LOOK INTO YOUR FUTURES

Managed commodities provide beta and add alpha.

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There has been rapidly growing interest in commodities as an investment in the last several years. Commodities are appealing because of low correlation to traditional asset classes, long-term returns roughly comparable to equities, positive correlation to inflation and returns that are not based on skill.

Investors seeking passive long exposure to commodities generally invest in long-only commodity indices such as the Goldman Sachs Commodity Index (GSCI) or the Dow Jones-AIG Index (DJ-AIG). All such indices seek to benefit from a passive, systematic exposure to returns from owning commodities, but differ significantly in their construction rules.

The most comprehensive research to date on passive returns from a long-only exposure to commodities was conducted by Wharton professor Gary Gorton, and Yale professor K. Geert Rouwenhorst. In their paper, "Facts and Fantasies about Commodity Futures," Gorton and Rouwenhorst (G&R) demonstrate that an equally weighted portfolio of commodity futures contracts rebalanced monthly and fully collateralized by a money market portfolio had an average annualized return of 10.69% with a standard deviation of 12.10% from July 1959 to December 2004. This can be defined as the beta of commodities.

In contrast to the passive nature of long-only commodity indices, investments in managed futures offer the potential for skill-based returns in commodities. The term managed futures refers to a global industry of regulated investment professionals or firms that actively invest in both long and short commodity price trends. In the United States, these entities are known as Commodity Trading Advisors (CTAs), and in Canada as Commodity Trading Managers (CTMs).

The most comprehensive source of managed futures return data is the Barclay CTA Index, an equally weighted index of returns from the universe of registered CTAs that goes back to January 1980. From the period January 1980 to December 2005, the Barclay CTA index exhibited a 12.63% average annualized return with a maximum drawdown in performance of -15.66%. Updated G&R data to the end of 2005 reveals that the G&R performance index yielded a 7.44% average annualized return and a maximum drawdown of -26.96% during the comparable period. As well, the Sortino ratio of managed futures was 1.17 compared with 0.47 in the case of G&R data. Clearly then, the history of managed futures returns has demonstrated alpha over passive commodity investments.

Going beyond the return data reveals other sources of alpha from managed futures that have to do with the investment performance from commodities when it is most needed for an equity portfolio, and also the impact on return distributions when adding commodities to an equity portfolio. For example, long-only commodity index returns are uncorrelated to equity returns; however, managed futures returns have been negatively correlated to equities when equities are down. When looking at the worst equity market declines since 1980, long-only commodity indices have not provided any statistically significant portfolio protection and have also declined materially in at least a couple of those periods. In contrast, managed futures provided above-average returns in all of those periods. Long-only commodity index returns increase negative skew when added to S&P 500 returns, but managed futures decrease negative skew and even create positive skew when the allocation is 30%.

The bottom line is that passive commodities provide an uncorrelated source of beta, but not much else. Managed futures provide the uncorrelated beta of commodities and add real alpha. Managed futures have historically provided superior absolute and risk- adjusted returns, negative correlation and portfolio protection during major equity declines. Further, when added to an equity portfolio, they eliminate the undesirable negative skew in equity market return distributions. ▮