Invest in Oil using ETFs!

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Please carefully consider the ETF's investment objectives, risks, charges and expenses before investing. ETFs may be complex in nature, investing involves risk including possible loss of principal. Before investing, PSPL recommends investors to read the Prospectus from the respective Issuer's website carefully. The respective website for all SGX listed ETF Issuer is available in our FAQ. PSPL does not provide any advice on the funds.

About Oil

When it comes to natural resources, oil is one of the most sought after assets on the planet.

Because the world is so dependent on oil, it is fundamentally linked to the economies of both the developed and emerging markets of the world. Oil can often be an indicator for economic health and at the same time be a driver of the economy.

It is also one of the most volatile commodities available to investors.

Oil, often dubbed 'black gold', like many other commodities, such as gold, platinum and corn, has traditionally a low correlation with equities. This means oil and oil related investments in a portfolio can provide a healthy element of diversification, as well as a hedge against inflation.

The Political Oil Stock market

Investing in oil stocks can seem like a lucrative way to make a lot of money. After all, the trend of oil prices seems to inevitably creep upward. However, not only is the perception that oil prices move inexorably upward inaccurate, there is no necessary relation between the price of oil and the price of the stocks associated with it.

There may be no other commodity that is as subject to political manipulation as oil. Given that oil is in virtually universal demand, and demand is growing as countries make a push for economic growth, oil producing countries with political axes to grind, such as those in the Middle East and Venezuela, can send shudders through the oil markets on a whim. Iran, Venezuela, and Arab oil producers together form OPEC, the Organization of Petroleum Producing States. OPEC is a producers' cartel that seeks to maximize profits by controlling the supply of oil. However, although they control most of the world's oil supply, policies of nations with huge oil reserves (e.g USA) can also drastically affect the price of oil.

These convolutions can impact the price of oil stocks in the short term. However, even politically volatile nations can't afford to turn off the tap indefinitely.

How to trade Oil?

Historical oil prices and historical oil stock prices have a tendency to be more stable than their short term prices.

This would seem to indicate two things:

First, there is money to be made by trading on a daily basis, as short term swings can produce very volatile changes in stock prices.

Second, there is money to be made by means of long term investing, as values based on historical performance tend to even out and generate gains based on the long term strategies of particular companies.

Where do Oil ETFs come in?

Oil ETFs are a simple way to gain exposure to the price and performance of oil. Oil ETFs consist of either oil company stocks or futures and derivative contracts in order to track the price of oil, or in some cases oil-related indexes.

One of the most popular oil ETFs is **USO, the United States Oil ETF**. In order to give investors exposure to the price of oil, the fund consists of futures, options and forward contracts for different oils, gases, and petroleum based-fuels.

For those who like the idea of investing across a number of oil stocks, **XLE, the Energy Select Sector SPDR Fund** allows investors to gain access to the top Oil Companies, with about 60% of the portfolio concentrated in the top 10. Exxon Mobil and Chevron are the largest holdings by far. It still requires close monitoring of political and other market developments, but the volatility of the investment is reduced by the fact that more than one company is represented by the shares, so developments affecting a particular company are watered down.

Whichever manner of trading one might choose, oil show historical long term gains, in general.

Although USO is a popular way to invest in oil, investors need to be aware that USO is a fund holding futures contracts as its underlying assets and is subject to the forward rolling cost of futures as well as the contango effect.

Beware Contango Trap

So what is Contango Trap? Contango is a phenomenon in the futures market where, in simple terms, the price to deliver a commodity in the future is higher than the spot price, or far future delivery is higher than shorter future delivery. It is exemplified by an upward slowing forward curve. The issue is magnified in future funds like USO, where contracts need to roll into more expensive future contracts.

USO is very much subject to contango when you compare it with the spot price of oil. The spot price for oil is based on immediate delivery, while USO invests in futures and has to roll contracts, thus dealing with contango (longer-dated futures are more expensive than near-month contracts). Because of contango, each time the fund rolls forward into the next near-month future, the fund can only afford to purchase less units than previous month. Because of this, even when the price of oil goes up, the positive effect on the USO would be reduced as there are now fewer units. Investors may lose more money than expected if they expect USO to track the Oil spot price. However, the opposite happens with backwardation (longer-dated futures are cheaper) where investors gain more than expected.

Reducing Contango Trap

Since there are no ETFs that physically hold barrels of oil instead of using futures, there is no way to completely remove contango. However, there are ETFs that are trying to reduce this problem.

Introducing **USL, the United States 12 Month Oil Fund**. The investment objective of USL is for the units' net asset value to reflect the average of 12 months' futures contracts on the spot price of light, sweet crude oil delivered to Cushing, Oklahoma. Rather than simply holding the near-month futures contract, USL holds equal positions in each of the next 12 months' worth of futures contracts. Spreading out its bets like that helps minimize contango, which tends to be worse in the near-month contract, and gives you more direct exposure to the spot price of crude.

Shown below is a chart displaying the difference between the USO (in blue) and the USL (in green).

Commodity ETFs

For investors interested in diversifying their commodity portfolio while still gaining an exposure to oil, there are ETFs in SGX that offer this option. The **Lyxor ETF Commodities CRB** aims to track the Reuters/Jefferies CRB Index which maintains broad diversification through 19 commodities representing all commodity sectors - energies, base metals, precious metals, livestock, grain and soft commodities with 23% in WTI Crude Oil.

The db x-trackers **DBLCI-OY Balanced Commodity ETF** tracks the DBLCI-OY Balanced USD Index (FX Hedged Deutsche Bank Liquid Commodity Index™ – Optimum Yield Balanced) and is intended to reflect the performance of 14 commodities: WTI Crude Oil, Brent Crude Oil, Heating Oil, RBOB Gasoline, Natural Gas, Aluminium, Copper, Zinc, Gold, Silver, Wheat, Corn, Soybean and Sugar. To tackle contango, the Optimum yield aspect of the index uses a methodology that seeks to optimise the roll yield that will maximise the positive roll yield or minimise the negative roll yield. One way they do so is by selecting the cheapest per month cost future contract out of a list of tradeable futures in contangoed markets that expire in the next 13 months.

Source: Google Finance