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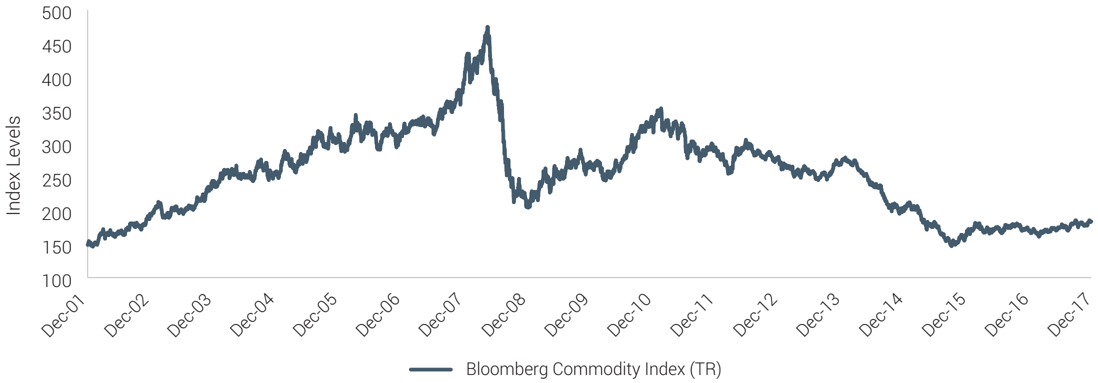
RISING PRODUCTION COSTS LEAD TO HIGHER COMMODITY PRICES

For the last several years, CoreCommodity Management, LLC has provided an annual analysis comparing production costs and prices of a wide range of commodities. Last year, our publication, "Production Costs and Their Effect on Commodity Valuations," led with Herbert Stein's famous quote, "If something cannot go on forever, it will stop." In other words, commodity producers will not continue to produce if prices are below their cost of production.

In this year's update, we observe that "Stein's Law" is, in fact, playing out in the commodity markets. We also provide data to refute the popular misconception that technology will reduce the cost of producing commodities. Since the turn of the century, in spite of technological innovations in some industries, e.g., shale, the cost of producing commodities has increased by over 6.7% per year.

Many investors do not distinguish between the price of physical commodities and the returns from investing in collateralized long-only commodity futures, as measured by benchmark indexes such as the Bloomberg Commodity Index ("BCOM").

Chart 1: Bloomberg Commodity Index Total Return

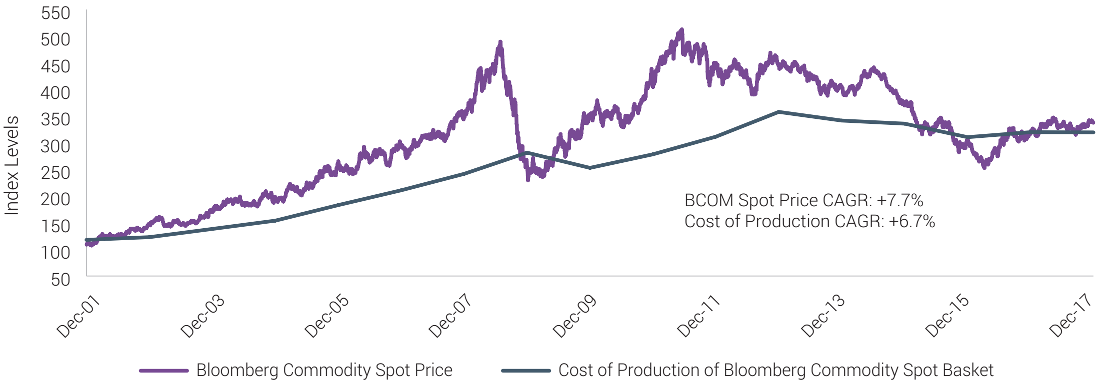


Source: Bloomberg LP; CoreCommodity Management, LLC

Data Range: December 31, 2001 – March 29, 2018

Chart 1 above shows that in spite of the impressive performance over the last two years, since 2002 the returns from passive, long-only futures investing have been approximately 1.2% per annum. Yet, as shown in Chart 2, commodity prices as measured by the Bloomberg Commodity Spot Price Index have increased 7.7% per year. The reason for this disparity will be discussed later, but first we will consider the drivers of commodity prices — fundamental supply and demand.

Chart 2: Cost of Production of Bloomberg Commodity Spot Index



Source: Bloomberg LP., CoreCommodity Management LLC

Cost of Production Data Range: December 31, 2001 – December 29, 2017

Spot Price Data Range: Decmber 31, 2001 – March 29, 2018

Cost of production is estimated based on publicly available information, data from market research providers, proprietary models and government data and is as of each year end. Compiled by CoreCommodity Management LLC. In periods where data for a particular index component was unavailable, cost of production was determined by using the price of the futures contract or through extrapolation.

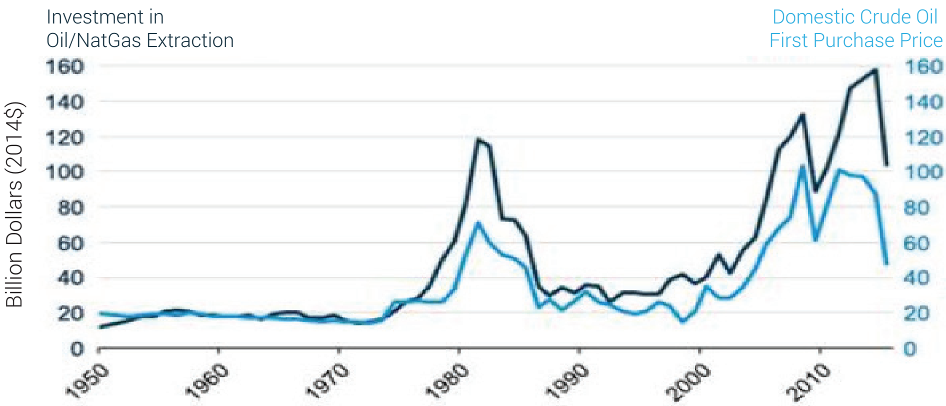
Past performance is no guarantee of future results and investment returns and principal value of the Fund will fluctuate so that shares, when redeemed, may be worth more or less than their original cost.

Supply and "Sein's Law"

Supply over a long period of time will be driven by the difference between price and the cost of production. For a producer to remain in business they need to sell products at a profit. As previously shown in Chart 2, since 2002 the weighted average price of the BCOM Spot Index was approximately 28% over its cost of production. When prices fell to or below the cost of production, they did not remain there for long. Today we are experiencing a similar scenario. On average, commodity prices are hovering slightly above their costs of production, which has not provided sufficient incentive to continue capital expenditures to sustain or to increase production in the past. Additionally, costs of production may be expected to increase, given the year on year oil price increase, which constitutes a significant component of the cost of production for many commodities. (See, "Rising energy prices hamper mining stocks," Financial Times, May 15, 2018.)

Chart 3 demonstrates how Stein's Law has been in effect for the oil and natural gas industry since 1950. A rise in crude oil prices has led to an increase in energy capital expenditures or "CAPEX"; a decline in oil prices has led to a decline in energy CAPEX.

Chart 3: CAPEX and Oil Prices



Source: Energy Information Administration, U.S. Bureau of Economic Analysis

Data Range: 1950– 2015

Difference in Commodity Prices and Commodity Investment Returns

If commodity prices have risen by over 7% per year since 2002, why have commodity investments returned approximately 1% per year, even though spot prices and futures investing returns have a correlation of over 95% during that time? The difference between a commodity's spot price and futures return is due to the inherent nature of commodity futures contracts: namely that futures contracts expire. When a futures contract is nearing its expiration date, the investor must sell the nearby contract and purchase a more distant contract in order to maintain exposure and avoid taking delivery of the physical commodity. There is often a cost ("negative roll yield") associated with rolling futures contracts; since 2001 more distant commodity futures contracts tended to trade at higher prices than those closer to expiration (a situation known as "contango"). In this case, the sale of the futures contract at a lower price than the more distant purchase effectively raises the cost basis and creates a negative roll yield. Successive rolls carried out under contango conditions are generally responsible for the divergence between commodity returns and spot prices.

Alternatively, nearby commodity futures contracts can be more expensive than deferred contracts (referred to as "backwardation"), which leads to a positive roll yield. (For a more complete discussion of these characteristics and their impact on returns, see "The Basics of Commodity Investing.")

Outlook—Spot Prices

Commodity investing returns are highly correlated to spot prices, and over a long period of time those spot prices have been dependent on the cost of production. Contrary to popular myth, technology has not led to a decrease in production costs since the turn of the century, as already shown in Chart 2 (and further explained in the Appendix to this paper). Several factors are likely to contribute towards production cost increases in the near-term:

- Energy is a significant component of the cost of production of other commodities (fertilizer, fuel to drive extractive machinery, etc.) and energy prices are higher now than a year ago.
- Growth in oil production from North American shale (the "marginal producer") is slowing due to higher drilling costs, distribution bottlenecks, and stockholder desire for higher ROI rather than simply higher production.
- Other extractive industries naturally develop the easier reserves first; as reserves diminish, it is more costly to expand a mine site.
- Synchronized global growth and the subsequent increase in demand for a wide range of commodities is surging while CAPEX and production are lagging behind.
- Except during the 2008 Global Financial Crisis, world oil demand has increased every year since 1994 and is about to surpass 100 million barrels per day.
- As interest rates rise, the cost and availability of capital will make it more difficult to raise money for resource development—unless higher prices justify the investment.

Outlook—Futures Returns

There are several positive factors for investors to consider when making a determination to allocate to this asset class.

- Spot prices are close to cost of production. We believe spot prices will likely revert toward their historical relationship to production cost, which would reflect a significant premium to current prices.
- If spot prices were to increase, futures returns should follow. Since 2002, the headwind of negative roll yield has been about -6.5% per annum. Today negative roll yield is approximately -2.3%[1].
- Typically, commodity returns have been stronger in late period expansions, which many economists argue is where our economy is today.
- Spot prices are trading, on average, at less than 40% of their highs of the last ten years, compared to stocks, bonds, and real estate, which are close to their 10-year highs. On a relative value basis, commodities are inexpensive compared to more traditional asset classes.

In conclusion, we repeat our statement of a year ago:

"Several years ago, when the sustainability of high commodity prices was questioned, the response came that, 'The cure for high prices is high prices,' which implied that those high prices would incent additional production while dampening demand. Now, it may be that the cure to low prices is low prices. Fundamental economics, as succinctly stated by Herbert Stein, still apply: 'If something cannot go on forever, it will stop.' "

Appendix: The Data

The following description elaborates on the methodology used to estimate production costs.

Cost of production data broadly across commodities is not readily available so CoreCommodity estimated the cost of production for various commodities, which can be categorized as an imprecise exercise. Some of the issues encountered in such an analysis include whether to analyze global costs or costs in a specific location and whether data pertains to mean or marginal production costs. In order to obtain an accurate estimate, data has been analyzed and compiled from many sources, including the United States Department of Agriculture, market research providers, CoreCommodity's proprietary models and, for some markets, the public filings of commodity producing companies. CoreCommodity's historical analysis utilizes a consistent methodology to examine the long-term relationship of prices and production costs. For any single time period, data imprecisions could bring into question the exact numbers reported for production costs. However when the same analytical process is consistently employed year after year, the pattern does have validity—especially when it is supported by fundamental economic reasoning.

For finite periods of time, companies may continue to produce commodities below their production costs. In cases where large up front capital expenditures have already been incurred, ongoing operating costs (so called "cash costs") may be significantly below full cycle production costs. In addition, if they have cash or borrowing reserves, some companies may actually continue to produce commodities at a loss in order to generate cash flow necessary for debt service or to maintain ongoing operations in the hope that prices/profits will eventually recover. However, ultimately, just like Steins' Law, the Law of Supply and Demand will prevail.

[1] *Measured via a one-year futures spread as a percent of the first contract price. Negative means the one-year out futures contract is higher (contango). As of April 30, 2018; Source – Bloomberg LP, CoreCommodity Management, LLC.*

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The Fund's investments may subject the Fund to significantly greater volatility than investments in traditional securities and involve substantial risks, including risk of a significant portion on their principal value. The commodities markets and the prices of various commodities may fluctuate widely based on a variety of factors. Because the Fund's performance is linked to the performance of highly volatile commodities, investors should consider purchasing shares of the Fund only as part of an overall diversified portfolio and should be willing to assume the risks of potentially significant fluctuations in the value of the Fund. The Fund invests in commodity futures related investments, which are derivative instruments that allow access to a diversified portfolio of commodities without committing substantial amounts of capital. Additional risks of Commodity Futures Related Investments include liquidity risk and counterparty credit risk. Counterparty Risk is the risk that a party to a transaction will fail to fulfill its obligations. The term is often applied specifically to swap agreements in which no clearinghouse guarantees the performance of the contract. Liquidity Risk is the risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss.

Another principal risk of investing in the Fund is equity risk, which is the risk that the value of the securities held by the Fund will fall due to general market and economic conditions, perceptions regarding the industries in which the issuers of securities held by the Fund participate or factors relating to specific companies in which the Fund invests. The Fund's investments in non-U.S. issuers may be even more volatile and may present more risks than investments in U.S. issuers. Equity investments in commodityrelated companies may not move in the same direction and to the same extent as the underlying commodities.

The Thomson Reuters/CoreCommodity CRB Index and the Bloomberg Commodity Index are unmanaged indexes used as a measurement of change in commodity market conditions based on the performance of a basket of different commodities. An investor cannot invest directly in an index.

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