HOW TO INVEST IN COMMODITIES

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Commodity futures have been easily tradeable since the 1970's. These futures were designed for commercial use on a wholesale scale. Since 2000, listed commodity derivatives such as Exchange Traded Funds, Exchange Traded Notes & Exchange Traded Commodities have made the purchase & sale of individual commodities more easily accessible to all investors. However, these have been used more as a tool for the occasional dabble in commodities (speculation) by retail and institutional investors alike, rather than providing risk managed exposure to a diversified basket of commodities as an asset class. The risk managed exposure to a diversified basket of commodities is what a diversified portfolio requires.

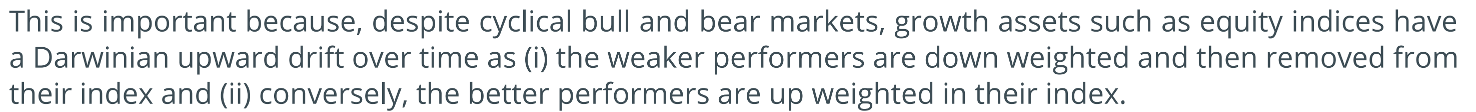
Beta, smart beta & non-beta in commodities

Many investors' initial foray into commodities is via beta (i.e. passive) exposure to the asset class. This is usually obtained via a single commodity or a commodity index ETF or ETN which obtains exposure to the underlying commodities via the purchase of futures.

Second generation 'smart beta' products have subsequently evolved from these simplistic early beta products, typically taking advantage of the shape of the futures forward curve. However, while these smart beta products have reduced simple beta's inefficiencies, they do not introduce exposure management nor loss control.

Third generation long-short strategies applied to commodities do not provide exposure to commodities as an asset class per se, as their return is derived from the strategy, not the asset class. These strategies therefore justify their inclusion in a portfolio on the basis of their return profile, not on the basis of their contribution to asset allocation per their correlation characteristics with commodities. In other words, they fit more comfortably in the hedge fund space than in the commodities space.

What is ideally required is a conditional correlation to commodities – something that runs with the constituents of the commodity basket, but which takes risk and loss control management actively into account i.e. minimises the size and frequency of capital losses.



This is important because, despite cyclical bull and bear markets, growth assets such as equity indices have a Darwinian upward drift over time as (i) the weaker performers are down weighted and then removed from their index and (ii) conversely, the better performers are up weighted in their index.

However, unlike equities, bonds and commodities are not growth assets. Commodity indices have no natural upward drift but are cyclical. This affects commodity index composition differently to equity indices e.g. just because crude oil fell by 95% from $147 in 2008 to $6 in 2020 does not mean that crude oil is removed from the commodity index. It remains the most-traded commodity globally and retained its significant weighting in global commodity indices. Conversely crude oil's rise of 940% from $6 to $68 in 2020 did not resulted in it being up weighted in the indices.

The buy-and-hold strategy which works well with growth assets such as equity indices, is therefore not an appropriate investment strategy for an index of cyclical assets such as commodities. It is more appropriate to invest in a strategy that actively selects a portfolio of, and risk manages exposure to, individual commodities.

Finally, despite the attraction of commodity investment, it is worth bearing in mind that this should be regarded as a specialist area. Commodity investment is typically separately regulated as an alternative asset class. The administrative, logistical, regulatory, and fundamental differences from investing in the traditional asset classes of bonds and equities strongly suggest that investors should strategically determine an allocation to commodities in their portfolio construction, and then contract the tactical management of this allocation to a commodity specialist.