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An Interview With Gary Gastineau
Written by Maureen Nevin Duffy
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Gary L. Gastineau used to design the complex instruments traded on the American Stock Exchange (Amex)Later he directed exchanged-traded funds (ETF) product development for Nuveen Investments. He wrote a manual about ETFs and the book Someone Will Make Money on Your Funds – Why Not You? *(2005), both of which were published by John Wiley & Sons. He is managing director of ETF Consultants LLC, in Summit, N.J. He spoke with HardAssetsInvestor.com about the current state of the market for commodity ETFs.*

Hard Assets Investor (HAI): Is there collusion among the commodity exchange-traded funds (ETFs) on the pricing front? If not, why are they all priced at 0.75%?

Gary L. Gastineau (Gastineau): I don't think collusion is the word I would use. Most of these investment products are offered by a small number of issuers and they understandably look at what the competitors are charging. Like any business, they don't want to be too far off from what the competition is asking. It's nothing sinister.

When the SPDRs [the first ETF, and one tied to the S&P 500] entered the market, they didn't sell well at 25 basis points. The Vanguard 500 Fund was charging 20 basis points. When the Amex dropped the SPDRs fee to 19.45 basis points, which rounded to 19 basis points, the fund assets doubled to $2 billion in one year and they have continued to grow. Assets were about $100 billion at the end of 2007.

HAI: Do investors understand the tax treatment of the various commodity ETFs?

Gastineau: Probably not. A grantor trust, which is used for the gold and silver ETFs, is a pass-through vehicle. Any capital gains are treated for tax purposes like a capital gain on a collectible; in other words, the tax rate is higher than the rate on stocks. Losses are deductible only to the extent that they can be offset against capital gains. Some commodities exchange-traded notes (ETNs) may be treated as prepaid forward contracts where the tax isn't due until the position is liquidated, but that is an area the IRS is still looking at. They have already said that currency notes will be taxed on an accrual basis.

HAI: Could we design better commodity indexes?

Gastineau: Better? A lot of work went into the ones already out there. They're relatively sophisticated.

Could they be improved? Yes. You probably could combine some things that haven't been combined before. Of course, it has to be something that can be replicated in the marketplace. You could roll from one futures contract into another, or a physical commodity into an index.

One problem is having to conform with the legal and regulatory structures out there. For example, the traditional Investment Company Act of 1940 ETF doesn't work with a lot of futures structures. There are ways you can use swaps or other kinds of derivatives, like structured products, to take a position inside an investment company. For example, you can get approximately twice the return— or twice the negative return—on the S&P Index, and the ETF can be redeemed daily, like other equity ETFs.

There are a number of new products proposed by people. But depending on the way a new product is structured, it will trigger the need for different kinds of exemptions and approvals by regulators. If it has to trade on a futures exchange, people have to be licensed to sell the commodity or futures product. In every other country I can think of, futures regulations are roughly the same as securities regulations—only in the U.S. are they very different. One reason is that futures markets in the U.S. have been dominated by ag [agricultural] contracts. So futures markets are regulated by ag committees in Congress. It'll be a cold day before we have futures and equities trading under the same umbrella. Meanwhile we continue to have hybrid products like Deutsche Bank's Commodity Index Tracking Fund, which was created in 2005.

HAI: But the DB Commodity Tracking Fund isn't actively managed, right?

Gastineau: Correct.

HAI: What about an actively managed commodity ETF? Are you working on something like that? How would it work?

Gastineau: A partner and I have actually formed a company, called Managed ETFs, to develop actively managed ETFs. The product, to be called Managed Shares, is in the design stage now. Managed Shares will compete with actively managed mutual funds. We just need regulatory approval for that structure.

HAI: Do you have the only one?

Gastineau: There are other proposals, but from what I have seen, they're not particularly good products.

HAI: Well, don't hold back. Tell us what you really think.

Gastineau: I'm serious. They're not good for investors because they have too much trading transparency.

If fund managers have to announce their intentions to add or delete a security, traders can get out in front of them and front-run—adversely affect the value of your fund.

We've eliminated that problem in our design by not revealing changes until after they're made. There's more, but if I tell you, I'll have to kill you.

HAI: I understand.

Gastineau: Note that we're not talking here about an actively managed commodities ETF. Some things we are doing are applicable to such a project, but we have no plans to do so now.

HAI: And your current plan for Managed Shares, does it require an act of Congress?

Gastineau: Not quite. But we do need SEC approval. If we didn't need permission from the SEC to do it, through exemptions to the Investment Company Act, people would've already launched actively managed ETFs—although I doubt they would all be good products. Existing mutual funds aren't as good a product as an actively managed ETF can be. If you buy shares in a no-load mutual fund, you're always going to get the NAV [net asset value price) with no transaction costs. That's because the costs of buying or selling securities to accommodate your trade are borne by all the shareholders in the fund. With most ETFs, shareholders moving in or out pay the costs of their transactions themselves.

HAI: What is the best ETF?

Gastineau: The SEC hasn't given us approval to issue it yet.

HAI: I see. What do you think about the commodity ETNs?

Gastineau: They're probably a reasonable way to get commodity exposure. But there's a limit to how much anyone can issue. There are probably a lot of financial intermediaries you would not buy one from. Due to the problems with mortgage loans, a lot of investors may be reluctant to take bank credit on exchange-traded notes. In these products, if the bank has a problem, you have a problem.

Back in the 1980s, Japanese Nikkei 225 put warrants were issued by different firms: one by Goldman Sachs, one by Salomon Brothers and one by Paine Webber. In addition to exposure to the downside in the Japanese market, put buyers got exposure to the issuer. So the Salomon warrant was worth less than the Goldman warrant; and Paine Webber's was worth less than that.

HAI: How should ETNs be taxed?

Gastineau: Ultimately, they probably will be taxed as though you own the commodities directly—like the gold fund and grantor trust are taxed. The Investment Company Institute [the trade group of the mutual fund industry] appropriately doesn't want these structures treated more favorably than an investment company.

HAI: Leveraged commodity ETFs just launched in Canada. Do you think the SEC will balk at having them here?

Gastineau: It depends on how they're set up and what regulator has authority. Also, if it's a limited liability product, you can't lose more than you invest. If it's a leveraged-linked note, the risk rests on how good a credit risk the issuer is. But that should be measurable, too. There may be an implied interest charge, or a margin on a futures contract that is equal to a small percentage of the contract. The structure of the equity-linked note or fund has to take that into account. It could be structured to de-leverage as the market moves against you. There are many ways to manage risk.