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The undiscovered asset class?

Commodities are one of the least understood investment opportunities but are growing in popularity.



Karl Marx once said: “A commodity appears at first sight an extremely obvious, trivial thing. But its analysis brings out that it is a very strange thing, abounding metaphysical subtleties and theological niceties.”

The German philosopher, credited with being one of the founders of modern day communism, certainly didn’t invest in the commodities markets given his strong opinions on capitalism but his view that they are deceptively complicated still abounds in the investment world today.

A recent white paper released by Vanguard titled: *Investment case for commodities? Myths and reality*, describes them as “one of the least understood asset classes.” And the paper was correct.

Part of the confusion surrounding the market is that many transactions in the commodities arena do not mean that the investor actually takes delivery of a tangible commodity like a barrel of oil. Instead, investors often deal in futures where a long investor enters an agreement to buy a commodity at a future date but also has

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IAIN ARMITAGE, HEAD OF COMMODITY INVESTOR PRODUCTS AT CITI

the option to sell it on before the actual physical date of delivery.

The market has evolved considerably since the days when farmers used to trade products and barter at markets in search of the best price. Nowadays the modern day commodities market consists of investments in commodity indexed assets and open positions on futures.

“Despite being probably the oldest derivatives market, the asset class has not really come to the fore for mainstream institutional investors until fairly recently,” said Iain Armitage, head of Commodity Investor Products at Citi.

“The pace of financial innovation in the commodities markets hasn’t been as fast as equities or bonds. Most investors are

now increasing their allocations to commodities because they are a very good diversification tool.

“It is really the great undiscovered asset class and we are starting to see it grow in popularity.”

Dan Rice, managing director in BlackRock’s Global Resources team added that it is taking time for investors to be educated on commodities.

“They have been generally ignored by the investing public for the last 30 or 40 years and it’s only become popular in the last five years or so which means there is a learning curve,” he explained.

While a greater understanding and awareness of commodities is one reason behind their increasing popularity, so too are the results the asset class has achieved recently compared to equities and bonds.

Perhaps once viewed as the poor relation to investing in equities and bonds, commodities are moving more and more into the mainstream. According to a white paper released by investment manager Pioneer in March titled *Five reasons to invest in commodities*, the asset class has outperformed both equities and bonds over the past five years.

Equities are a leading indicator of recession while commodities act in the opposite manner and are lagging indicators hence the discrepancy between how they performed.

While equities foresee a recession and begin to decline in advance of it hitting, the return on commodity futures is linked to the inventory levels of the economy. If inventory levels are low then commodities get good returns but if they are high then the opposite is true.

For example, when you go into a recession, you are in the last stages of the economic cycle and are coming out of a growth period so inventory is low. An example of this can be seen in June 2008 when commodity prices peaked – some eight months or so after equities did.

And it is this diversifying quality that is another reason behind the growing popularity of commodities.

“Commodities historically are a great diversifier,” Geetesh Bhardwajm, senior investment analyst with Vanguard Investment Counselling and Research told *Global Investor/isf*.

"You can hold cash to diversify, of course, but you aren't getting any return if you do that. What investors look for when diversifying is high rates of return and low correlation with the equity markets. Given that, commodities have been very good.

"They have moved in tandem sometimes but mainly they move in the opposite direction."

They are occasionally correlated to equities, however, like in the midst of the recent financial crisis.

And it is because of that clear correlation during the bad times that other observers remain cautious about commodities. A recent report from Morgan Stanley describes this lack of diversification during downturns as the asset classes "Achilles heel."

The report states: "If there is an Achilles heel to commodity investing, however, it has to be that commodities have not been good diversifiers in a downturn. Correlation with a traditional 60/40 equity/bond portfolio has jumped from negative 4% to a startling 43% during periods of market stress. This lack of correlation is a big deal."

Yet some believe this correlation was the exception and not the norm and that commodities remain a sound investment.

"Everything correlated during the financial crisis," says Rice. "Everything went down and there weren't any bright spots."

Pioneer's report also cites the degree of protection that commodities can offer from inflation as another reason they are viewed as being attractive by investors.

So by and large it seems that the advice for investors is not to choose commodities over equities or vice versa but rather to offset your investment in one with an investment in the other.

Armitage at Citi says: "If you ask institutional investors how much of their portfolio is allocated to commodities, I think they will say about one percent. If you ask them how much they would like to be allocated to commodities, the answer is likely to be between five and seven percent. There is a tsunami of interest at the moment."

A spike in interest in commodities has been caused in large part by the boost the asset class is being given by the growth of the emerging BRIC economies – in particular China and India.

The rapid growth of these countries and the heavy investment in infrastructure programmes is increasing the attractiveness of the commodities market to investors. China now has the second largest economy in the world having leapfrogged Japan following the release of its 2009 GDP of 8.7%. It is also now the world's largest consumer of copper, tin,

zinc and cotton and the second biggest of crude oil after the US.

This kind of activity has proved crucial for commodity demand across the globe.

Peter Königbauer, portfolio manager of the Pioneer commodity alpha fund told *Global Investor/ISF*: "They (China and India) are more or less the lead buyers for all commodities. China has a lot of coal but they don't have enough oil. They have changed from an exporter of agricultural products to an importer too so there is a big demand there. The behaviour has



Peter Königbauer

changed from producing for its own needs to becoming an importer for a lot of commodities. I expect more or less the same for India over the next years although they are probably five to seven years behind China at the moment."

Should the emerging markets continue to grow at the rate they are – and they show no signs of stopping – the future of commodities looks bright.

Rice at BlackRock says: "If the world economy grows more than 2% a year then the future for commodities is positive. A growth of 2% or more really strains the ability of the commodities sector to satisfy that growth rate which means commodity returns are good."

The three main commodity sectors to invest in remain energy, metals and agricultural products.

Energy demand is continuing to increase again driven by the emerging markets while metals are also in high demand with a number of production projects halted due to the financial crisis which means supply has slowed causing prices to rise. Finally, agricultural demand is also rising driven by the growth in global population.

Despite concerns around the rising cor-

relation of commodities to equities, the majority of the noise surrounding the asset class is positive.

But like any type of investment the need to invest wisely is paramount. Investing in a single commodity is generally viewed as riskier than investing in an index and a range of commodities.

One such index is the Citi BRIC commodities index which covers the four major emerging market economies.

Armitage said: "What it does is look at the consumption of commodities from those four economies rather than traditional indices, which are based simply on some measure of global production. There are a number of investors who believe the consumption of those four economies is going to be a far more important driver of commodity prices going forward."

On whether a single commodity is a riskier investment than investing in a cross section of the asset class, Armitage admitted it is and advised caution.

"It really depends on the type of product you use to access the market. It can be a more volatile asset class in general but it all depends on what you invest in and how you do it.

"You see a lot of interest in specific commodities such as gold and oil but investors are becoming more interested in looking at other single underlyers.

"Pension funds and asset managers tend to get access to commodities through a broad basket of commodities and will invest in indices which gives them a broad exposure and reduced the volatility. It gives a diversifier in terms of your point risk."

Safety in the number of commodities will not ensure a no-risk investment, however, and a thorough analysis of hidden correlations between commodities is advised before investing. Possible links between commodities, warned Bhardwajm at Vanguard, are not always immediately obvious.

"Individual commodities can be extremely volatile so when I talk about commodities I'm talking about an average of 30 commodities with amazing diversification among them."

He then joked: "You need to hold commodities in say pigs and gas. That way the only time that they will be affected is when everyone is barbequing! There is low correlation between them otherwise.

"If you go for individual commodities you are opening yourself up to a lot of volatility. You should invest in an index that can shield you from shocks." ■

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