Investing in Commodities and Futures without Losing Your Pants or Skirt

by Alan C. Snyder

Executive Summary

- Wading into commodities and futures investing (CFI) can increase returns and lower volatility, but how best to take the plunge? – active or passive management of your account?
- The author provides important insight and analysis for money managers on how to invest in this broadly defined and narrowly understood category that continues to gain institutional acceptance.
- In a sector that involves over 65 commonly traded asset classes and markets, the challenge for the investor is achieving the positive benefits of CFI exposure, while minimizing any detriments.
- Both active and passive CFI management can be done by the individual investor with advice from others.
- An active investor may invest through individually managed accounts, mutual funds or limited partnership interests.
- The most popular passive investing vehicles are Exchange Traded Funds (ETFs), which typically buy futures contracts in one of the many different markets.
- Many ETFs, with the exception of the newly formed funds that invest directly in gold and silver, have not accurately tracked the price movements of their underlying asset and market classes.
- More recently created Exchange Traded Notes (ETNs) guarantee price tracking by a financial institution rather than relying on the underlying futures contract; however, fears surrounding the guarantees and the overall safety of financial institutions have limited their acceptance.
- Statistics show that, historically, active CFI investors received meaningful benefits compared to passive investors: higher returns, lower correlation to stocks, lower volatility, lower maximum drawdowns and positive returns during stock loss months.

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Some of the smartest investors – Yale, Harvard, Ontario Teachers Pension Plan – realized years ago that commodities (grain, meats, oil and precious metals) and financial futures (currencies, equities) belonged in their portfolios. In a virtuous cycle between the practitioners and academic researchers, common agreement was reached that commodities and futures investing (CFI) does lower volatility (risk), increase returns and is uncorrelated to the typical asset classes of stocks and bonds.[1,2] Everyone else became a believer after 2008, when CFI was the only sector left standing. Now that everyone is on board, the debate has shifted to passive versus active management. Can an index of commodities or financial futures, available through Exchange Traded Funds or Exchange Traded

[1] The Potential Role of Managed Futures Accounts in Portfolios of Stocks and Bonds" (Dr. John Lintner, Harvard University, 1983)
[2] "Strategic Asset Allocation and Commodities" (Ibbotson & Associates, 3/27/06)

Notes, deliver the same performance as actively managed accounts? Our research says active outperforms passive by a wide margin and after all costs, too.

CFI, a commonly-used designation, is a bit of a head-scratcher because it encompasses much more than it literally says. "Commodities investing" refers narrowly to assets which come out of the earth and are in physical form, whether an agricultural product, a metal, oil, etc. The "futures investing" part technically only describes a single and specific trading vehicle, a futures contract.[3] While there are futures contracts on many different underlying assets and markets including currencies, bonds/interest rates, and commodities themselves, like oil, gas, metals, grains, orange juice, cattle, etc., CFI, in practice, includes many more trading vehicles. For example, these others may include forwards, options, swaps, commodity-related equities and even cash and carry in the physical commodities. The investment vehicles included in CFI are varied and the underlying markets and asset categories cover the waterfront. In fact, they may be the most diversified of all investment alternatives. Out of over 100 asset classes and markets commonly traded, approximately 65 have enough volume to be considered active and deep and are therefore used the most.

The challenge is how best to achieve CFI exposure and its positive benefits, while minimizing any detriments. Yet, we have all learned, heard and seen the risks, but know little about "how to get the benefits." What follows could be fairly labeled an exposé of some of the myths as well as a summarized comparison of alternatives.

There are many ways to accomplish CFI exposure but the first decision is how much money to allocate. In one study, Ibbotson, a notable research firm, calculated that 25% of a diversified portfolio was the optimal historical allocation. However, most investment advisors would say that a better target would be 5-15%, depending on the knowledge, time horizon and personal risk tolerance of the investor.[2]

Second, where and with whom should I put my money? And, should I go passive, active or both? A passive or static approach may be rules-based and implemented mechanistically without subjective discretionary judgments being made by the manager to respond to changing market conditions. Usually, trading is infrequent; most often, the strategy is long (seeking price increases). Some passive funds invest using an index or basket of "stuff," while waiting for the desired price movement. Active means relying on the manager's judgment to select which markets, allocation amounts and time period. Both passive and active CFI can be done by yourself, getting advice from others on where to invest or by delegating the decisions to the theoretical experts.

Active investing in CFI through your friendly broker means using your own or their advice. However, verifying the broker's prowess in offering advice may be more than challenging, so that you may be forced to rely on your own expertise (possibly an OMG moment?) Managed accounts at brokerage firms can work but are not for the faint-of-heart because of the margin issues, which expose the investor to the possibility of losing more than the starting capital! Of course, your broker might be happy to also sell you an indirect way to participate through an independent professionally managed approach, either active or passive.

The big sellers of financial services to individual investors have sought simple, broad-based and widely available investment alternatives to tap as many investors as possible for passive investing. The most popular [Ed. Note: intensely marketed and providing attractive revenues to the seller] have been Exchange Traded Funds, the ubiquitous ETFs offered on many different markets, e.g.,

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[3] A futures contract is an agreement to buy or sell a fixed amount of a commodity or financial instrument at a fixed price on a specific date in the future. Contracts are typically settled in cash in the open market prior to the settlement date.

the U.S. Oil Fund, U.S. Natural Gas Fund, etc. Most typically, an ETF buys futures contracts in its designated market hoping for price appreciation.

The challenge has been that many of these ETFs were launched during a time when many futures contracts traded more expensively in the near-term months of expiration and less so as time lengthened (called backwardation). This phenomenon meant that an ETF could passively invest in the desired futures contract and as it neared expiration, roll the investment forward to the next time period, earning small profits even without upward price movements in the underlying asset or market. Unfortunately, this price pattern can and did reverse. Longer-term futures contracts became more expensive than the shorter-term contracts (called "contango" by traders). When upward price movements were insufficient to offset the negative price spread between the contract being sold and the one being bought, steady losses were experienced as contracts were rolled forward. Worse yet, traders pounced on these "known" rolls seeking to capitalize on the ETF's trading patterns. In order to capitalize on the price movements from these new entrants, Wall Street firms have used storage facilities in unprecedented amounts to take physical delivery as another way to trade against them. Whether due to the trading from others or a flawed product design, many of these ETFs have not accurately tracked the price movements of their underlying asset and market classes. Imagine being long an ETF and watching the underlying asset go up, only to be in a losing position in your ETF!

CFI is growing quickly stimulating the creative juices of Wall Street and as a result its offerings will develop at a rapid pace. Move over Baskin and Robbins, the ETF flavors are many, growing, and evolving in their structures. There are spot funds investing directly in the asset, plus short (inverse), leveraged, equity-based, etc. To combat their flaws, there are new roll strategies, long dated futures contracts, and more on the drawing boards. The biggest, double digit billions, are the spot or directly investing ETFs in gold and silver. This approach solves the tracking error and costs of the future contract rolls but does incur costs of storage. Of course, it can't be applied to many assets, "Who wants to house a lean hog?"

ETF creators are now experimenting on the public with formula-driven semi-active strategies. These approaches, dreamed up by professors of finance and mathematics from major universities, may work, but who knows? As one professor recently said when queried about his poor performing approach, "We need more research!" Hence, we believe these newest ETFs are best avoided altogether until they prove themselves.

Exchange Traded Notes (ETNs) have sought to improve on ETFs. A financial institution directly guarantees the price tracking instead of using a futures contract to capture price movements from the underlying asset or market. However, since the financial meltdown of 2008, many market participants fear that these guarantees will not be collectible in the event of another crisis. As a result, the ETN marketplace has not yet displaced the flawed ETF, notwithstanding the improved tracking but should grow as 2008 fades from memory.

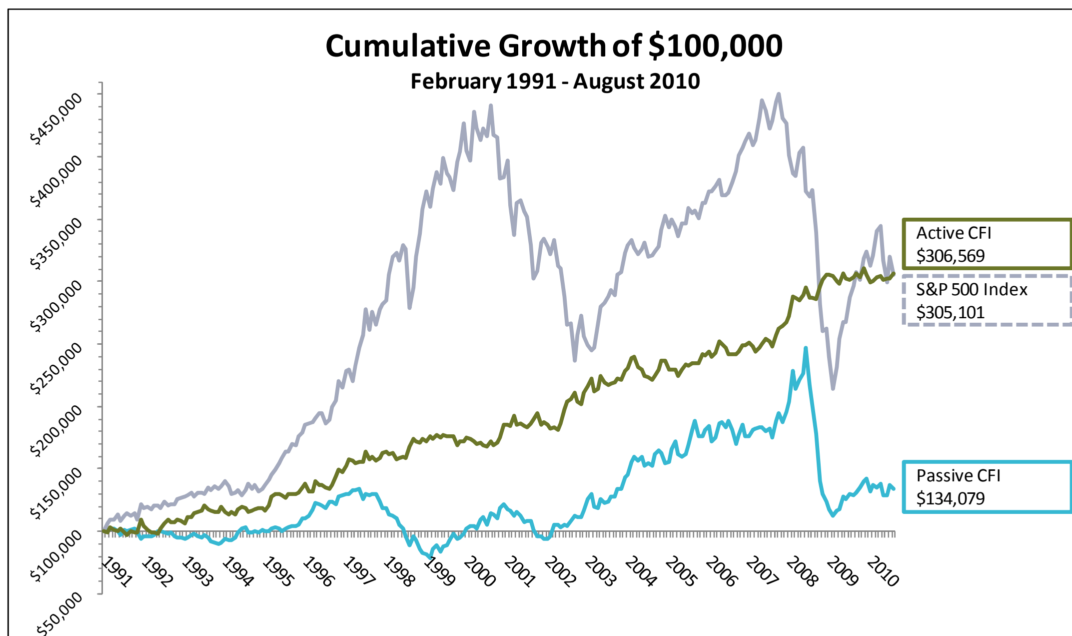
The Battle: Passive vs. Active

Random walk proponents argue that no money manager will consistently outperform a market. Other professional experts shout, "Hogwash," pointing to their own statistical proofs. Today, most seem to believe that intellectual energy carefully applied does make a difference. In the battle between active and passive CFI strategies, you be the judge.

<table>
<tr><th rowspan="2"></th><th rowspan="2">Passive CFI</th><th colspan="2">Active CFI</th></tr>
<tr><th>Single-Manager</th><th>Multi-Manager</th></tr>
<tr><td>Vehicles</td><td>ETF (Exchange Traded Fund), ETN (Exchange Traded Note).</td><td>Managed accounts, limited partnership interests, some mutual funds.</td><td>Managed accounts, limited partnership interests, mutual funds.</td></tr>
<tr><td>Strategy/Style</td><td>Typically long, usually passive, narrow and targeted to a single market or index.</td><td>Often broad and may include as many as 65 markets, even for single-manager funds.</td><td>Multi-manager funds of funds and mutual funds can cover the broadest swath of strategies and styles.</td></tr>
<tr><td>Markets</td><td>Broad choice among individual markets.</td><td>Typically more markets covered.</td><td>Groupings of markets in a single package.</td></tr>
<tr><td rowspan="2">Ease of Order Execution, Selection and Purchase</td><td rowspan="2">High.</td><td>Generally low - selection requires intellectual energy to pick best places to achieve optimal results, particularly with single managers given the wide variation in performance.</td><td>Medium - less work for fund of funds than a single manager because of the diversification but more work than for an ETF, given the variability.</td></tr>
<tr><td colspan="2">For mutual funds, there are substantial efforts required to make a wise selection given their generally short and unimpressive start, plus their surprisingly opaque fee disclosures. However, they are easy to purchase.</td></tr>
<tr><td>Investor Qualifications</td><td>Low (able to open a brokerage account).</td><td colspan="2">Mixed – For managed accounts and funds of funds, the range is from Accredited Investor to Qualified Eligible Person to Qualified Purchaser, so there is a higher standard. For mutual funds, the criteria are generally and surprisingly the same as ETFs/ETNs.</td></tr>
</table>

Active management wins by more than a nose… dollars ahead!

As the following chart highlights, active beats passive CFI.



Time Period for comparison: Lifetime of DJ-UBS Commodity Index
Passive CFI is represented by the Dow Jones-UBS Commodity Index; Active CFI is represented by the Barclay CTA Index
Sources: Yahoo! Finance; Barclay Hedge, Ltd., www.barclayhedge.com

Active CFI investors receive the key benefits of passive, with low or zero correlation to equities and bonds as well as lowered portfolio volatility when included in a traditional stock portfolio. In addition, active CFI historically offers more than passive:

1. Higher returns
2. Lower correlation to stocks
3. Forty-four percent lower volatility
4. Lower maximum drawdowns
5. Positive returns during stock loss months

See the table below for details.

				Pro forma Portfolio (85% Stocks / 15% Managed Futures)	
Shared History Period 2/1991 - 8/2010	Active CFI Index	Passive CFI Index	S&P 500 Index	Historical Results	Percent Better/Worse vs. Stocks Only
Annualized Return:	5.9%	1.5%	5.9%	6.1%	3.7%
Annualized Volatility:	8.1%	14.4%	15.0%	12.7%	15.1%
Max Drawdown:	(10.1%)	(54.5%)	(52.6%)	(45.3%)	13.8%
Correlation (r) to:					
S&P 500 Index:	(6.0%)	24.7%	100.0%	99.5%	n/a
Citi BIG Bond Index:	24.6%	3.9%	8.7%	11.1%	n/a
Passive CFI Index:	20.1%	100.0%	24.7%	26.7%	n/a
Active CFI Index:	100.0%	20.1%	(6.0%)	3.5%	n/a
Average Performance During Loss Months For:					
S&P 500 Index:	0.6%	(0.6%)	(3.8%)	(3.2%)	17.2%
Passive CFI Index:	0.1%	(3.1%)	(0.3%)	(0.2%)	20.0%

Time Period for Comparison: Lifetime of DJ-UBS Commodity Index
Passive CFI is represented by the Dow Jones-UBS Commodity Index; Active CFI is represented by the Barclay CTA Index ; Stocks are represented by the S&P 500 Index; Bonds are represented by the Citi BIG Bond Index
Pro forma portfolio assumes annual rebalancing to target allocations at the end of each year.
Sources: Yahoo! Finance; Barclay Hedge, Ltd., www.barclayhedge.com; Yahoo! Finance; Citi (yieldbook.com)

The index of active commodity and futures managers has outperformed the passive index. However, this comparison is far from perfect:

1. Is each market equally weighted between the indices? *No.*
2. Is there potential "survivor bias" in the Barclay manager index? *Yes.*
3. Does the selected time period matter? *Yes.*
4. Have individual active managers and funds of funds significantly outperformed their index? *Yes, and over even longer periods of time.*

The two yeses and one no in questions 1, 2 and 3 are trumped by the compelling yes of 4, and we believe would stay trumped even with perfect information, albeit the gap might narrow to be fair. Alas, perfect information is never available at an affordable price or in a timely fashion. Managing money or businesses requires the scary process of evaluating, digesting and acting upon imperfect information.

Our comparisons are based on asset indices and an average of "active" managers. If one were to compare a passive approach to an active one using some of the best and the brightest managers, the results are startlingly compelling, whether for a single manager or a fund of funds. Generally fund of funds have less volatility and surprisingly in some cases, better long-term returns than many of the best single managers.

Summary

With most ETFs still somewhat flawed, ETNs possibly insecure and the mutual fund executions new, untested and receiving renewed scrutiny from government regulators, active management is the best bet for the appropriate investors. Individually managed accounts and limited partnership interests win the race if analyzed deeply, ever so thoughtfully selected and invested in with moderate allocations, depending on the objectives of the particular portfolio.

Definitions and some important notes:

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

"Annualized Return" or "Returns" is the compound annual growth rate, which is the annual return that an investment would have realized over the specified period had the investment grown at the same rate each year.

"Maximum Drawdown" means the largest peak-to-valley decline experienced by the specified strategy, i.e. the greatest cumulative percentage decline in month-end net asset value due to losses sustained in any period in which the initial month-end value is not equaled or exceeded by a subsequent month-end net asset value.

"Annualized Volatility" is annualized standard deviation of monthly returns, which is a measure of how dispersed returns are from their average (a lower number indicates less volatility).

The Citigroup Broad Investment Grade Bond Index ("BIG Bond Index") measures the value of the broad U.S. investment-grade bond market, including Treasury, government agency, corporate, and mortgage-backed securities. All bonds in the index must be rated at least BBB- or Baa3, have a maturity of at least one year, and a total value outstanding of at least $200 million.

The Barclay CTA Index is a leading industry benchmark of Commodity Trading Advisors' representative performance. To qualify for inclusion in the index, an advisor must have at least four years of prior performance history. Additional programs introduced by qualified advisors are not added to the index until after their second year. © Barclay Hedge, Ltd. All rights reserved.

The Dow Jones-UBS Commodity Index represents the performance of an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. It is composed of futures contracts on physical commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The weighting of index components attempts to represent their relative significance to the global economy, using primarily market liquidity data along with production data, and is rebalanced annually.

We provide various indices as independent benchmarks. An unmanaged index does not represent the return available from any particular investment as there is no consideration of the costs that would be incurred to achieve the results, e.g. transaction fees, bid/ask spreads, administrative and management expenses, etc. Because the index data shown, except for the Barclay CTA Index, represents the performance of unmanaged indices not subject to any fees or expenses, a gross rate of return for any specific manager might be better for comparison purposes.