

Long Commodities, Short Contango via Commodity Currencies

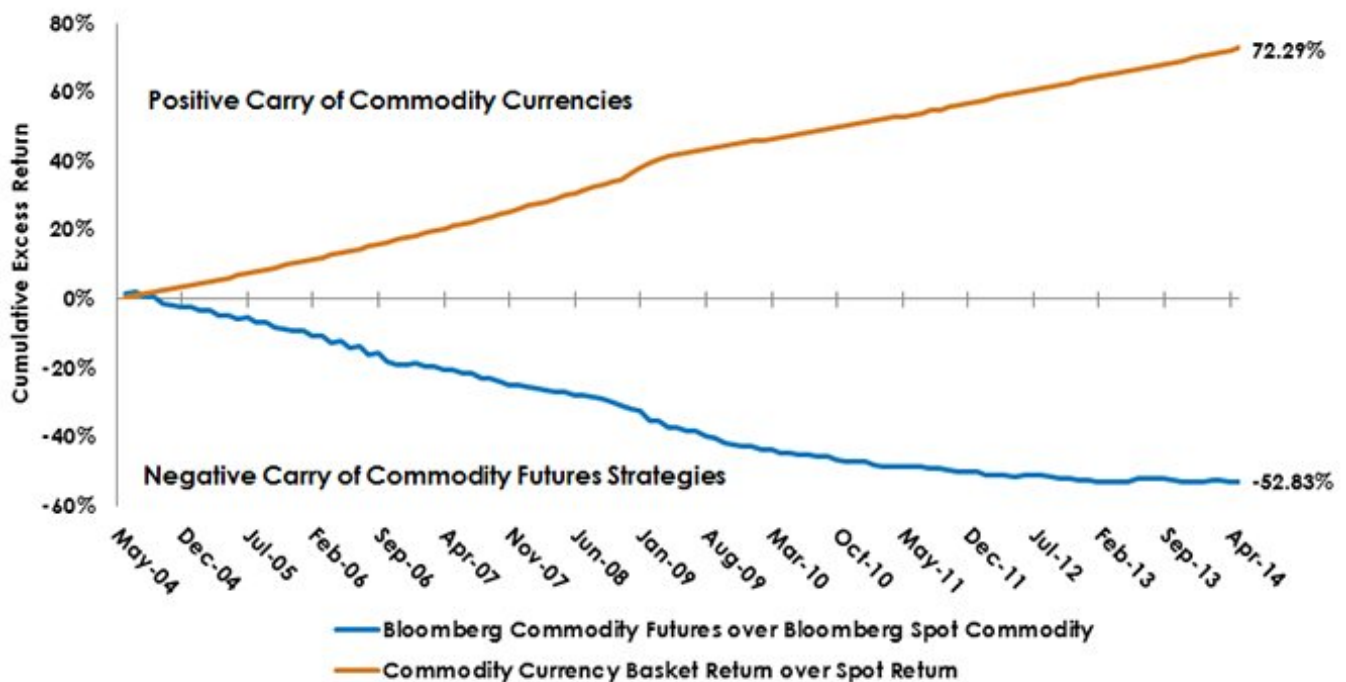
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On the back of a resurgence in Chinese economic data and rising geopolitical risk in Eastern Europe and the Middle East, increases in global commodity prices have reinvigorated investor interest in allocating to commodity-based investment strategies. However, a common complaint about commodity futures-based strategies stems from the drag on performance due to contango. In this blog post, we not only explain the potential costs of contango in commonly followed commodity strategies, we also explain how commodity currency strategies can provide a powerful alternative for commodity-focused investors. **Contango Explained** Contango is a phenomenon in the futures market that simply means that the current spot price is lower than the futures price. While contango can occur for many reasons, the primary driver of contango has to do with storage and financing costs. If investors pay for and take delivery of a commodity today to resell it at some point in the future, they will likely incur costs associated with storage or insurance. Additionally, instead of buying the commodity, the investors could have simply bought a short-term fixed income investment and earned the time value of money. To break even on their investment, investors need to pass these costs on to future buyers. Since the costs of storage, financing and insurance are proportional to the amount of time the owner must hold the commodity for delivery, the futures curve is upward sloping (higher prices farther out into the future). Investors who are attempting to bet on higher commodity prices often will buy a futures contract. Unfortunately, if the spot price today is exactly the same as the spot price three months from now, they do not break even, given the upward slope in the futures curve. This drag on performance is often referred to as a negative roll yield because it is the cost that investors incur when they “roll” from one expiring futures contract to another to maintain their position. **Commodity Currencies as an Alternative** We believe that currencies of commodity-producing countries can provide an attractive alternative to investing in commodity futures for investors hoping to profit from higher commodity prices. In this position, an investor goes long on a basket of currencies that have a significant amount of commodity exports. The logic and academic research supporting the trade reasons that, as demand for a commodity increases, the value of the currency will also increase as demand rises for that currency. Historically, countries with large amounts of commodity wealth have attracted foreign investment to extract their natural resources, thus increasing demand for their currencies. Additionally, interest rates in these countries tend to be higher than interest rates in the United States, and investors are typically able to capture this interest rate differential. As we show in the graph below, investors actually receive interest for putting on a position that is positively correlated to commodity prices, compared with the drag on performance experienced by positions in commodity futures contracts. The graph also shows that commodity currencies, due to their positive interest rate differentials, can have a significant impact on

total returns of an investment in the same way that contango can significantly erode the return of a position over time. **Cumulative Excess Return June 1, 2004- May 31, 2014**



Sources: WisdomTree, Bloomberg, Zephyr, as of 5/31/14. Past performance is not indicative of future results.
You cannot invest in an index. Index performance does not represent actual fund or portfolio performance.
A fund or portfolio may differ significantly from the securities included in the index.

For definitions of terms and indexes in the chart, please visit our [glossary](#). As one way to express a bullish view on commodities, we believe that the [WisdomTree Commodity Currency Strategy Fund \(CCX\)](#) can provide an attractive alternative to traditional commodity futures-based investing.

Important Risks Related to this Article

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