



# Merrill Lynch Commodity Investor Business

GLOBAL MARKETS & INVESTMENT BANKING

## Merrill Lynch Commodity Index eXtra (MLCX)\*

### Background

#### Why should any investor consider commodities?

There are two fundamental reasons why long-term minded investors should consider incorporating commodities into their investment portfolios. First, commodities may reduce portfolio risk due to their negative correlation to traditional asset classes such as equities and bonds. Second, commodities may enhance overall portfolio returns due to their high historical, equity-like returns. Thus, incorporating commodities into a portfolio can increase overall expected return per unit of risk. Swaps and notes on commodity indices can be the most simple, cost-efficient way to acquire commodity exposure.

#### What is a commodity index?

A commodity index represents a weighted basket of rolling commodity futures contracts. Total return commodity indices have three key return drivers:

**Spot price-return:** captures upward/downward spot price changes of the commodity basket.

**Roll-return:** captures the yield from rolling the nearby commodities futures into longer-dated contracts.

**T-bill return:** is added to capture the return of a fully collateralized commodity investment. Omitting this component results in an even simpler excess return index.

#### Why is there a need for an alternative commodity index?

While there are various established indices in the market, Merrill Lynch believes that an alternative index methodology is needed to keep up with the current state of the commodity markets. In particular, the rolling mechanics of the existing commodity indices may act as a drag on performance. Existing indices often roll front-month futures contracts into second-month contracts during a short and highly visible rolling window, creating a significant trading disadvantage. Merrill Lynch's Commodity Research team has analyzed these inefficiencies and launched the Merrill Lynch Commodity index eXtra (MLCX).

### Introducing the Merrill Lynch Commodity index eXtra (MLCX)

The MLCX is a rules-driven index where commodity contracts are initially selected by liquidity and then weighted by the importance of each commodity in the global economy, with particular emphasis on downstream commodities. **Importantly, the MLCX reduces mechanical inefficiencies of other indices by establishing a semi-continuous contract rolling schedule.**

\*This product note addresses clients with QIB status only.

### MLCX can increase returns by staying “further out on the curve” and rolling its components semi-continuously.

As opposed to keeping underlying futures positions in the highly populated front month part of commodity curves, **the MLCX benefits substantially from being in second month contracts** and rolling out to the third month. Yields are further enhanced by using a semi-continuous roll schedule where contracts are rolled monthly over a 15-day window. Broadening the roll schedule and avoiding the conventional 5 day window makes it very difficult for the MLCX to develop a trading disadvantage in the future.

### MLCX provides more exposure to downstream commodities.

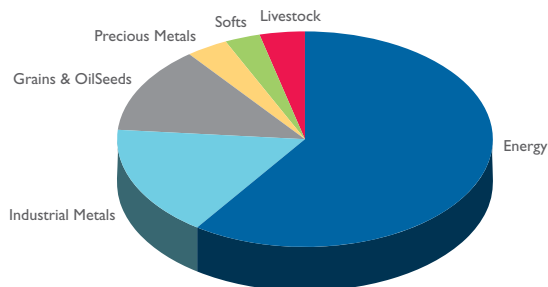
The MLCX differentiates between intermediate and final commodities, adjusting global production weights in favor of downstream commodities while avoiding economic double-counting. Thus, the MLCX provides a slightly higher exposure to final commodities, such as gasoline and livestock. Over long periods of time, **these commodities tend to reflect superior spot and roll returns** as they capture production capacity issues that are an integral part of commodities as an asset class.



### MLCX Weights

<b>Energy</b>	<b>59.9%</b>	<b>Grains &amp; Oilseeds</b>	<b>13.2%</b>
Crude oil	29.4%	Wheat	6.2%
Gasoline (RBOB)	12.9%	Corn	4.7%
Heating oil	11.8%	Soymeal	1.3%
Natural Gas	5.8%	Soybeans	1.0%
<b>Industrial Materials</b>	<b>16.5%</b>	<b>Livestock</b>	<b>3.6%</b>
Copper	6.7%	Live Cattle	2.5%
Aluminium	4.8%	Lean Hogs	1.1%
Nickel	2.8%	<b>Softs</b>	<b>3.1%</b>
Zinc	2.2%	Sugar	2.1%
<b>Precious Metals</b>	<b>3.6%</b>	Coffee	1.0%
Gold	3.1%		
Silver	.5%		

*Weights as of January 2008*



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## The MLCX is designed to give the truest possible representation of commodities as an asset class

To ensure that the MLCX is a broad based representation of commodities as an asset class, the share of any given sub-index has a cap of 60%. So that each sub-index remains a meaningful part of the MLCX, a 3% floor allocation is applied.

## MLCX offers ER, TR and spot indices, seven “sector-indices” and “single commodity indices” for each commodity in the index.

MLCX is presented in three formats: an Excess Return index (MLCXER) that factors in spot price movements and roll yields, a Total Return index (MLCXTR) that adds a funding (T-bill) component to reflect a fully collateralized commodity investment, and for research purposes a non-tradable Spot Return index (MLCXSP) that tracks only the spot price movements of the underlying commodity futures. Additionally, Merrill Lynch has created a family

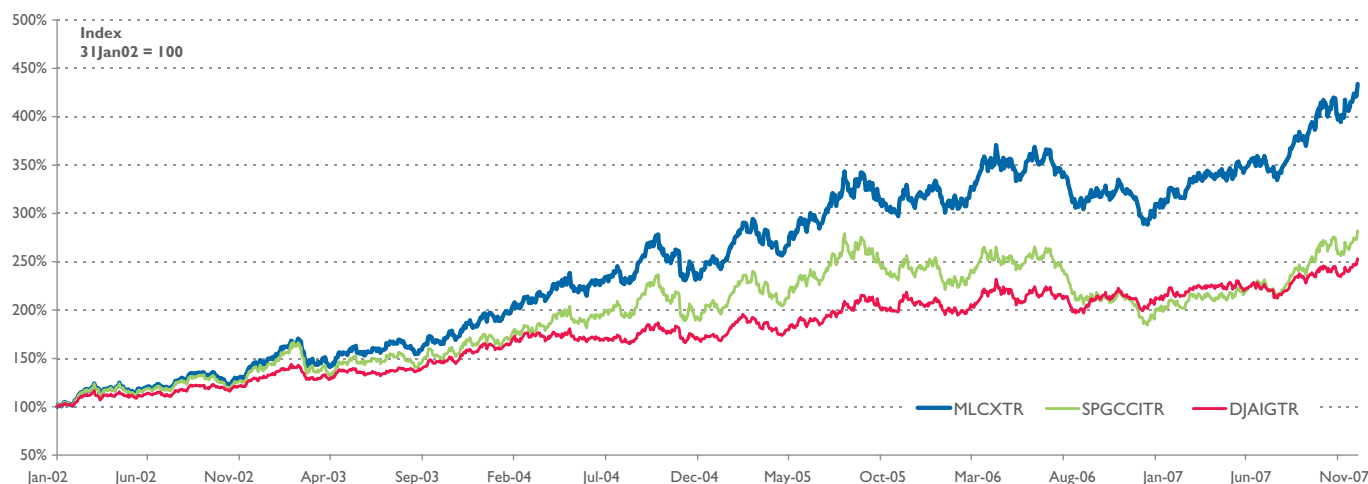
of sub-indices that reflect the performance of commodity sectors (energy, grains, industrial metals, precious metals, softs, livestock, agriculture) or single commodities (e.g. WTI crude oil, natural gas, copper, wheat). With sub-sector and single commodity indices, investors can benefit from the performance of a wide variety of different commodities packaged in customized ways without having to deal with the cumbersome mechanics of trading, rolling and managing futures contracts on an exchange.

## Outperformance

Based on historical back-testing, the MLCXTR index exhibits very strong monthly performance compared to other asset classes. In addition, the MLCX offers returns that are comparable to or higher than many of the existing commodity indices, mainly as a result of its optimized rolling mechanism and its focus on downstream commodities.

## MLCXTR outperformance vs SPGCCITR & DJAIGTR

January 2002 — December 2007



Source: Merrill Lynch Commodity Research, Bloomberg

## How do I find out more?

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