Is There Room for Commodities in Today's Investment Portfolio?

By Chew Loy Cheow (June 2012)

Conventional wisdom of asset diversification brought the commodities asset class into being at the turn of the twenty-first century. It coincided with the bull market in commodities that started quite unnoticed in 1998. Commodity cycles are known to be lengthy; it could easily be a decade-long. As we look at the commodities market today, there's some understandable trepidation: not only has the bull market seemingly run out of steam, if we are still in a bull cycle, surely it's already at an advanced stage.

The Global Financial Crisis (GFC) of 2007-08 caused the stumbling of commodity prices. This is no surprise, as commodity contracts are often bought with margins. The de-leveraging that followed the GFC led to the liquidation of investments, and commodity prices collapsed along with other risk assets. While there was a rebound in risk assets, helped by central banks' livid liquidity pumping in 2009-2010, risk assets turned in a lame performance in 2011; the S&P GSCI Total Return Index returned -1.18%, matching the MSCI-World Index in (negative) return.

The advent of financial flows into commodities has been the subject of much discussion. Increased participation in the commodities markets through futures contracts, commodity indices (which underlie the associated futures contracts), swaps and exchange-traded funds (ETFs) have brought structural change to commodities markets. Investing in commodities has become possible even for retail investors. With rising prices, especially in food prices, financial speculators have been accused of causing a bubble. An OECD paper in 2010 absolved financial flows as the cause of the increased volatility or for the creation of a price bubble in commodities.[1] Nevertheless, financial flows – which bring with it a fair share of traders and speculators – now exceed flows from commercial hedgers. Such a development is to be expected in the buildup of the market, where market liquidity is the life-blood of transaction interest. Improved market liquidity reinforces more investor and commercial interest as well as traders' and speculators' activities. We have seen, for example, the same phenomenon in the foreign exchange (FX) market. In the early years of freely floating exchange rates, namely in the seventies, volatility was extremely high. The increased participation of traders and speculators has lowered volatility and helped lubricate the efficiency of the FX market through tighter bid-ask spreads. The time has come for commodity contracts to be more liquid, and commodity markets to be more efficient as well. Technology such as electronic trading platforms that are offered by banks, brokers and commission agents, will attract more traders. Such platforms have spurred the global foreign exchange market from a turnover of US$2 trillion per day to US$4 trillion per day; who's to say this technological convenience cannot be repeated for commodities contracts. That commodities is a relatively infant market in turnover, we may well see greater percentage growth in the next few years.

[1] Irwin, S. H. and D. R. Sanders (2010), "The Impact of Index and Swap Funds on *Commodity* Futures Markets: Preliminary Results"

The GFC brought in its wake heightened consciousness about credit. The futures market, the complementary shadow of commodities market, continues to flourish. This should not be a surprise, as the futures market model's centralized clearing houses for exchange contracts have a robust daily mark-to-market mechanism bolstered by the collection or payment of margins. This makes the clearing houses' credit better than counterparties' credit in cash market transactions. **This confluence of comfortable credit and technological convenience should encourage higher turnover and better liquidity in commodities contracts.** Indeed the aftermath of GFC saw global futures contracts grow in turnover from 2009 to last year. Commodity contracts grew at a faster pace than futures contracts in general, until last year.[2] It would appear that the foundation for a sustainable futures market in the commodities listed in the popular commodity indices is now in place.

It was commodities – specifically, hedging of the price risk in crops – that led to the creation of futures market, centuries ago. Producers are often more prone to seek hedges for their produce than consumers. It's more difficult for a farmer to switch crop or to go into another occupation should the price of his crop falls, than for a supermarket shopper to buy another food item as a substitute, should price for his intended purchase becomes too high. The producer selling out in the future curve leads to a "backwardation" in futures or forward curves, which gives rise to a "convenience yield" for the buyer of the future contract. The extraction of this convenience yield, which is akin to the dividend yield in stocks or coupon yield in bonds, has been one good reason for investors to want to own the underlying commodity investments. Perhaps, more critically, fear of supply disruption makes one want to ensure commodities security through explicit ownership of commodities. Supply disruption cause prices to be elevated, sometimes to extremes, as we witnessed in oil prices during Hurricane Katrina. Although many commodity contracts in the last decade have seen a loss in their backwardation, one argument is that it was the sea of investing money flooding into commodities that has upset this. There's probably some truth in this, for as investor flow stabilized following the GFC, some contracts have regained backwardation. The analysis of the shape of commodity curves, and whether commodities are more often in backwardation or in contango, requires a separate study. However, historically, the spike in commodity prices due to supply disruption has tilted returns in favour of ownership of commodity investments.

The spikes in commodity prices due to supply disruptions characterize this asset class. Simply put, you can print new financial IOUs quickly in stocks and bonds, but you cannot replace a needed commodity fast enough. And some of these commodities rising too sharply in price are tinderboxes for explosive social unrest. In 1998, riots broke out in Indonesia following a sharp hike in gasoline and electricity prices. Rising food prices was also a factor that led to the Arab Spring in late 2010. Extreme weather conditions have been instrumental in disrupting crop production: in 2010, nineteen countries experienced record high temperatures. Extreme dryness or drought is the single most natural destroyer of crops. At this juncture in history,

[2] Agriculture and Industrial Metal contracts in China's exchanges led the drop in 2011, after years of rapid growth. Turnover in these contracts in the CME and LME continued to grow.

where social inequality is high and the risk of political upheaval in many countries is heightened, the weather seems to be joining in this conspiracy of spiking prices and revolutions!

A consequence of the GFC is the increased involvement of governments in financial markets. This has led to easy monetary policy. Doomsayers are legitimate in reminding us that it was easy money that led to asset bubbles (yes, commodities included), which culminated in the GFC. The sense of distrust in fiat money as the government printing presses churn busily, has led to a greater desire to own real assets.

Whatever may be the direction of stock and bond prices, commodities have established an infrastructure and value proposition for these to be included in a fair-sized, diversified investment portfolio. Even in this time when inflation is relatively subdued.

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