

DJ GETTING PERSONAL: Price, 'Backwardation' Boost Oil ETFs

By Ian Salisbury

A Dow Jones Newswires Column 9-19-2007

NEW YORK (Dow Jones)--With oil prices above \$80 a barrel, oil-tracking exchange-traded funds have a double wind at their backs.

The funds, which struggled earlier this year, have also benefited from a switch in the relationship between near-dated and longer-term futures contracts, which has given an extra boost to these ETFs' returns.

The largest oil-tracking ETF, the \$571 million United States Oil Fund (USO) is up 19% based on market prices in the past three months. During that time, stocks have performed poorly, with the Standard & Poor's 500 falling about 0.7%.

The double-digit returns are a big change from this spring when oil prices hovered around \$60 a barrel and oil ETFs - whose value actually reflects the price of futures contracts rather than actual barrels of oil - had fallen well behind spot prices for the physical commodity. Oil ETFs' change in fortune reflects a reversal on both those fronts.

Oil prices have surged recently as traders' worry that global oil supplies could fall short of demand. Among the latest concerns: Hurricane Humberto, which caused power outages in an area of Texas that's home to some major oil refineries, and the Organization of Petroleum Exporting Countries, which recently promised to raise crude output by an amount analysts considered minimal.

"All the time we see demand continue to grow," says Simon Wardell, an oil analyst at research firm Global Insight Inc. "There's not much room if something goes wrong" to disturb supply.

Some analysts feel that the Federal Reserve's rate cut on Tuesday also bodes well for hard assets such as oil.

But oil ETFs have also benefited from a change in the relative value of oil-futures contracts that require delivery on different dates.

Earlier this year, near-term futures contracts were less expensive than those a month further out, a situation known as "contango." That hurt investments like ETFs that own near-dated contracts and roll them over from month to month because managers were always in the money-wasting position of having to sell low and buy high.

Recently, however, the same supply concerns that are boosting prices overall have especially increased interest in near-term contracts, reversing the contango dynamic and giving oil ETFs extra momentum, a situation known as "backwardation." In backwardation, near-term futures contracts are more expensive than those a month out.

"We've seen a lot of commodity indexes post strong performance in the past few months and backwardation adds to that," says Philippe El-Asmar, a managing director at Barclays Capital. "Roll has a positive effect these days."

The Barclays iPath S&P GSCI Crude Oil Total Return Index ETN (OIL), an exchange-traded note that functions much like an ETF, has returned 17%, based on market prices, since the end of June. This vehicle outperformed the benchmark price for crude, which rose about 14%. (The fund still lags behind the benchmark year to date.)

The recent turnaround notwithstanding, some fund companies are trying to address the problem of contango. Victoria Bay Asset Management, which offers the U.S. Oil Fund, recently filed with the Securities and Exchange Commission to launch the U.S. 12 Month Oil Fund that will try to minimize such issues. Deutsche Bank AG and PowerShares Capital Management LLC also market a similar product.

Some financial advisors remain wary of oil-tracking ETFs. Don Martin, president of Mayflower Capital in Los Altos, Calif., says he prefers conventional mutual funds, such as the T. Rowe Price New Era Fund. That investment owns stocks of energy and natural resources companies, whose values are sensitive to commodity prices rather than futures or commodities themselves.

Unlike ETFs, conventional funds typically employ fund managers who can help with problems like contango.

"I am a believer in actively managed mutual funds," Martin says. "These people are policemen paid to watch these things all day long."

(Ian Salisbury is one of four Getting Personal columnists who write about personal finance; he covers topics including exchange traded funds and separately managed accounts.)

-By Ian Salisbury, Dow Jones Newswires; 201-938-5219;
ian.salisbury@dowjones.com