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COMMODITIES AND FUTURE CONTRACTS

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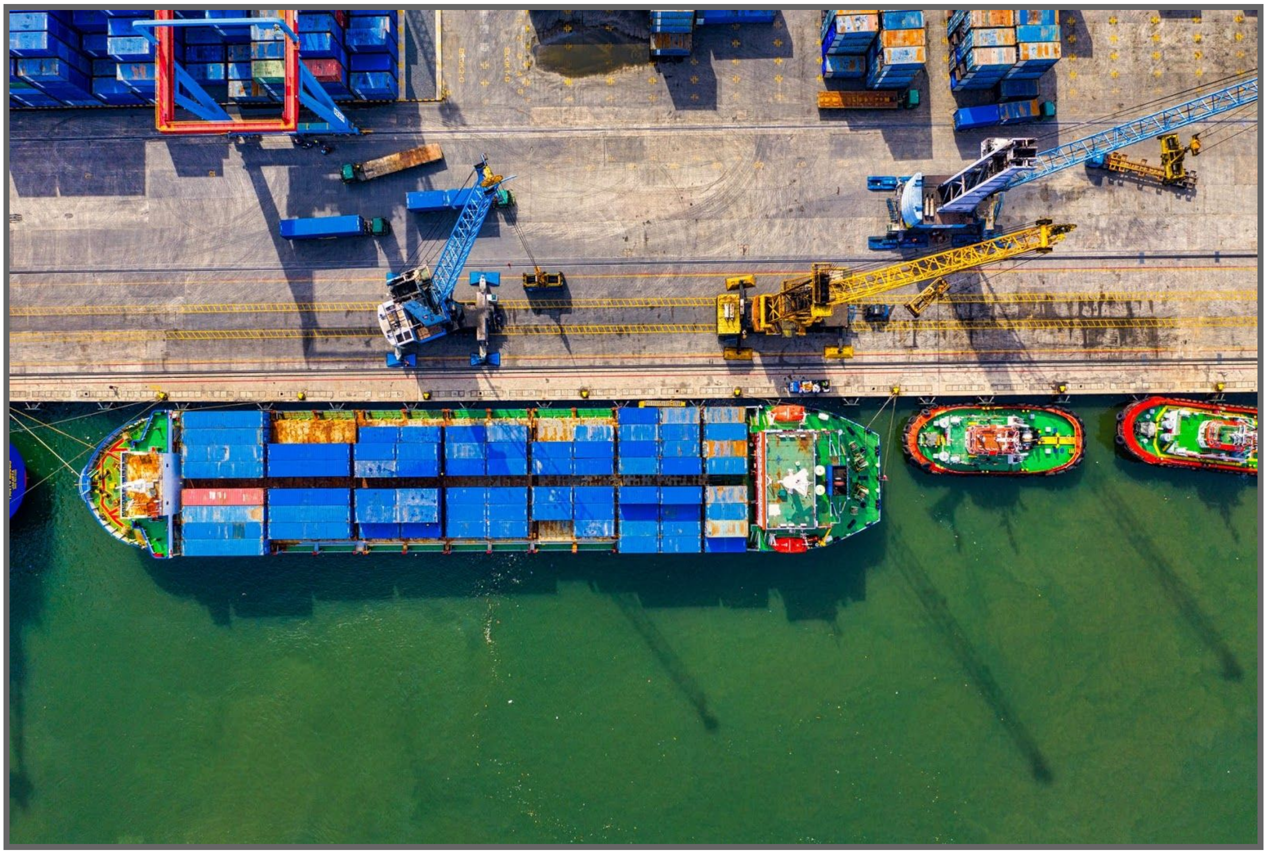
An Overview

Commodities, whether they are related to food, energy or metals, are an important part of everyday life. Anyone who drives a car can become significantly impacted by rising crude oil prices. The impact of a drought on the soybean supply may influence the composition of your next meal. Similarly, commodities can be an important way to diversify a portfolio beyond traditional securities – either for the long term or as a place to park cash during unusually volatile or bearish stock markets, as commodities traditionally move in opposition to stocks.

It used to be that the average investor did not allocate to commodities because doing so required significant amounts of time, money and expertise. Today, there are several routes to the commodity markets, some of which facilitate participation for those who are not even professional traders.



A History of Commodities Trading

Dealing commodities is an old profession, dating back further than trading stocks and bonds. Ancient civilizations traded a wide array of commodities, from seashells to spices. Commodity trading was an essential business. The might of empires can be viewed as somewhat proportionate to their ability to create and manage complex trading systems and facilitate commodity exchange, serving as the wheels of commerce, economic development, and taxation for a kingdom's treasuries. Although most of the principals were people who actually created or used the physical goods in some way, there were doubtless speculators eager to bet a drachma or two on the upcoming wheat harvest, for instance.

Important: Commodities can be an important way to diversify a portfolio beyond traditional securities – either for the long term or as a place to park cash during unusually volatile or bearish stock markets, as commodities traditionally move in opposition to stocks.

How They Work?

If the price of the underlying commodity goes up, the buyer of the futures contract makes money. He gets the product at the lower, agreed-upon price and can now sell it at today's higher market price. If the price goes down, the futures seller makes money. He can buy the commodity at today's lower market price and sell it to the futures buyer at the higher, agreed-upon price.

If commodities traders had to deliver the product, few people would do it. Instead, they can fulfill the contract by delivering proof that the product is in the warehouse. They can also pay the cash difference or provide another contract at the market price.

Pros	Cons
Ensures the commodity producer of a fixed sales price, come harvest or selling time.	In the event of a price increase, producers can miss out on considerable gains. Contract prices are fixed.
In a price drop, the producer does not lose money. He gets the agreed-upon price.	Trading in these contracts is very risky. World commodity prices are highly volatile.
Producers can limit their risk, in case of a price drop.	Commodity prices are influenced by world events, traders' emotions, and market speculations, even when demand and supply remain at the same level.
Producers or companies can make better production plans.	This investment type is best left to experts.

Commodities Exchange

There are still multitudes of commodities exchanges around the world, although many have merged or gone out of business over the years. Most carry a few different commodities, though some specialize in a single group. For instance, the London Metal Exchange only carries metal commodities, as its name implies.

In the U.S., the most popular exchanges include those run by CME Group, which was formed after the Chicago Mercantile Exchange and the Chicago Board of Trade merged in 2006 (the New York Mercantile Exchange is among its operations), the Intercontinental Exchange in Atlanta and the Kansas City Board of Trade.

Commodity trading in the exchanges can require standard agreements so that trades can be confidently executed without visual inspection. For example, you don't want to buy 100 units of cattle only to find out that the cattle are sick, or discover that the sugar purchased is of inferior or unacceptable quality.

Characteristics of the Commodities Market

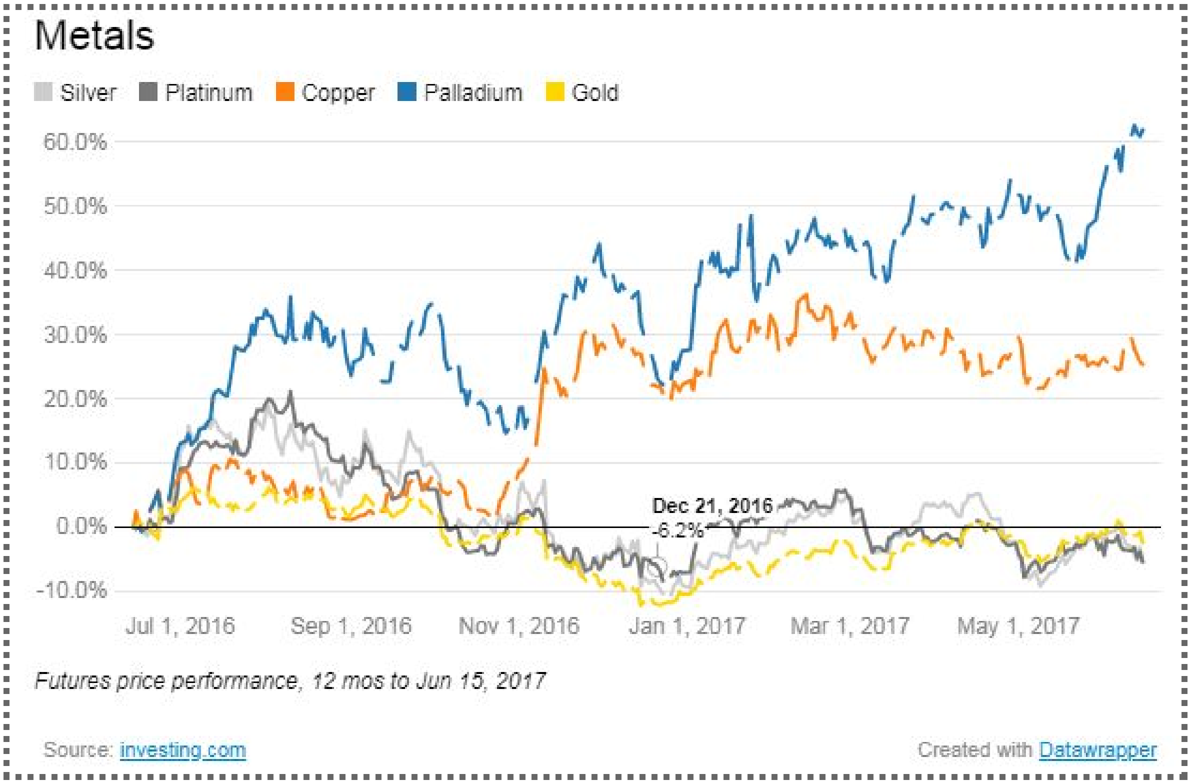
Basic economic principles of supply and demand typically drive the commodities markets: lower supply drives up demand, which equals higher prices, and vice versa. Major disruptions in supply, such as a widespread health scare among cattle, might lead to a spike in the generally stable and predictable demand for livestock. On the demand side, global economic development and technological advances often have a less dramatic, but important effect on prices. Case in point: The emergence of China and India as significant manufacturing players has contributed to the declining availability of industrial metals, such as steel, for the rest of the world.

Type of Investment Commodities

Today, tradable commodities fall into the following four categories:

- **Metals** (such as gold, silver, platinum, and copper)
- **Energy** (such as crude oil, heating oil, natural gas, and gasoline)
- **Livestock and Meat** (including lean hogs, pork bellies, live cattle, and feeder cattle)
- **Agricultural** (including corn, soybeans, wheat, rice, cocoa, coffee, cotton, and sugar)

Volatile or bearish stock markets typically find scared investors scrambling to transfer money to precious metals such as gold, which has historically been viewed as a reliable, dependable metal with conveyable value. Precious metals can also be used as a hedge against high inflation or periods of currency devaluation.



Energy plays are also common for commodities. Global economic developments and reduced oil outputs from wells around the world can lead to upward surges in oil prices, as investors weigh and assess limited oil supplies with ever-increasing energy demands. Economic downturns, production changes by the Organization of the Petroleum Exporting Countries (OPEC) and emerging technological advances (such as wind, solar and biofuel) that aim to supplant (or complement) crude oil as an energy purveyor should also be considered.

Grains and other agricultural products have a very active trading market. They can be extremely volatile during summer months or periods of weather transitions. Population growth, combined with limited agricultural supply, can provide opportunities to ride agricultural price increases.

Using Futures to Invest in Commodities
A popular way to invest in commodities is through a futures contract, which is an agreement to buy or sell a specific quantity of a commodity at a set price at a later time. Futures are available on every category of commodity.

Two types of investors participate in the futures markets:

- commercial or institutional users of the commodities
- speculators

Who Uses Futures Contracts

Manufacturers and service providers use futures as part of their budgeting process to normalize expenses and reduce cash flow-related headaches. These hedgers may use the commodity markets to take a position that will reduce the risk of financial loss due to a change in price. The airline sector is an example of a large industry that must secure massive amounts of fuel at stable prices for planning purposes. Because of this need, airline companies engage in hedging. Via futures contracts, airlines purchase fuel at fixed rates (for a period of time) to avoid the market volatility of crude oil and gasoline, which would make their financial statements more volatile and riskier for investors.

Farming cooperatives also utilize futures. Without futures and hedging, volatility in commodities could cause bankruptcies for businesses that require a relative amount of predictability in managing their expenses.

The second group is made up of speculators who hope to profit from changes in the price of the futures contract. Speculators typically close out their positions before the contract is due and never take actual delivery of the commodity (e.g., grain, oil, etc.) itself.

Requirements for Futures Trading

Investing in a commodity futures contract will require opening a brokerage account if you do not have a broker that also trades futures. Investors are also required to fill out a form acknowledging an understanding of the risks associated with futures trading.

Each commodity contract requires a different minimum deposit (dependent on the broker) and the value of your account will increase or decrease with the value of the contract. If the value of the contract decreases, you will be subject to a margin call and will be required to place more money into your account to keep the position open. Due to the huge amounts of leverage, small price movements can mean large returns or losses, and a futures account can be wiped out or doubled in a matter of minutes.

The Advantages of Futures

- It's a pure play on the underlying commodity
- Leverage allows for big profits if you are on the right side of the trade
- Minimum-deposit accounts control full-size contracts that you would normally not be able to afford
- You can go long or short easily

The Disadvantages of Futures

- Futures markets can be very volatile and direct investment can be very risky, especially for inexperienced investors.
- Leverage magnifies both gains and losses
- A trade can go against you quickly, and you could lose your initial deposit (and more) before you are able to close your position.

Most futures contracts will also have options associated with them. Buying options on futures contracts is similar to putting a deposit on something rather than purchasing it outright; you have the right, but not the obligation, to follow through on the transaction. Therefore, if the price of the contract doesn't move in the direction you anticipated, you have limited your loss to the cost of the option.

Using Options to Invest in Commodities

Many investors use stocks of companies in industries related to a commodity in some way. For example, those wishing to make an oil play could invest in drillers, refineries, tanker companies or diversified oil companies. Those bitten by the gold bug could purchase mining companies, smelters, refineries, or generally any firm that deals with bullion.

Equities are said to be less prone to volatile price swings than futures. Plus, stocks are easy to buy, hold, trade and track, and it is possible to narrow investments to a particular sector. Of course, investors need to do some research to help ensure that a particular company is both a good investment and commodity play.

Stock options, which require a smaller investment than buying stocks directly, are another way to invest in commodities. While risk is limited to the cost of the option, it is typical that the price movement will not directly mirror the underlying stock.

Advantages of Stock Options

- Investors usually already have a brokerage account, so trading is easier
- Public information on a company's financial situation is readily available
- The stocks are often highly liquid

Disadvantages of Stock Options

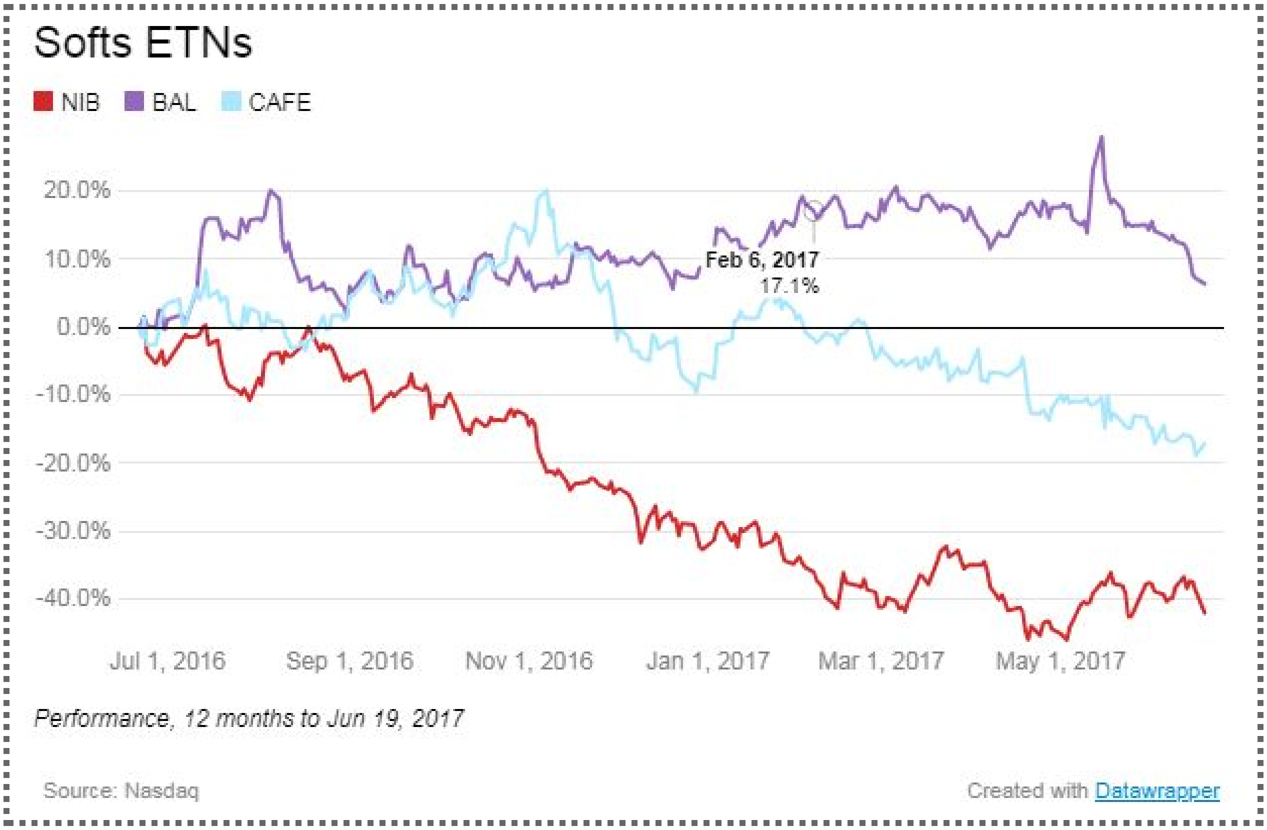
- A stock is not a pure play on commodity prices
- Its price may be influenced by company-specific factors as well as market conditions

Using ETFs and Notes to Invest in Commodities

Exchange traded funds (ETFs) and exchange-traded notes (ETNs), which trade like stocks, allow investors to participate in commodity price fluctuations without investing directly in futures contracts.

Commodity ETFs usually track the price of a particular commodity or group of commodities that comprise an index by using futures contracts, although a few investors will back the ETF with the actual commodity held in storage. In 2011, The University of Texas/Texas A&M Investment Management Company, which oversees $21 billion in endowment and related assets, famously placed 5% of its portfolio in actual bars of gold bullion that were held in a New York bank vault as a currency play.

ETNs are unsecured debt designed to mimic the price fluctuation of a particular commodity or commodity index and are backed by the issuer. A special brokerage account is not required to invest in ETFs or ETNs.



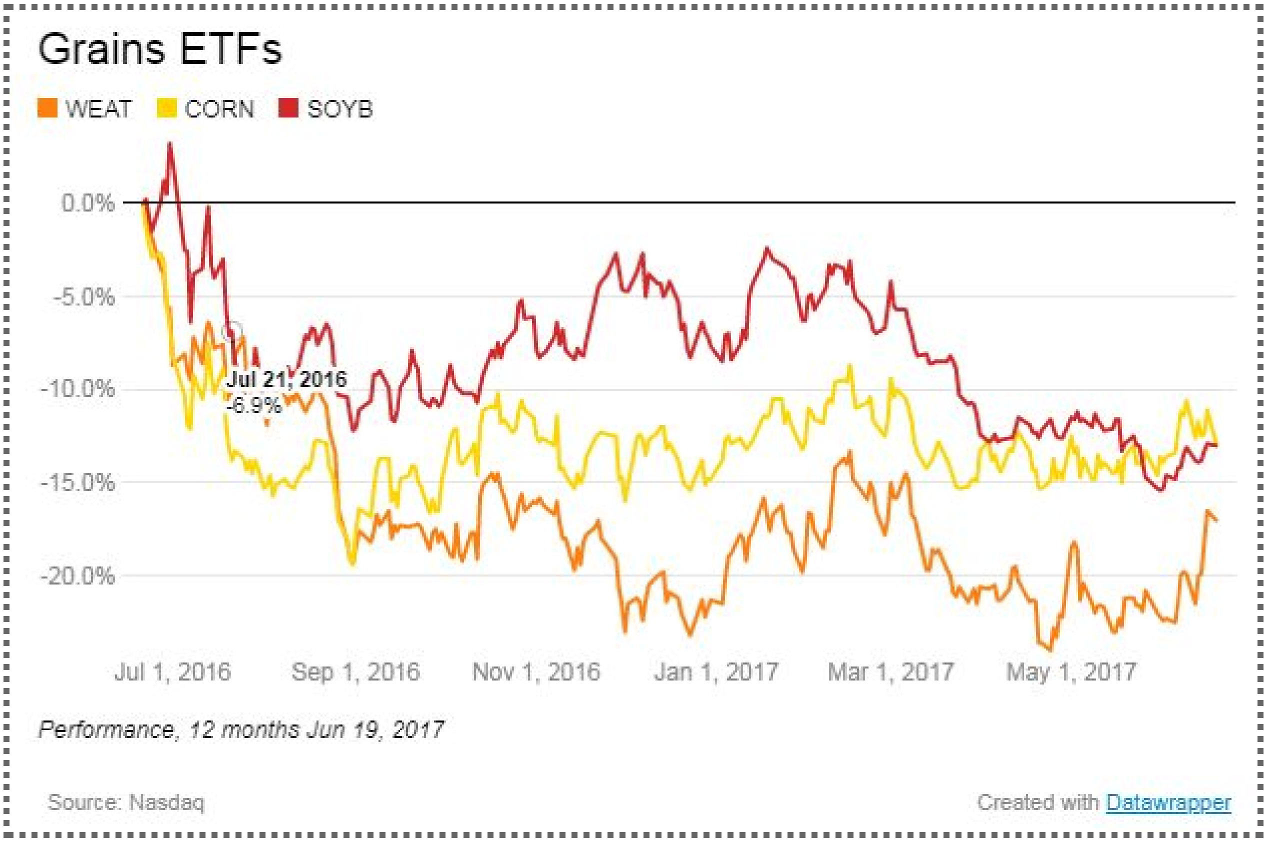
BAL: iPath Bloomberg Cotton Subindex Total Return ETN; CAFE: iPath Pure Beta Coffee ETN; NIB: iPath Bloomberg Cocoa Subindex Total Return ETN

Advantages of ETFs and ETNs

- There are no management or redemption fees to worry about because they trade like stocks.
- They provide an easy way to participate in the price fluctuation of a commodity or basket of commodities.

Disadvantages of ETFs and ETNs

- A big move in the commodity may not be reflected point-for-point by the underlying ETF or ETN.
- Not all commodities have an ETF or ETN associated with them.
- ETNs have credit risk associated with the issuer.



CORN: Teucrium Corn Fund; SOYB: Teucrium Soybean Fund; WEAT: Teucrium Wheat Fund

Using Mutual and Index Funds to Invest in Commodities

While mutual funds cannot invest directly in commodities, they can invest in stocks of companies involved in commodity-related industries, such as energy, agriculture or mining. Like the stocks they invest in, the fund shares may be affected by factors other than commodity prices, including stock market fluctuations and company-specific risks.

A small number of commodity index mutual funds invest in futures contracts and commodity-linked derivative investments, thus providing more direct exposure to commodity prices.

Advantages of Commodity Mutual Funds

- Professional money management
- Diversification
- Liquidity

Disadvantages of Commodity Mutual Funds

- Management fees may be high, and some of the funds may have sale charges.
- They are not a pure play on commodity prices because most commodity mutual funds invest in stocks.

Using Commodity Pools and Managed Futures

A commodity pool operator (CPO) is a person or limited partnership that gathers money from investors, combines it into one pool and invests it in futures contracts and options. CPOs need to provide a risk disclosure document to investors, and they must distribute periodic account statements as well as annual financial reports. They are also required to keep strict records of all investors, transactions, and pools they may be running.

CPOs will employ a commodity trading advisor (CTA) to advise them with the trading decisions for the pool. CTAs must be registered with the Commodity Futures Trading Commission (CFTC) and are required to go through an FBI background check before they can provide investment advice. They usually have a system to trade futures and use it to advise commodity-pool trades.

Advantages of CTAs

- They can provide professional advice.
- A pooled structure provides more money for a manager to invest.
- Closed funds require all investors to put in the same amount of money.

Disadvantages of CTAs

- It may be difficult to evaluate past performance, and you may want to look at the CTA's risk-adjusted return from previous investments.
- Investors should also read CTA disclosure documents and understand the trading program, which may be susceptible to drawdowns.

The Bottom Line

There are a variety of commodity investments for novice and experienced traders to consider. Although commodity futures contracts provide the most direct way to participate in price movements, other types of investments with varying risk and investment profiles also provide sufficient opportunities for commodities exposure. Commodities can quickly become risky investment propositions because they can be affected by uncertainties that are difficult, if not impossible, to predict such as unusual weather patterns, epidemics, and disasters both natural and man-made.