FINANCIAL TIMES

September 18, 2015 10:04 am

Commodity index investing debate reignites

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A decade on, two resource index investing reports are revisited

As the recovery has gained pace, commodities have tumbled while stocks roar ahead

As investments go, commodities have proven such a dog they almost seem not worth arguing about. Once-popular theories — that central bank money printing would inflate hard assets, or that China's appetite for commodities was bottomless — have dissipated like natural gas from a poorly sealed well.

The Bloomberg Commodity Index, a basket of 22 futures contracts, is scraping the lowest levels in more than a decade. The benchmark chalked up a total return of minus 42 per cent over the past decade, even as the world burnt a tenth more oil and digested two-fifths more corn.

So it is intriguing that two sets of researchers have just reignited a lively debate about commodities that began 10 years ago.

In 2005, academics Gary Gorton and K Geert Rouwenhorst issued a paper titled “Facts and Fantasies about Commodity Futures”. The same year Claude B Erb and Campbell R Harvey released “The Tactical and Strategic Value of Commodity Futures”. Both papers later appeared together in Financial Analysts Journal.

The first paper backed commodities index investing, then a niche area. It concluded that investors would get paid a “risk premium” by producers, such as farmers or oil companies, for providing insurance against future falls in commodity prices. Over the long haul, the academics’ estimated commodity index generated returns similar to US stocks.

The second paper was sceptical. It said that the main source of commodity investors’ returns came from the term structure of futures prices and this required a lot of skill to predict. There was no reason to expect an equity-like return from parking money in a commodity index.

It seems clear who had more influence. The Gorton and Rouwenhorst paper has been downloaded more than 25,000 times from SSRN, a scholarly research warehouse — three times more than Erb and Harvey. Investors have pumped billions of dollars into commodities since 2005.

Now after the bust, both teams of researchers have taken the rare step of revisiting their work. Professors Gorton and Rouwenhorst, both at Yale University, found their earlier conclusions “largely hold up” in a paper the FT described in June.

Erb and Harvey have issued their own “10 years later” paper prompted by what the latter calls the “rather surprising conclusion” of his counterparts at Yale.

“Most commodity investors were index investors and they had a horrible time,” says Professor Harvey.

Harvey, of Duke University, and Mr Erb, a former portfolio manager for Trust Company of the West, wrote of a misperception that “commodity futures are a play on commodity prices”. Even if the world population gets bigger and richer, commodities will not necessarily go higher. Technology — for example, “walking rigs” that make shale oil cheaper to drill — can depress prices for good.

Instead, they contend the most important source of returns in commodities is “income return”: the interest paid on collateral held against futures positions (currently almost zero) plus the money gained or lost when investors roll expiring futures contracts into new ones, as they must.

When the structure of commodity futures prices slopes downward, investors can earn nice income returns by selling expiring futures high and buying later-dated ones low. From 1970 to 2004, the annual income return from the S&P GSCI commodity index was 8.7 per cent, their paper reveals.

But for the past 10 years the income return has been minus 8 per cent as more futures prices sloped upwards. For example, Brent crude for November 2015 delivery cost $49 a barrel this week, while November 2016 Brent was $56. If you sell the 2015 contract and buy the 2016, you are paying more for each barrel.

Disturbingly, Mr Erb believes investors’ herding into commodities after 2005 partly caused the flip. “The reason that the income returns are so low in commodity futures investment is there’s too much capital chasing too small an opportunity,” he says.

There are other possible explanations for the changing structure of futures prices, among them the need to store plentiful supplies of oil, grain and metal. We also went through a financial crisis, as Gorton and Rouwenhorst’s new paper points out.

But if Mr Erb is correct, passive investors in commodities are their own worst enemy.

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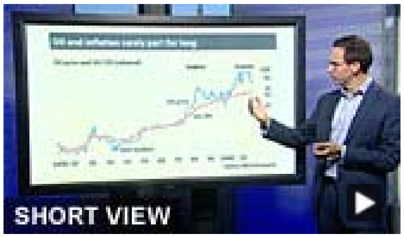

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