Keeping Current With Commodities

A roundtable

Journal of Indexes *caught up with some of the best-known names in commodities to discuss investor concerns around the space.*

Jim Rogers, Commodities Investor

JOI: Given that leading commodities indexes like the S&P GSCI and DJ-UBS are so different, does beta really exist in the commodities market? If so, what is it?

Rogers: The major commodity indexes change dramatically every year, which is a reason that you cannot capture any beta; instead, you capture somebody's construction of an index. I don't know if you're aware of it, but the S&P GSCI changes every year. Over three or four years, it changes very dramatically. That's true of all those indexes. In that sense, there is no beta. You're capturing performance more than anything else. If something goes up a lot, then the S&P increases its weighting in the index. I don't even know what that captures, as a matter of fact. If there's any way to capture beta, you need a stable, consistent, transparent index that doesn't change a lot.

JOI: Are index-based investments (and investing overall) affecting commodity prices?

Rogers: Essentially, in my index or any index, you would buy the future this month, and you sell it again next month. Or you sell it when it matures. So that may have some slight temporary effect on the actual cost, but it doesn't have much long-term effect.

You can see that, for instance, with stock indexes—and this is a very important differentiation. The stock index or stock funds take delivery. If the SPY buys one million shares of IBM, they take them off the market, and they're not available. That obviously affects the price of IBM. But if the S&P GSCI buys oil, they don't take it off the market. They buy the future, and then they turn around and sell the future a month later. The oil is never taken off the market, in other words. They don't really have too much of an effect on the actual price of the underlying commodity, other than perhaps a temporary effect in the marketplace when they're buying or selling the futures. While the prices of futures and commodity prices themselves usually move in the same direction, there can be differences.

JOI: What is the near- and longer-term outlook for commodities?

Rogers: Commodities are essentially a bull market because of supply problems, and that bull market has a few more years to go, in my view. Previous bull markets in commodities have lasted 18-20 years or so, but we still have several years to go, because you don't have new supply coming in. Eventually, all bull markets in the past have ended because supply has come into line and outstripped consumption. Then the price goes down until supply and demand fall out of balance again.

So far, you don't see much new supply of any commodities coming on-stream. In fact, the supply situation for some commodities is extremely serious. For instance, in agriculture, the average age of farmers in America is 58. In Japan it's 66. And farmers around the world are dying out. We have serious, serious supply problems facing us in agriculture.

In other commodities, the same problems exist. With oil, unless something happens pretty quickly, the supply problems are going to get much worse. Eventually, all other bull markets have ended, but I don't see this one ending yet.

JOI: Should individual investors be able to purchase commodities futures exposure without a gating mechanism? Do we need stricter position limits?

Rogers: I don't think individual investors need some kind of a gatekeeper. It's much more likely that you're going to find fraud in the securities business than in the cotton market or the wheat market or oil market. I think the world is full of all kinds of problems with manipulation in stocks, like with Enron. There's very little of that *ever* in the history of the commodities markets.

JOI: Should investors invest strategically in different commodities markets, or take a whole-asset-class approach to commodities?

Rogers: Index investing has been proven repeatedly to be best for most investors because investing outperforms the averages year after year. You should buy the S&P 500 rather than try to pick stocks, unless you're awfully good at picking stocks.

Now, within the S&P 500, if you really know about three or four industries, yes, you could probably focus and buy an index just for those sectors of the economy, and likewise with commodities.

If you really know a lot about agriculture, why not concentrate on agriculture? If you know a lot about metals or energy, why not buy the metals index, or the energy index, instead of the overall index? But most people don't know enough to make those kinds of distinctions and should just invest in the overall index.

Victor Sperandeo, President and CEO, Alpha Financial Technologies

JOI: Are index-based investments (and investing overall) affecting commodity prices?

Sperandeo: Yes and no. It depends on *when.* Most indices exaggerate the movements up and down. Most people don't realize that an index affects prices on the way down just as much as it affects prices on its way up.

Investors reduce exposure if they believe we're going into a deflationary or disinflationary economic cycle, versus an inflationary one. So yes, the index will exaggerate the movements, but it doesn't determine the trends. Those are determined by fundamentals of supply and demand, and government policy that restricts or increases the supply and demand of certain commodities. It's a double-edged sword: Sometimes prices move up more than they would if indexes didn't exist, but prices would also move down less if the indexes didn't exist.

JOI: What is the near- and longer-term outlook for commodities?

Sperandeo: The near term, I believe, is going to be determined a great deal by the elections in the United States and in Europe. Since Hollande won in France, for example, it will translate into more inflation than if he hadn't have won, because Sarkozy is more prone to side with Germany. And they're a more austere country, having lived through the Weimar Republic.

In the U.S., it's a very low-growth, relatively low-inflation environment. When I say "relatively," I mean relative to the numbers you're seeing and used to in the past. However, if the Republicans win, they have a much more pro-growth, real-growth administration mindset. Therefore, they will look to lower taxes, restrict regulations. And the money that's in the system that the Fed has created, which is not being used—all of a sudden, there will be lines around the block to get that money. You will see an explosion of the use of the money and the velocity of money, therefore, which is trending down from the low 2 percent level to 1.6 percent turnover per year. You'll see that start to go up, and that will increase inflation.

In the near term, it really depends on who wins these elections. In the long term, there is no question inflation will be the theme of the day. By long term, I mean up to five years, because the approximate $110 trillion world debt will never be paid back. It cannot be paid back. It can only be inflated away, so long-term inflation is definitely coming.

JOI: Should individual investors be able to purchase commodities futures exposure without a gating mechanism? Do we need stricter position limits?

Sperandeo: Restricted position limits for individual traders to a certain percent of volume and open interest are logical. If somebody dominates the markets—and the case that comes to mind is the Hunt brothers and silver in the late '70s—the distortions upset the system. I would have reasonable limits per individual trader or per entity. However, index funds—like those based on the Dow Jones UBS, which buy a predetermined weighted basket—should be unlimited. They allow pension funds, for example, as well as individuals, to get exposure in trying to protect their money from the inflation risks of what the Fed and governments are doing.

The only reason to limit investment in indexes is not to prevent prices from going up and harming consumers. It's to cover up what governments are doing and trying to accomplish to get re-elected and promote their agendas.

Jodie Gunzberg, Director of Commodity Indices, S&P Indices

JOI: Given that leading commodities indexes like the S&P GSCI and DJ-UBS are so different, does beta really exist in the commodities market? If so, what is it?

Gunzberg: We believe beta does exist in the commodities space, and believe that the S&P GSCI is the purest representation of it. This is because the S&P GSCI is production weighted, which reflects the way that the world looks. For example, there's more oil than corn, and so the weight in the index is greater for oil. If an investor believes that the S&P 500(which is market capitalization weighted), is equity beta, then for commodities, the S&P GSCI (which is production weighted), is analogous.

JOI: Are index-based investments (and investing overall) affecting commodity prices?

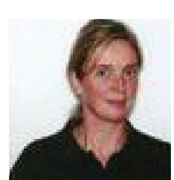
Gunzberg: Currently, we see no clear evidence of this. A recent article on Vox by Lutz Kilian was based on his paper, "The Role of Speculation in Oil Markets: What Have We Learned So Far?" He co-authored the paper with Bassam Fattouh and Lavan Mahadeva. The article neatly summarized the results of a number of studies on the topic and concluded that the literature has shown that the presence of index funds has, if anything, been associated with reduced price volatility. They found that the existing evidence is not supportive of an important role of speculation in driving the spot price of oil after 2003. Instead, there is strong evidence that the co-movement between spot and futures prices reflects common economic fundamentals, rather than the financialization of the oil futures markets.

JOI: Should investors invest strategically in different commodities markets, or take a whole-asset-class approach to commodities?

Gunzberg: In the spirit of what investors should do, it always goes back to their own objectives. For investors that have specific views, there are indices that they can invest with that are focused on sectors or represent long/short strategies. For those that would like to view it as an entire asset class, there's broad-based indices that are well diversified. Commodities definitely have a place in a well-diversified portfolio overall.

JOI: From an investment perspective, are first-generation commodities indexes good investments?

Gunzberg: It depends on the investment objective of the program. First-generation indices have historically provided diversification benefits and inflation protection, with equitylike risk and returns. Further—and maybe one of the most important characteristics in the first-generation indices—is that they have provided liquidity. For example, during the financial crisis, when liquidity dried up in many fixed-income and equity products, commodity futures remained highly liquid.



Shonda Warner, Partner, Chess Ag Full Harvest Partners

JOI: Given that leading commodities indexes like the S&P GSCI and DJ-UBS are so different, does beta really exist in the commodities market? If so, what is it?

Warner: The answer to that is yes, but *loosely* yes. Most commodities—some more than others—are sensitive to interest rates and economic progress. There is beta there.

When things are moving and growing, commodities tend to do well. And when they're not, commodities don't.

If you drill down, all these indexes are different because they have different allocations to energy. I wouldn't want to trade the beta, because it can move out of line, if you will, for short periods of time, due to specific incidents—like weather issues, or a BP oil spill. But if you sort of smooth those away, and look at it over long periods of time, I do believe that they can move in tandem.

JOI: Are index-based investments (and investing overall) affecting commodity prices?

Warner: I believe that they are. While it's true that futures are a zero-sum game, I think that when investors come in and out of the markets in a herdlike fashion, it does increase volatility significantly. That makes it more difficult for actual hedgers to do their jobs. Why were futures invented? Why were indices invented? To be able to hedge, not to be able to speculate. It makes it harder for hedgers to hedge when you've got increased volatility.

JOI: Should investors invest strategically in different commodities markets, or take a whole-asset-class approach to commodities?

Warner: I personally think that people need to use their brains. They need to read the paper. They need to assess an economic environment or economic situation, and make strategic investments. I think commodities, as a whole, is a bit of a too-pat, too-easy answer. But I also don't think that the more specific products that investors may purchase will necessarily benefit them best, ultimately, at the end of the day.

JOI: What is the near- and longer-term outlook for commodities?

Warner: I think the near term is a bit more dicey or iffy, and I'm a little cautious. I think we have a lot of systemic risk in the world, both on the interest rate and the growth sides of the picture. But I think for the medium-to-long term, it's fairly bullish.

JOI: From an investment perspective, are first-generation commodities indexes good investments?

Warner: No. I just think that people don't understand the roll exposure. The reason that Goldman Sachs originally weighted its commodities index so highly in energy is that energy had backwardation. So you were always selling high and buying low in the next month. That was free money—until that changed. Most commodities have forward carry, and that's pretty big head wind.

Greyson Colvin, Managing Partner, Colvin & Co.

JOI: Given that leading commodities indexes like the S&P GSCI and DJ-UBS are so different, does beta really exist in the commodities market? If so, what is it?

Colvin: From an academic standpoint, I can't really give you a definitive yes or no to that question. But from personal observations and experience, I would say that the beta today is the equity market. Correlations between asset classes seem to have risen substantially over the last decade. It really takes specific news or data in a commodity to break correlations. Today's markets seem to be so macro-driven that positive news about reductions in corn supplies can be more than offset by bearish news on the European sovereign debt crisis, or a trading mistake at J.P. Morgan.

Historical data shows the lack of correlation between commodities and other asset classes, but I don't think this data hold quite as true in today's marketplace.

JOI: Are index-based investments (and investing overall) affecting commodity prices?

Colvin: I would say so. With the lack of attractive investments available today, commodities are really one of the only bright spots. But with the stock market essentially flat over the last decade, and 10-year Treasurys below 2 percent, investors are certainly looking for alternatives. A decade ago, I knew very few individuals or institutions with exposures to commodities. Today the question is, How much? And which commodity?

With the inception of ETFs and indices, access to commodities has become very easy for investors. Flows to commodities have surged in recent years, which has been one of the drivers behind the rising commodity prices. And the fund flows have really increased daily volatility as well. A good example: I remember 10-15 years ago, when a 3 cent move in corn prices per day was a big deal. Now that happens every minute. Fund flows through the ETFs and indices and managed accounts are just adding capital to the sector. But I see that as positive.

JOI: What is the near- and longer-term outlook for commodities?

Colvin: We're very bullish on commodities for the long term, especially the grain complex. Emerging-market growth and the development of middle classes in countries such as China and India are creating demand for Western goods and diets.

There will certainly be volatility in the near and long term with commodities. But the long-term demand story becomes more compelling every day.

JOI: Should individual investors be able to purchase commodities futures exposure without a gating mechanism? Do we need stricter position limits?

Colvin: I think individual investor participation should be encouraged and that more participants will provide liquidity and increase competition. For most investors I speak with, their hurdle to establishing a futures account isn't their lack of knowledge, but rather the difficulty of opening and executing a futures account. The futures markets and their level of execution are well behind the equities market, as far as platform and accessibility for individuals. As far as position limits, I think that stricter position limits will only limit liquidity to the commodities markets and make it harder and costlier to hedge.

JOI: Should investors invest strategically in different commodities markets, or take a whole-asset-class approach to commodities?

Colvin: The answer is really driven by how much time and interest investors have to research commodities. For the investor looking for generic commodity exposure and diversification, I think a diversified index would best achieve those goals. For investors who are willing to take a more strategic approach and more time, they will certainly be able to outperform the index by identifying commodities that have better supply-and-demand stories over the next decade.

JOI: From an investment perspective, are first-generation commodities indexes good investments?

Colvin: Overall, I think first-generation commodity indexes are good investments, but there are more efficient structures for long-term buy-and-hold investors. Indexes taking positions across the curve minimize the effects of contango and will limit trading costs.

In some cases, the best opportunity is the front-month contract. There is a lot of criticism of first-generation commodity indexes, but the real issue here is educating investors about the different ways to gain commodity exposure that will allow them to choose the model that best fits their goals and needs. I'm a big believer of choice, but I also believe that investors need to be educated about the differences between first-generation, second-generation and third-generation indexes and be allowed to make the decision that fits their best investment goals and criteria.

The problem today is that the amount of people that understand the difference between the indexes is small. I fear that a lot of people are going into these first-generation indexes not really knowing the risks and costs of the investments.

Scott Irwin, Laurence J. Norton Chair of Agricultural Marketing, University of Illinois at Urbana-Champaign

JOI: Given that leading commodities indexes like the S&P GSCI and DJ-UBS are so different, does beta really exist in the commodities market? If so, what is it?

Irwin: I recently completed a paper investigating exactly that question. We looked both at logical arguments for sources of returns and commodities, and also at the actual record over a 50-year period for a broad portfolio of long-only commodity investments.

What we found is that the returns to individual futures markets over long periods of time are zero. There can be a positive return to a portfolio that is called a diversification return, but that depends crucially on the weighting schemes and, in essence, what are embedded trading strategies involving your assumptions for how you're going to rebalance your portfolio. As everyone knows, there's no natural value weighting to a commodity investment.

JOI: Are index-based investments (and investing overall) affecting commodity prices?

Irwin: I think the answer depends on what characteristic of commodity futures markets that you use. Most of the interest has focused on what I like to call the Masters hypothesis,[1] which is that the wave of long-only commodity investments since 2004, 2005 has at different times created a massive bubble in commodity futures markets.

I think it is now quite clear that there really isn't any compelling evidence that that happened on a large scale. We could never eliminate the possibility that some distortions might have happened over relatively short periods of time, but the Masters hypothesis has two key components: 1) that there was a bubble; and 2) that it was massive, causing, for example, crude oil to be overpriced by 40, 50 percent or more. There's no evidence that that's the case.

Then we can look at further characteristics of commodity markets, like volatility. The evidence is mixed on volatility, but there is some intriguing evidence that the rise of long-only commodity investment may have actually moderated price volatility in commodity futures markets. There's some logical support for this idea: If you increase participation, you increase the pool of capital in the markets, and as you increase the liquidity of the markets for hedgers, price fluctuations might be a little bit smaller.

It's hard to imagine changes in the participation in the commodity futures markets as large as have been associated with the rise of long-only commodity index funds and think it didn't have some kind of market impact.

JOI: What is the near- and longer-term outlook for commodities?

Irwin: I'll stick with the agricultural commodities, where I have more expertise. I do not believe that real agricultural commodity prices are entering a new era of rising real or inflation-adjusted commodity prices. People are arguing that demand from emerging economies like China and India has strained some production, infrastructure and so on, and that this will end the long and steady but slow reversion of real agricultural commodity prices. In essence, they are arguing that productivity will not keep up with demand.

I'm not on that side of the debate. I expect that we will resume our ever-downward march like we always have in the past after having gone through a major spike. We will really be reversing historical patterns if that trend does not resume.

JOI: Should individual investors be able to purchase commodities futures exposure without a gating mechanism? Do we need stricter position limits?

Irwin: [The question of gating mechanisms] is a tough one because you're then asking what kind of consumer-level protections are needed. Certainly, there's some minimum level of customer protection that should be afforded to those that don't really understand or have experience or knowledge of commodity investing. Particularly in light of how easy it is these days to access them through online brokerages and the ETF revolution.

I'm in favor of as much transparency as is possible without making market access so expensive that those kinds of investors are prohibited from investing. However, if that then means something like all financial innovation and access has to go through some kind of consumer protection czar, then no; that seems like that would be beyond the traditional protections that we have for retail investors.

I do not believe that the case can be made that stricter position limits are needed. Stricter limits would be needed if we could prove that groups of speculators, and in particular the index investors, were somehow harming discovery and the hedging function in futures markets. But there just isn't the evidence.

JOI: Should investors invest strategically in different commodities markets, or take a whole-asset-class approach to commodities?

Irwin: I believe if you're going to invest in commodities, you should recognize that it is fundamentally a zero-sum game. Therefore, you should seek out some prudent market timing, more active strategies. I think while they tend to be riskier, they historically have tended to have a higher chance of success.

Ashmead Pringle, President and Founder, GreenHaven LLC

JOI: Given that leading commodities indexes like the S&P GSCI and DJ-UBS are so different, does beta really exist in the commodities market? If so, what is it?

Pringle: Yes; beta exists in all the markets, by definition. Critical to measuring a given market's beta is choosing a metric to serve as the benchmark for performance. In order to reflect a given market's beta, a benchmark index must be diversified; independently constructed and maintained; reflective of changes in market composition; highly visible; and backed by a substantial history.

The major differences among the leading commodities indexes tracked by exchange-traded products are diversification across commodity groups and the independence of the index from the ETP fund manager.

JOI: What is the near- and longer-term outlook for commodities?

Pringle: Commodities tend to rise in times of global economic growth and during periods of inflation and/or dollar weakness. Overall, the broad commodities market is flat over the last four years. In the short term, three major uncertainties are weighing on prices: a possible slowdown in China's growth; a deeper recession in Europe; and geopolitical developments driving a spike in the oil price, which might depress the global economy. While the last would obviously be bullish for crude, higher oil prices are bearish for the global economy and for other commodities.

Longer term, the powerful trends that have been lifting commodity prices since 2000 are still in place: global population growth; growth in per capita global GDP; and significant expansion in the global middle class. The China story is an old one; however, it's still a strong and ongoing story that will take another 10 to 15 years to play out and will likely continue to have an impact on demand for commodities.

JOI: From an investment perspective, are first-generation commodities indexes good investments?

Pringle: The notion of second- and third-generation commodity indexes is misleading since it implies that there is an evolution toward better indexes. Instead, what we see is active strategies creeping into what have been purely passive index approaches. These strategies add a layer of discretionary trading by adding methodology that varies the commodities traded, their relative weightings, and the placement and movement of positions on the forward price curve.

There are four possible components of the return from tracking a broad index with commodity futures contracts: spot yield; roll yield; collateral yield; and rebalance yield.

If a second-generation index moves its positions further out on the futures curve in order to mitigate a negative roll yield, it is also exchanging the spot return for the return of a more distant month. There's no guarantee that the tradeoff will be optimal. Indeed, one could implement a profitable trading strategy if the return from holding and rolling a long position six months out always exceeded the return from holding and rolling the front month.

And if, for example, a third-generation index periodically changes the composition and weightings of its commodities holdings, the implication is that the strategy will outperform holding all the basket components at a constant weighting. Again, if this were the case, one would want to buy the third generation and short the first generation, and apply leverage to the strategy.

JOI: Should investors invest strategically in different commodities markets, or take a whole-asset-class approach to commodities?

Pringle: There are three main reasons to allocate to commodities: to diversify a portfolio; to hedge against inflation; and to hedge against a weak dollar. My view is that commodities should be a strategic allocation, not a tactical one, and one that should be held for the long haul. In that case, exposure to a broad basket of commodities across all commodity groups should work better than exposure to just one sector or one single commodity, because it should have lower volatility.

Endnote

[1]Michael Masters testified before the U.S. Senate Committee on Homeland Security & Governmental Affairs on May 20, 2008. He argued that institutional investors in commodities futures were part of the reason for the rise in food and energy prices. *Journal of Indexes* ran an excerpt of his testimony in its November/December 2008 issue.