COMMODITIES

Commodities in Your Portfolio? It’s All Hogwash Says Wall Street Dissenter

Campbell Harvey, a finance professor at Duke, is looking to upend conventional investing wisdom again.

Campbell Harvey, a Duke University finance professor, is researching a new paper on the foolhardiness of commodities investing as traders are again pouring money into these materials and resources. PHOTO: NATALIA WEEDY

By Ira Iosebashvili and Timothy Puko
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Campbell Harvey looks at Wall Street and sees a lot of ideas that are easy to sell, but hard to trust.

The Duke University finance professor is making a career out of challenging research backing the products firms pitch to investors. A lot of it, he says, just isn’t sound.

His studies have shown that more than half of all research pumped out by both academics and analysts is, in his words, “likely false.” Mine enough data, and you can find a result that backs up your idea, Mr. Harvey says.
While his contrarian ideas have put him at odds with many on Wall Street, Mr. Harvey’s work has shown up in research and strategies employed by Goldman Sachs Group, GMO LLC’s Jeremy Grantham and the Federal Reserve Bank of New York, among others.

His next project is aimed at one of his favorite targets: Commodities. When a famous academic paper helped bring the asset class into the mainstream in the early 2000s, Mr. Harvey warned commodities were too opaque and volatile to hold for the long term, and were unlikely to provide the stocklike returns that some consultants suggested. Prices for oil, metals and other raw materials crashed twice in the following decade, vindicating his position.

With the asset class coming back into vogue, Mr. Harvey is preparing a paper challenging popular strategies in commodities investing.

“People still believe they should be buying commodity futures,” Mr. Harvey said. “I feel the obligation to correct that misperception.”

He may have some convincing to do. With signs of global economic growth picking up, commodities have bounced back after bottoming in early 2016. The S&P GSCI Index, which tracks commodity futures, rose 28% last year. That was the index’s biggest gain since 2009, though it is down a bit this year with falling oil prices.

The recent rally has reignited investor interest in materials and resources. Commodity assets under management are up 41% from a year ago, rising to $408 billion as of the end of February, according to Citigroup Inc.

“Commodities, over long cycles, have provided diversification that reduces volatility,” said Omar Aguilar, chief investment officer at Charles Schwab Investment Management.

Mr. Harvey, 58 years old, was born in Toronto. Growing up, he often discussed stock-picking and finance with his grandfather, a businessman and part-owner of the Toronto Star newspaper. Mr. Harvey worked at the newspaper as a copy boy, and now sits on its board of directors.

As an undergraduate, Mr. Harvey initially focused on classical literature, but reconsidered after receiving a C+ for his first effort, a paper on Geoffrey Chaucer’s “The Canterbury Tales.” He completed his Ph.D. at the University of Chicago in just three years. His thesis, which showed how the relationship between long- and short-term bond yields can predict U.S. recessions, was supervised by Nobel Prize winner Eugene Fama, widely recognized as “the father of modern finance.”

His ideas have sometimes missed the mark. In 2012, he said there was an 80% chance that Greece would exit the eurozone, a prediction that hasn’t yet come to pass. One of his earlier papers suggested that countries with a younger population tended to boast higher stock market returns. His thesis was disapproved a few years later by his own students. Those students earned an “A,” Mr. Harvey said.

“Good for them,” Mr. Harvey said. “I was proud of them. It took courage to do the presentation.”
Mr. Harvey’s interest in commodities was piqued by a 2004 paper from Yale University professors Gary Gorton and K. Geert Rouwenhorst.

Their research analyzed a commodity futures portfolio from 1959 to 2004. They argued that a broad index of commodity futures offered annual returns on par with the S&P 500, but with the added benefit that their prices didn’t move together with stocks and bonds.

Messrs. Gorton and Rouwenhorst worked with American International Group, Inc., they noted in the paper. The insurer had developed the Dow Jones AIG Commodity Index about six years before, and then used the research by Messrs. Gorton and Rouwenhorst to sell investment products tied to that index, according to people familiar with the process. Typically, an index owner will receive a small fee every time a fund buys or sells options contracts tied to that index.

An AIG spokeswoman declined to comment for this article.

Messrs. Gorton and Rouwenhorst declined to comment. In their 2015 follow-up paper, they said their earlier findings on commodities “largely hold up.”

Many consultants seized on their research to market commodities products to large investors. Giant pension funds like the California Public Employees’ Retirement System and the Illinois Teachers’ Retirement System began allocating money to commodities for the first time.

Calpers still holds commodities in its portfolio. The Illinois Teachers’ Retirement System jettisoned its commodities strategy in 2012.

“When we read that paper, we just shook our heads,” Mr. Harvey said, referring to himself and co-author Claude Erb, at the time a portfolio manager at Trust Company of the West. “The narrative was problematic.”

Mr. Harvey stress-tested some of the other paper’s main claims. For example, he said that replicating as diverse a commodities portfolio as Messrs. Gorton and Rouwenhorst recommended would prove challenging in the real world since many commodities, such as tin or butter, are thinly traded.

Another assumption that didn’t stand up was the concept of “roll yield,” or the bonus investors pocket when selling expiring commodity contracts and buying newer ones, which were often cheaper.

There was no guarantee that prices for future-dated contracts wouldn’t eventually rise, Mr. Harvey argued. In fact, many commodities are now more expensive further out in time, hurting investors who hold futures for long periods.

“This is much more complicated than buying a stock or bond,” Mr. Harvey said. “The sector is fraught with risk for retail investors, and it is discouraging that so many institutions get it wrong as well.”

Some prominent investors have come around to Mr. Harvey’s views, and even expanded on his research.

A Goldman Sachs Group Inc. study last year found that a portfolio of stocks, bonds and commodities showed a worse return in the period from 1987 to 2015 than a portfolio of just equities and debt. Nor did commodities prove a good hedge during more recent selloffs: Commodities fell more than U.S. equities during deep market selloffs in 2010 and 2011, the bank’s research showed.

For long-term investors, “we don’t think there is a role for commodities in a portfolio,” said Sharmin Mossavar-Rahmani, chief investment officer at Goldman Sachs Wealth Management.

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Corrections & Amplifications
An earlier version of this article incorrectly said Mr. Harvey was an economics professor in the caption of the photograph. He is a finance professor. (April 14)