

Investing in Commodities: A Wise Choice?

Overview: On the surface, investing in commodities may not look attractive to investors. However, looking at the asset class in isolation is a mistake. The following takes a look at the potential effect commodities investing has on a portfolio.

One of the more hotly debated issues among both academics and investors in general is: Should investors include an allocation to commodities in their portfolios? While there are arguments on both sides, the evidence favors including some exposure to commodities.

Allocations to commodities are frequently discussed in terms of providing portfolio insurance against unexpected inflation. One of the arguments against including commodities is that they have no real expected return above the rate of inflation. While this is true, the argument is not a sufficient one. The reason is that an investment should never be viewed in isolation. Instead, it should be judged based on how its addition impacts a portfolio's overall risk and return. Consider the following from the period of January 1991 through March 2009:

There are two main reasons for using this period. First, this allows for examining the returns of the two major commodities indexes: the GSCI and the DJ-AIGCI. Second, the U.S. Consumer Price Index (checking the style book to see it referenced this way if you are using the monthly Labor Department statistics) rose just 2.6 percent per year during this period, or 0.4 percent below its long-term average of 3 percent. This means the time period used was one where the portfolio insurance against inflation that commodities provide was not needed. Thus (with the benefit of hindsight), this should not be a particularly good period for commodities.

	Return (%)	Standard Deviation (%)
GSCI	2.11	23.41
DJ-AIGCI	4.42	16.08
Fama-French (FF) Total US Stock Market Index	7.57	16.74

Investors looking at this data would question why they should have invested in commodities. However, looking at commodities when part of a portfolio can offer a different conclusion:

	Return (%) With Quarterly Rebalancing	Standard Deviation (%)

100% FF Total US Stock Market Index	7.57	16.74
90% FF Total US Stock Market Index/ 10% DJ-AIGCI	7.48	15.30
90% FF Total US Stock Market Index/ 10% GSCI	7.38	15.41

The portfolios with commodities produced slightly lower returns. However, they were also more efficient at delivering risk-adjusted returns. Using volatility as the measure of risk, the portfolio with an allocation to the DJ-AIGCI was 8.6 percent less risky, while returns were just 1.2 percent lower. The portfolio with an allocation to the GSCI was 7.9 percent less risky, while returns were just 2.4 percent lower.

Diversification Benefits

By focusing only on returns and volatility, investors miss the bigger picture. The high volatility of commodities and their low correlation to equities combine to provide a significant diversification benefit. Consider the following: While the DJ-AIGCI returned 4.4 percent, a 10 percent allocation impacted the portfolio as if it had actually returned 6.7 percent (or 4.1 percent above inflation). The incremental return of 2.3 percent (6.7 minus 4.4) is a “diversification benefit.”

The diversification benefit of the GSCI is even greater due to its higher volatility. While the GSCI returned 2.1 percent, a 10 percent allocation impacted the portfolio as if it had returned 5.7 percent (or 3.1 percent above inflation). Thus, the diversification benefit was 3.6 percent (5.7 minus 2.1).

Summary

When constructing a portfolio, it is important to remember that considering the risk and return of an asset class such as commodities in isolation is a mistake. While commodity returns were poor during this period, including an allocation would have improved the risk-adjusted returns of the portfolio. It is also important to note that this was a period of low inflation, when this portfolio insurance was not needed. There was no guarantee that history would play out that way.

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