ETF Specialist

Survival of the (Un)Fittest

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Besides being uncollateralized loans to investment banks, many exchange-traded notes are larded with hidden fees and other harmful terms. A classic example is iPath DJ-UBS Commodity Index ETN (DJP), which uses a devilish fee calculation to quietly shift more risk to investors at the worst times possible. However, the actions of some shouldn't necessarily condemn all. Despite many similarities with DJP, ELEMENTS Rogers International Commodity ETN (RJI), a broad commodity index tracker, is a far better deal. Strangely, DJP has more than $2.4 billion in assets while RJI has less than $800 million, a clear instance of the inferior triumphing over the superior.

It's all really unfair. Even though it doesn't seem like it at first glance, RJI handily beats DJP on three major criteria: credit risk, fees, and diversification. Let's look at each in turn.

Credit Risk

All ETNs possess credit risk, but some have a lot more than others. According to Moody's, DJP's backer Barclays PLC is a solid Aa3 credit, only three notches below the coveted Aaa. Moody's thinks RJI's backer, the Swedish Export Credit Corporation, or SEK, is an Aa1 credit, only a notch below Aaa. The rating agency describes Aa ratings as signaling "high quality" and "very low credit risk." One might be tempted to conclude there's not much of a difference in credit risk between DJP and RJI.

In reality, credit ratings issued by the major agencies--Moody's, Standard & Poor's, and Fitch--are sticky, lagging indicators. The ratings are the product of a hopelessly conflicted business model, where issuers pay the raters and are able to shop around for the best ratings. (Morningstar issues its own corporate credit ratings for free.)

The credit default swap market is a better source of credit-risk information. A CDS is basically an insurance contract that pays off when a loan defaults. CDS prices can be interpreted as the market's judgment on the probability of default. Many sophisticated institutions trade in the market, staking billions of dollars on the outcomes. It's a no-brainer that CDS spreads should be the primary input in estimating an issuer's credit risk.

As of this writing, five-year CDS spreads for Barclays PLC debt trade at levels implying Barclays is really a Baa-rated debt--that is, according to Moody's rating scale, debt with "speculative" characteristics. No surprise here. Barclays is close to the epicenter of the slow-burning eurozone debt crisis.

SEK doesn't have a liquid CDS market for its debt, if at all. However, SEK is fully owned and backstopped by the Swedish government, which itself has CDS spreads narrower than all but the governments of Norway and the United States. (Sweden has its own currency and a solid balance sheet, so it's better insulated from the

debt crisis than many other European sovereigns.) SEK's Aa1 credit rating is likely close to reality.

Bottom line: RJI's credit risk is likely *much* lower than DJP's, regardless of what the credit rating agencies say.

Fees
Both RJI and DJP charge 0.75% annual investor fees. However, DJP's fee is path dependent, meaning the ETN's tracking error to its benchmark can widen significantly, depending on the path prices take. The worst part about DJP's path-dependent fees is its terrible timing: It effectively increases most when the ETN's value drops the hardest. RJI doesn't use this unusual fee calculation. Investors can expect 0.75% in tracking error, year after year, regardless of the underlying index's path.

Diversification
RJI and DJP have tracked each other fairly closely since 2007. They're not substitutes. RJI's benchmark, the Rogers International Commodity Index, or RICI, invests in 38 commodity futures that represent "significant global consumption," with the aim of replicating the overall movements of raw commodity prices worldwide. DJP's benchmark, the Dow Jones-UBS Commodity Index, or DJ-UBSCI, invests in 20 commodity futures, and weights its holdings based on global production and contract liquidity. While the number of commodity futures an index holds might seem next to irrelevant, it's actually one of the most important drivers of commodity index returns. Claude Erb and Campbell Harvey note that the diversification return, or the incremental return from regularly rebalancing uncorrelated assets, has been one of the biggest drivers of commodity indexes' excess returns. In other words, all else equal, the more contracts, the better.

Reasons Not to Dump DJP
Based solely on credit risk or fees, RJI is the clear winner. But when both credit risk and cost favor RJI, the ETN looks dominant. However, it may make sense to keep DJP in some circumstances. Maybe you really don't like RJI's allocations: DJP splits its allocations to energy, agriculture, and metals roughly equally; RJI favors agriculture and energy at the expense of metals. Or maybe you have big embedded capital gains with DJP, in which case the savings may be swamped out by taxes. These are narrow reasons. Most investors would be better served by RJI, should they wish to exploit the tax-arbitrage opportunity ETNs offer.

Brand Recognition Can Mislead
From a marketing standpoint, DJP's success isn't surprising. It enjoyed the first-mover advantage, coming out over a year before RJI did. IPath, backed by the marketing heft of BlackRock's iShares business, is the biggest ETN issuer. In contrast, the Merrill Lynch-backed ELEMENTS platform is effectively dead, with an outdated website that spits out erroneous data, and no brand recognition to speak of. It's surprising RJI has succeeded in gathering as much in assets as it has, when at first glance it looks like a less liquid, quirkier version of DJP. Perhaps the secret is out.

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