

A focus on commodity indexes

KOSTAS ANDRIOSPOULOS, ASSISTANT PROFESSOR IN FINANCE AT **ESCP EUROPE BUSINESS SCHOOL**, EXAMINES THE NEW STYLE INVESTMENT THAT COMMODITY INDEXES REPRESENT, AND HOW THEY COMPLEMENT TRADITIONAL PORTFOLIOS

Commodity indexes have been around for many years and as is the case with all early equity indexes, they were used mostly for benchmarking and to track spot commodity processes. One of the first published commodity indexes is the Economist's Commodity Price Index that started in 1864. Then, in 1957 the Commodity Research Bureau (CRB) Index was established, tracking spot commodity processes, and after undergoing major revisions in its composition it is still published today. Nevertheless, it is in the past 20 years that the development of commodities indexes has witnessed tremendous changes. The first generation of investable commodity indexes appeared only in 1991 when the S&P GSCI (originally the Goldman Sachs Commodity Index) was introduced. A few years later, in 1998, the Dow Jones-UBS Commodity Index (originally the Dow Jones-AIG Commodity Index), and the Rogers International Commodities Index (RICI) were both launched. Both the S&P GSCI and the RICI are heavily weighted towards the energy sector, while the Dow Jones-UBS, because of the rule that no sector can weigh more than one-third of the index, has energy at its limit; in many instances this limit is exceeded between the annual rebalancing periods.

The common characteristic, and a major disadvantage of these early indexes is that they invest in commodity futures contracts that are close to expiration, thus they roll forward their futures positions more frequently which makes it very expensive to follow an index replication strategy using exchange-traded futures. In addition, holding a long futures position via an index that

invests in the front of the curve is sub-optimal, especially in recent years, because many commodity futures curves have been experiencing steep contango (a state when the futures price curve is upward sloping) at the front end of the curve, thus also diminishing the returns of the various investment products that are based on the respective index. Nonetheless, correlations among these early indexes over long periods of time are quite high, even though they have many differences in terms of their construction methodology.

The latest addition to the family of commodities indexes is the so-called third generation indexes that attempt to improve the returns of the previous two

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by incorporating commodities selection; overweighting or including only commodities that are expected to deliver higher returns in the near future, while underweighting or omitting completely commodities that are expected to perform poorly. The UBS Bloomberg CMCI Active Index introduced in 2007 and the Summer-Haven Dynamic Commodity Index introduced in 2009, are two

examples of the third generation commodity indexes. The latter index includes 14 equally weighted commodities from a total of 27, rebalancing its futures portfolio every month using basis and momentum to identify the greatest possible risk premium. The former index uses a discretionary approach of its research analysts who, according to their view adjust the component weightings of the index. However, these types of indexes carry with them a major disadvantage since the method or the research analysts used to select the commodities and

their respective weightings can be unsuccessful, and thus underperform passive indexes.

Based on the aforementioned, commodity investing could safely be considered a new style of investment as there is a large number of mutual funds, hedge funds, exchange-traded funds (ETFs), exchange-traded notes (ETNs) and over-the-counter (OTC) return swaps that follow commodities through index investing. Recently, many new energy commodity ETFs and ETNs have come to the market, making it easier for a retail investor to obtain exposure to commodities. There are various types of these Energy Index Funds either based on the construction type of the fund (single- or multi-contract, long-only or bearish), or based on the energy sector



Trading commodities

they track (broad energy or sector specific). In fact, in the US alone, based on industry estimates, assets allocated to commodity index strategies have risen from \$40 billion in 2001 to \$320 billion in 2011, with an estimated 70% of these funds invested in the energy sector. According to a 2008 Commodity Futures Trading Commission (CFTC) report, from the total of commodity index investing in US exchanges alone, about 42% is conducted by institutional investors (pension and endowment funds), 25% by retail investors (ETFs, ETNs and similar exchange-traded products), 24% by index funds (a client/counterparty with a fiduciary obligation to match or track the performance of a commodity index), and 9% by sovereign wealth funds.

Commodity indexes attempt to replicate the returns equivalent to holding long positions in various commodities markets without having to actively manage the positions. Being uncorrelated with the returns of traditional assets such as stocks and bonds, commodity index investments' returns provide a significant opportunity to reduce the risk of traditional investment portfolios; thus explaining the economic rationale for including a commodity index investment in institutional portfolios such as those of pension funds and university endowments. Currently there are numerous publicly available futures' indexes, with different risk and return profiles, offering exposure to commodity markets; each of these indexes also offers specific exposure to certain commodity sectors via their traded sub-indexes.

The variations in commodity index performance across indexes and during different market conditions lie with the differences in the construction methodology

of each index. It is critical for every investor in the commodities markets to be aware of these differences. The main differentiations relate to the index sectors' composition, constituent commodities selection, rolling and rebalancing strategy, which are crucial and apply only for futures indexes, and the methodology used for calculating the constituents' respective weights; such as liquidity- or production-based weights, arithmetic or geometric calculations. The latter has been an important determinant of the indexes' performance, especially with the recently large weight allocations towards the energy sector across all indexes. Nonetheless, these tracking funds have a number of advantages over traditional debt instruments (notes, bonds, certificates). They offer less expensive and less risky investment products, while at the same time providing protection against inflation. Also, they can provide easy access to a broad range of investors, a simple way to manage accounting and disclosure procedures, and can lead to fewer taxes since in many countries index fund returns are treated as capital gains and not as income. A commodity ETF can be used by the respective industry market players to complete parts of their existing portfolio or to perform tactical strategies. They can be used for hedging commodity investment risk, portfolio diversification, or as a control measure of inflation exposure.

To conclude, commodity index investing is still relatively 'young' compared to other more established asset classes such as stocks and bonds, but we should expect an increasing interest in and innovation by market players in the coming years ■