

The Growing Trend Toward Commodities Exposure



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In the context of modern portfolio theory the objective of most investors is first, to use a portfolio on the so-called “efficient frontier” that is commensurate with their return/risk preferences and second, to find ways to shift this efficient frontier toward more return and less risk. This may explain why investing in commodities to improve a portfolio’s risk return tradeoff is gaining wider acceptance among institutional investors.

This article discusses the growing interest in this asset class as a potential portfolio diversifier, the investment characteristics of commodities, various strategies, available benchmarks, sources of return, and ways to gain more active exposure to this unique asset class.

Introduction

In the search for portfolio diversification and protection against unexpected inflation, many investors have increased their allocation to commodities from the low base at the beginning of this decade. Commodity assets under management rose to a record US\$376 billion in 2010, up from approximately US\$80 billion globally in 2005, and inflows for 2010 reached US\$62 billion, according to Barclays Capital.¹

We believe commodities are being added to portfolios for the following reasons:

To mitigate risk and improve portfolio diversification, given commodities’ low correlation with other asset classes.

As an up-and-coming asset class, commodities have been no stranger to academic dissection over the years. As a result, it is well established that commodity returns demonstrate low-to-negative correlation with stocks and bonds. We believe this characteristic explains much of the recent interest in commodities, as investors seek to protect themselves from market volatility through greater diversification. By reallocating a modest percentage of a portfolio to commodities, we believe overall volatility may be reduced without sacrificing return.

¹ Source: Bloomberg. “Commodity Assets Rise to Record in 2010, Barclays Says”. January 27, 2011

² Source: Bloomberg. For the period 1/30/70-12/31/10.

To provide a possible hedge against unanticipated inflation

Commodities are positively correlated with inflation indicators and have performed well when inflation was rising, even from a low base. In contrast, inflation tends to weigh on stock and bond returns. In addition, commodity prices often respond favorably to catastrophic event shocks (e.g., drought, geopolitical tensions, war, hurricanes) that periodically threaten oil, agricultural or other resource supplies and punish stocks and bonds.

To attain high, equity-like returns

On a total return basis, commodities, as represented by the S&P Goldman Sachs Commodity Index (S&P GSCI), have returned 10% per year since 1970, basically in line with the 10.2% return of S&P 500 Index.²

To participate in the new long-term secular bull market for physical commodities

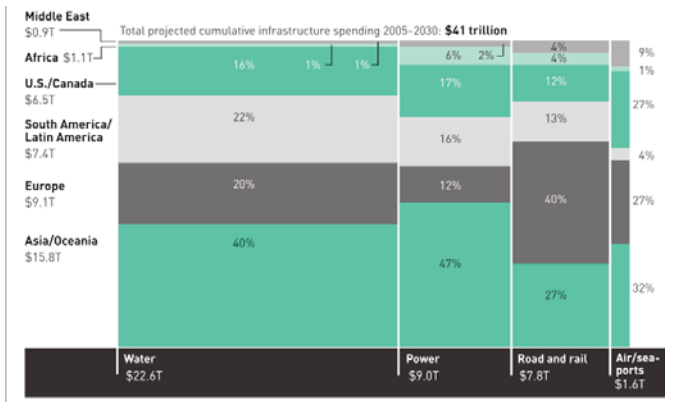
The rapid industrialization of emerging economies has created unprecedented demand for oil, coal, iron ore, copper, and many other commodities to support manufacturing and infrastructure development. This demand shows no sign of abating and is not limited to just China and India as many other nations are also consuming natural resources at a fast pace. Commodity producers are ill equipped to meet this increased demand as they failed to improve their production capabilities during the two prior decades of weak commodity prices. It is now harder and costlier to find and produce many of these materials than ever before.



Sustained Demand For Raw Materials Appears Likely

Exhibit 1: The Infrastructure Challenge

Percentages of total projected cumulative infrastructure investment needed during the next 25 years to modernize obsolescent systems and meet expanding demand, broken down by region (rows) and sector (columns).



Source: Booz Allen Hamilton, Global Infrastructure Partners, World Energy Outlook, Organisation for Economic Co-operation and Development (OECD), Boeing, Drewry Shipping Consultants, U.S. Department of Transportation. Reprinted with permission from strategy+business. Booz Allen Hamilton, Copyright 2007. www.strategy-business.com.

Global infrastructure spending and other powerful economic and demographic trends are contributing to buoyant commodity prices.

Various Approaches to Commodity Investing

Exposure to commodities as an asset class can be achieved through a variety of active or passive strategies. Most institutional investors take a passive approach, utilizing unleveraged commodity indices to offset risks in their portfolios from investments in other asset classes, such as equities. For these investors, exposure to a variety of commodity indices and sub-indices can be achieved by investing in ETFs, ETNs, over-the-counter (OTC) swaps and other structured products designed to track the performance of a specific commodities index. Larger institutions can also choose to run their own in-house, active strategy by utilizing fundamental research to strategically set individual commodity weights and employ long-short pair trades.

Making the Index Choice

Presently, there are over half a dozen leading commodity indices to choose from, although the S&P GSCI and the Dow Jones-UBS Commodity Index (DJ-UBS) are the most widely used by institutional investors. The S&P GSCI was first published in 1991, but historical price data was combined with its rules-based methodology to create a performance record that dates back to 1970, the longest return history among commodity indices. The DJ-UBS was created in 1998 and has a backfilled performance record that starts in 1991. Both benchmarks represent unleveraged, long-only investments in commodity futures near to expiration with the collateral being invested in cash instruments. Their mechanics for buying and rolling futures are also similar. The differences between the two arise from composition methodology.

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The S&P GSCI represents 24 commodities whose weights are based on world production quantities over the last five years. The DJ-UBS represents 19 commodities whose weights are two-thirds based on liquidity and one third based on world production values. In addition, the minimum allowable weight for any one commodity is 2% and no more than 33% may be invested in any one group of commodities. These methodologies lead to the S&P GSCI being approximately 70% weighted in energy, versus 33% for the DJ-UBS. The next largest sectors within the two benchmarks are grains and industrial metals.

Three Sources of Returns

Since commodities do not pay dividend or coupon income, how have commodity indices managed to produce attractive equity-like returns, particularly during the 1980s and 1990s when commodity prices were more range bound? The answer lies in the three sources of returns from a long-only fully collateralized index strategy, which include spot price return, the interest earned on the collateral, and the roll return or roll yield.

Spot Price Return

Spot-price appreciation from price fluctuations in the underlying commodities is the directional exposure to commodities that investors with a bullish outlook on the asset class are seeking. For example, if you own oil futures and the spot price jumps from \$80/per barrel to \$100/per barrel, the position is profitable.

Collateral Return

Commodity Index investments are “fully-collateralized” meaning that for every desired \$1 dollar in commodity futures exposure, an investor has set aside \$1 dollar in cash equivalents, making the investment unleveraged. Because only a minimal cash outlay is actually needed to buy or sell futures, the rest of the principal outlay is invested in short-term instruments, such as Treasuries.

Roll Yield

Roll yield is the return generated by rolling a futures contract from month to month as that contract converges to the spot price. Unlike stocks or bonds, futures contracts expire on a monthly or quarterly basis. To maintain exposure to a basket of commodity futures, a commodity index or manager must continuously “roll” contracts forward by selling out of the expiring contracts and buying the next month’s contracts. When the expiring contract is rolled into a later month contract, this strategy earns profits when the later month contract is cheaper than the contract being sold, often called “backwardation”. But it results in losses when the forward curve is upward sloping or the later month contract is more expensive, often called “contango”.

Active Approaches to Commodity Investing

Although commodity indices have posted strong returns over the last few years, their historical volatility is similar to stocks and may be manifested by dramatic price swings. Passive long-only indices have little protection from downward price spikes as they cannot sell short. They also make no distinction between markets trading in backwardation or contango, either on a persistent or short-term basis and cannot mitigate the negative roll yield associated with contango.

For these reasons, some institutional investors actively invest through asset managers, commodity-focused hedge funds, Commodity Trading Advisors (CTAs), or a few manage internally through direct investments in commodity futures contracts and ETFs to complement a passive index approach and improve on the three components of total return. These investors still seek the low correlation and beta return of their preferred commodity benchmark, but are also making some active commodity bets to generate alpha.

GE Asset Management began its active approach to commodity investing in May 2006, leveraging its fundamental equity expertise in the global energy and basic materials sector. In addition to attempting to

forecast where prices will go, the investment team seeks to exploit mispricings and emphasize situations that appear to provide interesting active risk opportunities. For example, they can implement both long and short positions to potentially capture price movement opportunities resulting from supply and demand imbalances. The active component of the strategy also helps them to mitigate negative roll yield when certain commodities are in contango.

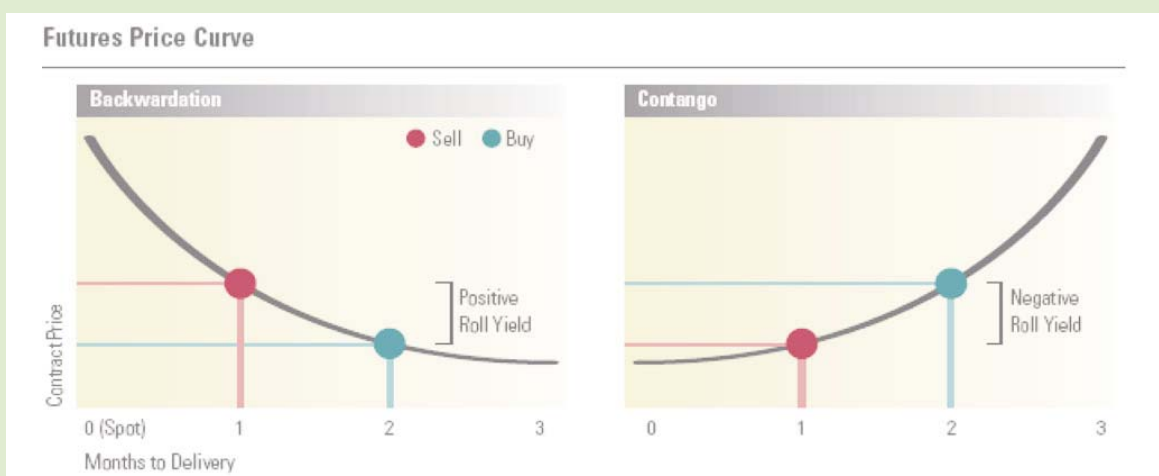
In declining or volatile commodity markets, the high liquidity of most futures contracts may provide active investors with the flexibility to increase cash and more nimbly exit positions to protect capital, potentially offsetting the limitations of long-only index strategies.

Because commodity market participants include producers and consumers in addition to investors, we believe the potential for identifying alpha opportunities can be greater than in other more efficient markets. While a passive approach to commodity investing is likely to generate beta in a long-term secular bull market, we believe that a component of active exposure to the asset class can provide tactical opportunities to derive excess returns from market inefficiencies.

Spotlight On Roll Yield and The Futures Curve

For passive long-only index strategies, the process of continually rolling over expiring futures contracts can be either a good way to pick up consistent yield or a costly activity that slowly eats away at returns depending on the shape of the futures price curve. In a backwardated commodities market, nearby contracts have a higher price than later-month contracts, and the term structure of the forward curve is naturally downward sloping as shown in the chart below. Thus, investors buy later month contracts at a lower price spread to spot, which slowly converge or roll up to the spot price as the contracts approach maturity, allowing returns to accrue to the holder. This is the positive roll yield that an investor captures for bearing commodity

price risk by taking the long side of the trade and providing commodity producers with a form of “insurance” against falling spot prices. Even if the spot price stays constant, one will earn returns from buying discounted later month contracts that continuously roll up to the constant spot price. The reverse occurs when a commodity market is in contango, meaning that the forward curve is upward sloping. Because the later month contract’s price is at a premium to the spot price, the investor continuously locks in losses from later month contracts converging to a lower spot price as they approach expiration.



Source: Paul Kaplan, “Beyond Beta-Passive Alternatives to Active Commodities Strategies”, Morningstar Indexes ©2008.

Risk Considerations

No commodity investment is without risk regardless of whether the strategy is actively or passively managed. While commodities carry risk levels comparable to equities, their prices can be impacted by a wide range of forces, including demographic and technological changes as well as weather and geopolitical events, which may create substantial uncertainties in the marketplace. These uncertainties can cause individual commodity prices to move sharply higher or lower exposing an investment to volatility that may not be suitable for all investors.

Past performance is no guarantee of future results. There is a risk of loss from an investment in securities.

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