

Commodity Investing –A Case Study

The common thing about us equity investors is that we would like to get great returns for no risk. Once you step away from deposit accounts the reality is that, generally speaking, the greater returns you want the greater the risk you have to take. We are very comfortable with this when things go our way i.e. the price of our investment goes up, However, none of us like it when things go the other way, the price of investments fall and we lose money. We could simply retreat to the deposit account when this happens, but very few of us have the foresight to predict market declines and will only do this after the event, thus losing the opportunity to recover our losses.

A better way of dealing with the risk to our capital from market declines is to spread our risk across a range of investments i.e. diversify. Historically this was achieved by varying the domicile of our equity investments and their market capitalisation i.e. investing internationally and holding small, medium and large sized companies.

However, the downturn of 2001-3 changed peoples thinking. With regards to the international investing theory, if we look at a chart of the major global stock market indices during this period, such as the FTSE 100, S&P 500 or Dax, you would be hard pressed to tell them apart. This is because globalisation of the world's economy has increased the correlation of stock markets to each other. According to Merrill Lynch, in 2000 non-US stocks were only 32 percent correlated to the US stock market. However, by 2006 this figure had changed to 96 percent. Correlation is how investments behave towards each other: two stocks that are 100 percent correlated behave exactly the same as each other, therefore why hold both of the two stocks to diversify your risk? However, if the two stocks were zero percent correlated then there would be a benefit from holding the two because they behave completely differently. Therefore, the increased correlation of stock markets globally is bad for investors because it has significantly reduced the attraction of investing overseas to diversify risk,

The other problem with big stock market declines, such as 2001-3, is that the capitalisation argument didn't really hold up either, with the FTSE 100 faring as badly as the FTSE Small Cap. Sure, it helped if you didn't hold tech stocks, but you still lost money and, as a result, investors started to look to other forms of investments that could give you a return better than a deposit account but had low correlation with equity markets. An obvious example would be property, and haven't investors done well? However, will they do so in the future? Is property fair value at the moment? Probably not, but the point is that, while shares declined, property went up, thus providing diversification of risk for investors, allowing holders of shares to hold on for the recovery, which duly came.

A lesser known source of diversification during the stock market correction were commodities. A portfolio of commodities (as represented by the RJ CRB Total Return Index) held from the start of 2001 to the middle of March 2003, when the FTSE declined around 45 percent, would have received a positive return of around 9 percent, in sterling terms. This was very fortunate but it highlights an important feature of commodities, their long term correlation to equities is very low, in fact research indicates it is nearly at that zero percent mark. Therefore, they tick a big box for investors because holding them along with other assets classes means that they have every chance of providing a source of return that is not reliant on the performance of shares, property or even fixed interest securities for that matter. Importantly, the longer-term returns from commodities, which include roll-yield and collateral yield², have been similar to that of equities, so we have every reason to include them in our mix of assets.

(² For the purposes of expediency I shan't expand these terms much further, but simply put they represent a kind of insurance premium received by investing via the futures market and the interest received from keeping the majority of your money on deposit when investing in futures, as many Exchange Traded Funds do.)

However, commodities can exhibit the same risk and volatility as shares, although we hope at different times, and as such we as managers have to manage this risk. The volatility of late 2006 gave us stark evidence of this fact, with our benchmark, the RJ CRB, falling by as much as 22 percent. This was the most volatile period for commodities for decades, so for our commodity fund to emerge after 12 months just slightly below its launch price should be regarded as satisfactory. When this is compared to the RJ CRB, which was still down around 13 percent the value of an active approach to investing in commodities can be demonstrated.

The ability to deliver this performance during an extremely volatile period, which saw one hedge fund lose \$6bn, was evidence that a disciplined, objective analysis of individual commodities can pay off. The iFunds approach is based on the relative measurement of risk and reward, which takes away the subjective element of whether you should be holding an individual commodity or not. Commodities are not like shares, there are no balance sheets to analyse, cash flow projections or price to earnings ratios on which to base your decision, as an equity fund manager would do. It is also impossible to predict one off disasters, such as the devastating drought in southern Australia in 2006, which pushed up the price of grains. We will hold commodity related equities, as the share prices of mining or oil companies can sometime outperform the price of the resource they are producing. This was evidenced by the performance of gold mining shares since the recovery in the gold price. However, we don't attempt to be predictive about this effect and let our prices tell us whether we should be holding the product, producer, or both. Long term we prefer to hold the product to maintain the diversification benefits.

Looking forward, just like other asset classes, commodities are a long-term investment and have recovered a significant percentage of the losses from last year. We hope that we are now returning to a period of more normalised returns from commodities and we have recently started to see evidence of this. Our willingness to hedge the currency risk from a declining dollar may well be a decisive factor in delivering these returns to sterling investors, given most commodities are dollar denominated.

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