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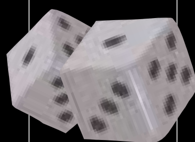
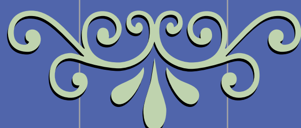


The Case for Commodities

Not ready to go the full round with commodities? No need. Any wrangler with the right approach can ride out the rough spots and reap the rewards.

BY GREGORY TAGGART
ILLUSTRATIONS BY ANTHONY FREDA



IN THE MOSTLY PIN-STRIPED WORLD OF INVESTING, COMMODITIES HAVE LONG BEEN COWBOY COUNTRY.

To invest there, you not only have to be on familiar terms with pork belly futures and historical price yields for lean hogs, you must also put up with volatility worthy of a ride on a Brahma bull. For the years 1972–2002, for example, the standard deviation for the Goldman Sachs Commodity Index (GSCI)—representing an unleveraged, long-only investment in a broad spectrum of commodities via commodity-linked investments—was a scary 25.67 percent, almost 8 points greater than the standard deviation on the S&P 500 index, according to Roger C. Gibson, president of Gibson Capital Management in Pittsburgh. In return for the additional risk, investors got only a slightly higher compound annual return—11.19 percent—than they did with the S&P 500—10.93 percent—during the same period.

The payoff hardly seems large enough to justify the bruises from the ride. And that's why so many advisers and their clients shun commodities. But they're missing an important point, Gibson argues. In building a portfolio, "you have to go beyond the risk/return characteristics of the individual assets and pay attention to how those assets are interacting."

The proof in Gibson's pudding is a study he updates each year that compares the risk/return characteristics of various one-, two-, three-, and four-asset-class portfolios, made up of various combinations of large U.S. stocks, non-U.S. stocks, real estate securities, and commodities (as represented by the GSCI). In his 2002 study, six of the eight portfolios that included commodities in their asset allocation turned in the best Sharpe ratios of the 15 portfolios studied—a statistical gold star for their risk/return performance (see "Comparing 15 Portfolios: 1972–2002," page 63). And the seventh portfolio holding commodities ranked eighth. On the other hand, the second-to-the-worst Sharpe ratio—a measure (named after Nobel laureate William Sharpe) of a portfolio's excess return relative to its total variability—belonged to the portfolio invested exclusively in—you guessed it—commodities. Nevertheless, "the least-risky portfolios all have this incredibly volatile asset class as an equal component," Gibson says. "So there's a pattern here. As you move from a one-asset-class portfolio to a two- and three- and finally to a four-asset-class portfolio, volatility drops and returns increase."

The comparative returns are equally compelling: the compound annual return on the U.S. stock, non-U.S. stock, real estate securities, and commodities portfolio (ABCD) beats the U.S. stock, non-U.S. stock, and real estate portfolio (ABC) by 82 basis points; and the U.S. stock, non-U.S. stock, and commodities portfolio (ABD) beats the U.S. stock and non-U.S. stock allocation (AB) by 131 basis points. "Why did that happen?" Gibson asks. "Because the reduction in volatility due to the dissimilarity in patterns of return among the asset classes adds to the compound return of the portfolio."

Over the years, long-only commodity portfolios generally have been negatively correlated with the stock market. In the year 2000, for example, when the S&P 500 was down 9.13 percent, the GSCI was up an astonishing 49.74 percent. In 2001, stocks were down only 11.88 percent while commodities dove into the deep end with a –31.93 percent return. Last year, the 32.07 percent return on commodities would have softened the stock market's –22.12 percent crash landing. And that's just the picture for the last three years. "I'm convinced that in any given 3-, 5-, or 10-year period, the presence of commodities in a portfolio can reduce risk and very likely increase return," says Steve Cassaday, president of Cassaday & Co., an independent investment-management firm in McLean, Va.

Unfortunately, most investors aren't aware of these correlations, let alone familiar with the mysterious trigonometry of commodities. What's more, the average investor is generally wary of investments he doesn't understand, and commodities is one of the most obscure asset classes around. So before you suggest clients mount the bull, Cassaday recommends giving them a tutorial in asset allocation. "We explain to clients that if they do business with us, they're going to own things that—viewed in isolation—would make them cringe. But viewed as a component of a diversified portfolio, they make sense," he says. Even then, "clients occasionally say things like, 'Why the heck do we own commodities?' So we go back and explain asset allocation again."

Once clients are comfortable with the asset class, the

question becomes what to buy and how to buy it. After all, there are a number of ways to invest in commodities—some better than others. Investing directly in the ownership of the hard assets themselves doesn't make sense, at least for most investors. "Think of the logistical nightmare of trying to own and control a warehouse full of crude oil and soybeans and cattle," laughs Bob Greer, real return product manager for PIMCO, in Newport Beach, Calif. "And historically the cash price of commodities has not kept pace with the general rate of inflation, and you'd have all of your money tied up in these cash products."

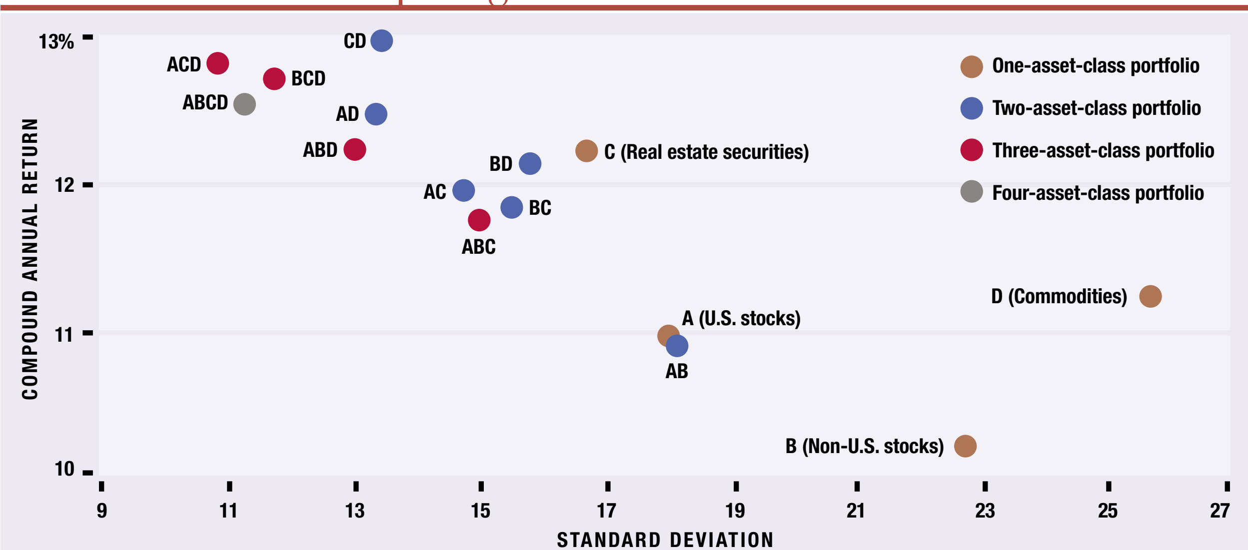
Buying futures contracts based on the underlying commodities is not an attractive option either, particularly if the goal is to hold the investment for extended periods of time, in expectation that the price will rise. That's because diversification across a broad spectrum of commodities using futures is difficult to manage and requires a large investment. But even if you got past those obstacles, trading commodity futures on one of the commodity exchanges is the epitome of high risk, especially for the uninitiated. And that's not a risk you can sidestep, because rebalancing in a commodities portfolio is critical to higher long-term returns, according to Adam De Chiara, senior vice president, and Daniel Raab, vice president, at the AIG Trading Group in Greenwich, Conn. "This return from rebalancing is perhaps one of the least understood yet most important aspects of commodity index investing," they explain in their study, "The Benefits of Real Asset Portfolio Diversification," which appeared in *Euromoney International Commodities Review* in 2002. Neither the average investor nor her adviser is interested in doing the heavy lifting such rebalancing entails. "We certainly don't have the time or the inclination to do that," says Reed Fraasa, a partner with Tyras, Fraasa, and Associates, a financial-planning firm in Paramus, N.J. "Instead, we see our role as managing clients' expectations,

as part of managing their overall goals."

Some investors looking for commodities exposure invest in the commodity producers rather than the commodities themselves. On the surface, the idea makes sense. If your client doesn't have oil storage facilities, buy Exxon Mobil Corp. If there's not enough room in his garage for tons of red wheat, buy Archer-Daniels-Midland Co. And instead of a safe for a load of precious metals, have him buy Placer Dome. But the approach has problems: as with futures contracts, a well-diversified portfolio of equities is an expensive proposition. Moreover, the exposure to the whims of the stock market that comes with owning the stocks of commodity producers could outweigh the diversification benefits of going long in commodities. "Exxon does not move up and down in lockstep with the price of crude oil," says Gibson. "Exxon is a business after all. And although a shift in the price of crude oil does impact the business, it's not the sole determinant of the stock's price."

Instead, experts say, advisers should counsel their clients to take long-only positions in commodities via some

Comparing 15 Portfolios: 1972–2002



A . . . . . . U.S. stocks
B . . . . . . Non-U.S. stocks
C . . . . . . Real estate securities
D . . . . . . Commodities
AB . . . . . Equal allocation: U.S. stocks and non-U.S. stocks
AC . . . . . Equal allocation: U.S. stocks and real estate securities
AD . . . . . Equal allocation: U.S. stocks and commodities
BC . . . . . Equal allocation: non-U.S. stocks and real estate securities
BD . . . . . Equal allocation: non-U.S. stocks and commodities
CD . . . . . Equal allocation: real estate securities and commodities
ABC . . . . Equal allocation: U.S. stocks, non-U.S. stocks, real estate securities
ABD . . . . Equal allocation: U.S. stocks, non-U.S. stocks, commodities
ACD . . . . Equal allocation: U.S. stocks, real estate securities, commodities
BCD . . . . Equal allocation: non-U.S. stocks, real estate securities, commodities
ABCD . . . Equal allocation: U.S. stocks, non-U.S. stocks, real estate securities, commodities

Sharpe Ratios: 1972–2002

PORTFOLIO	RANKED HIGH TO LOW
ACD	0.63
ABCD	0.58
BCD	0.58
CD	0.54
AD	0.51
ABD	0.50
AC	0.44
BD	0.43
C	0.42
ABC	0.42
BC	0.41
A	0.33
AB	0.33
D	0.30
B	0.26

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broad-based investment linked to a commodity index. There are five well-known commodity indexes, including the GSCI, the Dow Jones–AIG Commodity Index (DJAIG), the S&P Commodity Index (SPCI), the Reuters/Commodity Research Bureau Index, and the Rogers International Commodities Index (RICI). Of those, only the GSCI, DJAIG, and RICI are actually investable—that is, used as benchmarks by professionally managed separate accounts, mutual funds, and commodity pool funds accessible to individual investors. In turn, the managers invest in swaps, structured notes, index futures contracts, and sometimes the underlying futures contracts themselves, to achieve index-like returns. Typically, such management expertise has been available only to institutional investors and individuals with very deep pockets. PIMCO, for example, will tailor a separate account to a commodity index of your client's choosing if he can meet the stated $100 million minimum, says Greer. For a minimum investment of $10 million to $15 million, Goldman Sachs Asset Management in New York will manage separate accounts benchmarked to the GSCI. And Beeland Management Co. in Barrington, Ill., which manages the RICI, will help your client if he has at least $500,000 to invest in commodities.

If your client can't meet those minimums, there are other ways to gain exposure to commodities, says Greer. She can buy a futures contract on her favorite commodity index on the Chicago Board of Trade or the Chicago Mercantile Exchange, making sure to roll it over before settlement, so she always stays long in the index. "That way you don't have to buy futures in all of the underlying commodities. However," he says, "there's a better way: A couple of mutual funds offer commodity index exposure very much like you would receive in a separate account or institutional fund."

Mutual fund giants Oppenheimer and PIMCO, for example, have retail mutual funds benchmarked to the GSCI and DJAIG, respectively. And Beeland plans to begin marketing the Rogers Raw Materials Index Fund, a long-only commodity pool pegged to the RICI, to retail investors sometime in the third quarter. The minimum investment for the three funds ranges from just $1,000 to $10,000 (see "Fund Roundup," page 66). And the retail offerings probably won't stop there. Industry sources report that a number of fund families are jumping through the legal and regulatory hoops necessary to start their own commodity-linked mutual funds.

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None of the funds currently available are very large, and their track records are relatively short. The Rogers institutional fund had just over $60 million in assets at the beginning of April. PIMCO's Commodity Real Return Strategy Fund had about $170 million, and Oppenheimer's Real Asset Fund led the group with roughly $325 million under management. For those to whom longevity is more important than size, the Oppenheimer fund has been around the longest of the three—since March 1997. The Rogers fund opened to institutional clients in August 1998. PIMCO's fund is the newest kid on the block, opening for business in June 2002, but it already has a fan in Fraasa. "PIMCO's fund is very attractive because the AIG index is more diversified," says Fraasa. "We'll be watching it closely for the next year to see how it tracks."

Others, though, say that it doesn't make much difference which benchmark a fund uses. "The correlations of the indexes are essentially the same. If you have one, you have the other," notes Fernando Diz, associate professor of Finance at the Martin J. Whitman School of Management at Syracuse University.

Oppenheimer Real Asset Fund's benchmark, the GSCI, is

an index of 26 commodities, which is “world production–weighted”—that is, the percentage of a given commodity in the index is determined by that commodity’s average production during the last five years. As of August 29, 2003, for example, crude oil made up 26.16 percent of the GSCI (the energy category as a whole made up 66.64 percent), but orange juice made up only 0.33 percent (agriculture as a whole made up 17.18 percent). The reason, according to Kevin Baum, portfolio manager for the fund, is that if orange juice quadrupled in price, your family’s budget would hardly feel it, whereas a jump in the price of oil could stop your car in its tracks. “Energy as a sector clearly has the largest impact on the global economy,” says Baum. “For that reason, it derives the largest weighting in the GSCI. We think that makes good sense, because the diversification properties you’re looking for when you invest in commodities are largely determined by the impact that commodity prices have on the economy.”

What’s more, the proportion of each commodity in the index is never rebalanced to some predetermined, fixed percentage. If the price of crude went from $25 a barrel to $35, for instance, the index would have a higher dollar percentage weight in energy. The other indexes, the argument goes, would actually reduce the weight of energy in the index even as energy had a greater impact on the world’s economy. “Every year we adjust the world production weights based on a five-year rolling average,” says Heather Shemilt, head of commodity index marketing at Goldman Sachs. “So it’s a readjustment [to the index] not a rebalancing.”

Like the GSCI, the DJAIG gives greater weight to commodities that are important to the world’s economy, such as oil or natural gas. To determine that importance, index managers look at liquidity and, to a lesser extent, dollar-adjusted production data averaged over five years. As a result, the percentage allocation of each commodity in the index will vary over time, just as it does in the GSCI. The DJAIG prospectus, however, unlike that of the GSCI, says that no related group of commodities—those that fall under the umbrella of energy, for example, or precious metals—can make up more than 33 percent or less than 2 percent of the index. “That forces the indexes to have a more diverse exposure to the world of commodities,” says Greer. “Because they do this reallocation each January, it causes a sort of rebalancing once per year.” The DJAIG, as of August 25, 2003, is composed of 20 different commodities, ranging from natural gas, which makes up 11 percent of the index—the energy sector makes up 33

Fund Roundup

FUND NAME	TICKER	INCEPTION DATE	MINIMUM INVESTMENT	LOAD	EXPENSE RATIO
OPPENHEIMER REAL ASSET FUND	A shares: QRAAX B shares: QRABX C shares: QRACX	3/97	$1,000	A shares: 5.75% B shares: none C shares: none	1.68% 2.45% 2.45%
PIMCO COMMODITY REAL RETURN STRATEGY FUND	A shares: PCRAX B shares: PCRBX C shares: PCRCX	6/02 for institutional investors; 5/03 for retail	$2,500	A shares: 5.5% B shares: none C shares: 1.0%	1.24% 1.99% 1.99%
ROGERS RAW MATERIALS INDEX FUND*		8/98 for institutional investors; slated for 3Q '03 for retail	$10,000	5%	2.25%

*This is a commodity pool fund. Investors can exit fund at the end of the month only. Figures are for the retail fund.

percent—to soybean oil, which makes up just 2 percent.

Of the three indexes, the Rogers is the only one that rebalances to fixed percentages for each of the raw materials in the index. Like the others, the RICI is heavily weighted toward oil, with crude oil accounting for 35 percent and energy as a sector making up 44 percent of the index. "Rebalancing every month forces a partial buy low–sell high in each of the 35 commodities," says Clyde Harrison, founding member of the fund. "So if coffee goes way down, we will own a lot more units of coffee, but [we'll still] own 2 percent at the end of every 30 days."

Just as each index is different, so too is the management style of the funds that use them as benchmarks, though again, there is some common ground. The return on each fund, for example, comes from two basic components, in addition to any benefits that may result from rebalancing. First, the investor participates in any gain or loss on the commodity-linked investments—typically futures contracts—in the relevant index or in the underlying commodities themselves. And, the underlying collateral generates returns. For the Rogers fund, that return comes from seven-month T-bills. In the PIMCO fund, it's generated from Treasury inflation-indexed securities, known as TIPS. And in the Oppenheimer fund, it comes from structured notes, essentially one-year bonds. In fact, the Oppenheimer fund can invest in a wide variety of derivative and debt-related investments: its prospectus states, "Because the fund's assets are not invested solely in commodity-linked investments and because the fund's commodity-linked investments may be allocated in amounts that vary from the proportional weightings of the GSCI, the fund is not an 'index' fund."

One investment manager interviewed believes that commodities and other hard assets will perform during the next 15 years like the stock market did from 1982 to 2000—and has placed his bets accordingly. But the managers of these funds and the advisers who use them recommend that they be employed only as part of a long-term asset-allocation strategy to reduce risk and increase return. And they suggest starting slowly with just a 5 to 10 percent allocation, so that clients won't be frightened as volatility outruns returns. "We recommend that even the most risk-averse have some commodity exposure," Cassaday says.

This market niche is bound to change dramatically during the next few years—and may do so in a matter of months—as investors search for ways to punch up the returns in their moribund portfolios and commodity funds proliferate to help with the punching. But remember, Greer says, "these funds are not designed as an absolute-return vehicle that will have great returns year after year. They're designed to counterbalance what's going on in the rest of your portfolio." Translation: With less risk and better returns, your client can sit back and enjoy the rodeo.

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