



# **Metal ETFs**

## **Speculation Tools or Physical Demand Drivers**

Traditionally, fundamentals for metals have been driving the price of metals. The price movement of metals during 2010 showed very little correlation between fundamentals and the price of metals. When taking a closer look, various factors appear to have contributed to the recent rally in the price of metals. The focus of this white paper is one of the main drivers of metal prices – exchange traded funds (ETFs). Recently, the impact of metal ETFs on metal prices has increased.

## Base Metal ETF – An Introduction

A base metal ETF allows an investor to take a position with a forward view/expectation of appreciation in the price of the metal. ETFs are expected to buy metal stocks at low prices and sell at high prices, especially during times of shortages.

### ETF Strategies

The use of base metal ETFs during contango (i.e. when the futures price is less than the spot price) is an expensive and very risky strategy for investors. However, it is a good means of funding for ETF providers during times of contango. The use of base metal ETFs during backwardation (i.e. when the futures price is more than the spot price) could cause more damage to the market than expected if it increases the price of the metal beyond fundamentals.

### Effect of ETFs on the Market

When the market for a metal is in deficit, physically backed ETFs for that metal increase the shortage of

the metal. If normal conditions prevailed, these diverted stocks would have been released into the market. The launch of physical backed metal ETFs in a tight market, like copper or tin, increases price volatility. As a result, the price of the metal increases, surpassing the fundamentals. The capital deployed for such an ETF would either reduce the inventory or compete for the metal in an already deficit market.

### Perceptions toward ETFs

There is a perception that an ETF for any metal acts as new demand for the metal and is likely to change the fundamentals for that metal, thereby increasing the price of the metal. However, there exists a different point of view which argues that ETFs impact prices only for the short term. According to this view, after a point of time, the tightness in the market is expected to generate a good return on investment for the investor, which would encourage the investor to sell the metal.

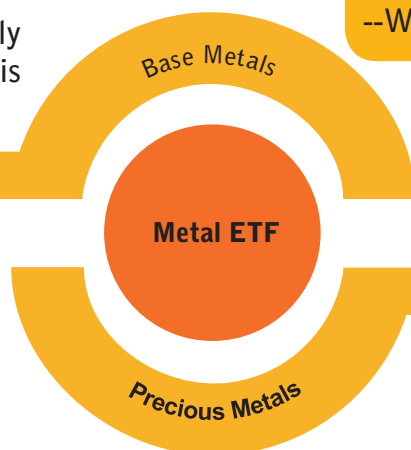
## Difference between Base Metal and Precious Metal ETFs:

A physically backed metal ETF can be backed by either a base metal or a precious metal.

- ▶ A base metal ETF is used by investors to cash in during times of bullish expectations for the metal.
- ▶ The main objective of a base metal ETF is making a profit.
- ▶ The storage cost for physically backed base metal ETFs is high.

“Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy when others are fearful.”

--Warren Buffett



- ▶ Precious metal ETFs act as a good bet against inflation and currency movements.
- ▶ Precious metal ETFs are considered to be a tangible asset and a safe haven for investments.
- ▶ The storage cost for physically backed precious metal ETFs is low.

With ETFs you can get essentially pure exposure to gold without any other risks associated with owning a mining company," such as political, geological and management risks

-- Catherine Raw (BlackRock Inc)

### Historical Metal ETF Snapshots:

ETF securities physically backed by copper, nickel and tin have seen inflows of about \$30 million from December 2010 till mid January 2011.



According to information from the World Gold Council, ETF GLD was the sixth largest holder of gold at the end of 2010. The gold stocks held by ETF GLD are considered to be one of the major factors that drove the recent increase in the price of gold.

The recent increase in silver price was the result of silver buying by the silver ETF, SLV (which started in April 2006). As of mid January 2011, SLV was estimated to hold about \$10.2 billion worth of physical silver bullion, making it one of the largest ETFs in the world.

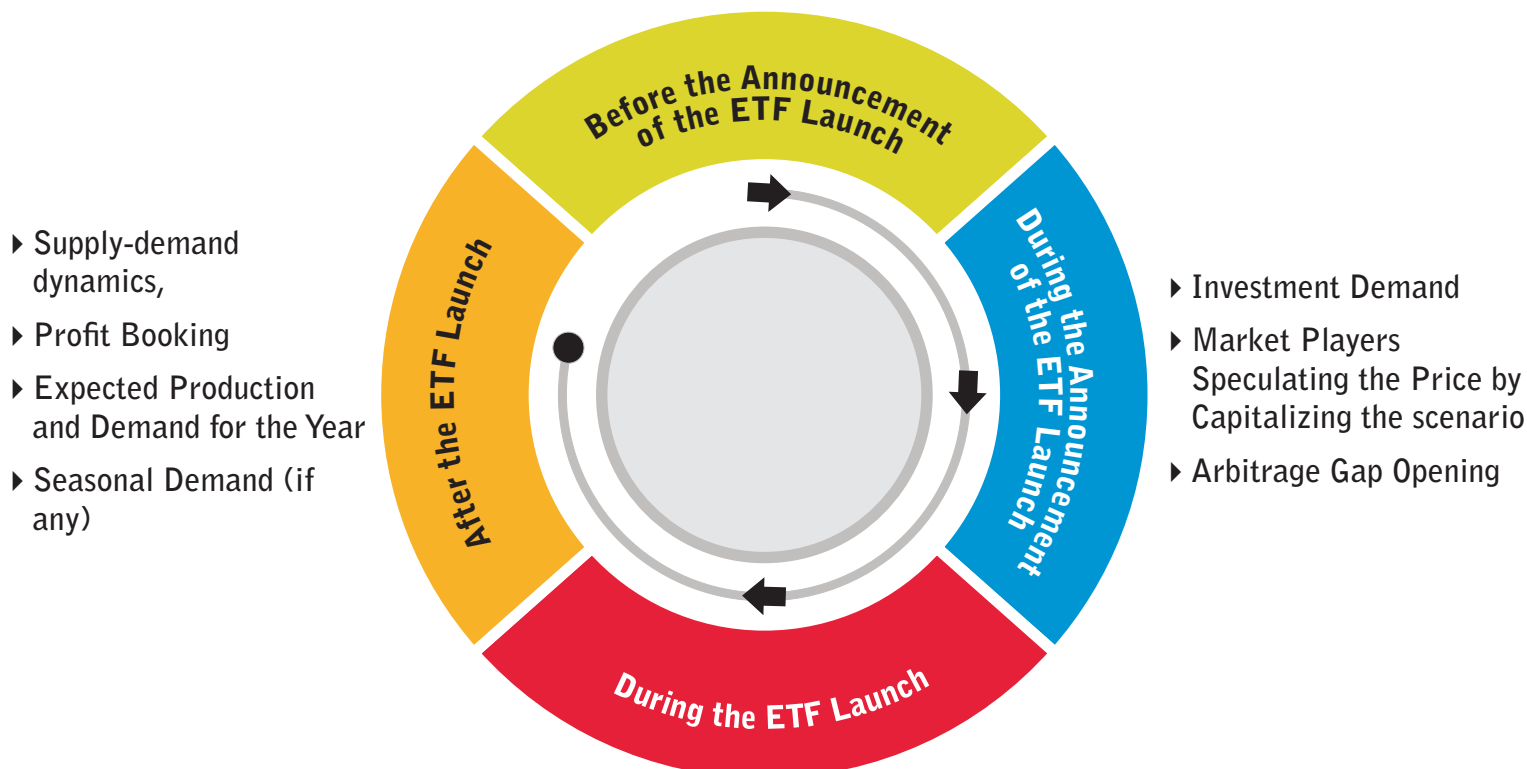
Source:fxinvestmentstrategies, resourceinvestor, commodityonline

### Metal ETFs in the Pipeline:

BlackRock Asset Management International and Goldman Sachs are planning to launch a physical copper based ETF and are waiting for approval from the US Securities and Exchange Commission (SEC). The approval of these ETFs for copper, which is expected to absorb about 50,000 metric tons of copper, is likely to increase the volatility of the price of copper due to expectations of a deficit copper market in 2011.

### Factors Driving Metal Prices before and after the ETF Launch:

- ▶ Supply-demand Dynamics
- ▶ Expected Production and Demand for the Year



- ▶ Supply-demand dynamics,
- ▶ Profit Booking
- ▶ Expected Production and Demand for the Year
- ▶ Seasonal Demand (if any)

- ▶ Investment Demand
- ▶ Market Players Speculating the Price by Capitalizing the scenario
- ▶ Arbitrage Gap Opening

- ▶ Data Regarding Change in Inventories
- ▶ Cautious Buying Activity
- ▶ Investment Demand
- ▶ Expected Change in Supply-demand Dynamics due to the ETF

**Impact of Metal ETFs:**

1. The base metal ETF is expected to absorb the surplus of the metal (if the market is in surplus) or reduce inventories and further increase the shortage of the metal (if the market is in deficit).
2. As mining companies notice a rise in metal stocks (in spite of an increase in the price), they may match their production levels to cater to only real demand.
3. Money that is supposed to have moved to equity would be diverted to ETFs. These diverted funds will increase the price volatility of the metal and reduce the ability of companies to raise capital.
4. However, as other new investment avenues emerge, ETFs may start releasing stocks of the metal into the market (to book profits), which would change the supply-demand dynamics of the market.

**Takeaways:**

1. Inventories in warehouses must be understood in terms of holders of the stocks. The stocks held by ETFs in warehouses may show as if the demand for the metal is decreasing. However the real idea may be to wait till the market is set for higher returns.  
As of December, 2010, it was reported that about 50% to 80% of LME copper stockpiles (355,750 metric tons) was held by a single trader rumored to be JP Morgan.
2. Unusual volatility in the price of metals should be very well analyzed to check whether the volatility is a result of real demand. Panic buying/selling decisions should not be taken based on just the volatility in the markets, as volatility could also be as a result of buying or selling of stocks of a metal by the exchange traded fund.

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