ROUNDTABLE

Plan Sponsors Eye Commodity Returns

A few years ago commodities hit the headlines as investors were treated to hefty gains from playing in these notoriously dangerous reaches of the financial markets. But for pension plans and investment managers the risks of taking big positions in pork belly futures—and suddenly having to take delivery of a truckload of hogs—put them off many forays into commodity investing. On the back of the big gains in the markets, a group of investment banks led by Goldman Sachs & Co., with their Goldman Sachs Commodity Index (GSCI), broke new ground by providing financial players the ability to invest in the commodity markets without the obvious problems with playing in the physical markets. Seeing a good thing, other providers appeared—JP Morgan and Bankers Trust among them—with commodity indexes of various complexions. In the last three years commodity returns have been spectacular, causing many plan sponsors to reconsider commodity investment as part of a wider involvement in alternative assets classes.

Steve Strongin

Director of Commodity Research, Goldman Sachs

Today's economic scenario is very friendly to commodity investments such as the Goldman Sachs Commodity Index (GSCI), which has been producing returns in excess of 35 percent over the last year due to strong global demand, but it is not that friendly to other so-called tangible assets. In discussions of tangible or real assets, sometimes very different assets are lumped together. Real estate, resource-based equities and energy private partnerships are basically equities with a particular bias in terms of the sources of earnings. When measured on a transactions basis (which is sometimes very hard), these assets have returns that are very similar to the overall stock market. Historically, appraisal-based real estate investments have done well in high-inflation environments, acting much like inflation-linked bonds. Commodities, in contrast, have historically done well in rising inflation environments (a sign of strong global demand) and poorly in falling inflation environments (the rate of inflation has been largely irrelevant to returns). In the current environment, while there is some risk from rising inflation, I think it's pretty clear that we are a long way from a high-inflation environment.

For an investor who is primarily invested in equities and bonds, it is important to understand that these assets have historically done well in periods of falling inflation and poorly in periods of rising inflation (the rate of inflation has had only a minor impact on returns). As a result, if you are looking to hedge a equity or bond portfolio, commodities have historically provided a much better match in terms of meeting investors' needs than real estate, as well as better returns.

For most institutional investors, a GSCI commodities investment works just like an enhanced S&P fund that is based on S&P futures. The GSCI index futures contract trades on the Chicago Mercantile Exchange right next to the S&P pit. As a result, the investor has a extremely liquid exposure that is quite easy to manage.

The structural case for commodities is as good as it has ever been. The overall global economy is quite strong and inventory levels in commodities have been driven down to historic lows. Further, the composition of world growth is better for commodities than it has been for a long time. Growth in the 1980s was dominated by Japan and European countries, which tend to be modest consumers of commodities. Now that the U.S. and the emerging markets are again growing more strongly, consumption of commodities has risen again.

Gregory Oberholtzer

Vice President and Director, Commodity Portfolio Group, Jeffries & Co.

On a total return basis, commodity indexes are enjoying their third consecutive year of double-digit returns. Over the past 10 years we have witnessed a reduction in inventories and decreased per capita production. Coupled with scenarios of heightened industry demand and increased consumption by countries such as China and Russia, one can support continued appreciation in commodity prices. We don't see commodities as being an alternative to financial assets, but rather as part of a balanced portfolio. In a well-known study by Frank Russell in 1992 (Exchange Traded Real Assets, Commodities and Asset Allocation), the empirical evidence suggested that even if commodities only return 12 basis points over the risk-free rate, they can earn as much as two percent in an institution's portfolio. While there is a correlation between commodity indices and inflation, there is a higher correlation between commodities and unanticipated inflation, which is why we view commodities as a source of returns and as a tool for diversification rather than an inflation hedge. (Unanticipated inflation is that which is not expected and

thus not priced into commodities.)

Jeffries has exposure to real assets through our commodity index-based investments. The program is indexed to the total return performance of an equally weighted broad basket of commodities. In addition the firm has exposure from time to time in natural-resource-based equities.

In addition to our passive commodity index investment, our firm has proprietary investments in several market-neutral programs in both commodities and equities. The commodity based strategy is a hedge/arbitrage program that seeks to profit from opportunities in listed commodity index futures such as the Commodity Research Bureau and Goldman Sachs Commodity indexes. The market-neutral index programs are internally benchmarked against the risk-free non-view-oriented programs. Indexes which measure the total return performance of an investment in commodities using futures such as the Investment Commodity Index, GSCI, or the JP Morgan indexes are useful for benchmarking active programs as well measuring the manager's skill in allocating the portfolio to a particular market. In return for his fee, we would be making an implied decision as to which markets are most important. Such a view needs to be reconciled with the manager's mandate style, universe of markets traded and incentive compensation.

We have chosen an indexed investment because gains in commodity markets rotate among sectors and individually these markets can be volatile. As a result we participate in broad-based price movements with less overall volatility. If a manager has the skill set necessary to successfully select which markets will appreciate or decline, a managed commodity program depends not only on the manager's proficiency, but also in the investor's ability to find and hire the successful manager.

Both fall under the category of real assets, but their returns are not highly correlated, and real estate investments are more geographically specific than global commodities. The existence of listed futures contracts on commodities and commodity indexes provides a greater degree of liquidity than real estate investment and more accurate pricing due to daily mark-to-market valuation. I think the introduction of commodity-index-based OTC derivatives and securitized products will facilitate institutional investing in the same way that the introduction of REITs provided a more favorable investment vehicle for investing in real estate.

Christine Downton

Partner and CIO, Pareto Partners

The outlook for financial assets relative to real assets remains benign. Real assets tend to outperform financial assets only in inflationary environments.

The outlook for inflation is positive. While falling inflation is probably a thing of the past, there is little threat of any significant resumption of inflation. Financial markets are still on the alert for any inflationary signs, and continue to act as a contract on inflationary policies. We would continue to favor financial assets over real assets.

We have no exposure to real assets at this time. The most appropriate exposure to this sector would be through natural-resource-based equities and active managers. Only these strategies are likely to produce a competitive return with financial assets in a noninflationary environment.

We would see a role for an active management category both as a diversifying source of return, and because the internal volatility of commodity markets and natural resource equities offers significant opportunities for systematic exploitation. Managed futures offer the most efficient and cost-efficient way to access active commodity management returns.

Over the very long term commodity investments have yielded a negative return, while real estate investments have yielded a positive return. Commodity index investments therefore are not suitable strategic investments for long-term funds. However, real estate investments are relatively illiquid and their risk-diversifying attributes frequently illusory. They should also, at most, play only a limited role in long-term investment funds.

In free market conditions and free capital movements, the final arbiters on inflation are investors. Over the past 16 or 17 years, the markets have been strongly influenced by the memories of the devastating effects of inflation in the 1970s on the value of capital. This has acted as a barrier to the re-emergence of inflation. The time for commodity and other real assets will return when markets have again become complacent over the threat of inflation. As the 1994 bond market has demonstrated, investors retain a lively fear of inflation. Nevertheless we are approaching a time when complacency will re-emerge. Real assets can be seen as a hedge against such complacency. However, over the next few years at least, such a hedge is likely to bear a cost in terms of relative performance. But given the massive underperformance of real assets over more than a decade this cost is likely to be modest.

John Rowsell

First Vice President, Director of Research, Credit Agricole Futures

Commodities as an asset class have only recently become an alternative for investors. That was in part because it was difficult for investors to gain a

commodity exposure, and interest in commodities in the 1980s was weak with a sustained bear market. In 1991 with the introduction of the GCSI and structured products commodity-linked bonds, and then in 1992 with the introduction of the Chicago Mercantile Exchange's futures and options on the GSCI, an efficient method for investors to gain exposure to commodities suddenly existed. Subsequent to the introduction of OTC and exchange-traded products on the GSCI, we saw a flurry of knockoff products from Merrill, Bankers Trust, JP Morgan, Lehman and others. All of this had the effect of drawing the attention of institutions to the idea of incorporating commodity returns in an investment portfolio. In part because it was first out of the blocks and had both OTC and exchange-listed products, as well as a broad economic base to its structure, the GSCI has become the dominant commodity benchmark for investors.

From my perspective, the economic conditions that were favorable to commodities caused institutions to focus attention on the GSCI futures and options. After years of being starved for capital, the combination of stimulative policies that are producing synchronous economic growth in the major industrial economies and the rapid increases in income levels in the less-developed economies have created excellent conditions for a sustained period of increased demand for physical commodities. For U.S. investors looking at the 145-year-old bull market in equities, the opportunities available for more commodities become compelling.

Turning to how commodity allocations are implemented, institutions are primarily linking their investment to the GSCI. As a futures broker, we work with institutions that are either passively or actively managing their investment relative to the GSCI, using the CME's GSCI futures contract and the component future markets of the GSCI. Those strictly running a passive program establish a GSCI futures position based on the notional value of the allocation and then roll their positions monthly. Some of those who are active managers put on a GSCI futures position and opportunistically tilt the basket with selected underlying component futures. Some managers are establish their exposure where they feel they get the best relative value, within the futures market or within 22 component markets.

Kris Mahabir

Managing Director, AIG International

Institutional allocations to commodities have grown dramatically in the past year in response to several factors. The diversification argument is well understood, but in the early 1990s investor interest languished because the diversification was not well accompanied by positive returns in common commodity indices. During that time inflation expectations were, and continue to be, subdued, and advancements in technology seemed to indicate that the long-term trend in spot commodity prices was down. Several factors have contributed to change this view. I believe the most important change is the realization that commodities are an asset class that performs well even when inflation is low. Witness the experience in recent years. In the current business cycle we have experienced excess returns of 21 percent from precious metals in 1993, 66 percent from base metals in 1994, 41 percent from grains in 1995 and 34 percent from energy in the first half of 1996. During this time inflation has ranged between 2.3 percent and 3.3 percent.

Valuations in commodities remain attractive because this performance has not been driven by higher prices alone. In fact, a large proportion of these returns have resulted from "roll yield" which is analogous to the fixed income return that results from "rolling down" the yield curve. Let's take an example. Over the last year energy has returned 74 percent. Price changes are responsible for only 26 percent, however, while roll yield has contributed 48 per cent. The roll yield is a repeatable event, even if prices remain constant. The annualized roll yield for a broad-based commodity basket is currently about 14 percent. This is the return an investor would realize the next year in the event that commodity price curves remain unchanged. These types of returns start to look very attractive compared with investments in the equity and fixed income markets. In fact another reason for investor interest is the realization that equity market valuations are highly based on fairly optimistic assumptions for future earnings growth. Several commodities, on the other hand, have recently traded near their cost of production.

One of the areas of debate in the industry is whether or not roll yield will eventually be eliminated by institutional investors making large allocations to commodities. While this can happen in theory, I believe that the roll yield is likely to persist for several reasons that are not widely appreciated. Over the past 10 years the trend towards just-in-time inventory management has led to conditions that will continue to create demand for near-dated commodity contracts as end-users rely on the futures markets instead of physical inventory to provide for their near-term consumption needs. This activity promotes backwardation, or an inverted price curve, and will tend to result in attractive roll yields.

A second factor that contributes to the roll yield is that many commodities are prone to supply disruptions

due to the nature of their distribution networks. Again, an example serves to illustrate the point. Given the large fiscal deficits run by the OPEC member countries, I do not expect a coordinated effort on their part to orchestrate a supply shock. However, as we saw in the winter of 1994–1995, oil prices can rise for sustained periods due to distribution problems. A final factor worth noting is that the producers are often willing to sell forward at prices that are lower then the cash market in order to lock in a profit on a significant portion of their production. This forward hedging activity tends to preserve the roll yield in the market.

Over the past year we have seen institutional interest grow for both structured trades and for managed accounts. Investors have sought customized commodity strategies and commodity fund managers have focused on value-added ideas to outperform their benchmark.. Even clients who traditionally favor passive approaches to investing in equities and fixed income have considered more active approaches to managing their commodity exposure. They recognize that managing against a commodity index provides opportunities that are not available in the stock or bond markets. The reason is market segmentation. Very few people who are knowledgeable about the oil market know anything about cattle. The same is true in reverse. Consequently, a manager who has a deep understanding across markets can outperform a broad-based commodity benchmark.

Going forward there are several trends that support the outlook for commodities. First is the long-term secular shift between financial assets and real assets. The trend for many years has been towards reducing inventories; however, the movement toward just-in-time management for physical commodities has now resulted in markets that are more susceptible to supply shocks than in the past. On the institutional side, while several companies are ahead of their competitors, investment in the commodity still resembles that of the bond market in 1981. At that time the majority of fixed income managers had done everything possible to diversify their activities away from actually owning bonds. As a result they were not prepared when the bull market began. The majority of institutional investors today have no exposure to commodities, and commodity traders focus on trading futures on FX, interest rates or stock indices. So even though the returns in commodities have become attractive recently, I believe that we are still at the early stages of a long-term secular bull market.

Hilary F. Till

Senior Vice President, Chief of Derivative Strategies, Derivative Strategies Group, Putnam Investment Management

Today there are a number of alternative asset classes competing for attention. Unique among new asset classes, the returns of a commodity program are tied to broad economic themes and are negatively correlated with the dominant financial asset classes. Also uniquely among real-asset investments, one can invest in this asset class through deeply liquid, transparent futures markets. And lastly, a commodity investment's returns are unexpectedly competitive: the Goldman Sachs Commodity Index's (GSCI's) returns, for example, have topped 10 percent per annum for the last decade.

In retrospect the last year has been a good time to be invested in commodities. On a year-over-year basis, the GSCI is up almost 40 percent. This should not be too much of a surprise, given that historically, commodities instruments tend to do well when economic growth is strong.

In addition to tactical arguments for investing in commodities while strong economic growth is evident, there are also powerful portfolio diversification reasons for investing in commodities. From a strategic asset allocation point of view, a portfolio that includes a fractional amount of collateralized commodity exposure always appears on the efficient frontier of optimal asset allocations. This is because commodities offer solid returns and are negatively correlated with stocks and bonds. A commodity program also provides effective inflation protection by holding good proxies for real economic assets that have a value independent of the monetary units in which they are denominated.

The use of commodities as a strategic investment has not yet been popularized. An investment in commodities allows a portfolio to increase its allocation to stocks, thereby increasing overall portfolio returns. A commodity investment lowers the standard deviation of a portfolio enough to allow for an increased allocation to higher-returning equities without increasing overall portfolio risk, according to internal Putnam asset allocation research.

In some ways it is surprising that commodities have not yet become a mainstream asset class, given their competitive returns and compelling portfolio diversification properties. The reason probably lies in a lack of understanding of the source of returns from this type of investment. For example, a 1994 International Monetary Fund paper concluded that spot commodity prices were in a long-term secular decline, which by itself would discourage investments in commodities. But then how is it that the returns implied by the GSCI and other commodity indices have been so competitive in the last ten years? ■