By Andy Pfaff

INVESTMENT

Diversifying a portfolio through commodities

Managing a commodity holding in your portfolio is a specialist endeavour requiring skill. It has been done for centuries.

People have traded commodities for millennia, long before the advent of formal financial exchanges. Amsterdam (notorious for the tulip mania) was one of the earliest formal commodities exchanges in the 16th century. Osaka, in Japan, was the first to trade commodity futures (rice) in the 17th century.

A hundred years later, formal commodity futures exchanges began trading in the US (agricultural contracts on the US Chicago Board of Trade in 1848) and in England (metals on the London Metals Exchange in 1877).

Commodities have been easily tradeable since the 1970s through a broad range of commodity futures. Since 2000, listed commodity derivatives such as exchange-traded funds (ETFs), exchange-traded notes (ETNs) and exchange-traded commodities (ETCs) have made the purchase and sale of individual commodities more easily accessible to all investors.

The driving rationale for investing in commodities is that it may be considered as a distinct "asset class" that has a unique risk premium which is not replicable by combining other asset classes. It has three attractive investment characteristics: it offers protection against inflation, diversification from other traditional asset classes, and finally, as the drivers of returns of individual commodities are fundamentally different it means that there is usually something that is "working" in this sector.

As commodities are typically inputs into the production of most goods, some of the changes in the inflation rate can be explained by the changes in commodity prices. The oil price shock of the 1970s was the most extreme example of this effect. The fundamental nature of the relationship between the price of inputs and the price of outputs makes this positive relationship between the two a reliable one over time (although there will be some variability in terms of the lagged effects of cost-price increases filtering through to consumer prices changes). This positive relationship between commodities and inflation in South Africa is clearly visible in the comparisons of rolling 12-month returns **(see table 1)**.

Diversification is an important element of portfolio risk management. The greater the range of uncorrelated assets with positive returns included in a portfolio, the better the overall risk-adjusted performance. Commodities have excellent low, or even negative, correlations with other traditional asset classes. In addition, the differing natures of their underlying return drivers should provide investors with confidence that these correlations will remain low or negative into the future **(see table 2)**.

Sandra Gordon, a consulting economist, said: "Agricultural commodity prices are driven by the weather, energy prices by politics and metal prices by economics." As summarised in the quote, there are significantly different drivers of returns in the broad commodity sectors of agriculture, energy and metals, which means that something in this asset class is usually increasing in value.

TABLE 1: ROLLING 12-MONTH RETURNS OF COMMODITIES RELATIVE TO SA INFLATIONARY PERIODS

Period	1972 – 2021	2000 – 2021
Periods of rising inflation	20.3%	13.7%
Periods of falling inflation	2.8%	-5.6%

SOURCE: Bloomberg Commodity Index in rand and SA CPI

TABLE 2: CORRELATION OF SA ASSET CLASSES WITH THE BLOOMBERG COMMODITY INDEX (BCOM) 2000-2021

	Top40	Resi20	Bonds	Property
BCOM	0.398	0.016	-0.377	-0.278

SOURCE: Bloomberg

Many investors' initial foray into commodities is through a passive exposure to either a single commodity or commodity-index ETF or ETN (which offers access to a diversified bundle of commodities). This is likely to lead to significant disappointment as indices for growth asset classes like equities are constructed in such a way that they have a Darwinian-type of upward drift over time, but commodity indices do not. Weaker performers in an equity index are down-weighted (and then ultimately removed) and conversely, the better performers are up-weighted. This leads to an upward bias in the index level. By comparison, commodity indices have constant weights over time. As all individual commodity prices are cyclical but at different times, investors cannot expect a consistently positive real return over time by buying and holding a diversified commodity index.

Investors thus need to actively manage their commodity portfolios to realise the potential returns on offer from this asset class. Their portfolios require a conditional exposure to individual commodities. It should only have exposure to the constituents of the commodity basket that are trending upwards, but not when the opposite is happening. To maximise the benefit of investing in commodities, the investment process must also take risk management and loss control actively into account – that is one that minimises the probability and quantum of capital loss when individual commodities go through a bear market. It is a risk-managed exposure to a diversified portfolio of commodities that will realise the benefits of inflation hedging, diversification and absolute returns for investors from this asset class.

Finally, it is worth bearing in mind that this should be regarded as a specialist investment area. The administrative, logistical, regulatory, and fundamental differences from investing in equities or bonds strongly suggest that investors should strategically determine an allocation to commodities in their portfolios, and then look to a commodity specialist for the tactical implementation and management of this allocation. ■

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