

Plan Sponsors Eye Commodity Returns

A few years ago commodities hit the headlines as investors were treated to hefty gains from playing in these notoriously dangerous reaches of the financial markets. But for pension plans and investment managers the risks of taking big positions in pork belly futures—and suddenly having to take delivery of a truckload of hogs—put them off many forays into commodity investing. On the back of the big gains in the markets, a group of investment banks led by Goldman Sachs & Co., with their Goldman Sachs Commodity Index (GSCI), broke new ground by providing financial players the ability to invest in the commodity markets without the obvious problems with playing in the physical markets. Seeing a good thing, other providers appeared—JP Morgan and Bankers Trust among them—with commodity indexes of various complexions. In the last three years commodity returns have been spectacular, causing many plan sponsors to reconsider commodity investment as part of a wider involvement in alternative assets classes.

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Today there are a number of alternative asset classes competing for attention. Unique among new asset classes, the returns of a commodity program

are tied to broad economic themes and are negatively correlated with the dominant financial asset classes. Also uniquely among real-asset investments, one can invest in this asset class through deeply liquid, transparent futures markets. And lastly, a commodity investment's returns are unexpectedly competitive: the Goldman Sachs Commodity Index's (GSCI's) returns, for example, have topped 10 percent per annum for the last decade.

In retrospect the last year has been

a good time to be invested in commodities. On a year-over-year basis, the GSCI is up almost 40 percent. This should not be too much of a surprise, given that historically, commodities instruments tend to do well when economic growth is strong.

In addition to tactical arguments for investing in commodities while strong economic growth is evident, there are also powerful portfolio diversification reasons for investing in commodities. From a strategic asset allocation point of view, a portfolio that includes a fractional amount of collateralized commodity exposure always appears on the efficient frontier of optimal asset allocations. This is because commodities offer solid returns and are negatively correlated with stocks and bonds. A commodity program also provides effective inflation protection by holding good proxies for real economic assets that have a value independent of the monetary units in which they are denominated.

The use of commodities as a strategic investment has not yet been

popularized. An investment in commodities allows a portfolio to increase its allocation to stocks, thereby increasing overall portfolio returns. A commodity investment lowers the standard deviation of a portfolio enough to allow for an increased allocation to higher-returning equities without increasing overall portfolio risk, according to internal Putnam asset allocation research.

In some ways it is surprising that commodities have not yet become a mainstream asset class, given their competitive returns and compelling portfolio diversification properties. The reason probably lies in a lack of understanding of the source of returns from this type of investment. For example, a 1994 International Monetary Fund paper concluded that spot commodity prices were in a long-term secular decline, which by itself would discourage investments in commodities. But then how is it that the returns implied by the GSCI and other commodity indices have been so competitive in the last ten years? ■