Commodities are a distinct asset class with returns that are largely independent of stock and bond returns. Therefore, adding broad commodity exposure can help diversify a portfolio of stocks and bonds, potentially lowering the risk of an overall portfolio and boosting returns. Given their impact on consumer goods prices, commodities can also offer a hedge against inflation.

**WHAT ARE COMMODITIES?**

Commodities are raw materials used to create the products consumers buy, from food to furniture to gasoline or petrol. Commodities include agricultural products such as wheat and cattle, energy products such as oil and natural gas, and metals such as gold, silver and aluminum. There are also “soft” commodities, or those that cannot be stored for long periods of time, which include sugar, cotton, cocoa and coffee.

The commodity market has evolved significantly from the days when farmers hauled bushels of wheat and corn to the local market. In the 1800s, demand for standardized contracts for trading agricultural products led to the development of commodity futures exchanges. Today, futures and options contracts can be traded on exchanges around the world on a huge array of agricultural products, metals, energy products and soft commodities. These standardized contracts enable producers of commodities to offload their price risk to end users and other financial market participants.

Commodities have also evolved as an asset class since the 1990s, with the development of commodity futures indexes and subsequently, investment vehicles that benchmark against these indices. Today investors can choose from a variety of vehicles for investing in the commodities futures markets, from mutual funds to exchange-traded funds or notes, covering the wide spectrum from single commodity exposures to sector based and broad based commodity exposures.

**WHY INVEST IN COMMODITIES?**

Investors typically look to a commodities allocation to provide three key benefits to their portfolios: inflation protection, diversification and return potential.

Because commodities are “real assets,” they tend to react to changing economic fundamentals in different ways than stocks and bonds, which are “financial assets.” For example, commodities are one of the few asset classes that tend to benefit from rising inflation. As demand for goods and services increases, the price of those goods and services usually rises as well, as do the prices of the commodities used to produce those goods and services. Because commodity prices usually rise when inflation is accelerating, investing in commodities may provide portfolios with a hedge against inflation.

In contrast, stocks and bonds tend to perform better when the rate of inflation is stable or slowing. Faster inflation lowers the value of future cash flows paid by stocks and bonds because that future cash will be able to buy fewer goods and services than they would today.

For these reasons, returns from a broad and diversified commodity index such as the Bloomberg Commodity Index, Credit Suisse Commodities Benchmark or the S&P Goldman Sachs Commodity Index, have historically been largely independent of stock and bond returns, but positively correlated with inflation.

Between 1970 and 2015, annual returns on the Bloomberg Commodity Index had a very low correlation with U.S. equities, as represented by the S&P 500 Index, and a correlation close to zero with global bonds, as represented by the Bloomberg Barclays Global Aggregate Index. However, they were positively correlated with the U.S. Consumer Price Index.
Correlation of annual returns from 31 Dec 1970 to 30 June 2017

<table>
<thead>
<tr>
<th></th>
<th>Bloomberg Commodity Index</th>
<th>U.S. equities¹</th>
<th>Global bonds²</th>
<th>U.S. inflation³</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bloomberg Commodity Index</td>
<td>1.00</td>
<td>0.30</td>
<td>0.30</td>
<td>-0.03</td>
</tr>
<tr>
<td>U.S. equities¹</td>
<td>0.30</td>
<td>1.00</td>
<td>0.18</td>
<td>-0.10</td>
</tr>
<tr>
<td>Global bonds²</td>
<td>0.30</td>
<td>0.18</td>
<td>1.00</td>
<td>-0.10</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Bureau of Labor Statistics as of 30 June 2017

1 U.S. equities are represented by the S&P 500 Index.
2 Global bonds are represented by the Bloomberg Barclays Global Aggregate Index.
3 U.S. inflation is represented by the U.S. Consumer Price Index.

Although the correlation of commodities to equities saw a temporary pickup in the aftermath of the global financial crisis in 2008/2009 period, this was the result of the decline in aggregate demand that uniformly affected many asset classes, resulting in higher correlations among them.

Since then, commodities have returned to responding more to fundamental supply factors. These can include weather, which affects natural gas and grains prices, geopolitical instability, which influences crude oil, or mining strikes, which affect metals. Importantly, these factors do not tend to affect stock or bond market returns to the same degree, and accordingly, correlations between commodities and other asset classes have come down.

Commodities’ low correlation to stocks and bonds illustrates what may be the most significant benefit of broad exposure to commodities: diversification. In a diversified portfolio, asset classes tend not to move in sync with each other, which tends to reduce the volatility of the overall portfolio. Lower volatility reduces portfolio risk and should improve the consistency of returns over time. However, diversification does not ensure against loss.

HOW TO INVEST IN COMMODITIES?

In the past, capturing the full benefits of commodity exposure was challenging. Investing in physical commodities – a barrel of oil, a herd of cattle or a bushel of wheat – is impractical for most, so investors tended to seek commodity exposure either by purchasing commodity-related equities, or through Commodity Trading Advisors (CTAs) via managed commodity futures accounts.

However, these investment strategies may not capture the potential diversification and other benefits of commodity exposure in a portfolio. For example, commodity-related equities will not necessarily reflect changes in the price of commodities. If an oil producer has already sold its supply on a forward basis, the producer's stock price may not fully benefit from a rise in the price of oil. Commodity-related equity returns can also be affected by the issuer’s financial structure or the performance of unrelated businesses. In fact, commodity-related equities may actually have a higher correlation to movements in equities than the commodity market. CTA managed futures accounts also may not provide the benefits of commodity exposure suggested by historical commodity index performance, because these accounts tend to reflect the manager’s skills at selecting the right commodities, at the right time, rather than the inherent returns of the commodity market.

The emergence of investment vehicles benchmarked against commodity futures indexes has provided investors with another option for gaining exposure to commodities. Investment vehicles managed against commodity futures indexes are not the same as CTA managed futures accounts. Instead, the base exposure of the commodity index provides exposure to a broad range of commodities. For example, the Bloomberg Commodity Index tracks the futures price of 22 different commodities within seven categories, including energy, livestock, grains, industrial metals, precious metals and “soft” commodities. Changes to the composition of the index are determined by preset rules rather than a manager’s discretion.
One potential advantage of commodity exposure managed against a diversified index is that commodities are not highly correlated with each other and thus returns should be less volatile than the returns on an individual commodity. Another advantage is that commodity indexes themselves have existed for decades, providing ample historic data for asset allocation studies and research.

**WHAT ARE THE RISks?**

While diversified commodity exposure can provide investors with a number of potential benefits, investing in commodities entails risks as well. In particular, commodities may not perform well during cyclical downturns in the U.S. or global economy, when consumer and industrial demand slows, they may also be impacted by market, political, regulatory and natural conditions, and may not be suitable for all investors. Commodities have historically been about as volatile as the equity market, potentially resulting in periods of underperformance.
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