
ALTERNATIVE INVESTMENTS

Commodities: Active Strategies for Enhanced Return

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Journal of Wealth Management

vol. 8, no. 2 (Fall 2005):42–61

Recent research has demonstrated the diversification value of commodities relative to financial assets. The authors argue for an active commodities overlay to core exposure through index investment, much as equity management is evolving toward alpha/beta separation. Several apparent inefficiencies are discussed, along with justifications as to why such inefficiencies may persist. Finally, the authors outline the key requirements of an investment process that involves active management of commodities.

The authors consider it a given that commodities belong in the asset allocation mix, noting recent research from Greer (*The Handbook of Inflation Hedging Investments*, 2005) regarding the protection from both inflation and adverse economic surprises. The article explores whether active commodities management can add to the benefits, much as equity investors are increasingly turning to separation of alpha and beta components. They justify this overlay approach by noting that active commodities management could potentially negate the diversification benefits for an overall portfolio, as managers could be short the needed commodity when exposure is most needed. Despite such risk, however, active commodity management has demonstrated a high Sharpe ratio and low correlation with commodity indices over time, suggesting an opportunity for further benefits relative to indexing alone.

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The authors note two limitations to the scale of such a strategy. The first is that because any hedge strategy requires exploitation of inefficiencies, other investors must reliably provide the inefficiency. Second, certain futures markets limit the size of speculative positions. Although investors can circumvent this factor via swap arrangements, doing so introduces counterparty credit risk.

Several sources of structural return are noted, each providing opportunities for active management. First, because commodity futures are linked to the underlying commodity markets, they are not truly zero-sum propositions. Commercial participants will often tolerate a premium for the opportunity to lay off inventory and other risks. As such, speculators should be able to rely on such an insurance premium in exchange for the risk they accept. Second, several studies have shown that long positions taken when contracts are in backwardation tend to offer excess returns. Finally, some research has shown that fear of adverse weather conditions often results in excessive premiums during certain critical periods for various commodities, providing an opportunity for short positions that profit from the excess premium.

The authors conclude with a discussion of crucial elements of an investment process for active commodity management. Employing such a strategy requires discipline with regard to trade sizing, entry and exit rules, trade construction, portfolio construction, and risk management. Trades should be sized so that the investor can withstand the high levels of short-term volatility and should consider the relative merits of various trade structures (futures, swaps, spreads, etc.). Portfolios should be well diversified, with particular care taken to avoid inadvertent risk concentrations. For example, both corn and natural gas can be sensitive to severe summer weather patterns in the U.S. Midwest, which is not necessarily apparent during normal market conditions.

The authors conclude by reiterating the strong evidence for indexed commodity investing and their position that active management can be a successful alpha overlay for a well-diversified portfolio that already has beta exposure to commodities.

Keywords: Alternative Investments: commodities; Portfolio Management: other