Commodities: a new asset class for many types of investors

François Combes, Commodities Global Head of Trading at Société Génerale describes how commodities have become an important asset class with highly liquid and transparent markets

Hard assets have always been important in an investor's portfolio, historically taking the form of land, property and precious metals. Commodities, such as oil, corn and copper, while also being hard assets, have historically been the concern primarily of producers and consumers. To deal with output and input price and timing risks, commodity futures markets were developed, starting with rice futures trading in Japan around 1730 to the corn and wheat trading in Chicago from 1865 – the world's oldest commodities futures market. What risk wasn't taken from producers by consumers, and visa versa, was and still is left for investors to take.

First generation

It wasn't until 1991, with the introduction of the Goldman Sachs Commodity Index (now the S&P GSCI), a broad long-only index of energy, base and precious metals, agriculture and livestock commodities, that commodity futures became more broadly available to investors. The Dow Jones-AIG Commodity Index (now DJ UBS) was launched seven years later. These remain the main first generation benchmark indexes. Academic research helped increase demand for these indexes, with strong empirical evidence that broader commodity indexes should help lift risk-adjusted returns. But the indexes saw critical limitations as investments continued to rise, due to design construction. Specifically, these passive indexes took long positions on nearby contracts and rolled them on a specific schedule to the next nearby contract as they moved closer to expiration. The roll proved generally profitable when most contracts were in backwardation (nearby contract higher than the deferred contracts). However, with key markets like oil moving into more prolonged contango structure (nearby contract lower than the deferred contracts), this construction started to underperform. Also, the similar 5-9 business day rolling period and a known roll schedule for the benchmarks resulted in trading losses by creating opportunities to exploit these predictable trades.

Second generation

Second generation commodity indexes continue to be designed to address these shortcomings. By creating non-discretionary rule-based rolling, newer indexes can move out of the forward curve in commodities that are in steep contango, minimising losses, and stay close to the first nearby contracts that are in backwardation, to maximise gains. Moving away from nearby contracts reduces traditional correlation to equities, but increases expected returns while also reducing expected volatility – net improving the gain in risk-adjusted returns to both the commodity index as well as the broader investment portfolio. Also, by choosing different rolling schedules, predictable trading losses could be avoided.

Third generation

The third generation of commodity indexes looks to exploit time-varying information within commodity markets as well as better exploit curve information to position indexes, across commodity forward curves and also across commodities by changing relative weights.

Commodity investors have moved from being solely specialised investors who take near-term speculative positions to more passive retail and institutional investors who are looking for long-term diversification. Private banks, pension funds, endowments, insurance companies, and institutional investors are looking for improved risk-adjusted return in an increasingly low yield market. Here, interest is increasingly in second and third generation indexes, including both long-only and absolute return indexes. On the active side, hedge fund, commodity trading advisors (CTAs) and institutional investors may still look to first generation indexes for short-term risk management, given the higher volatilities and still likely stronger negative correlations with other parts of their portfolio; however, here too investors are looking increasingly at second and third generation indexes to improve expected risk-returns, especially within the context of their overall investment portfolio. ■