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Natural Gas ETF Down More Than Fuel as Fund Sells Out (Update2)

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By Asjlyln Loder



July 20 (Bloomberg) -- The largest exchange-traded fund for natural gas, so popular that it ran out of shares two weeks ago, has lost 43 percent this year and probably will keep falling until winter, trailing the fuel it's supposed to track.

The **United States Natural Gas Fund** will suffer from record-high gas inventories and seasonal prices hitting the ETF harder than the fuel, said **Teri Viswanath**, the director of commodities research at Credit Suisse Securities USA in Houston. Investors piled into the fund this year, driving up its number of outstanding shares 11-fold.

"The amount of interest in this fund is a surprise given the trend in gas is down and not looking to change any time soon," said **Tom Orr**, the director of research for **Weeden & Co. LP**, a Greenwich, Connecticut, securities brokerage, in a telephone interview. He predicted natural gas, this year's worst performing major commodity, will fall below \$3 per million British thermal units next month, from \$3.689 today, and rise to \$4 in the fourth quarter.

The \$4.6 billion fund, managed by **United States Commodity Fund LLC** in Alameda, California, made 300 million new shares available May 6 and grew to **347.4 million** shares before running out July 7. It's awaiting Securities and Exchange Commission approval to sell up to a billion more.

"If I knew then what I know now, we certainly would have registered a lot more shares than 300 million back a few months ago," said **John Hyland**, the ETF's chief investment officer.

Commodity ETF Boom

Its popularity coincides with a boom in commodity-backed funds. Investors poured \$16.9 billion into such ETFs this year through May 31, more than triple last year's first five months, according to the **Investment Company Institute**, a Washington trade group.

The **Commodity Futures Trading Commission**, in an effort to prevent speculators from pushing around energy prices, will hold hearings this month on limiting how many oil and gas futures that speculators, including ETFs, can hold. The **Industrial Energy Consumers of America** wants the SEC to block the fund's expansion to prevent "excessive speculation," according to a July 16 letter from the trade group, which includes **Goodyear Tire & Rubber Co.** in Akron, Ohio, and **Tyson Foods Inc.** in Springdale, Arkansas.

Investors bought the natural gas fund expecting the fuel to rise after it fell in June to the cheapest level compared with oil since 1992, Orr said. Instead, gas continued a yearlong slide. Since Dec. 31, natural gas futures on the New York Mercantile Exchange have declined 34 percent, 9 percentage points less than the ETF's drop. The fund rose 9 cents, or 0.7 percent, to \$13.25 today in New York Stock Exchange composite trading.

High Supplies

Fuel stockpiles increased **90 billion cubic feet** the week ended July 10, reaching **2.886 trillion cubic feet**, the highest for any July since the Energy Department started keeping records 15 years ago. Consumption by factories, steel mills and chemical plants, which accounts for 29 percent of U.S. demand, tumbled 13 percent in 2009's first four months compared with 2008, the most recent Energy Department data show.

Viswanath predicts supplies will reach an all-time high by late October, making price increases unlikely until the first quarter of 2010, when cold weather and the early stages of an economic recovery boost demand.

The fund aims to mimic price changes in futures contracts on natural gas delivered to **Henry Hub** in Erath, Louisiana. It buys contracts for delivery in the next, or front, month. As those contracts near expiration, the fund sells and replaces them with the following month's futures, a process called rolling.

Contango

Rolling hurts performance when the current contract is worth less than the next month, known as contango. The natural gas market has been in contango 94 percent of the time since the fund started in April 2007, compared with 78 percent since April 1990.

Contango doesn't matter as much when prices rise. Gas cost \$7.50 when the fund debuted and increased 81 percent to a 2 1/2-year peak of \$13.58 on July 3, 2008. The **fund** gained 25 percent during that time, besting the **Standard & Poor's 500 Index**, which fell 14 percent.

The ETF gave retail investors a way to "tag along on the commodity plays," said Orr, who sometimes trades the fund in his personal account. When the fund started, "contango was not a factor, since people saw gas in a bull trend."

From last year's peak to now, gas has fallen 73 percent, and the **S&P 500** has lost 25 percent. The **gas ETF** is down 79 percent.

'Double Whammy'

For the fund's investors, "even if prices stay stagnant, they lose on the roll," Viswanath said. "If prices fall, it's a double whammy."

The steeper the contango, the more expensive rolling becomes. Contango has started increasing in late August and remained elevated for up to about three months every year for the past decade, data compiled by Bloomberg show. On Aug. 28, 2008, the spread between the front and second months doubled to 42 cents. On Aug. 30, 2007, it surged six-fold to 97 cents.

August is when traders move out of bearish bets made during the U.S. summer to wager that Gulf of Mexico hurricanes or cold snaps will increase prices as winter approaches, said **Chris Jarvis**, president of **Caprock Risk Management LLC** in Hampton Falls, New Hampshire.

Hyland, the fund's chief investment officer, said contango is just one issue to consider when investing. The ETF offers a way to diversify, to bet on energy and to hedge against inflation, he said.

Profiting 'Easily'

"The fund was designed for the majority of investors, both professional and retail, who can't or don't want to invest directly in futures," Hyland said in a July 14 telephone interview. "If you believe that natural gas is cheap and that it's going to rally and move back to the \$7 or \$8 range, then even if it stayed in contango the whole time, you could easily come up with a scenario where you make money."

Jarvis said investors can profit on the ETF and avoid contango's bite with options to buy shares in January and February at prices set now. Buyers would profit if the fund gains more than the sum of that so-called strike price and the option's cost.

He predicted gas prices as high as \$5.20 by then because producers will struggle to meet increased

demand as the economy recovers. The number of [active U.S. rigs](#) has fallen to a seven- year low of 665 from a peak of 1,606 on Sept. 12, according to [Baker Hughes Inc.](#), an energy services company.

"The value on the curve isn't in the front month," Jarvis said. "It's in the January and February contracts."

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