

TalkingPoints: How Market Participants Found Light With Commodity Indices in a Dark Decade



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To many market participants, it may seem like a “lost decade” for passive commodity indexing. After all, the most widely-recognized passive commodity index, the S&P GSCI (TR), lost about 10% annualized over the past 10 years. It is not the most impressive statistic, and what is worse is that the drop was not from a one-time crisis event. It was the result of an ongoing saga of dismal fundamental factors like slowing Chinese demand growth and an oversupply of oil from OPEC and U.S. producers, in conjunction with a range of unfavorable macro factors like a strong U.S. dollar, low interest rates, low inflation, and low growth.

However, as with all crises, opportunities arise. In the last decade commodity indexing has not only survived, but grown, with approximately 1,000 new headline commodity indices launching according to internal estimates. Over 80% of these indices launched between 2013 and 2015 during the first consecutive 3-years of negative commodity returns in history dating back to January 1970. This uptick in index creation reflects the market’s appetite for modified indices that may help manage risk.

1. What attracted market participants to commodities a decade ago and are those qualities still desirable?

Inflation protection and diversification to traditional assets like stocks and bonds with equity-like risk and return originally drew market participant interest that held strongly until the global financial crisis. The demand for commodities to provide inflation protection still holds; however, the demand for commodities as a diversifier has diminished in the past decade. There is a wide perception today that commodities have become highly correlated with other risky assets, since stocks and commodities fell together from July 2008 to March 2009, and more recently,

early this year. It begs the question, how does a substantial simultaneous drop in risky assets affect diversification? The real problem is that stocks have had a major bull run, while commodities have dropped. So it’s not necessarily diversification that is the issue, but rather the negative commodity returns.

2. Is it fair to say that the commodity decline in the past decade hurt the case for using commodities for diversification?

Traditionally, assets that are good diversifiers have low correlation. Although the correlation between commodities and other assets has remained low, whether commodities diversify well is debatable.

On average in the past 10 years, the 90-day rolling correlation between the S&P 500 and S&P GSCI has been 0.35, and is now at 0.45; which is still generally low. Even though in the time following the global financial crisis, when correlation peaked at 0.71, it reverted back to average levels in about six months, allowing the long-term correlation to stay low through the past decade. While diversification holds by the correlation metrics, the problem for many investors is that the risk reduction from the low correlation is no longer enough to overcome the return loss to improve the Sharpe Ratio in a portfolio of stocks and bonds. From January 2006 to December 2015, the Sharpe Ratio of a 60/40 stock/bond mix was 0.46 with an annualized return of 4.3% and annualized risk of 9.2%. By replacing 10% of stocks with commodities, the risk was reduced to 9.0%, but the Sharpe Ratio also fell to 0.45 from the return that dropped to 4.2%. It has been challenging for commodities to maintain their status as a good diversifier with this underperformance.

3. Then how are market participants getting their inflation protection without diminishing their risk-adjusted return profile in their portfolios?

The good news is that with slight modifications to the [S&P GSCI](#), market participants can not only maintain diversification, but they can improve their Sharpe ratios. The evolution of commodity indices was probably accelerated in the past decade from the unfavorable market situation that was dominated by contango, a losing condition resulting from large excess inventories. Energy was most affected by the contango from the glut of expensive-to-store inventory that made it the worst-performing sector over the past 10 years. So, one immediate remedy was to reduce the energy weight from the roughly 70% that resulted from the world production weighting scheme. The [Dow Jones Commodity Index](#) (DJCI), which is equally weighted, has just one-third of its weight in energy, and that improved the Sharpe ratio of the aforementioned mix to 0.54 by reducing the annualized risk to 8.8% and improving the annualized return to 4.9%.

Also, in response to the contango, many advanced rolling strategies have been developed that use contracts with later expirations to minimize the negative impact of contango, improve index performance, and reduce risk. For example, substituting 10% of stocks with the [S&P GSCI Dynamic Roll](#), which selects optimal contracts every month, can illustrate how the Sharpe ratio of 0.46 from the 60/40 stock/bond mix improved to 0.56. It also reduced the annualized risk to 8.7% and improved the annualized return to 5.0%. Not only have modified weights and rolls been developed to address the abysmal long-only commodity index performance, but the modifications have also been combined intelligently to maximize the long-only index performance. More commonly known as smart beta, the [Dow Jones RAFI Commodity Index](#) applies all the modifications, designed to give market participants the most potent payoff in the universe of long-only indices. In the last decade, market participants would have significantly increased their Sharpe ratio from 0.46 to 0.67 by moving from the 60/40 stock/bond mix to the 50/40/10 stock/bond/smart beta commodity mix. Again, not only did the annualized risk drop notably from 9.2% to 7.7%, but the annualized return improved from 4.3% to 5.2%.

4. With all the complex combinations of modified weights and rolls, is commodity indexing still considered passive?

Not all commodity indices today use well-known passive characteristics like long-only, nearby most liquid contracts that are world-production weighted across several commodities. However, commodity indices can use more unique rules and still be considered passive if they deliver the five components of return from commodities as an asset class: the Treasury bill rate, risk premium, rebalancing, convenience yield, and expectational variance. Indices that construct and calculate

with a passive and specified method, consider only exchange-traded futures contracts on physical commodities, assume only long positions, and collateralize each position fully may deliver all the components of commodity returns and be considered passive.

5. Have market participants accepted the passive enhancements in the face of the challenging economic environment for commodities?

Many market participants making long-term strategic commodity allocations appreciate the new developments in passive indices that can provide inflation protection and diversification in more difficult times. However, a growing number of market participants are seeing a different kind of opportunity from these indices that is perhaps more tactical in this volatile time. They may be designing their own alpha exposures from beta by using long and short forward indices with different expiration dates to create calendar spreads. Other market participants are using single-commodity indices that include 100% of only one commodity, like crude oil or gold, to express their views, and they may even double down by using a leveraged version or bet against the commodity with an inverse index. Still others are using well-diversified long/short indices to capture momentum, possibly reduce their risk to beta exposure, and get more diversification.

6. What do you see as the new frontier for commodity index-based investing in the next decade?

It depends on the environment we are heading into. If growth and inflation rates rise, that could be quite favorable for traditionally passive commodities. Still, the darkness of the past decade in commodities looms, so market participants may be wary of the risk that commodities might not protect them in crisis times. For the market participants in this camp, risk management is the key. They are more likely to use the long/short strategies, or to reduce risk even further, they may choose some of the latest instruments that are multi asset. For example, commodity futures have been combined in risk-weighted, strategic futures indices with other futures spanning equities, currencies, fixed income, and short-term interest rates that go long or short based on momentum rules to provide diversification. On the inflation front, commodity futures have been mixed with global stocks and bonds of natural resources, properties, infrastructure, and inflation-linked bonds to provide more comprehensive inflation protection and also greater diversification. These multi-asset strategies are on the cutting edge of asset allocation for the risk management required in the aftermath of the crisis times of the last decade.

Source: S&P Dow Jones Indices LLC.

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