Opinion **Exchange traded funds**

Small-time investing fuels real world consequences

Non-professionals have increased oil market volatility, and suffered from it too

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There are many differences between the Covid-19 and 2008 financial crises. But both illustrate the way market speculation can exacerbate dangerous price swings, particularly in tumultuous times.

A recent case in point: the plunge in US crude prices last month that resulted in part from a big sell-off of West Texas Intermediate futures contracts by the country's largest oil fund, USO.

There have been many reasons for oil prices to crash, from the massive drop in demand due to the coronavirus lockdown to the petro-politics of Russia and Saudi Arabia. But another reason was the level of speculation in oil markets.

The CME Group, a derivatives exchange, "became concerned" about the fact that USO, an exchange traded fund that deals in oil futures, had amassed a quarter of the WTI futures contract due to be delivered in June. The CME felt this was a dangerously large position, and ordered USO to scale back. At this point, furious trading ensued and June futures prices plunged.

This reminds me very much of the way in which oil prices spiked to almost $150 a barrel in 2008, even as a giant recession was taking hold.

Then, as now, there were some real supply-and-demand dynamics at work. But increased use of commodities as a financial instrument also played a role. This was brought home by hedge fund portfolio manager Michael Masters, co-founder of the non-profit financial reform advocate Better Markets, in striking Senate testimony on the topic in May 2008.

"What we are experiencing is a demand shock coming from a new category of participant in the commodities futures markets . . . corporate and government pension funds, sovereign wealth funds, university endowments, and other institutional investors," he said, noting that such investors now hold the largest share of outstanding commodities futures contracts.

The "financialisation" of commodities, which academic research shows has distorted markets, isn't coming just from institutions. The rise of ETFs like USO mean that plenty of retail investors are dabbling in oil derivatives too, a trend that The Oxford Institute for Energy Studies has linked to the recent collapse of WTI prices.

Even with coronavirus-related demand destruction and the saturation of global storage capacity, writes Oxford Energy author Ilia Bouchouev, “it is very unlikely that any of us could have foreseen WTI ever trading at negative $40, and the critical role that retail-oriented derivatives products played in such a historic event”.

It’s hard to understand why anyone would have wanted to be in USO, given that it had a negative 94 per cent return from its start in 2006 through to mid-April. But as the Oxford white paper notes, oil ETFs have attracted large inflows from retail investors in recent months despite such huge losses.

According to Robintrack.net, which follows the number of users holding each asset on the online trading platform Robinhood, there were a record 220,905 user accounts holding the USO fund at the end of April, almost 30 times more than two months earlier.

All this is part of a long-term trend towards retail investors using low-cost vehicles like ETFs to take part in a specific investing trend that was hitherto only available to professionals — for example, using oil as a financial asset class to hedge against inflation and geopolitical events.

In some ways, ETFs are just the latest iteration of a trend that began with index funds, and has extended to low cost brokerages, e-trading platforms, and even fintech robo-advising.

That’s not a bad thing, per se. In fact, you could argue that it’s only fair for the little guy to be able to get the same upside as market professionals. But of course, that means they get the downside, too. New technology platforms such as Robinhood (which added 3m users in 2020, half of them first-time investors) allow novices to make such bets in the blink of an eye.

"I'd wager that 90 per cent of investors in USO couldn't explain what contango is," says Mr Masters, referring to the difference between spot and futures prices that traders must try to navigate.

Now that oil ETFs have imploded and USO's own broker, RBC, has refused to place more orders, some are undoubtedly figuring it out. That's wise, especially given that a new rule proposed by the Commodity Futures Trading Commission could lift the Dodd-Frank position limits put in place after the post-2008 oil spike.

That may create more liquidity in the market at a time when it's arguably needed. But it could also pour kerosene on the next bout of market volatility.

That could come from more sudden price drops, if the reopening of the US economy doesn't go well. Or it could mean a sudden spike of inflation if strong demand coincides with record monetary easing and asset purchases by the US Federal Reserve.

The CFTC itself has issued a warning about the risks of investment products linked to commodity futures. Dan Berkovitz, one of the CFTC commissioners who smartly voted against the loosening of position limits, has summed up the situation.

"When the oil market gets volatile, whether its trending up as we did in 2008 or trending down now, we see an increase in interest in these funds exacerbating the trends that we're in and even affecting the physical markets," he has said.

Then, as now, treating fuel as a Wall Street instrument has real world consequences as well.

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