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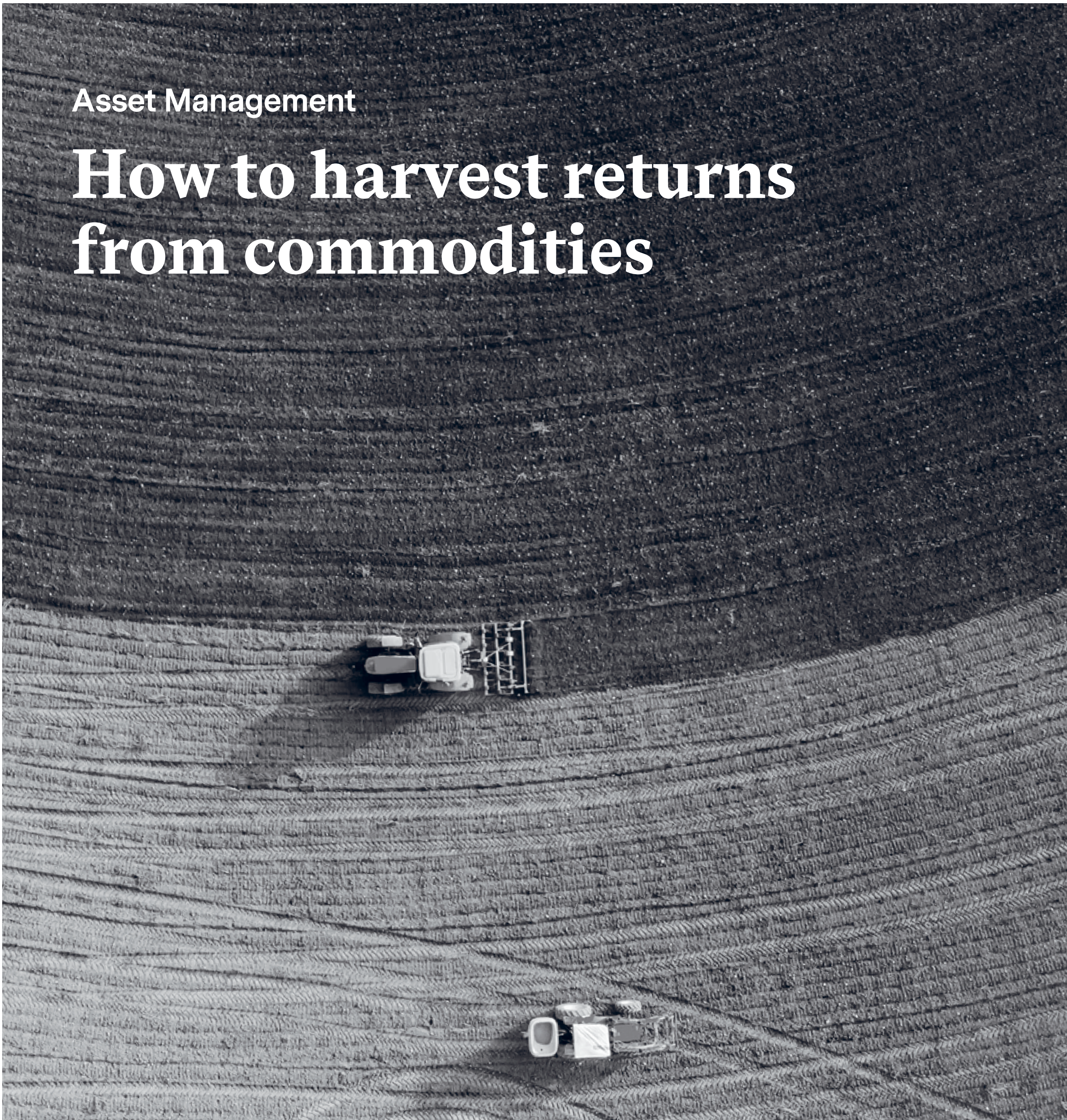
Asset Management

How to harvest returns from commodities



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Kerstin Hottner joined Vontobel Asset Management in November 2014 as Portfolio Manager for customized institutional mandates and mutual funds in the field of multi-asset and commodities. Since May 2016, she has managed all of Vontobel's quantitative commodity funds and strategies.

Kerstin Hottner holds an MSc in Economics from Ludwig Maximilian University in Munich and is a CFA charterholder.

How to harvest returns from commodities

Commodities play an essential role in our everyday lives. Whether we eat a slice of toast for breakfast, take the bus to work, or drink a coffee with colleagues, we are users of commodities. The commodities value chain employs millions of people. Switzerland, a country without significant natural resources, acts as a global trading hub for physical commodities, which contributed 4.8% of GDP.[1]

Contrary to some investors, we believe that demand for commodities will remain strong. Even if Chinese and industrialized economies slow down, emerging markets will continue investing to reduce their infrastructure deficit, while their growing population will continue to live in expanding cities. This will drive growth in commodities consumption.

This paper makes the case for incorporating commodities investments into a broader multi asset portfolio by answering the three questions that clients ask us every week:

1. **Why commodities?**
   Because commodities as an asset class can deliver a unique combination of diversification, inflation hedging, and income.

2. **Is there value?**
   Yes, commodities are one of the few undervalued areas of the market today, making them extremely attractive compared with equities and bonds.

3. **How should I invest?**
   By adopting an active approach, investors have the opportunity to extract returns without taking excessive risks, and outperform passive, index-following strategies.

We also address the misconception that investing in commodities has a speculative character.

Kerstin Hottner, CFA
Portfolio Manager

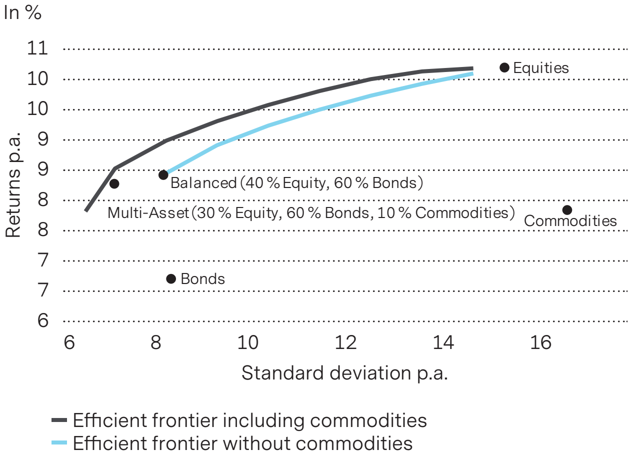
[1] Source: Swiss state secretariat for economic affairs, 2019

Part 1: Why commodities?

Diversification benefits
Commodities are highly complementary to a traditional equity and bond portfolio as they have a low correlation with equities (0.11[2]) and even negative correlation with bonds (– 0.14[2]). This is because commodity prices, in general, lag the economic cycle and each individual commodity is influenced by different supply and demand factors such as colder weather increasing demand for natural gas, or stricter emission standards in the car industry increasing the demand for palladium.

Chart 1 shows that adding commodities to a typical balanced portfolio shifts the efficient frontier, enabling the investor to significantly improve the risk / return profile of their portfolio.

Chart 1: Adding commodities to a balanced portfolio improves the risk / return profile



Source: Vontobel, Bloomberg. Commodity returns: BCOMTR index, equity returns: S&P500 total return in USD, bond returns: Bloomberg Barclays US Aggregate total return USD, 01.01.1960 – 30.08.2019. Past performance is not a guide to current or future performance.

Strong performance when equities suffer
Commodities tend to be an attractive investment when other markets are challenging (see table 1).

During the global financial crisis, investors in commodities experienced losses because the recessionary environment that developed during 2008 reduced demand for commodities, which were already highly valued. However, investors holding commodities between 2000 and 2008 had already reaped the benefits of the asset class, thanks to gains of 15 % per annum over the period, ten times more than the MSCI World TR index during the same period.

Table 1: Returns in market stress

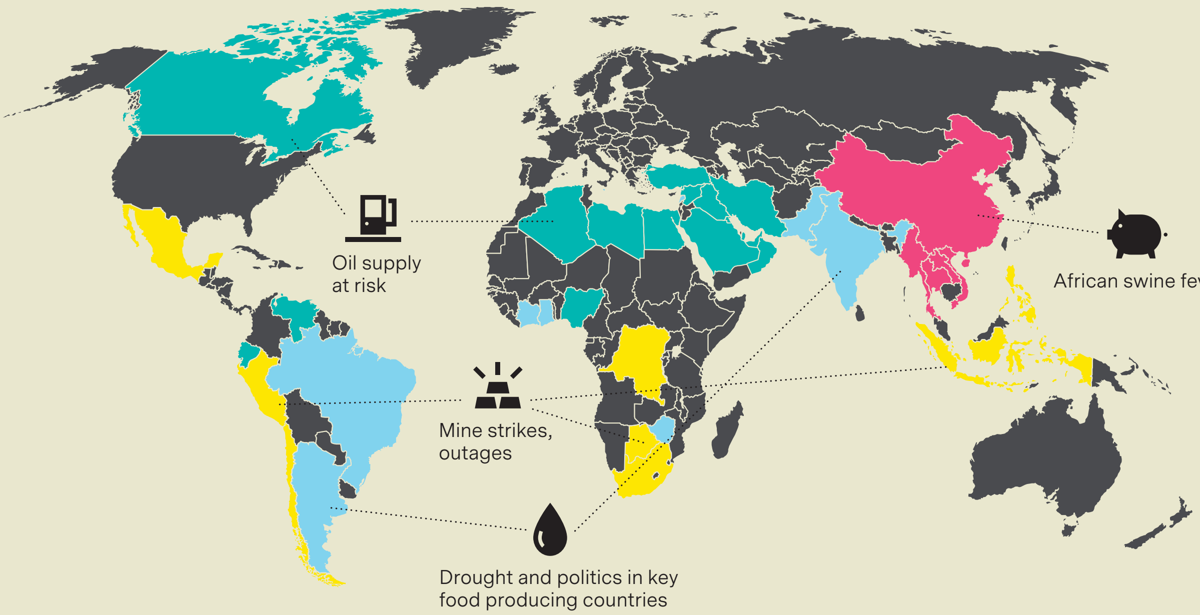
CRISIS	TIME	COMMO-DITIES	EQUITIES
70s oil crisis	1973 – 1974	230 %	– 37 %
1987 Crash	09.1987 – 11.1987	5 %	– 20 %
Early 1990s recession	1990	19 %	– 17 %
Dot-com bubble burst	2000 – 2002	34 %	– 42 %
Global Financial Crisis	10.2007 – 03.2009	– 39 %	– 51 %

Source: Vontobel, Bloomberg. Commodity returns: BCOMTR index, equity returns: MSCI World total return index in USD.

[2] Source: Vontobel, Bloomberg. Commodities: Bloomberg Commodity Index total teturn BCOMTR, equities: S&P500 total return in USD, bonds: Bloomberg Barclays US Aggregate total teturn USD. Monthly returns, 1 year rolling, 1.1.1960 – 30.08.2019.

Commodities futures as a hedge for geopolitics, risks and recessions
Many equity-investors despair when they see popular unrest, armed conflict, or even adverse weather events. However, investors in commodities may benefit as the resulting supply shocks (see chart 2) often lead to price increases, helping to offset declines in other areas of their portfolios. Oil futures, in particular, offer a powerful hedging effect against trouble in the world's most volatile regions. Historically, oil prices spiked before many major recessions since the 1970s.[3]

Chart 2: Potential sources of commodity supply shocks



Source: Vontobel.

[3] As well as the well-known 1973s oil crisis when OPEC stopped exports, examples include the energy crisis recession from January 1980 to July 1980, the Iran / energy crisis recession July 1981 – November 1982, the Gulf war recession July 1990 – March 1991.

Commodities as an inflation hedge

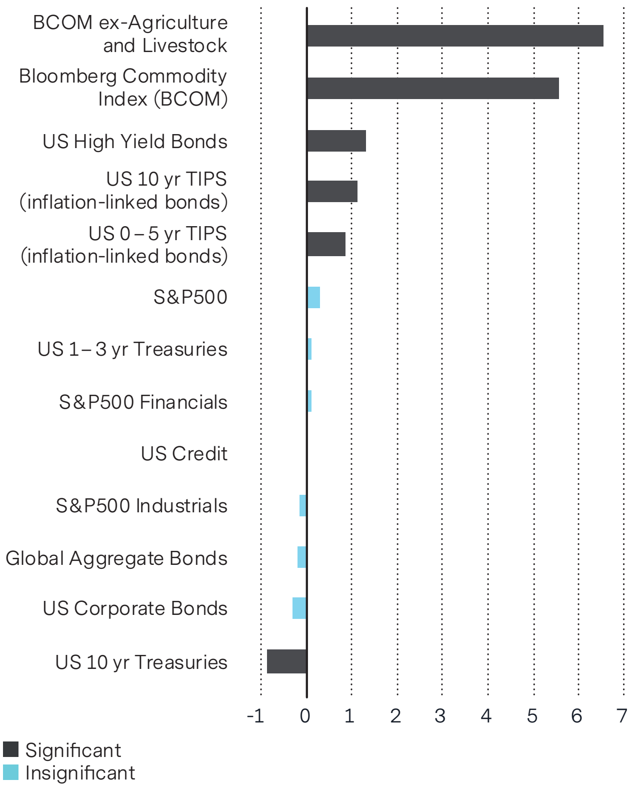
Currently no economist worth his salt is predicting a rapid acceleration of inflation in the US or the European Union within the next three years, but inflation should remain on your agenda. Purchasing power erodes even when inflation is low, and anyone holding US dollars for the last ten years saw their purchasing power shrink by 19 %[4] in real terms. Moreover, countries like the UK have seen significant pick-ups in their inflation expectations.[5] For pension investors, it is particularly important to maintain purchasing power as all payments from pensions come in the future. The past also shows that the future is unpredictable, so many of our portfolio managers regularly plan for scenarios where inflation returns, and stress test their portfolios against these scenarios. We recommend you do the same.

Commodities are almost unique in offering an effective hedge against inflation, but it is not well known that different commodities sectors have different hedging characteristics. Chart 3 illustrates the betas of the regression of US-inflation on various asset returns (a higher beta estimate indicates a better inflation hedge). It shows that a small investment into a commodities index excluding agriculture and livestock (i.e. only including metals and energy) is the most effective instrument in protecting a whole portfolio against inflation. For instance, a five-times larger allocation to TIPS (inflation-linked bonds) would be needed to hedge a given portfolio against inflation.

Undervalued commodities look set for the next bull cycle

The fixed income and equity markets have both experienced unprecedented gains over the past few years, accelerating ahead of commodities as free money from central banks, and a search for yield drove up prices. In contrast, commodities faced headwinds as they are unaffected by central bank liquidity flowing elsewhere and emerging market demand remaining depressed. Now many investors are concerned that there is too much money looking for returns in bond and equity markets, which means commodities are at the bottom of their valuation cycle and may provide excellent value, as shown in chart 4.

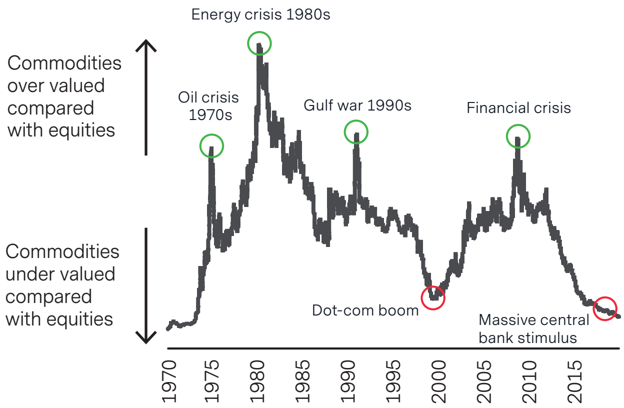
Chart 3: Commodities offer the best inflation hedge



Source: Vontobel, Bloomberg. Quarter on quarter regression betas, significance level 5 %, regression is defined as: change in asset return = α+β * change in US-inflation + ε. Higher estimates indicate a better hedge. 01.1991 – 06.2019. Past performance is not a reliable indicator of current or future performance.

Chart 4: Commodities are at the bottom of their valuation cycle

Ratio of commodity to stock market price



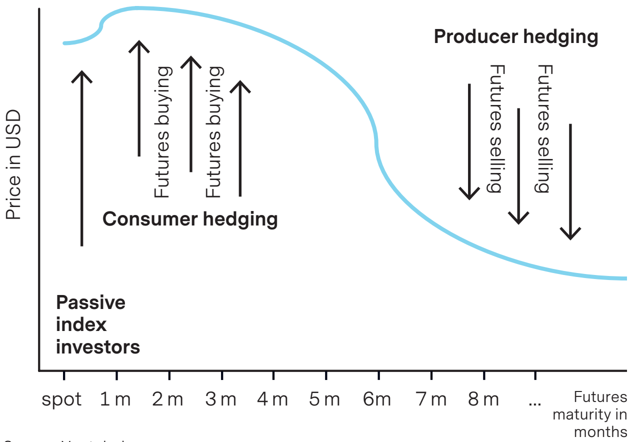
Source: Vontobel, Bloomberg. Calculated as BCOMTR index divided by S&P500 index over period 02.01.1970 – 30.08.2019. Past performance is not a reliable indicator of current or future performance.

[4] Source: Vontobel Asset Management; ten years prior to 2019 in USD.
[5] For example, as measured by the GBP inflation five-year swap rate, five-year forward.

Part 2: Harvesting returns from commodities

The price curve: commodity investors as liquidity providers
Trading commodities is an old profession, pre-dating trading of stocks and bonds. Initially, trading focused on buying and selling physical commodities, such as bushels of corn, but through the 1900s developed to incorporate standardized futures. In this respect, commodities futures appeared 100 years before equities futures because commodity producers and consumers needed to hedge their revenues and costs. This rapidly enabled liquid markets with fast and efficient price discovery. Today, almost all trading takes place on electronic futures markets, such as the Chicago Board of Trade (CBOT) for agricultural goods.

Chart 5: Different hedging needs may lead to mismatch on futures curve



Source: Vontobel.

Real producers and consumers still dominate commodity markets by using future contracts to transfer undesired price volatility to those who are willing to take over the risk.

For example, a US oil refinery can guarantee the prices they will receive for their oil production to enable long-term investments. Meanwhile, an airline can hedge the price of kerosene. The balance of producer and consumer hedging activity then determines the shape of the price curve. If for example, producers decide to hedge for longer maturities than consumers, this can give the futures curve a downward tilt like shown in chart 5.

Commodity investors play an important role between producers and consumers. They fill the gaps between market participants and provide liquidity, leading to lower volatility levels and faster price discovery. Thus, active investors can help to stabilize the inherent imbalance between producer and consumer and benefit from inefficiencies. Passive traditional index investors (e.g. Bloomberg Commodity Index), in contrast, invest always close to the spot price, by rolling into the nearest future.

What you need to know about backwardation and contango

While index investors in traditional indices such as the Bloomberg Commodities Index (BCOM) or S&P Goldman Sachs Commodity Index (GSCI) buy and sell commodities at a price close to the spot price only, active investors can be more selective in choosing where to invest along the curve.

When the shorter-dated futures price is higher than a longer-dated futures price, the market is said to be “in backwardation”. Backwardation typically occurs when there are more producers than consumers active in the market, fearing falling prices. Then, long-only investors can buy longer-dated future contracts to “roll” along the curve to a higher price with time, to make a gain. By investing where the curve has maximum negative gradient, investors maximize their roll returns.

In contrast, if consumers expect rising prices, they will hedge by buying futures, giving the right to consume tomorrow’s production at today’s future prices. This changes the consumer-producer relationship and can shift the curve into “contango”, where future prices are higher than today’s spot prices. In such markets, roll return is negative for long-only investors. Chart 6 summarizes these two market conditions and results for long-only investors.

Three sources of returns in commodities

The discussion above shows that investing in commodities is not the same as investing in equities, where market exposure is equal to the invested amount and returns are simply down to changes in price and dividends. Commodities investments usually involves futures contracts, which enable investors to gain a large exposure in return for a small investment, and then invest their remaining cash in a “safe” asset class as collateral. This enables commodities to deliver three sources of returns (see chart 7):

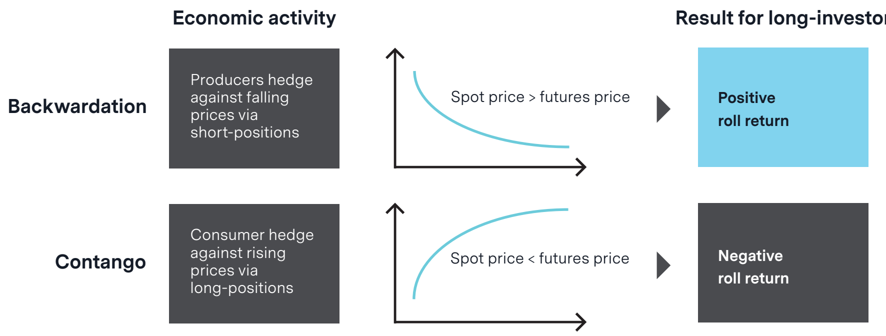
Chart 7: Three sources of commodity futures returns

Spot Return	Roll Return	Collateral Return
Return due to changes in commodity spot prices	Return from rolling along the price curve	Return from safe asset class

Source: Vontobel.

Typically, collateral is invested in high-quality bonds. For larger investors, a tailored collateral investment strategy is possible. For example, focusing on bonds that meet ESG criteria, or longer duration bonds to increase returns.

Chart 6: Shape of the futures curve drives roll returns



Source: Vontobel.

Part 3: How should I invest?

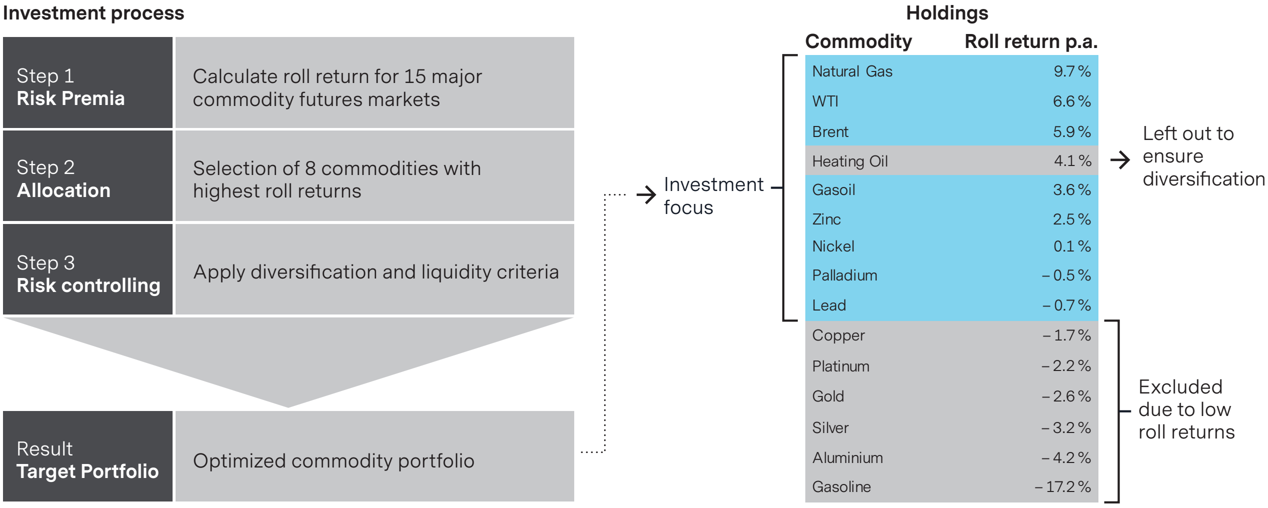
How we meet the implementation challenge
Our investment team aims to capture all three sources of commodity returns. We use a "man and machine" approach, which combines analysis of market supply and demand changes in order to identify mispricings to deliver spot returns, with a systematic approach to harvest risk premia from roll returns. We invest collateral in short-term, liquid fixed income to minimize risks.

One of our successful machine approaches is based on academic research showing that it is possible to systematically harvest returns by investing in commodities that offer the highest roll returns from a broad universe within the energy and metals sectors, then applying diversification and liquidity criteria.

In this way, our strategy can consistently achieve higher roll returns than its benchmark. Since its inception in May 2014 until the end of October 2019, our CYD Diversified Commodities ex Agriculture and Livestock Total Return composite had 3.3 % per annum higher roll returns than its benchmark the Bloomberg Commodity exAL Total Return index. As a result, our strategy outperformed its benchmark by 5.4 % per annum (see page 12, Table 2).

Whilst the machine approach predominantly optimizes for roll returns, the "man approach" comes into play in analyzing for abrupt shifts in supply and or demand. Think about changes in OPEC production quotas, export bans for agriculture goods, shifts in planting intentions for grains: these regime shifts all are hard to model in a purely systematic way and are therefore analyzed and traded from a fundamental discretionary perspective. The man approach is most effective when a broader commodity universe is applied, e.g. grains, softs and livestock commodities in addition to energy and metals.

Chart 8: Vontobel machine strategy: Investment process and portfolio construction



Source: Vontobel. Positions of CYD Diversified Commodities exAL strategy in September 2019.

Conclusion

In our view, commodities are an asset class that should be in every institutional investor's portfolio. Following the continuing equity and bond rallies, they are one of the few areas of the market where there is value. We believe they represent an excellent option for anyone worried about when the current investment cycle will end. Investments in the asset class provide liquidity and enable hedging as well as price discovery between producers and consumers.

Investors need to carefully choose an investment strategy able to profit from commodities' characteristics. By employing an active manager, investors can benefit from commodities income generation, diversification, and inflation hedging properties, while achieving attractive returns from both their commodity exposure and collateral investments.

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Performance

Table 2: Performance information (USD)
Vescore – Commodities – CYD – Diversified exAL

	GROSS PERFORMANCE	NET PERFORMANCE	BENCHMARK PERFORMANCE
31.10.2019 – 01.11.2018	5.6%	5.0%	–1.6%
31.10.2018 – 01.11.2017	4.5%	3.9%	3.0%
31.10.2017 – 01.11.2016	17.9%	17.2%	8.7%
31.10.2016 – 01.11.2015	0.7%	0.1%	–4.4%
31.10.2015 – 01.11.2014	–27.9%	–28.4%	–31.3%
MTD	1.6%	1.6%	2.2%
YTD	14.2%	13.7%	8.7%
2018	–7.5%	–8.0%	–11.2%
1 year	5.6%	5.0%	–1.6%
3 years p.a.	9.2%	8.5%	3.3%
5 years p.a.	–1.2%	–1.7%	–6.3%
Since Inception p.a.	–2.5%	–3.2%	–7.9%
Excess return since Inception p.a.	5.4%	4.7%	

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Composite name: Vescore – Commodities – CYD – Diversified exAL

Composite description: The composite includes all funds and segregated accounts of the investment strategy CYD Diversified exAL that aim at managing the risk premium in commodity futures markets, excluding agriculture and livestock, through a roll yield-optimized investment strategy.

Composite benchmark: The composite benchmark is a capitalization-weighted and dynamic aggregation of all accounts associated with the composite (“Asset Weighted Aggregate Composite Benchmark”), weighted by the market value of the portfolios assigned to the composite at the beginning of the month. Indices and weights used in the benchmark may vary.

Composite currency: USD
Composite inception date: 01.05.2014

Past performance is not a reliable indicator of current or future performance. The return may go down as well as up due to changes in exchange rates.

Source: Vontobel, as of November 2019.

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