# Properties that attract managers

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The worst reason to buy something is because it has gone up in price. Until, of course, that magical point is passed when the price has gone up for so long it is judged a mark of long-term performance.

Armed with such a reliable record, investment consultants and salesman can start to press investors on the latest addition to a balanced portfolio.

In the past decade, commodities experienced that transformation. "It's becoming a new asset class", says Wei Xiong of Princeton University. "Commodities are no longer a sleepy backwater composed of hedgers trading with specialised commercial traders."

From less than $10bn institutional assets under management in commodities in 2000, funds committed to the sector have risen to more than $400bn, according to Barclays Capital.

The twin lures of performance and diversification that excite any asset manager form much of the attraction.

Between its start date in 1969 and 2004, the Goldman Sachs Commodity Index (GSCI) produced a compound annual return of 12.2 per cent, against 11.2 per cent for the S&P 500, and did so with lower volatility, according to Claude Erb of the Trust Company of The West, and Campbell Harvey of Duke University.

Those benefits also provided the basis for a healthy sales effort by the investment management industry.

Barclays Capital, for instance, makes the case that active management, repeatedly shown to underperform blind indexing in stocks, might work in commodities.

"The data that might prove conclusively that things are different in [commodities] are somewhat sparse. However, there are some good reasons to believe that active management strategies are better suited to commodities", says Kevin Norrish, head of commodities research.

Others tout it as a magic bullet for underfunded pension schemes chasing returns.

"We certainly feel that commodities will provide the bang for buck that many schemes and institutions still require to meet their funding deficits", says Colin O'Shea, head of commodities at Hermes Fund Managers.

At the same time, commodities provide a way for fund managers to invest in the rapid development of emerging economies, particularly China. Urbanisation and the expanding appetites of new middle classes, the argument goes, will keep prices for scarce commodities rising for several years to come.

"You have to build in some of the other factors. The demand side of the equation is affected by GDP growth, while the supply side is more thematic. **Crude oil is a finite resource**; with agriculture, there are questions of land availability," says Mr O'Shea.

Yet the logic for investing in commodities is unusual. The main indices are based on futures. Buying actual bushels of corn or barrels of oil is an expensive business that requires expertise and costly storage facilities, and sacrifices liquidity – a seller must find a buyer for that specific item, rather than a generic financial contract for which there are many buyers.

And, as with precious metals, which have limited industrial use, buying the physical commodity is very simply a bet that someone will pay a higher price for it in the future. There are only costs, no cash flows to compensate the investor for the risk that generous buyers will not appear on the horizon.

Commodity futures produce no cash flows either, but an investor is, in theory, paid for taking on the risk of short-term fluctuations in commodity prices. Risk is transferred from producers and users to investors, who are rewarded for the service.

However, following that theory to its logical extension, an influx of capital should spread the risk further, and so damp returns.

Mr Erb and Mr Harvey note that trading in the GSCI only began in 1992, with the performance calculated from historic data. From 1969 to the launch, the index would have returned its theoretical investors 15.3 per cent annually, beating the 11.6 per cent return for the S&P 500.

In the 12 years that followed, real investors got just 7 per cent, significantly lagging stocks.

Correlation with other asset classes has also risen.

During the financial crisis, the GSCI, which showed almost no correlation with stocks before 2000, plunged as well.

Commodity managers argue that this was a special case, as correlation for all asset classes soared. But work by Mr Xiong at Princeton finds that correlation between commodities has surged since 2005.

Historically, prices for soya beans and crude oil were unrelated, with correlations moving in a range around zero between -0.1 and 0.2. Since 2004, however, as increasing numbers of financial investors discovered commodities, the correlation rose steadily from 0.1 to 0.6 in 2009.

China could, of course be the answer: demand from the country could push prices for several commodities up at the same time.

Yet Mr Xiong finds that commodities traded inside China do not show the same linkages as those forming part of the indices outside it.

Of course, a canny investment manager might be able to produce uncorrelated returns in commodities that justify the exposure. Mr Erb and Mr Harvey, writing in 2005, argued that tactical allocation is the way to do better than simple long exposure to a basket of commodities futures.

Yet in a 2008 paper, “Fooling some of the people all of the time: The inefficient performance and persistence of Commodity Trading Advisors”, academics from Rutgers and Yale found that, after fees, CTAs – a subset of hedge funds – fared little better in aggregate than an investment in US Treasuries between 1994 and 2007.

The paper also found that, even before fees, CTAs display no alpha when compared with simple easy-to-replicate futures strategies such as following trends.

“CTAs appear to persist as an asset class despite their poor performance, because they face no market discipline based on credible information.

“Our evidence suggests that investors’ experience of poor performance is not common knowledge”, the paper concludes.