Positioning for the 2020s Commodity Bull Market – Select Your Exposure Wisely

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SUMMARY

- **Historically commodities have provided unique portfolio diversification benefits and comparable returns to equity markets. From 1970 to 2015, commodities outperformed equity indexes.**
- **Recency bias has led to commodities being shunned. This has been conflated by the misuse of linear/ arithmetic chart scaling: appropriate for the short to medium term, but not the long term.**
- **Resource equity investments of commodity producers have been favoured in recent years given the stock market outperformance. Tactical commodity investments have many advantages beyond resource equity and direct long-only commodity benchmark strategies.**
- **Timing of commodity investments is long-term, cyclical and currently attractive.**
  a. Inflation/reflation, money supply, and a potential USD tailwind.
  b. Supply/demand imbalance with broad commodity supply deficit.

INTRODUCTION

The return potential and portfolio diversification benefits of commodities are under-appreciated. Given the outperformance of the equity market over much of the last decade, commodities have been underutilized.

This paper will discuss the portfolio benefits of adding commodities using three different approaches. First, adding exposure through resource equities of producers focused in energy, metals and agricultural sectors. Secondly, using a more direct exposure in a basket of underlying commodities using a benchmark index. Thirdly, using a tactical approach to commodity investment. We will then highlight the advantages and disadvantages of the different approaches.

Further, we will look at the commodity sector from a cyclical perspective and examine the potential opportunity that this presents at the current time. We believe the current opportunity is unlike anything we have seen for commodities in decades.

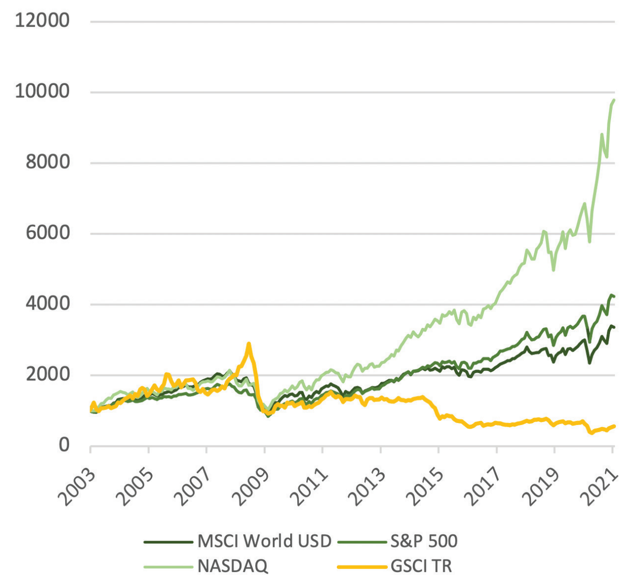
LONG TERM COMMODITY OUTPERFORMANCE

When investors consider commodities, or any investment, they tend to focus on recent performance. Few investors appreciate that until the last decade, commodities have outperformed equities. This is conflated by the fact that we tend to rely on linear/arithmetic charts: appropriate for short to medium time frames, but misleading when considering the long term.

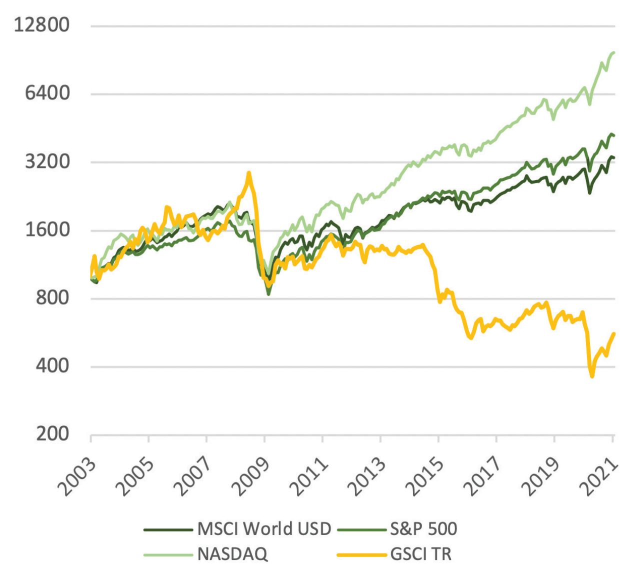
Consider Figure 1. In the top chart (Figure 1A) a typical linear/arithmetic chart is used since the bottom of the tech bubble (2003). From this perspective, the Nasdaq appears to have had exponential or even parabolic growth. The logarithmic scaling however (Figure 1B) displays a much more consistent price appreciation and is more representative of the returns an investor realizes. Said differently, an increase of 1000, from 1000 to 2000, is much larger than an increase of 1000 from 8000 to 9000. This is the benefit of a logarithmic chart when looking at a longer term perspective; returns are scaled proportionately.

Figure 1 LINEAR/ARITHMETIC (A) CHART DISTORTS NASDAQ RETURNS SINCE TECH BUBBLE RECOVERY. LOGARITHMIC (B) CHART DISPLAYS PROPORTIONAL RETURNS

1A



1B



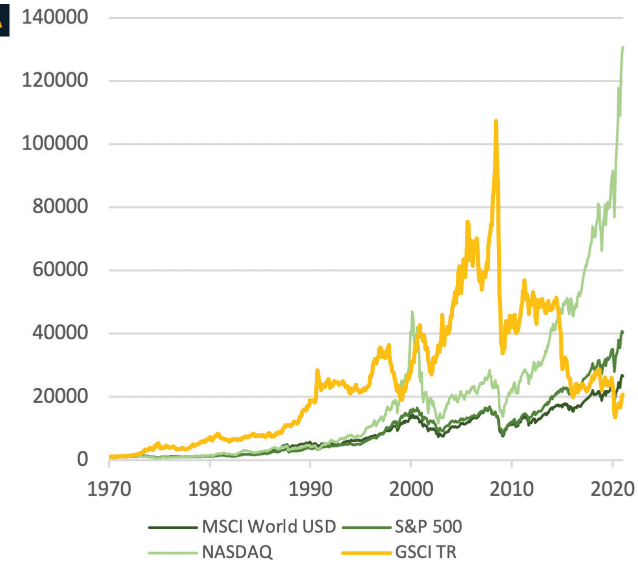
Regardless of chart scaling however, the most recent commodity experience has not been rewarding. This is in stark contrast to long term returns.

Consider the GSCI TR (S&P Goldman Sachs Commodity Index, Total Return) in Figure 2A and 2B. We have included the GSCI TR commodity index given its extended track record dating to 1970. In the top chart (Figure 2A) the prevalent perspective on commodities is portrayed by the linear/arithmetic chart: Commodities were a story of the 2000s, and performance in that period was an anomaly.

This is inaccurate, the opposite is in fact true: the recent under-performance of commodities may be the anomaly.

Figure 2 LINEAR/ARITHMETIC (A) CHART DISTORTS EQUITY AND GSCI TR RETURNS SINCE 1970. LOGARITHMIC (B) CHART DISPLAYS PROPORTIONAL RETURNS

2A



Consider Figure 2B. Since 1970 an investment in the S&P GSCI TR, the longest tenured commodity index, has outperformed the MSCI World, S&P 500, and the Nasdaq until recently. It has done so with similar annualized returns, and importantly for portfolio managers, with low correlation to equity markets. See Table 1 next page.

2B

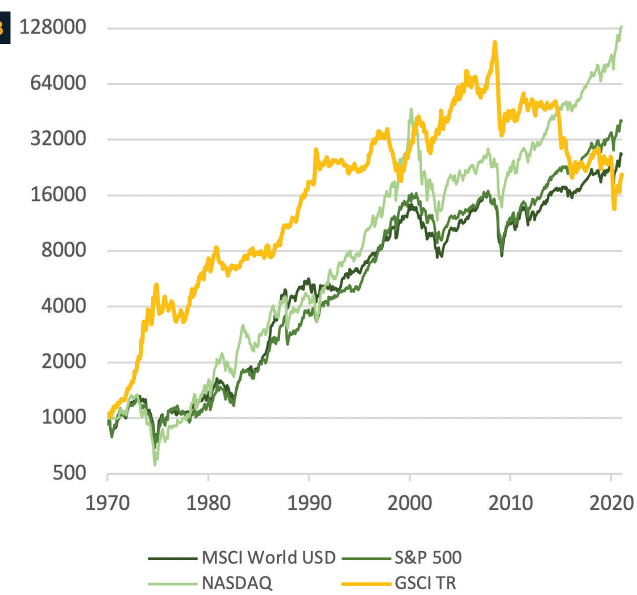


Table 1 COMMODITIES VERSUS EQUITIES

JAN 1970 - FEB 2021	MSCI WORLD	S&P 500	NASDAQ	GSCI TR Commodity
Annualized Return	**6.68%**	**7.55%**	**10.01%**	**6.32%**
Volatility	14.82%	15.26%	20.55%	20.56%
Equity Correlation (MSCI World)	1.0	0.90	0.78	0.18

PASSIVE COMMODITIES, RESOURCE EQUITIES, AND TACTICAL COMMODITIES

Over long periods commodities have produced attractive returns, but what is the best choice to access this exposure? This fundamentally important question is typically not given rigorous consideration. Given the relative equity outperformance since 2009, the choice to use resource (producer) equities has been an easy and familiar solution. However, is it the best one going forward?

Much of the bias towards resource equities can be understood from the negative performance of passive (long only) commodities in recent years. Yet as illustrated, if we consider the long term, returns are comparable. Further, if we consider the period prior to the commodity bear market, the returns are even more compelling, having significantly outperformed equity indexes. See Table 2.

Table 2 COMMODITIES VERSUS EQUITIES PRIOR TO GLOBAL FINANCIAL CRISIS

JAN 1970 - Dec 2007	MSCI WORLD	S&P 500	NASDAQ	GSCI TR Commodity
Annualized Return	**7.55%**	**7.56%**	**9.01%**	**12.02%**
Volatility	14.1%	15.06%	21.3%	18.78%
Equity Correlation (MSCI World)	1.0	0.86	0.74	-0.02

We can't invest with perfect timing and the benefit of hindsight, but some basic rules-based strategies have effectively mitigated much of the commodity bear market exposure, reducing the downside, and we can compare the results of these strategies to both resource equities and passive commodities.

To do so we consider the following alongside the S&P GSCI TR (Table 3):

- MSCI World Commodity Producers Index, the bellwether for resource equities (MSCI WCPI)
- Bloomberg Commodity Index, a more diversified passive commodity index (BCOM TR)
- Morningstar Long/Flat Commodity Index, a tactical commodity index (MSDILFTR)
- Auspice Broad Commodity Index, a second long/flat tactical commodity index (ABCTRI)

Limited data exists for these indexes prior to 2000, so the time period since 2000 serves as the basis for our analysis (despite this being the poorest period for commodity returns).

Table 3 COMMODITY INVESTMENTS USING 3 APPROACHES

JAN 2000 - FEB 2021	Passive Commodity 1 S&P GSCI TR GSCI TR	Passive Commodity 2 Bloomberg Commodity TR BCOM TR	Resource Equity MSCI World Commodity Producers Index MSCI WCPI	Tactical Commodity 1 Morningstar Long/Flat Commodity Index MSDILFTR	Tactical Commodity 2 Auspice Broad Commodity TR ABCTRI
Cumulative Return	-17.17%	29.81%	151.1%	222.0%	422.3%
Annualized Return	**-0.89%**	**1.24%**	**4.45%**	**5.58%**	**8.13%**
Volatility	23.94%	15.95%	21.1%	11.1%	11.12%
Equity Correlation (MSCI WRLD)	0.38	0.48	0.79	0.21	0.27
Bond Correlation (Barclays Agg)	-0.07	0.01	-0.05	-0.01	-0.05
Commodity Correlation (BCOM)	0.83	1.00	0.70	0.77	0.77
Skew	-0.61	-0.53	-0.26	0.17	0.29

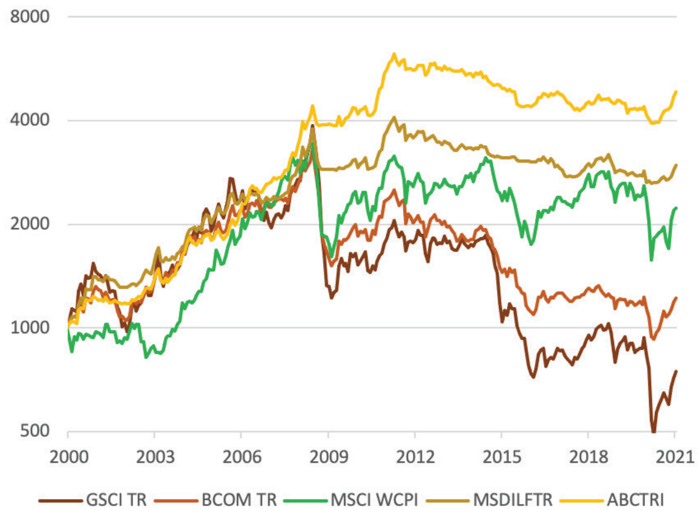
Notably, while the resource equity index outperformed passive commodity indexes, it did so with 30% more relative volatility and a much higher correlation to the equity benchmark (MSCI WRLD), the very thing one seeks diversification from (both highlighted in red). Further, commodities outperformed equities for the 30 years prior. Had there been more data for resource equities we would expect the returns to be comparable albeit with passive commodities having significantly lower correlation than resource equities.

However, it is the tactical commodity approach that really shines during this period. Not only is the performance greater, but the volatility is far lower and the correlation to equity is very low and thus the most accretive. We could stop right here but the next section explores the detailed elements of a tactical strategy that may provide the opportunity for outperformance.

TACTICAL COMMODITY

There are many reasons to consider using a tactical approach to commodity investing. In simple terms, as opposed to a simple benchmark of long only exposures, it considers timing and commodity selection all while protecting capital with disciplined, rules-based risk management. An example of this is highlighted in Figure 3 with two managers with specific expertise and long track records. Notably, the performance in the first eight years of the bull market is comparable across strategies, but the risk management in tactical approaches significantly differentiates performance in the ensuing bear market.

Figure 3 PERFORMANCE OF PASSIVE COMMODITIES, TACTICAL COMMODITIES, AND RESOURCE EQUITIES



The features of a tactical commodity solution can be summarized as the following:

- **Tactical positioning** – Active positioning based on technical and/or fundamental insight rather than passive buy and hold commodity exposure.
- **Dynamic Risk Management** – Individual positions are weighted and rebalanced based on the component's historical volatility to maximize risk-adjusted returns.
- **Roll Optimization** – "Smart roll" approach to optimize the impact of contango/backwardation while ensuring adequate liquidity and minimal transaction costs.

Given the commodity asset class is so diverse, the fundamentals driving the sub-sectors such as Energy, Grains, Soft Commodities and Metals are very different. Even within these sectors, the characteristics are highly unique. This creates an incredible diversification opportunity within an asset class that already adds valuable portfolio diversification. As such, commodities are the ideal asset class to manage tactically, based on the trends in the individual commodity, as opposed to the sector (all commodities) or sub-sector (Grains, Energies etc) basis.

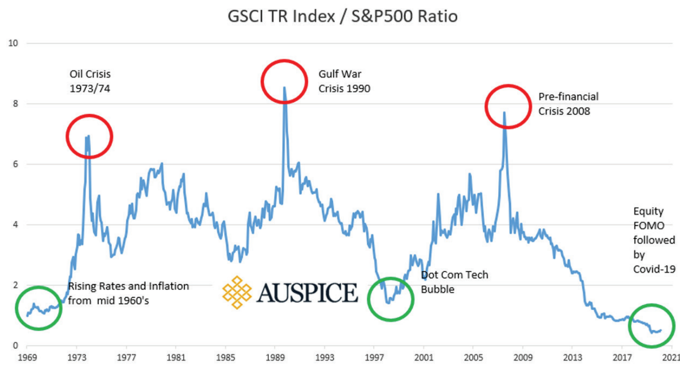
Using a tactical approach based on trend following, smart roll optimization methods, and disciplined risk management can create a better experience in the challenging times while extracting better risk-adjusted returns as the upside opportunity presents itself. Arguably this may be where we are at in the current cycle.

COMMODITY TIMING

There is a commodity value cycle that has emerged several times in history (Figure 4). Similar to the equity rally of the 1990s that outstripped commodity performance and left investors without a sector focus, the commodity to equity ratio is stretched far below average as evidenced.

Simply put, the current ratio is low in front of a typical long-term cycle. We believe this is an opportunity.

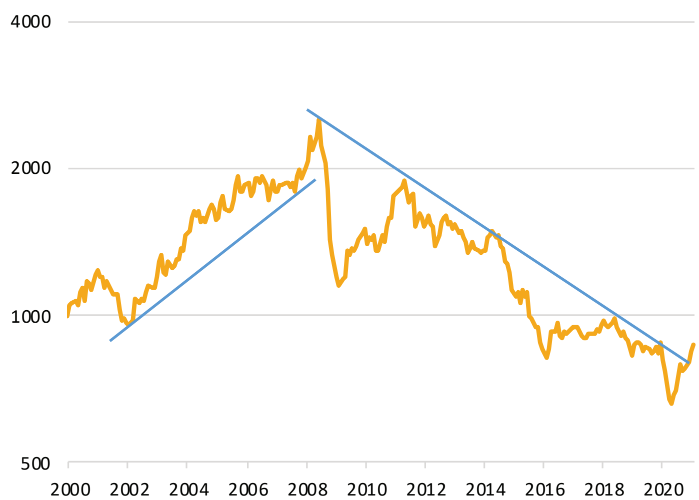
Figure 4 COMMODITY TO EQUITY RATIO



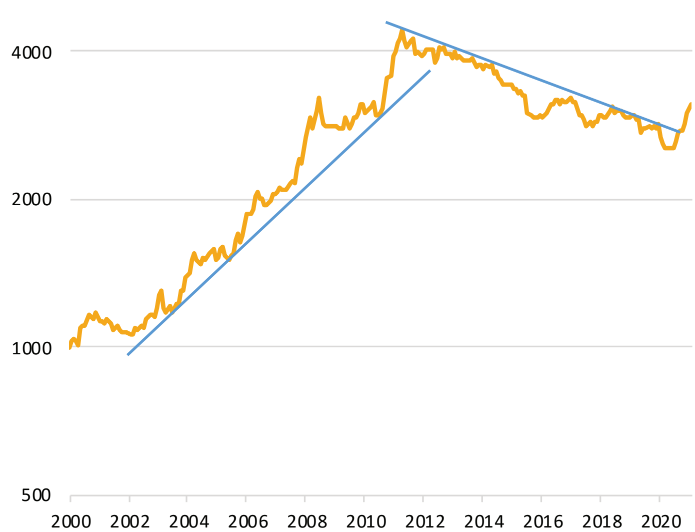
Zooming in to the 2000s in Figure 5 we can see that the leading passive (BCOM) and tactical (ABCERI) commodity indexes have broken previous 12-year bear market trendlines, indicating a new commodity bull market has potentially emerged.

Figure 5 BEAR MARKET BREAKOUT

Bloomberg Commodity Index (BCOM)



Auspice Broad Commodity Index (ABCERI)



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As per Table 2, in the previous commodity bull market (1970-2007) the worse performing commodity strategy of the last two decades (S&P GSCI TR) outperformed equity indexes and did so with -0.02 correlation to the MSCI World (equity) Index.

PORTFOLIO DIVERSIFICATION BENEFITS

Despite the lackluster performance of commodities over the last decade, including the asset class in a portfolio is historically accretive over the long-term. Given that the correlation of financial assets and commodities is low, the diversification benefit is tangible. However, beyond the performance attributes of the three commodity paths presented, the important decision to make is in the context of an accretive portfolio allocation. In this regard, there is an obvious choice that provides the most value.

Referring to Table 4, the typical "60/40" equity to fixed income base case portfolio (column 1) generates 4.39% annualized return and 0.55 Sharpe with a 34% pullback at 9.07% volatility. This portfolio has a 99% correlation to the S&P500 itself. By adding commodity diversification through producer equities (column 2) at the 10% level, there is a reduced correlation to the equity market, however the volatility actually increases.

Table 4 ADDING COMMODITY DIVERSIFICATION TO A PORTFOLIO

JAN 2000 - FEB 2021	60/40 (Without Commodities)	with MSCI WCPI Commodity Producers	with BCOM TR Commodity Index	with ABCTRI Tactical Commodity
Commodity Allocation	0%	10%	10%	10%
Annualized Portfolio Return	4.39%	4.50%	4.20%	4.88%
Volatility	9.07%	9.84%	9.03%	8.47%
Correlation to MSCI World	0.99	0.98	0.98	0.98
Max Drawdown	-34%	-35%	-34%	-29%
Sharpe	**0.55**	**0.52**	**0.53**	**0.63**
Sortino	0.80	0.76	0.75	0.94
Skew	-0.61	-0.60	-0.74	-0.54

Taking it a step further, adding direct investment in commodities through the benchmark BCOM index (column 3) and a lower correlation to equity than resource equity has the beneficial effect of lower volatility. While one might expect improved absolute and risk-adjusted returns, the results are actually slightly lower. This is due to the fact the passive long commodity benchmarks have underperformed the equity market and the 60/40 portfolio in the specific highlighted timeframe.

However, despite the timeframe, by adding the tactical commodity strategy (column 4), the portfolio has the opportunity for real improvement on all measures. In addition to improved returns, the portfolio now has lower volatility and drawdown, along with higher risk-adjusted metrics of Sharpe and Sortino. This has also reduced the negative skew of a traditional portfolio, a desirable outcome.

AUSPICE OUTLOOK

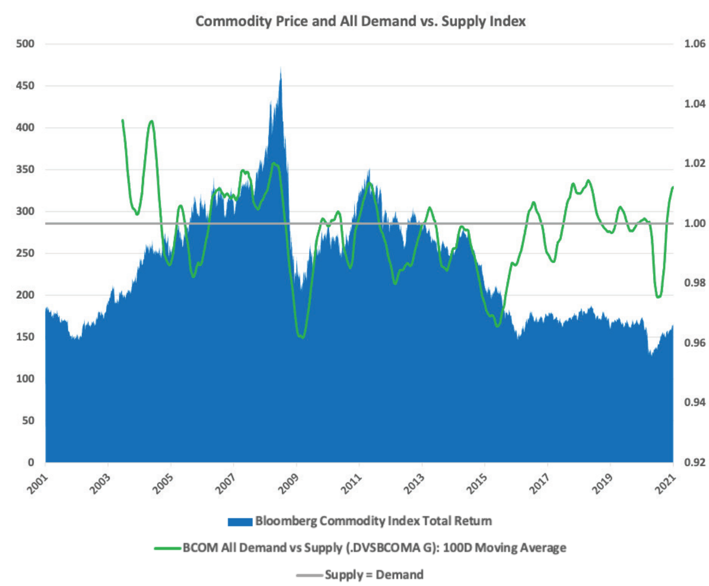
Despite global central banks guidance of "lower for longer" overnight rates, the cautionary tone remains the "reflation trade" as inflation targeting is being discussed alongside an unmistakable shift in commodities.

The last major reflationary trade occurred in 2009 as financial market valuations had been compressed and risk appetite couldn't have been much lower. This is in stark contrast to the current environment marked by the "Reddit rally" and record high financial market valuations to start 2021.

Equity and bond markets have largely priced in the end of the pandemic, yet the timeline to "back to normal" is largely uncertain. Will we return to business and leisure travel this year? Go to a movie, concert, or ball game? Maybe, maybe not. Significant risks lie ahead for global economies and financial markets.

One thing we do know is that we will continue to eat and continue to buy goods. Commodity demand has been outpacing supply for several years and commodity indexes are just beginning to reflect this (See Figure 6). Whereas equity market sentiment is arguably exuberant, commodities are still largely ignored by retail and institutional investors alike.

Figure 6 COMMODITY SUPPLY/DEMAND IMBALANCE



CLOSING

Regardless of the timing aspects of commodity cycles or fears of inflation, the most important takeaway is that adding a tactical commodity exposure potentially benefits a portfolio more than resource equity or long-only commodity benchmark approaches. Including a tactical broad commodity index allocation has the ability to improve overall performance and significantly reduce volatility and drawdowns.

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PERFORMANCE NOTES

The Equity benchmarks used in this material are intended to reflect the general equity market performance. They are shown to illustrate the noncorrelated attributes versus other assets. Adding non-correlated assets within a portfolio has the potential to reduce portfolio volatility and drawdowns.

DETAILS OF INDICES

Auspice Broad Commodity Index (Total Return) aims to capture upward trends in the commodity markets while minimizing risk during downtrends. The index is a tactical long strategy that tracks either long or flat positions in a diversified portfolio of 12 commodity futures which cover the energy, metal, and agricultural sectors. The index incorporates dynamic risk management and contract rolling methods. "ABCTRI" represents returns calculated and published by the NYSE.

Bloomberg Commodity Index (Total Return) (BCOM TR), is a broadly diversified index that allows investors to track 19 commodity futures through a single, simple measure. Total Return (TR) Indexes include collateral return.

S&P Goldman Sachs Commodity Index (Total Return) (S&P GSCI TR), is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The total return (i.e., the return on the S&P GSCI™ total return index) is the measure of commodity returns that is completely comparable to returns from a regular investment in the S&P 500 (with dividend reinvestment) or a government bond, while the return on the excess return index is comparable to the return on the S&P 500 above cash.

60/40 Portfolio: The benchmark 60/40 portfolio uses 60% MSCI World and 40% Bloomberg Barclays US Aggregate Bond Index, rebalanced annually.

Bloomberg Barclays US Aggregate Bond Index: Total Return Value Unhedged USD. The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

The MSCI World captures large and mid-cap representation across 23 Developed Markets (DM) countries. With 1,582 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI World Producers Index (MSCI WPI) captures the global opportunity set of commodity producers in the energy, metal and agricultural sectors. Constituents are selected from the equity universe of MSCI World, the parent index, which covers large and mid cap securities across 23 Developed Markets (DM) countries*. All index constituents are categorized in one of twelve sub-industries according to the Global Industry Classification Standard (GICS®), including: integrated oil & gas, oil & gas exploration & production, gold, steel, aluminum, precious metals & minerals, agricultural products, paper products, and forest products.

The Morningstar Long/Flat Commodity Index (Total Return) (MSDILFTR) is a fully collateralized commodity futures index that is derived from the positions of the Long/Short index. It takes the same long and flat positions as the Long/Short index and replaces the short positions with flat positions.

The NASDAQ Index is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks, as well as limited partnership interests. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.