

# Investing in Commodities

## A Conversation with David Morton

Rocaton believes that an allocation to commodities may increase diversification, lower risk and provide a hedge against inflation over the long-term. **Rocaton's David Morton**, Co-Head of Alternatives Research, answers questions about the benefits and issues associated with investing in commodities.



### What does a commodities portfolio invest in?

Commodities portfolios predominantly invest in futures contracts whose performance is tied to the supply and demand for physical commodities. For example, when you see a reference to crude oil prices in the U.S., the price being quoted is a futures contract for high-grade crude oil delivered at Cushing, Oklahoma. This futures contract is an exchange-traded derivative contract that promises the delivery of crude oil at Cushing at a specified date in the future. Portfolios of commodity futures invest in similar energy-related contracts, such as gasoline and heating oil, as well as industrial metals, precious metals, agricultural commodities, soft commodities and livestock. The weighting schemes of various commodities benchmarks can vary greatly. For example, the S&P GSCI recently had an approximate weight of 50% to crude oil (U.S. crude oil is known as West Texas Intermediate (WTI) and European crude oil is known as Brent) and 69% to the energy sector overall. As a result, the returns and volatility of this index are dominated by the oil and energy markets. More diversified benchmarks, such as the Dow Jones-UBS Commodity Index, have lower energy weights and

typically lower volatility. In general, Rocaton prefers more diversified benchmarks with lower concentrations of individual commodity contracts.

### What are some of the potential benefits associated with investing in commodities?

Historically, commodity portfolio returns have largely been driven by different factors than stock and bond returns. Over longer periods of time, commodity returns have tended to have low correlation with equity markets. If this relationship continues, the addition of commodities in a diversified portfolio may reduce its overall risk. Furthermore, an exposure to commodities may provide a benefit as input prices such as labor and raw materials increase, commodity prices may rise, thus providing a hedge against inflation.

### What is Rocaton's long-term expected return and risk for commodities?

Rocaton's current long term return expectation for a passive investment in commodities is a compound rate of 3.3%, with long term volatility between 16.5% and 21.5% depending on the index used and its exposure to energy. In addition, over the

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long-term, Rocaton expects commodities will have a low correlation to equity and other risk assets. Of course, there's no guarantee these assumptions will be realized.

**Rocaton's return expectation for commodities seems fairly low. Why should we include commodities in our investment portfolio?**

Rocaton's current return estimate assumes that, over the long term, commodities prices do not increase. This may sound counterintuitive in today's world in which oil prices have risen and gold prices are near all-time highs. However, over the long-term, commodities returns have not kept pace with inflation. This is largely because commodity price increases tend to lead to demand declining and/or production increasing. Further, commodity price increases can lead to substitution of a cheaper commodity for the more expensive commodity. In short, commodity markets typically respond to price increases in such a way as to result in these price increases being reversed over time. In addition, over the long-term, productivity gains in production weaken prices.

Even so, a 3.3% return can be a positive for a larger portfolio in a number of ways. First, commodities prices are typically volatile and an investor's total portfolio may generate incremental returns if a disciplined rebalancing policy is followed. For example, in mid-2008, oil prices in the U.S. hit a high of \$147 per barrel, only to fall eventually to a low of \$30 per barrel in early 2009. At that price, we believe oil production across the globe was largely unprofitable, which led to a reduction in supply. In turn, an increase in demand and other factors led to a subsequent increase in price.

Ideally, investors who adhered to a rebalancing policy would have reduced commodity exposure as oil prices moved toward \$147 and increased exposure as oil prices fell.

Further, 3.3% is merely the expectation for the traditional index returns. Commodity indexes were not developed as efficient investment tools and Rocaton believes that active management has the potential to add value over a market cycle, enhancing long-term returns.

**Why should an investor consider an allocation to commodities or increase commodities exposure given today's relatively high prices?**

The actual level of a commodity's price is only one of three components that drive commodity index returns. These components are the commodity's price change over time, the “roll return” and the collateral return. Depending on the commodity, futures contracts generally expire monthly, bi-monthly or quarterly. Typically, exposure to an underlying commodity is maintained by “rolling” the exposure from a soon-to-expire contract to the next contract. If the short term price curve of these futures contracts slopes upwards (a condition known as contango), rolling the contract tends to produce a negative return, everything else being equal. If the short term curve slopes downwards (a condition known as backwardation), the roll return will tend to be positive.

Getting back to your question, recent U.S. crude oil prices today are in the \$95 range. According to energy industry experts, this is only slightly higher than the global marginal cost of crude oil production. As such, \$85-95 may be a fair long term price, in the

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absence of a global recession, and not necessarily too high a price for a new investment by long-term investors. In addition, the commodity futures curve was recently in a slight contango in the U.S. but in backwardation in Europe, which resulted in a slightly positive roll yield for an equal weighted crude basket. It is impossible to know whether the shape of futures curves in the future will be additive or not for total returns, but we can say that at this point in time, the influence of the roll return is a factor to be considered and reduces the utility of merely focusing on one factor, such as the price level.

The world population is growing and the economies of the emerging nations such as China, India and Brazil are growing rapidly. We have finite supplies, however, of many commodities. In crude oil, the concept of “peak oil” may come into play. This is the argument that global crude oil production is either at or close to peak levels. From the peak, crude oil supplies could decline, which could trigger spikes in crude prices. If oil prices move higher, risk assets such as equities will probably be hurt and an exposure to commodities could be a positive for portfolio returns. Given the different return drivers, Rocaton feels that investors should focus less on the absolute level of prices and more on how an investment in commodities may impact an overall portfolio over time.

#### What is Rocaton’s view of gold?

An investment in a commodities basket is generally a poor way of owning gold as the weight to gold is typically quite small (recently less than 3% in the S&P GSCI and 13% in the DJ-UBS). There’s no doubt that gold has had a fantastic run over the last

decade, moving from a low of \$271 in December, 2001 to the current price of roughly \$1,750 an ounce. It is difficult to know what the true value of gold should be, as its current elevated level has arguably been largely driven by the lack of confidence in major currencies such as the U.S. dollar, the euro and the yen and heightened geopolitical instability. At some point, we feel gold may fall precipitously in price, but we don’t know whether this will be soon, or if the price of gold will first climb considerably higher. Investors should tread carefully in gold if they invest. Gold is a small market and if sentiment changes, the market could become less liquid and potentially result in a dramatic and sudden price correction.

#### Should I invest in commodities using an active or passive approach?

Rocaton believes that experienced and talented investors can fairly consistently add value versus a commodities benchmark. The commodities markets tend to be heterogeneous and dominated by the producers and consumers looking to hedge their revenues or their costs. Rocaton believes this leads to inefficiencies in the market that can be exploited by knowledgeable and experienced active managers. Additionally, the relative inflexibility in supply and demand of the more than two dozen distinct markets should continue to lead to price spikes and troughs creating opportunities for alpha. Furthermore, active managers can vary their exposure across the futures price curves in an effort to mitigate the negative impact of roll yield and enhance their return potential relative to a passive benchmark.

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#### How can we invest in commodities?

Investors have a number of options from which to choose. There are a small number of mutual funds and ETF's available for individual investors, small institutions or defined contribution plans. Larger institutions can create separately managed accounts or use a wider selection of commingled products.

While every investor's objectives and risk tolerance vary, in general, given the potential for low correlation to risk assets over the long term, the possible relative scarcity of some raw materials and the diverse factors driving commodities prices, Rocaton sees significant benefits to adding commodities to broadly diversified portfolios.

**David Morton**, *Co-Head of Alternatives Research*,  
*is a founder and Partner of Rocaton.*

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