BACK TO BASICS

Global commodities are a diversifying asset class.

MARY ANNE WILEY
Principal, Barclays Global Investors

As an asset class, commodities have been getting a lot of attention from plan sponsors who wonder if now is the right time to add them to their portfolios. Historical returns have been strong and commodities offer even stronger diversification benefits than other traditional assets. They have a low to negative correlation with traditional asset classes such as stocks and bonds. Looking back over periods of three to 15 years, commodities have a near zero correlation with Canadian, U.S., and international equities as well as Canadian fixed income. Furthermore, unlike equities and bonds, commodities have a positive correlation with the overall business cycle. While equities and fixed income can exhibit weak returns at the top of the cycle, commodities typically deliver strong returns because they are in high demand for economic production.

Good hedge

Commodities also hedge against risks not normally covered by traditional investments. The positive correlation between commodities prices and inflation means they provide a good hedge against inflation. At the same time, they also hedge against risks such as weather-related disasters, political unrest, and other events that typically lead to supply disruptions and, in turn, price increases. Commodities exposure provides the opportunity to benefit from growth in developing markets such as China and India before that growth is reflected in stock prices. As emerging market economies develop, the strong demand for base metals and energy to develop infrastructure is reflected in the prices of commodities.

Institutional investors are also attracted to commodities futures because they are relatively liquid and offer transparent pricing and implementation. At the same time, commodities don't require leverage. But there is a common misconception that the total return of commodities is equal to the spot return. The spot return, however, is only one of three elements that contribute to the total return. Income is the second component and, because commodities futures can be held on a fully collateralized basis, a yield is generated from the underlying cash collateral portfolio. This yield is approximately the same as short-term cash returns and may be enhanced through modest duration and credit exposures.

Rolling back

The third component of the total return is the roll return. This is perhaps the least understood component and yet it can have a significant impact on the portfolio. In order to maintain a continuous exposure to commodities, futures contracts must be rolled on a monthly or quarterly basis. There is an opportunity to add value through this roll process primarily because many commodities futures contracts trade in backwardation. Backwardation occurs when the price of the current most actively traded contract is higher than the next nearby contract. As the most active contract expires, rolling the exposure forward is essentially selling high and buying low. Not all futures contracts trade in backwardation and those that do have periods of time when the relationship doesn't hold. Over longer periods of time, however, many commodities futures contracts have traded in backwardation (i.e., energy futures).

Bringing it all together at the total portfolio level, commodities can dramatically reduce overall risk and smooth out returns. Assuming historical volatilities hold and commodities deliver a return that is similar to equities (between 7% and 9% annualized), a 10% allocation to commodities can reduce the overall risk of the portfolio by 55 to 120 basis points. It is hard to imagine another investment that could have such a dramatic and meaningful impact on risk. The benefit of risk reduction makes commodities a worthwhile consideration for all institutional investors. ■