a bearish trend, or they can be bought with leveraged effect.

Focus on physically-backed ETCs

Buying and keeping precious metals such as gold and silver for investment purposes is possible, but also costly and risky. Through physically-backed ETCs, it is possible to eliminate these critical factors.

Physically-backed ETCs are guaranteed by raw materials deposited in the vault of a bank hired by the issuer, therefore their value is directly linked to the spot price trend of the commodity, but may need to be converted into EUR if that is not the trading currency of the underlying.

Physically-backed ETCs allow investors to gain exposure similar to that which they could achieve by buying and keeping the physical raw material, but with the advantage of avoiding risks and costs linked to their management (warehousing, custody, insurance, etc.).

Physically-backed ETCs are the optimum technical choice if the underlying commodity has a high intrinsic value, is not perishable and proves to be easily stockable according to broadly recognised delivery standards.

Physically-backed ETCs use the same primary market mechanism as ETFs, defined as creation and redemption in kind, in which authorised participants can request the creation or redemption of the physically-backed ETCs by exchanging with the custodian the exact quantity of raw material controlled by each ETC for a determined minimum lot. This procedure ensures that the physically-backed ETCs are effectively fungible with the underlying commodities from the standpoint of both price and liquidity which is created on the secondary market, where ETCs can be purchased by retail investors even in small amounts, as the minimum trading lot is just one security.

Physically-backed ETCs have a total annual commission contained and applied in proportion with the time of security possession through the reduction of the quantity of raw material that each ETC controls, while the investor is not charged an “entrance”, “exit” or “performance” fee.
The fair price of a physically-backed ETC can be easily controlled by any investor since it is simply given by the current price of the underlying commodity (for example, the spot price of 1/10 of a troy ounce of gold or 1 troy ounce of silver) multiplied by the entitlement (and any division by exchange rate).

The ETFplus market

ETFplus is the regulated market managed by Borsa Italiana, with a dedicated segment for the trading of ETCs. It is arranged with clear rules aiming to guarantee high liquidity, tight spreads and the greatest possible transparency in the price discovery process.

Microstructure

Liquidity

The liquidity of a financial instrument is directly linked to the availability of both bid and ask prices on the trading book, along with competitive spreads and high tradable quantities, i.e. provision of an adequate width and depth on the trading book.

As Borsa Italiana aims to guarantee the maximum liquidity for each ETC listed on the ETFplus market, Borsa Italiana requires the constant presence of:

- at least one specialist, who agrees to meet obligations both in terms of minimum bid/offer quantities and maximum spread between bid and ask price and who is obliged to restore quotes in the event of a total or partial hit on the book. Borsa Italiana monitors the performance of these obligations on a continuous basis;
- different liquidity providers that may also supply additional liquidity in these instruments by displaying their own prices, even though they have no quotation obligations.

Trading hours
Trading of ETCs occurs continuously from 9.00 am to 5.25 pm (without an opening or closing auction). Contracts are executed through automatic matching of bid and ask orders according to price/time priority criteria.

During continuous trading, orders may be added to the book through an intermediary with or without a price limit and with various specifications on the duration, for example "good till cancelled" or "good till time".

To ensure proper operation of the market, as with shares, maximum limits are fixed for the movement of prices. A maximum price variation limit is established for orders inserted onto the order book compared to a control price, also a maximum variation limit for the execution price compared against the control price and, finally, a maximum limit to the movement of prices between two consecutive executions. The limits vary depending on the segment and the specific volatility of the instruments.

Clearing of contracts is managed by Monte Titoli (the company for the centralized administration, clearing and settlement of the Borsa Italiana - London Stock Exchange Group) on the third business day after the trade. Final settlement is guaranteed by the Central Counterparty (Cassa di Compensazione e Garanzia).

The smallest quantity that can be traded is one share/unit so it is possible to purchase the instruments listed on ETFplus in very small amounts.

Transparency of information

A continuing flow of up to date information is a fundamental requirement to guarantee the proper operation of the market, so Borsa Italiana requires that issuers make available the official value of the ETCs and the outstanding number of ETCs to investors and provides access through its web site www.borsaitaliana.it/ETFplus to a wide range of market statistics to prospectuses and issuers' brochures.

Borsa Italiana
London Stock Exchange Group

Borsa Italiana S.p.A. and its subsidiaries are subject to direction and coordination of London Stock Exchange Group Holdings (Italy) Ltd – Italian branch.
The Group promotes and offers the post-trading services of Cassa di Compensazione e Garanzia S.p.A. and Monte Titoli S.p.A. in an equitable, transparent and non-discriminatory manner and on the basis of criteria and procedure aimed at assuring interoperability, security and equal treatment among market infrastructures, to all subjects who so request and are qualified in accordance with national and community legislation, applicable rules and decisions of the competent Authorities.

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