

Oil ETF's Got A Gusher of Problems

Far and away, the most common question I have received from *RealMoney* readers over the years can be summarized as, "How do I trade [commodity name] without opening a futures account?" The aversion to opening a futures account is so acute you have to wonder how the industry survives.

Just because you don't want to do something has no bearing on the action's intrinsic merits. Not only do futures traders receive favorable tax treatment under Section 1256 of the Internal Revenue Code (60% long-term, 40% short-term capital gains), they are assured of no basis risk to what they are trading, in this case crude oil futures. Moreover, as futures markets evolve to transfer risk, buying and selling are treated symmetrically.

Despite all those advantages, it's tough to shake futures fear, which is why the new oil ETF is attracting so much attention. However, a look under the surface suggests this instrument is not all it's cracked up to be. Here's a point-by-point look:

First, the prospectus for the new United States Oil Fund states on the bottom of Page 1 it will endeavor to match the 30-day average price changes of itself and the "Benchmark Oil Futures Contract" within 10%. Ten percent? Would you trade SPY or QQQQ with a 10% tracking error?

Second, on Page 25 in the discussion of legal risks, the prospectus notes a March 29 letter from the New York Mercantile Exchange threatening to terminate the data feed to any vendor and to prevent USO from using NYMEX settlement prices unless USO enters into a licensing agreement with the NYMEX.

Third, on Page 26, the prospectus notes Goldman Sachs may seek intellectual property damages for patents pending concerning the methods for creating and administering publicly traded interests in a commodity pool.

Fourth, the fund is falling into the same trap of buying the front month and then rolling it forward two weeks prior to expiration that has eviscerated the long-only commodity index funds. Given the lack of understanding of the negative roll yield I have encountered from professional investors, how can anyone expect the retail trader to know they are walking into a trade with a negative roll yield of nearly 10% per annum? That's quite a bogey to overcome.

Fifth, Page 72 notes the general partner's conflicts of interest, which include: "The General Partner's officers, directors and employees, do not devote their time exclusively to USOF. These persons are directors, officers or employees of other entities which may compete with USOF for their services." It goes on to say: "The General Partner's principals, officers, directors and employees may trade futures and related contracts for their own account. Limited partners and other unit holders will not be permitted to inspect the trading records of the principals. A conflict of interest may exist if their trades are in the same markets and at the same time as USOF trades using the clearing broker to be used by USOF. A potential conflict also may occur when the General Partner's principals trade their accounts more aggressively or take positions in their accounts which are opposite, or ahead of, the positions taken by USOF."

But, hey, don't worry -- they have a code of ethics.

Sixth, Page 24 discusses the tax risks: "We could be treated as a corporation for federal income tax purposes, which may substantially reduce the value of your units." USO is proceeding as if it were a partnership, not a corporation, but who needs that uncertainty?

Seventh, the discussion of operations beginning on Page 30 is riddled with blanket assumptions, such as this: "The General Partner believes that market arbitrage opportunities will cause USOF's unit price on the American Stock Exchange to closely track USOF's NAV."

Wrong, just wrong: The cash price of West Texas Intermediate crude oil and the prices of succeeding futures contracts are subject to the forces of backwardation and contango. And as far as arbitrage, how did they do on Day One? The intraday tick charts for USO and June crude oil futures, respectively, are presented below.

USO Equity GIP

N166 Equity GIP



CLM6 Comdty GIP D

N166 Comdty GIP

