



# Merrill Lynch Commodity Investor Business

GLOBAL MARKETS & INVESTMENT BANKING GROUP

## Single Commodity, Commodity Sub-Sector and Commodity Variation Indices\*

### Background

#### What are single commodity indices?

While major benchmark commodity indices such as the S&P GSCI, DJ-AIG or MLCX are baskets comprised of a number of commodity futures contracts, single commodity indices are similarly constructed baskets that contain only one underlying commodity. Virtually any commodity in the benchmark indices can be packaged as a single commodity index. Exposure to single commodity indices is frequently captured through “plain-vanilla” OTC swaps. Options and structured notes are alternative vehicles for getting long or short single commodity index exposure.

#### What are commodity sub-sector indices?

In contrast to broad-based benchmark indices and single commodity indices, sub-sector indices capture the performance of a particular segment of the asset class. For example, an investor can gain long or short exposure to a mix of copper, aluminum, nickel, zinc and lead simply by taking a position in a base metals sub-sector index. Frequently used sub-sector indices include:

- ▶ Energy
- ▶ Petroleum Sector
- ▶ Agriculture
- ▶ Softs
- ▶ Grains
- ▶ Base Metals
- ▶ Precious Metals
- ▶ Meats

#### What are commodity variation indices?

By definition, commodity indices incorporate some methodology or strategy in their construction. Key areas involved in index construction are 1) **commodity selection**, 2) **curve placement** and 3) **roll-schedule**. A fourth element of index construction involves volatility which can be factored in to create some of the more sophisticated indices (e.g. ML Oil RIS).

Variation indices alter one or more of these basic building blocks in order to achieve customized performance characteristics. Merrill Lynch is expanding its universe of variation indices that optimize performance, extract value and capture alpha for our clients. Good examples of variation indices include:

**MLCX01** Production weighted components; ML methodology for curve placement and roll schedule; ML Unseasonal Natgas Index.

**MLCX02** ML methodology for commodity selection but more traditional methodology for curve placement and roll schedule.

**MLUNGI** “ML Unseasonal Natural Gas Index” is a natural gas specific, single-commodity index, that uses an optimized methodology for curve placement and roll schedule.

**MLCXCL4** “ML 4-series Crude Oil Index” is a WTI crude oil specific single-commodity index that takes advantage of the superior historic performance derived from being further out on the crude oil curve.

#### How are swaps on these indices structured?

The most straightforward format is an **excess return** swap where, simply put, positive or negative performance is paid out (less fees) on reset dates. While tenors are frequently one year and resets are often set to occur monthly, a huge amount of flexibility is available. **Total return** swaps additionally capture the element of funding and are more often used for comparisons with other asset classes and where a client is looking to capture *beta*.

#### What are the costs?

An accruing per annum fee is usually charged on the notional amount of “plain vanilla” swaps for as long as the swap is in place. No other fees or commissions are typically charged on swaps. There are usually no break fees for early termination.

#### What are the basic requirements\*?

ML documentation (ISDA) and credit availability are minimum requirements for unfunded OTC swaps. Some initial margin is usually posted. Structured notes and options may be less credit documentation intensive.

#### What are the advantages/disadvantages of single commodity, sub-sector and variation index swaps?

These swaps are exceptionally easy and transparent ways of gaining targeted long or short commodity exposure. 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. Aside from margin, swaps are typically unfunded investments, tying up only minimal capital.

Another key advantage is that Merrill Lynch is often able to guarantee execution at official closing prices when orders are received prior to specific cut-off times in the morning (EST) and when the markets are trading under normal conditions (i.e. no market disruption events).

Single commodity index OTC swaps are best suited for long and medium term strategic positioning and are typically not favorable for intra-day trading. There are a number of retail oriented / exchange traded products linked to single commodity indices that do offer intra-day liquidity. These products, however, tend to have higher fees, bid/offer spreads, commissions and are typically fully funded.

#### How are these indices most frequently used?

1. **Tactical** (directional) – single commodity indices can be used to express long or short views on specific commodities or sectors.
2. **Commodity Beta Management** (“smarter beta”) – single commodity indices allow otherwise passive investors in broad based indices (such as S&P GSCI, DJ-AIG, MLCX) to add, subtract or overlay specific exposures to customize their overall position in a highly flexible manner.
3. **Relative Value** (alpha) – typically long/short strategies designed to isolate and take advantage of index mechanics and characteristics such as curve placement, roll schedule and inter-market relationships.
4. **Equity Management** (cross-asset class) – single and sub-sector commodities can be used to opportunistically neutralize the underlying commodity risks associated with commodity equities (e.g. going short an energy sub-sector index to protect a long portfolio of E&P and other energy related equities).

#### How can I trade single commodity indices?

For institutional buyers in the Americas, contact:

**Oscar Bleetstein, Michael Ranieri and Natalie Glavan**  
Merrill Lynch’s Commodity Investor Business: **212-449-2133**

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



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## BLOOMBERG TICKERS FOR SOME FREQUENTLY USED COMMODITY INDICES

BROAD BASED		Excess Return / Total Return
Merrill Lynch Commodity Index		MLCXER / TR
S&P GSCI Commodity Index		SPGCCIP / TR
Dow Jones - AIG Commodity Index		DJAIG / TR
Rogers International Commodity Index		ROGRER / TR
SUB-SECTOR		
Energy		MLCXENER / TR
Industrial Metals		MLCXIMER / TR
Precious Metals		MLCXPMER / TR
Soft Commodities		MLCXSCER / TR
Grains (& Oilseeds)		MLCXGRER / TR
Livestock		MLCXLSE / TR
Agriculture		MLCXAGER / TR
SINGLE-COMMODITY		
Energy	Exchange Code	
WTI Crude Oil	CL	MLCXCLER / TR
Brent Crude Oil	CO	MLCXCOER / TR
Heating Oil	HO	MLCXHOER / TR
Natural Gas	NG	MLCXNGER / TR
Gasoline (RBOB)	XB	MLCXXBER / TR
Industrial Metals		
Copper	LP	MLCXLPER / TR
Aluminium	LA	MLCXLAER / TR
Zinc	LX	MLCXLXER / TR
Nickel	LN	MLCXLNER / TR
Precious Metals		
Gold	GC	MLCXGCER / TR
Silver	SI	MLCXSIER / TR
Grains & Meats & Softs		
Wheat	W	MLCXWER / TR
Corn	C	MLCXKER / TR
Soybeans	S	MLCXSER / TR
Soybean Meal	SM	MLCXSMER / TR
Live Cattle	LC	MLCXLKER / TR
Lean Hogs	LH	MLCXLHER / TR
Sugar	SB	MLCXSEER / TR
Coffee	KC	MLCXKCEER / TR
Some Merrill Lynch Variation Indices*		
MLCX02: MLCX weights, traditional curve placement and roll schedule		MLCX02ER / TR
MLCX01: More traditional commodity weights, ML curve placement, ML roll schedule, MLUNGI		MLCX01ER / TR
MLUNGI: Merrill Lynch Unseasonal Natural Gas Index		MLCXUGER / TR
ML Oil RIS: Merrill Lynch Oil Return and Income Strategy (optimized roll, captures volatility)		MLEIORIS / TR
MLAG RIS: Merrill Lynch Agriculture Return and Income Strategy (optimized roll, captures volatility)		MLCXAGRE / T
MLCX 2-Series: A family of single commodity indices using traditional curve placement and roll schedule		example Aluminium: MLCX2LAE / T
MLCX 4-Series: A family of sub-sector and single commodity indices positioned further out on the term structure		example WTI Crude Oil: MLCX4LAE / T
MLCX "Unseasonals": A family of indices where roll mechanisms are optimized around seasonality using commodity specific strategies		

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