



Investment Commentary

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Why We Like Commodities

Whenever an asset class is out of favor, as commodities have been recently, it is helpful to review why investors should not dismiss it, or fall victim to decision making based on recent price action. The three principle reasons an allocation to commodities makes sense (and here we're referencing diversified, long-only strategies) have not changed, and only the commodities asset class offers this unique combination of attributes: a history of attractive long-term returns, beneficial impact on the broad portfolio, and the built-in hedge against inflation.

We judge all investment candidates by their history of returns (and hopefully, risk), and derive from that an expectation of what future returns are likely to be. This is certainly true of mature investment markets like equities and fixed income, with long-established return histories that provide a reasonable expectation of what we might earn over the risk-free rate. Commodities are a relatively recent investment candidate and institutional and individual investors are not accustomed to regarding them as a core investment holding. This is partially the case because investors sometimes have difficulty grasping the seemingly intangible sources of commodities returns, and traditional securities analysis doesn't apply (e.g., what's the P/E of soybeans?). Investors may also have trouble distinguishing between the subtle, but very important, differences in commodity portfolio construction methodologies (we will examine these issues in more detail in our next Investment Letter). Nevertheless, well designed, but still index-based, commodity strategies have exhibited both returns and, arguably, volatility similar to equities over full market cycles since they were introduced as an investible asset class.

That, by itself, should make commodities a desirable investment, but this frequently goes unnoticed since commodities are generally countercyclical to other asset classes, especially equities, and when the stock market is rallying commodities usually aren't. Of course, the opposite has typically been the case as well, and this is one of their great attributes when considered as part of a larger, multi-asset class portfolio. They typically deliver returns when financial assets are disappointing. Many investors understand that commodities offer diversification of returns, but commodities are really a *true* diversifier, with return sources that are not derivative of stocks or bonds, unlike private equity, many hedge fund strategies, and other alternatives. When a diversifying asset class with low correlations, yet equity-like returns, is added to the portfolio, investors can expect improvement to risk-adjusted returns. A typical analysis done on a 50/50 stock and bond proxy portfolio, adding commodities and solving for the efficient frontier, results in allocations to commodities as high as 20% and portfolio returns similar to or slightly higher than the proxy, but more importantly, a dramatic *de-risking* of the portfolio, sometimes by several standard deviation points.



Although the rationale for commodities investing clearly stands on its own for the reasons above, commodities are always highlighted for their inflation hedging benefits. This does not seem very valuable when inflation expectations are low, as they currently are. But another way of looking at this benefit is that it's virtually free. Judging by the current pricing of other inflation-linked assets, inflation hedging is relatively cheap. This is precisely the time to "purchase the insurance" against *unexpected* inflation, when the premium is low (akin to buying life insurance more cheaply when one is young and healthy). So, regardless of the outlook for inflation, the high correlation to CPI that commodities enjoy basically comes attached along with the investment package at low or no additional cost, at least right now. By the time inflation does begin to creep up, prices will have already risen, and hedging it will no longer be inexpensive.

Commodities have some other interesting and unique traits. Although the return distributions are similar to equities, during most periods commodities are positively skewed vs. the negative skewness of equities. This means that on the rare, *n*th standard deviation event, commodities crash up, not down. This is most likely due to the fact that commodities exhibit a positive relationship to event risk. When bad things happen in the world (weather, natural disasters, geopolitical crises, terrorism, etc.), it typically results in either a real or perceived production shock, which has a positive and usually dramatic effect on commodities pricing. Commodities prices are also far less subject to the vagaries of the relative value judgments and liquidity capacity of a small universe of financial intermediaries and counterparties. They have an intrinsic valuation anchored in thousands of commercial price points arrived at daily across the globe. Needless to say, their prices seldom, if ever, decline towards zero, unlike the occasional stock or bond.

Commodities prices respond to the global supply vs. demand market mechanism, and systemic supply/demand imbalances will inevitably equilibrate. The response to high prices is higher production and reduced consumption, which drive prices lower. Conversely, low prices stimulate demand and reduce production incentives, which drive prices higher. Although there is a long-term upward pricing bias to commodities (mostly because they are measured in *currencies*), on an interim basis commodities tend to predictably *mean revert*. All investments can be considered cyclical in nature, regression to the mean is a pervasive tenet in investment theory, and the trick is to buy cheap assets and sell them expensively. The commodities markets are unique, though, because their cyclicality is due mostly to the naturally fluctuating pricing mechanics driven by the consumption vs. production of raw goods, not to the relative popularity of the investment proposition. Historically these cycles have been pretty reliable. Periods of price decline in commodities have always been met with corresponding periods of higher prices, which implies that a protracted decline in commodity prices typically offers a higher-confidence entry point for investors.

Perhaps because commodities investing is still relatively nascent, and the sources of returns and differences among the various strategies are not as well understood, the asset class tends to be scrutinized more than stocks or bonds, and subjected to a higher recent performance standard. This is unwarranted. If an investor looked at a "black box" investment strategy that had beaten both equities and fixed income benchmarks over



the last 15 years, with similar risk, and returns that were not dependent on a persistent active management advantage, they would be very interested. When this investment is revealed to be a rules-based commodities strategy, some investors become skeptical.

The truth is, with attractive historical returns, portfolio construction benefits, and inflation hedging properties, it's actually pretty hard to make a case for *not* adding a broad commodities strategy to the portfolio. The only barely rational reason for not adding commodities is if the investor has made a tactical determination that now is not the right time. Aside from the classic pitfalls of market timing, this litmus test should only apply if the same investor is *thinking tactically about every asset class they're invested in* (this is rare). More typically, the core stock and bond allocations remain relatively static, and investments considered exotic (less traditional, so perhaps less defensible) are added or reduced on a much shorter performance leash. This is a mistake. We believe that if an investor is adhering to important investment principles like timely rebalancing, mean regression, and especially market completion, commodities have proven that they deserve to be included in the portfolio, and held with a commitment and time horizon consistent with other core asset classes.

John Reese
Chief Executive Officer
www.priceasset.com
www.pcscommodityfunds.com

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