Strategic Diversification Through Commodities

Commodity Commotion

Commodities continue to receive media and investor attention. Some have been bullish on the asset class as a tactical bet on the developing world's current appetite for raw materials. Others
have touted it as a short-term hedge against the prospect of rising inflation or to compensate for a tepid stock market.

The enthusiasm has cast an overdue spotlight on commodities, but it has also obscured for many what we think is the true value of this unique 'real' asset: significant diversification opportunities
and a new source of potential return for investors' portfolios.

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The Commodities Advantage: A Complementary Asset

The Great Diversifier

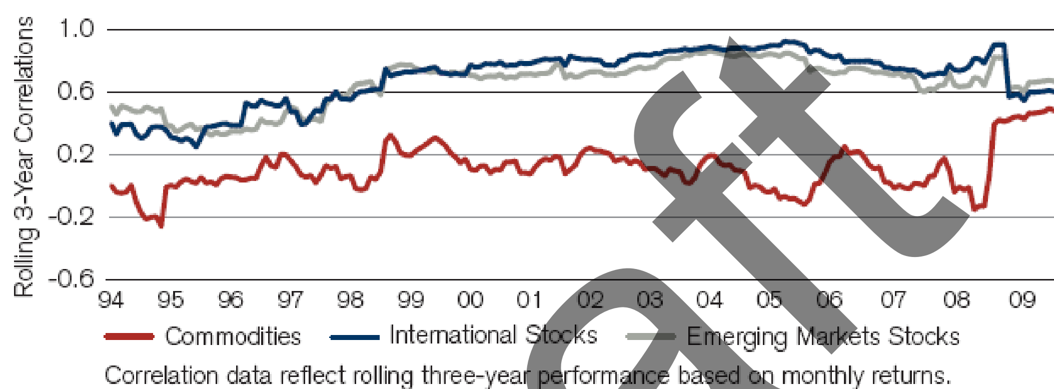
A critical factor to consider when adding any investment to a group of assets is how it interacts with the other portfolio elements. The more dissimilar the assets' behaviour under a range of different market conditions, the greater the potential for diversification. And therein lies the power of commodities, for when traditional assets like stocks and bonds zig, commodities tend to zag. When examining the returns of
individual commodities, such as crude oil or gold, the volatility may seem prohibitive, and in fact, investors should familiarise themselves with the potential industry- and commodity-specific risk factors. However, as shown in the chart below, the historical characteristics of the commodity and

stock markets show very low correlations. Because of this, commodities have offered significant diversification benefits, historically reducing the overall risk of a well-diversified portfolio, while adding a new source of potential return.

Opposites Attract

Unlike financial assets, commodities march to the beat of a different economic drummer. Financial assets are ‘earning’ assets, whose value is tied to their future cash flows: bonds promise potential interest payments and return of principal upon maturity; stocks promise potential dividends or appreciation in share price. Commodities, however, pay no interest and offer investors no share of any future profits derived from a company. It is current global supply and demand for raw materials that is the main driver of commodity prices. As a result of these differences, the historical risk and return characteristics of commodities have displayed little or no relationship with those of most other financial assets.

Stocks and Commodities: Correlations to US Stocks based on rolling three-year performance (1/1/91-12/31/09)



Correlation data reflect rolling three-year performance based on monthly returns.

Commodities: Correlations to Traditional Assets (1/1/91 – 12/31/09)

	Commodities	US Stocks	US Bonds	International Stocks
Commodities	1.00			
US Stocks	0.22	1.00		
US Bonds	0.06	0.14	1.00	
International Stocks	0.37	0.76	0.11	1.00

Correlation data is based on monthly returns.

Sources: Credit Suisse; Ibbotson. **US Stocks** measured by: Standard & Poor’s 500 Index, an unmanaged index of US companies generally deemed representative of the US stock market. **Commodities:** Dow Jones-UBS Commodity Index Total Return, composed of futures contracts on 19 physical commodities and dating back to 1/91. **International Stocks:** Morgan Stanley Capital International EAFE Index (tracks 21 country indexes in Europe, Australia and the Far East); **Emerging Markets Stocks:** Morgan Stanley Capital International Emerging Markets Index (tracks 26 emerging market country indexes); both are free float-adjusted market capitalization indexes. **US Bonds**: Barclay’s Capital US Aggregate Bond Index. Formerly known as Lehman Brothers US Aggregate Bond Index, composed of the Lehman Brothers Government/Corporate Bond Index and the Lehman Brothers Mortgage-Backed Securities Index and includes US Treasury and agency issues, corporate bond issues and mortgage-backed securities rated investment grade or higher. Indexes are unmanaged and assume reinvestment of dividends or interest. Investors cannot invest directly in an index. **Past performance does not guarantee future results.**

Given the degree to which commodity values move against the grain of the broader financial market, the addition of even a modest basket of this real asset to any traditional portfolio has historically offered stronger returns while helping to reduce its overall risk. If one had to identify the key benefit of commodities to the traditional investor it would be the way commodities have the potential to cushion risk from their exposure to stocks and bonds.

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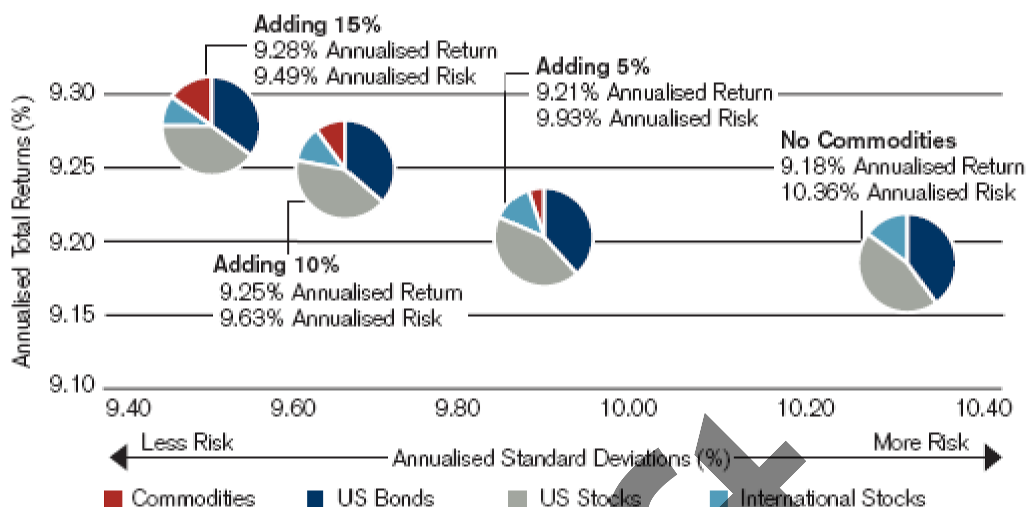
Adding Commodities for a More Complete Portfolio (1/1/70 – 12/31/09)
As this chart of historical performance shows, even a modest addition of commodities to a balanced portfolio has helped improve returns and manage risk.



Sources: Credit Suisse; Ibbotson. **Risk** measured by **standard deviation**, a statistical measurement of dispersion around an average which depicts how widely returns varied over a certain time period. **Allocation:** Initial allocation: 40% US bonds, 45% US stocks, 15% international stocks. As commodities were added, other asset classes were reduced proportionately. **Commodities** measured by: Standard and Poor's Goldman Sachs Commodities Index, a composite of commodity sector returns, representing an unleveraged, long-only investment in commodity futures broadly diversified across the spectrum of commodities. **US Bonds:** Ibbotson Intermediate-Term Government Bond Index, a one-bond portfolio with a maturity near five years. Please see disclosure in charts on prior page for **US Stocks** and **International Stocks** index information. Indexes are unmanaged and assume reinvestment of dividends or interest. Investors cannot invest directly in an index. **Past performance does not guarantee future results.**

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Commodities as an Inflation Hedge
Ultimately, investors focus on the real purchasing power of their returns, which means that the threat of inflation is always a concern. As a general rule, financial assets, such as stocks and bonds, have tended to go down in value when inflation rises. Real assets, like commodities, have behaved in an opposite way. With commodity prices linked to inflation's key components—the cost of the raw goods themselves—commodity prices have usually risen along with increasing inflation. The opposite has historically also been true: deflation has typically had a negative impact on commodity prices.

The Ultimate Globalisation Play
Commodity price volatility is often driven by worldwide supply and demand. Hence, commodities introduce what we believe is a valuable global element into portfolios. For example, the global forces of demand and supply can combine in constantly shifting proportions, disrupted by discrete and largely unpredictable geopolitical events, (including work-stoppages, weather and war), thereby affecting the local production of commodities. By creating artificial or temporary supply shortages, these events hold the potential prospect of commodity price outperformance. And because the pricing and trading of most standard commodities is carried out in dollars, a dollar decline on the foreign exchange markets can cause a rise in the dollar price of commodities, another potential driver of returns.

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Commodities: A Powerful Diversification Story

- Commodity returns have historically had low correlations to the returns of stocks and bonds
- Adding a commodity index to a diversified portfolio may reduce risk, while providing stronger returns
- Commodity prices have tended to rise with inflation, where the value of financial assets typically has tended to decline
- Commodity investing is subject to specific risks, such as currency movements, deflation, price volatility and volatility in global demand; individual commodities are also subject to industry-specific risk factors, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments

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Because of the contrary way commodities behave relative to stocks and bonds, they have historically improved the efficiency of a well diversified portfolio, helping to hedge away potential exposure to volatile markets, rising inflation, geopolitical risk and even currency movements.

A Digestible Piece of the Action

Even prudent investors face formidable barriers to building a position in commodities. Buying commodities directly is impractical—very few of us can take delivery of several hundred head of cattle or store several thousand barrels of oil. Buying the stocks of commodity-producing companies, on the other hand, may actually limit commodity exposure, as these companies are rarely pure plays on the raw materials they produce. Moreover, such companies typically hedge their exposure to upward price movements in these materials, further reducing any relationship they may have to the prices of commodities.

That leaves individual investors with few practical alternatives in our view. They can buy managed futures run by registered commodity trading advisors, either as a separate account or in a pooled fund. However, the active commodity management that this entails commands a hedge-fund like premium. Fees for managed futures accounts range from 2% or more of invested capital, plus upward of 20% of any gains.

Ways to access the commodity markets	Considerations
Direct investment in physical commodity	High storage and transportation costs
Stocks of commodity-producing companies	Exposure to company risk/return in addition to commodity risk/return May have greater correlation to the stock market in general Commodity-producing companies typically hedge their exposure to the raw materials they produce
Managed futures/ Commodity trading advisors	High investment minimums and fees (typically 2% of assets, plus 20% of profits) Often leveraged and highly speculative bets on individual commodities Less predictive diversification benefits
Index-based commodity mutual fund	Efficient access to broad commodity markets Professional management Transparency Open-end liquidity and daily pricing Low minimum investment

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Index investing can offer investors a simple, efficient way to access the commodities market. A broad basket of these raw materials may help 'complete' a portfolio, regardless of passing economic conditions.

Buying the World's Production Through a Commodity Index

We think a simpler approach might be a fund that seeks to track returns of a diversified index. The major commodity indexes provide efficient price exposure to a cross section of the world's principal raw and semi-finished goods. Of course, investors cannot invest directly in an index; however, an indexed commodity-based fund can seek to replicate the index's performance. Index funds, of course, impose management fees and other charges and expenses.

Two of the broadest and most liquid commodity indexes are the Dow Jones-UBS Commodity Index and the S&P Goldman Sachs Commodity Index. Individual commodity weights in the S&P GSCI reflect the weighted average world production of the last 5 years and the Index tracks 24 commodities.

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The Benefits of Investing in Commodity Index Funds
Investing in commodity indices also provides all of the virtues that index funds are known for: a clear benchmark, deep pools of liquidity, daily price transparency and low management costs. Investors in a fund that shadow indices do not own the underlying physical commodities—there is no storage or transport expense — and their exposure is designed to be limited to changes in the expected future price of the commodities in aggregate. A commodity-indexed fund may offer the simplest and most efficient way for individual investors to gain direct price exposure to a cross section of the principal raw and semi-finished goods used by the world's producers and consumers.

Summary
Indexed Commodity Funds Provide:

- Direct price exposure to a broad range of global commodities
- Reduced volatility through more 'diversified' exposure to the commodity complex
- Transparent, liquid and efficient access to an established and trusted index that is rebalanced annually
- A fund tracking a commodity index is subject to tracking error, as well as risks impacting derivative securities, such as interest rates, liquidity and leverage

What's Driving The Market?

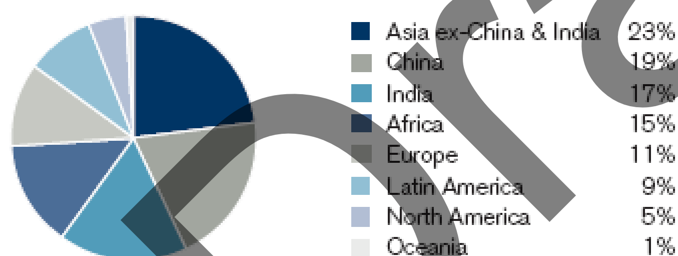
Global Commodity Demand
The past decade has witnessed strong returns from commodities due largely to increased demand from developing economies. But in addition to increased demand for commodities from developed nations, the forces of industrialisation in emerging market countries are fueling increasing

consumption of oil, metals and other raw materials. China is one prime example. As of November 2007, China consumed over 7 million barrels of oil per day,[1] and is expected to consume 15.3% of the world's oil by 2030.[2] In 8 years, from 1999 to 2007, China tripled its annual refined copper consumption.[3] Additionally, non-OECD (Organisation for Economic Co-operation and Development) Asia countries, which include China and India, account for 90% of the projected increase in world coal consumption from 2006-2030[4].

As these and other emerging market countries continue on the road to industrialisation, urbanisation and increasing per capita income, their immense populations may help spur a long-term, secular increase in demand for commodities in our view. Over time, there will probably be more people eating beef in Beijing and driving more cars in Calcutta.

Because they are real assets, commodities have historically tended to do best when economic growth is strongest, reflecting high current demand for the raw materials needed in the production of finished goods.

World Population (2009 estimate)



Source: 2009 Population Reference Bureau

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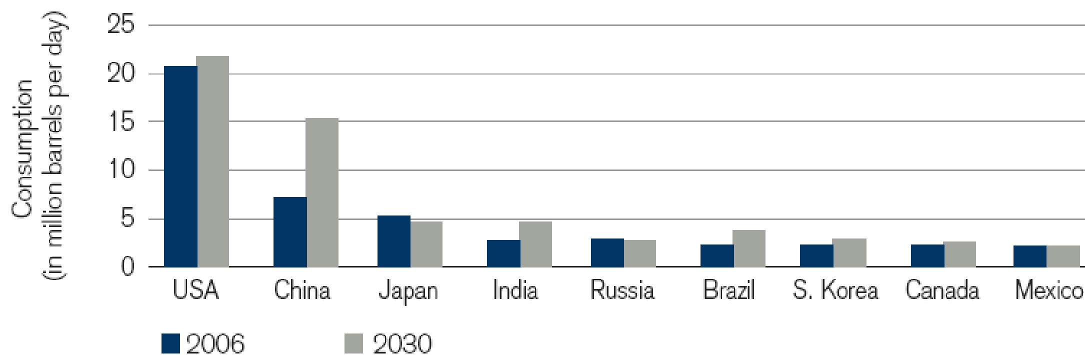
Yet even as demand for commodities increases, there are growing signs of depleting inventory levels and supply constraints. The world's resources—copper, soybeans, gold, wheat—are by nature limited in supply. New production infrastructure can take years and significant outlay to develop; output is limited by available resources and governed by geopolitical and meteorological events. Furthermore in our modern economy, storage and supply-chain enhancements have shortened the manufacturing pipeline, reducing dependence on large inventories and increasing the market's sensitivity to supply interruptions or demand surges.

A Crude Awakening: Constraints in the Oil Business

Many commodities, including oil, are in a tight supply/demand balance, and small changes in this balance relative to expectations can cause drastic price movements. From 2007 to 2009, prices of crude oil fluctuated quite dramatically due to factors relating to the turmoil in the financial markets and its effect on demand projections, currencies, and inflation. Prices more than doubled from the end of 2006 to June 2008, but with reduced demand projections due to continued financial market turmoil, most of the gains were given back by October 2008. With the supply/demand situation remaining tight, disruptions to the crude supply – without significant new oil discoveries – or other refinery problems could magnify such price changes.

Oil Consumption and Projections



Source: EIA, *International Energy Outlook 2009*

Chastened by past experience and, perhaps, certain political issues, producers have been reluctant to invest in new infrastructure, even as demand continues to drive global prices. And the fact that much of the supply (of oil and other commodities) comes from some of the least stable parts of the world seems to only exacerbate existing supply concerns. Despite the current worldwide economic downturn and lessened demand in the near term, in the longer term as economies recover, demand may return.[5]

The above information suggests to us that there may be opportunities to achieve significant returns in energy-related and commodity-related investments over the next decade. *Your financial advisor can provide you with more information about the potential benefits and risks of commodity investing.*

Exposure to commodity markets should only form a small part of a diversified portfolio. Investment in commodity markets may not be suitable for all investors. The use of derivatives such as swaps, commodity-linked structured notes and futures entails substantial risks, including risk of loss of a significant portion of their principal value, lack of a secondary market, increased volatility, correlation risk, liquidity risk, interest-rate risk, market risk, credit risk, valuation risk and tax risk. Gains and losses from speculative positions in derivatives may be much greater than the derivative's cost.

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Conclusion

Building a More Complete Portfolio

With some market watchers expecting lower stock and bond returns in the foreseeable future, many investors might now be seeking alternative sources of potential return. Unlike stocks and bonds, commodity markets are generally driven by
near term supply-demand dynamics and demonstrate low correlations to traditional financial assets. Also, as real economic
assets, commodities may provide an attractive inflation hedge. And with increasing demand of bulk goods from developing countries, we think the investment appeal of commodities should continue to rise dramatically.
More importantly, commodities can increase a portfolio's diversification, potentially reducing risk and improving overall returns.
Furthermore, these benefits have historically tended to increase with the length of the holding. While not suitable for every investor, we believe commodities may provide some of the best portfolio completing
qualities of any asset class, and should be considered as a key element in an optimal, long-term asset allocation strategy.

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