Investment Commentary **May 2016**

Commodities: If You Were Tactical, Now What?

We interrupt our normal Investment Commentary to bring you this bulletin: Brent Crude Oil, the world's largest "market cap" investment, is up over 75%* from its low in January. All three major commodity sectors, metals, energy and agriculture, are comfortably positive year-to-date. Does this signal a reversal in commodities in general? Yes, we believe it does.

Over the last few years, the consistent theme we heard from many investors was that, although they appreciated the many portfolio benefits of owning commodities (which are unequivocal), they had adopted a tactical approach and were waiting for a better time to get in. The market had been in a steady decline since 2012 and they didn't want to "catch a falling knife," so allocations to commodities were reduced or eliminated. Unfortunately, this has left investors out of position to "catch a rising star" as well. At the time, with other asset classes still performing well, the opportunity cost of avoiding commodities was low. Last year, however, in what in hindsight may turn out to be a fulcrum year for many asset classes, the highest risk-adjusted return was essentially cash. Now, through the first 4 1/2 months of 2016, the benchmark Bloomberg Commodities Index is up 8.82%, the Barclays U.S. Aggregate Index is up 3.04%, and the S&P500 is lagging significantly, up only 1.06%.* So, not only are commodities performing well on an absolute basis, but other asset classes are also disappointing. The opportunity cost has shifted.

If you, as an investment advisor, had previously made a tactical decision to underweight commodities, now is a good time to reexamine the drivers of that decision. Regardless of the methodology you have adopted, the specific tools you are employing, and the signals you are watching for, we believe the catalysts are in place to more than justify a return to your previous market weight in commodities. Let's acknowledge for a moment, in our safe space here, that it's incredibly difficult for most investment advisors to manage assets in the portfolios on a truly tactical basis. It's difficult for even the best global macro funds, and they do this as the basis of their entire investment process. We know asset allocation is the biggest determinant of total return. This is why, with a nod to Modern Portfolio Theory, advisors typically employ rebalancing strategies to periodically return the portfolio to its optimal state. The optimal portfolio is itself a collection of *assumptions* of expected returns, volatility, and correlations that will hopefully deliver a more directionally-correct bias combined with the lowest risk path. But the reality is that the decision to include, or not include, certain asset classes is sometimes subject to interference from influences, both pragmatic and behavioral, that tend to infect the investment process. We believe that the period of time we are entering, with potential directional shifts in multiple asset classes, is a time where advisors could be especially vulnerable to this.

As intermediaries, we do not truly control the assets we invest, and must weigh investment considerations together with business imperatives. If we experience a meaningful deviation in performance from peer managers to the downside, our clients will seldom have the patience to give us the 7-10 years a full market cycle might require to determine how well we ultimately did with their money. If we've timed an asset class poorly, it better be a traditional asset class, so we'll at least be wrong in a crowd. If we're wrong about an alternative asset class, our clients will keep us on a much shorter leash. So if we wish to retain assets, which is the business we're in, we are somewhat forced into short term-ism. The tendency to tack toward those investments deemed most defensible under fire can be difficult to resist. It would be totally understandable, then, if some of the so-called tactical decisions were as much about avoiding recently underperforming asset classes because they can be harder to defend in the face of potential client blowback. Unfortunately, the clients who are the most upset at having too much of an asset class that is underperforming will also be the same ones who complain about not having enough when it's outperforming! Jeremy Grantham famously wrote about this in 2012 when he claimed he could manage his sister's money with more freedom than GMO's because she was a "client" that presented no career or business risk for him. He also brilliantly paraphrased Keynes: "the market can stay irrational longer than the client can stay patient." This is not meant to indict managers for this practice. On the contrary, business and client risk is real, and needs to be managed effectively. But let's recognize that it is occasionally in conflict with pure *investment* decision making.

Taking a quick look at the behavioral influences on investment decisions, the first thing we observe is that *avoidance is easy* (particularly with regard to non-traditional asset classes like commodities, which can require more complex conversations). Avoidance is also abetted by the fact that we don't spend a lot of time measuring the performance of investments we don't own, unless the cost of non-participation slaps us in the face. This is one of the non-investment related reasons why portfolios generally contain a high concentration of equities and fixed income—they're the most *visible*. The much more difficult choice becomes, then, reversing a previous investment decision, especially where we were rewarded for opting out, in order to do what investment theory tells us is correct; to buy cheap assets when they're cheap. We actually tend to think that reversing a previous allocation decision *confirms the validity of it,* but it's hard to shift an investment perspective, not the least because we must directly confront a number of behavioral issues. Cognitive dissonance, along with confirmation, anchoring, outcome, and recency biases are all screaming at us *not to do anything,* or at least not yet. Because of this, advisors are more often late than early investing in an asset class as it returns to outperformance because it usually takes some positive momentum to provide the rationale to do so.

So how do we judge when to invest? The first question we always have is: why is this particular asset class being treated tactically? But having answered that, for now, the second question becomes: if not now, when?

If investors were waiting for a confirmation of a bottom to reallocate to commodities, it's likely already happened and the high-confidence entry period is upon us. Trying to pick tops or bottoms in any asset class, core or not, is a well-established recipe for despair, and it's also totally unnecessary. It's far more important to participate in an improving market than to not invest at all because the timing wasn't perfect (which it never will be). The recent improvement in commodity prices was so dramatic that some investors might rationalize a decision to wait further, thinking they've "missed the move." They haven't, in our opinion, even if (or especially if) prices experience some settling from here. It's important to remember the asymmetrical nature of sequence-of-return percentages, which is especially true of commodities, since they mean revert so consistently. The simple example is to assume an investment is down 50% from a previous point. The subsequent retracement back to that point represents, of course, a return of *100%.* But note that with regard to commodities, we're not talking about previous high prices, only previous *equilibrium levels*. Crude Oil is already up 75% from the low of a few weeks ago, which is huge, but a return to the prices of roughly only 18 months ago would be *an additional 100% return*. A return to *previous high prices* would be closer to a *200% return* from this point. If you have managed to tactically avoid some or most of the downward move in commodities, congratulations! You are now incredibly well positioned on the asymmetrical side of the recovery equation, one that can deliver enormous returns...but only if you re-enter the market.

The overall investment rationale for investing in commodities has not changed. Stocks and commodities have very similar historical risk-adjusted returns. Surprisingly, even after the worst bear market for commodities in a generation, the difference in average annual returns between the S&P 500 and the Rogers International Commodity Index®, since the RICI®'s inception in 1998, is less than 90 basis points.* Even though the two asset classes are not highly correlated, due to their very different return drivers, they happen to exhibit similar volatility. Combined with the typical counter cyclicality of commodities and stocks, this means that commodities are highly efficient at de-risking the broad portfolio, while not penalizing returns—a home run. Commodities also represent an undervalued (and essentially perpetual) option on unexpected inflation and global event risk, both of which have renewed significance currently. Along with all of the portfolio benefits of including commodities, investors also now have technical support and a positive performance tailwind to justify new investment. If you were building the optimum portfolio this month, what would your commodity return assumptions be? Ask yourself, of stocks, bonds, or commodities, which asset class has the most potential to deliver a 30% or 40% or even 50% return over the next 3-5 years? *The time to add to commodities is now, while prices are still closer to multi-year lows than not.*

John Reese
Chief Executive Officer

*YTD data as of May 18, 2016. Source: Bloomberg

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