

Are commodities still a valid inflation hedge in this low price environment?

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Prelude

While the outlook for inflation is difficult to gauge, the more pertinent question is “how do we prepare for its arrival?”

Historically, commodities have been used as an inflation hedge by both Institutional and Retail investors for reasons we will outline below. Given the commodity weakness of the last few years, is it still a valid use? We believe it is, but also believe that the asset allocation decision should form part of a long term strategy, not a tactical or timed trade. While timing and tactics do play a role in mitigating some of any asset class’s particular risks, we argue that that role should fall to the specific investing strategies selected to achieve the desired exposure.

The Benefits of Commodity Investing

Benefit 1: Diversification

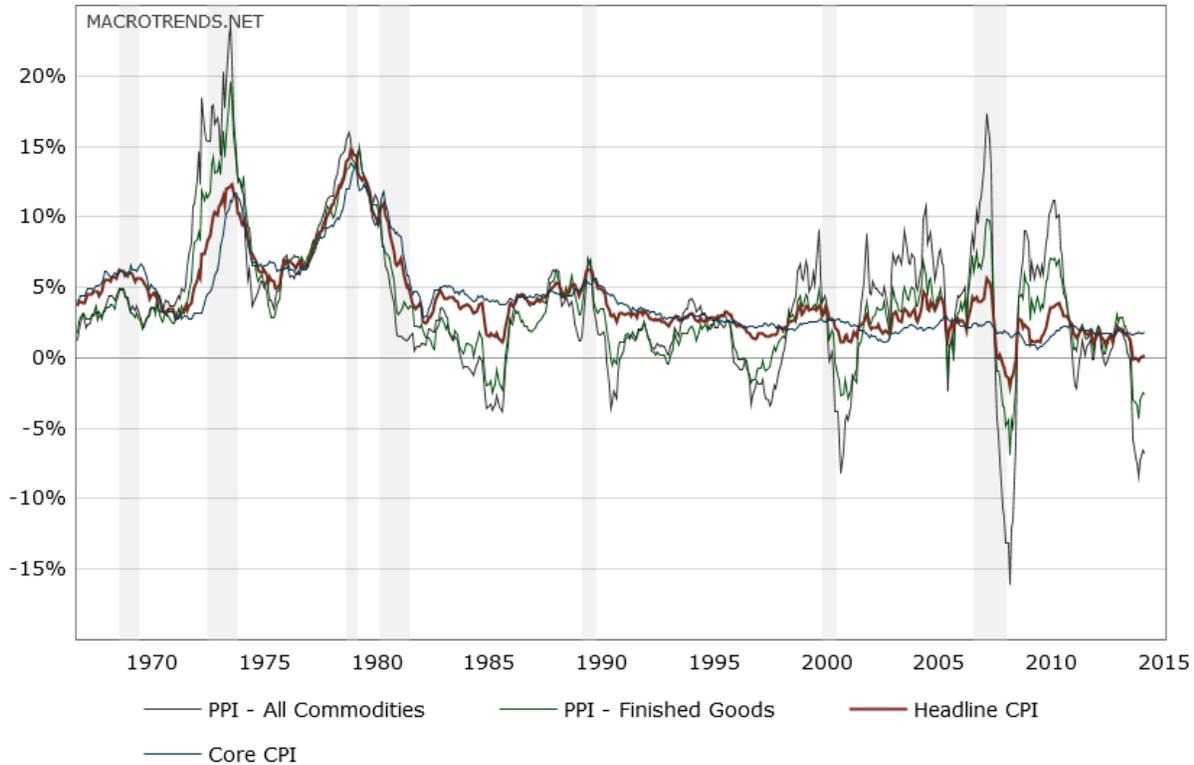
The correlation of financial assets and commodities is low. This diversification benefit is often called the “only free lunch” in investing because commodities have the ability to perform positively when financial assets are also positive, yet there might be no correlation between them over specific time periods.

Benefit 2: Inflation protection

Given that commodities are “real assets”, unlike stock and bonds which are “financial assets”, they are going to react to changing environments and economics conditions differently. As a simple example, commodities tend to rise in price as demand for goods that require their input increases. This not only makes sense, it is why it is one of the few asset classes that can be considered an inflation hedge.

As illustrated in the chart below, commodity exposure is clearly an important tool in protecting against inflation. It shows the level of inflation over 40 years and the corresponding price increase of commodities.

Figure 1



Source: MacroTrends Data Source: Bureau of Labor Statistics

It is clear that commodities and headline inflation are highly correlated (per Figure 1), therefore strategic investments in real assets such as commodities could help protect investor’s portfolios in fluctuating inflationary environments (Louie and Burton 2010).

As such, commodities are especially effective in hedging against “unexpected” inflation which has not been properly priced into the market. It can be argued that this reflects the current market situation - where central bank participation in markets has held rates and inflation low thus increasing the chance of an unexpected adjustment.

Moreover, financial assets tend to perform best during periods of low inflation (as witnessed post financial crisis 2010 - 2014), so investors exposed to both financial assets and commodities have seen strong investment performance across both inflationary and non-inflationary environments.

Benefit 3: Event Risk

This is a special case. While there are many examples of commodities rallying while equities tumble during a geopolitical, weather, or natural disaster event, it has also occurred in the opposite way. In 2008, as the financial crisis was underway by mid-year, both commodities and financial assets dropped at the same time, leaving many wonder if there was a better way to reduce portfolio risk.

As such, we suggest there are two main solutions available to solve for these circumstances: be short commodities at the time of the event, which requires a tactical directional approach (like a CTA/Managed Futures portfolio), or simply move to cash (a long / flat approach in commodities) as commodities experience a significant trend lower.

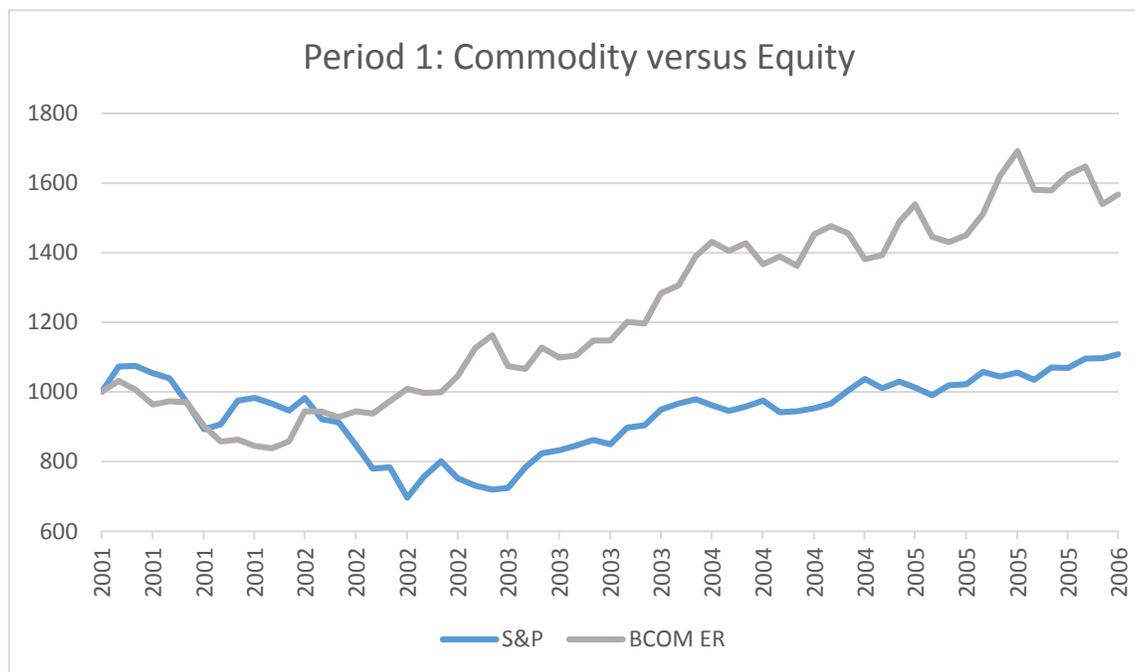
A Tale of Three Periods

Investor interest in commodities has suffered the last few years as commodities prices have fallen and equities marched higher in a low volatility fashion. Yet one does not need to look too far back to a time when that story was different.

Period 1 – Low Correlations, modest Inflation and Stronger Commodities Performance

For the 5 year period ending March 31 2006, the Bloomberg Commodity Index (hereafter “BCOM”, referring to the Excess Return version, previously the Dow Jones UBS ER), gained 9.41% annualized while the S&P 500 gained just over 2%.

Chart 1: S&P, BCOM 5 year ending March 31 2006



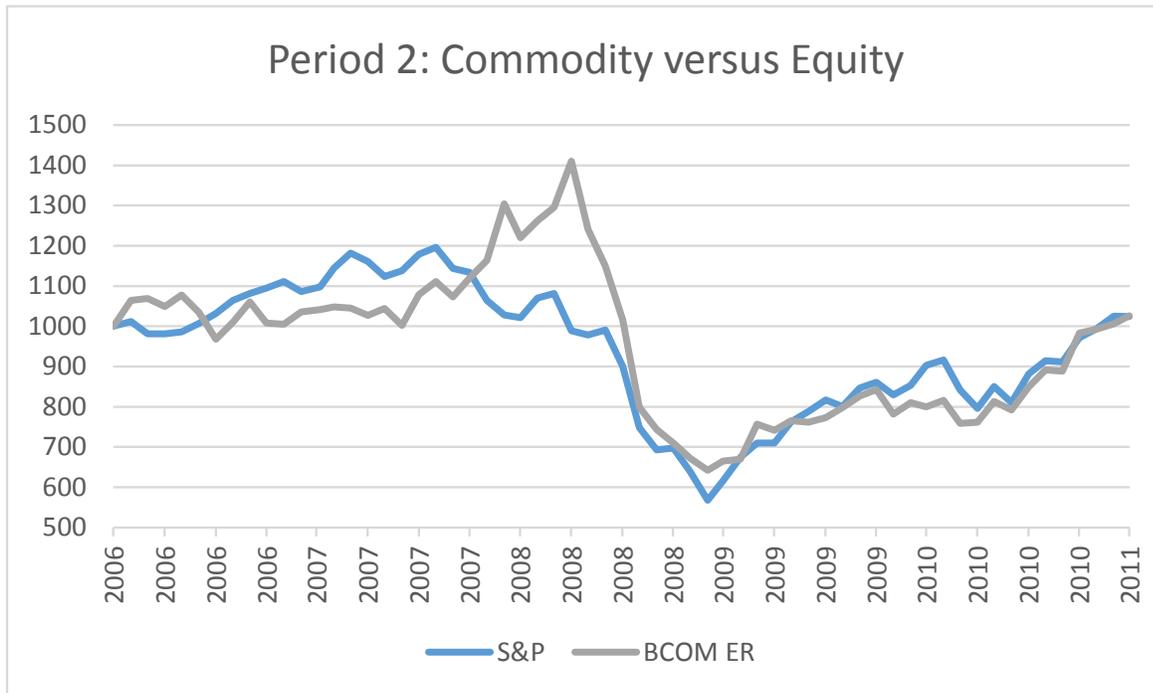
Not surprisingly, this period was a golden age for commodity investors alongside modest inflation as stronger performance coupled with virtually no correlation at 0.12 made commodity exposure seem almost too good to be true.

Life is about trade-offs, however. No strategy performs well all of the time, and, as such, we must be realistic and temper the temptation to overweight an asset class with so much obvious value. The trade-off is that while non-correlated to traditional asset classes, it doesn't mean commodities will always outperform on the upside.

Period 2 – Medium Correlations with Similar Performance

The following 5 years were challenging for both asset types. From April 2006 to March 2011, both asset classes were virtually flat. BCOM gained 0.52% annualized while the S&P gained 0.48% with a correlation of 0.54. During the period, commodities exposure served its purpose of providing modest inflation protection, but did not provide a significant return over and above the broad equity market.

Chart 2: S&P, BCOM 5 year ending March 31 2011



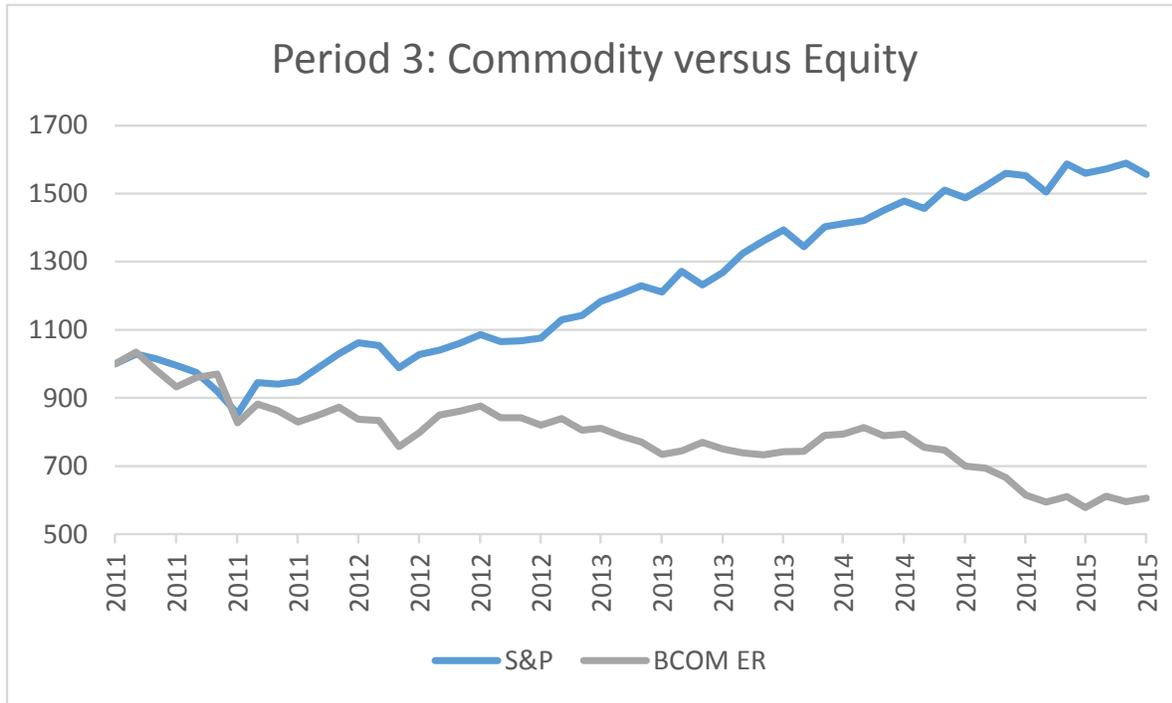
Period 3 – Medium Correlations with Weaker Commodity Performance

There are, of course, periods in which commodities and financial assets move in totally opposite directions.

For the last 4 plus years, commodity prices were under significant pressure. From April 2011 to June 2015, BCOM dropped 11.13% annualized while the S&P rose 10.96%.

While this drag on portfolio performance may have come as a surprise if one's only experience was during 2001 to 2006, the correlation was still only 0.56 during this period, suggesting the continuation of the strong diversifying effects of commodity investments - even during times when commodities themselves have underperformed.

Chart 3: S&P, BCOM 4+ year ending June 30 2015



Summary of Periods

We see that commodities can perform well in both times of inflation and at times when other financial assets are suffering (period 1). We also see they can fall asleep from a price perspective yet still provide inflation protection and diversification benefits (period 2).

"Strategies that track long-only commodity indices or are invested directly in commodities (physical or futures based), are extremely transparent and have very low fees. This is very attractive to investors, but the trade-off is that the commodity markets do not always deliver low correlations to or better performance than equities and bonds."

Tim Pickering, CIO of Auspice Capital.

Is there a way to reduce the negative returns (period 3) without compromising inflation protection, non-correlation and event risk protection?

The answer is yes.

Part 2

Compared to first generation, long-only commodity indices (*such as the BCOM or S&P GSCI*), 'third generation' Enhanced Beta exposures utilize some of the elements that can generate alpha in a package that is transparent, replicable and a reasonable cost.

By utilizing...

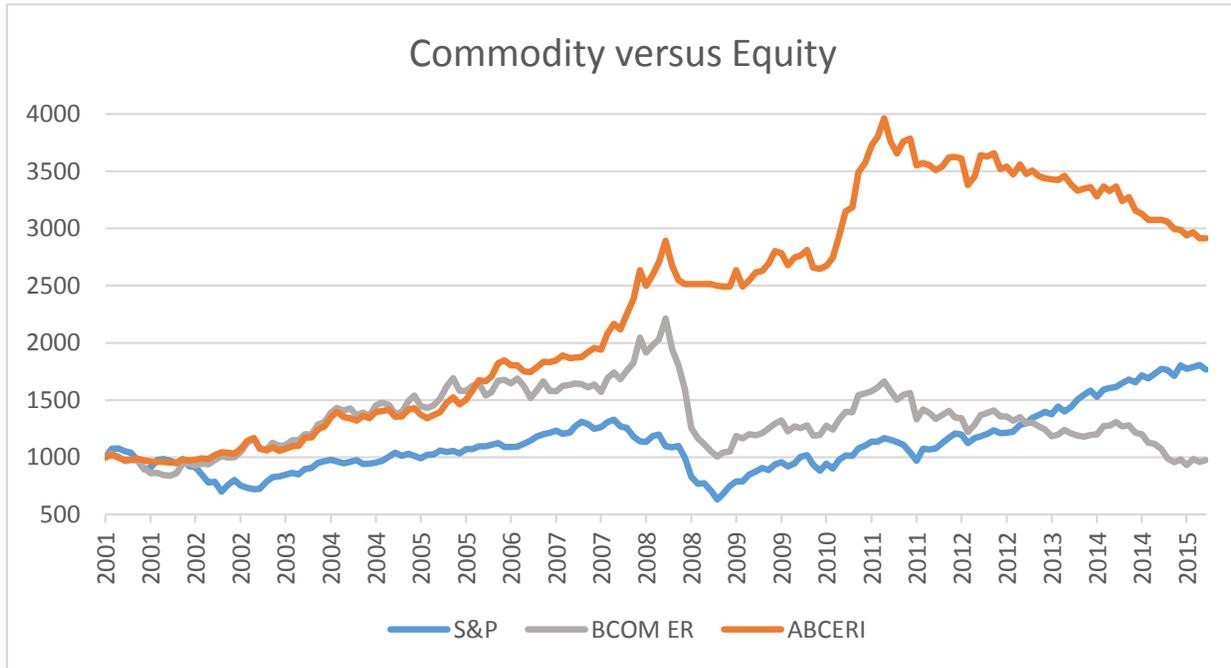
- 1) *Active positioning*: holding long exposures in positive trending environments and shifting to cash as asset prices fall,
- 2) *Risk and reward consideration*: Position sizing and rebalancing to adjust risk based on actual risk and volatility, and
- 3) *Roll Optimization techniques*: to reduce the negative roll yield that is inherent in long futures positions,

...one can improve upon the performance characteristics of long-only commodities exposure through the robust methods used in active investing while maintain the key benefits of indexing. The result is an index approach that aims to capture upward trends in commodity markets, thus providing an inflation hedge, while minimizing risk during downtrends.

"Enhanced Beta" approaches borrow some of the elements that generate alpha, making them transparent and replicable. The benefits are provided for a reasonable cost (index like fees not hedge fund like fees) while avoiding the volatility, deep drawdowns, and cross-market correlations that occur with pure beta strategies.

Additionally, the delivery mechanism is flexible and may include licensing an index from a manager or third generation index provider, running a managed account with a manager that specializes in enhanced beta, or investing in an ETF or Mutual fund (ex. US 40 Act) that tracks a third generation commodity index. Enhanced beta commodity strategies are well-suited to investors looking to add commodity returns to their portfolios while maintaining transparency and low fees.

For example, in considering the Auspice Broad Commodity Index (ABCERI) performance over the entire period considered earlier (from April 2001 to end of June 2015), the Auspice ABCERI returned 7.79% annualized, significantly outperforming the BCOM (-0.18%) and the S&P (+4.07%) while providing an accretive portfolio benefit and a substantially lower correlation to S&P (see below Table 1). Moreover, the volatility of the ABCERI is over 25% lower than the S&P and over 30% lower than the BCOM.

Chart 4: S&P, BCOM, ABCERI Apr 2001 ending June 30 2015

Table 1

	<i>S&P</i>	<i>ABCERI</i>	<i>BCOM ER</i>
<i>S&P</i>	1		
<i>ABCERI</i>	0.18	1	
<i>BCOM ER</i>	0.41	0.78	1

Solutions like this enable the investor to add inflation protection along with the added benefits of portfolio diversification and event risk protection while reducing the downside and volatility of the traditional methods of doing so.

Currency Risk

But what about for investors in other currencies? Canadian Dollar pensions? Norwegian Krone? Aussie Dollar?

Given that most commodities are US dollar denominated and the market has standardized on the common reserve currency for commodities, the trading of commodities in a strengthening dollar environment has a natural hedge. As such, those investors buying commodities in dollars who are not US-based are at risk due to higher costs. While this is partially offset by lower costs for purchasers, if commodities are being considered for their inflation hedging properties, home currency considerations are important.

For example, if a Canadian investor uses a long \$USD denominated inflation hedge and invests using \$USD (or holds futures contract in \$USD margin), there is risk of home currency appreciation. The risk may be magnified if the



Canadian dollar appreciates (eroding the value of the \$USD holding) at the same time that the commodities rise in price, providing an exact offset to the hedge that was intended.

A simple example:

A Canadian investor invests in gold at \$1,000 USD. Doing this requires \$1,200 CDN at 1.20 (\$CDN/\$USD)

The value of their investment increases from \$1,000 to \$1,200, resulting in a \$200 gain. But what if the \$CDN appreciates to par (1.00 \$CDN/\$USD) at the same time? The investor would face a profitable gold position sale at \$1 200 USD, but converts that to a \$1 200 CDN, with no gain as the result.

Simple Solution

The solution? Establish a \$USD hedge: sell \$1,000 USD at \$1,200 CDN. Thus, as the CDN \$ appreciates, the hedge rises and the \$1,200 CDN is sold for a \$1,200 USD - a \$200 gain, thus covering the flat investment and locking in the gain.

Fortunately this solution is simple to implement. In ETFs, fund structures and managed accounts, this can easily be managed by selling or hedging the US dollar exposure on a daily basis or any other term that makes sense. For retail vehicles such as ETFs, this is done at the product level on behalf of the investor. For Institutional managed accounts, the Institution or manager can take on that responsibility.

In fact, CTAs like Auspice Capital (which are based in Canada) have always done this - hedged out the currency exposure so the return stream results are currency agnostic.

Conclusion

Like many other asset classes, we believe that various global macro forces - many that are difficult to time perfectly - ensure that commodities will remain a valuable, non-correlated return source to equity and fixed income portfolio exposures over time.

Some argue that current commodity weakness is due to cyclical over-supply as opposed to a lack of long term global demand and thus a hidden inflation risk exists. Given that the world's population keeps growing and will require the same access to goods and "stuff", in addition to the infrastructure required to sustain it, this makes sense. Growth in the developing world (China, India etc.) creates long term manufacturing and infrastructure demand, suggesting that the world's need for "stuff" is not likely to abate any time soon.

We continue to believe that the current commodity market environment may represent a shorter-term correction within a longer-term trend, and that the long-term outlook for commodities remains promising in a global context. Moreover, we believe that it is possible that equities are becoming overvalued while commodities are undervalued. If we are correct, the continued value of a tactical long/flat approach in establishing long commodity exposure and inflation protection based on the merits of individual market momentum and volatility (versus a long only method) would prove to be a powerful portfolio driver in times to come.

As such, commodities represent a good choice for an inflation hedge despite the low priced environment. The added benefits of diversification and event risk protection can be further enhanced by using third generation commodity index products.



References:

Louie, Nelson and Burton, Christopher: 2010. How Commodities Can help investors face the uncertainty of the Inflation /Deflation Debate. Credit Suisse Asset Management White paper

Figure 1: Source: MacroTrends: <http://www.macrotrends.net/1281/cpi-vs-ppi-historical-chart>