The Predictable Fate Of Commodity Indexation

Whenever you hear the phrase, “Any idiot can do it,” be assured many have done it already. If the “it” in question is a long-only broad-based commodity index, no sympathy will flow from these quarters. I spent a good deal of time riding the conference circuit in 2004-2006 preaching abstinence in the bawdy house on just this subject.

I have shared a few of these thoughts here, beginning with a February 2010 column on commodities and inflation and a March 2010 column on poor intra-index correlation. The arguments commodities did not constitute an asset class, were unsuitable to broad indices, would be unable to overcome their roll-yield costs, (see the U.S. Oil and Natural Gas Funds, USO and UNG as co-exhibits A) were not really diversifiers against financial assets, could not provide protection against currency debasement and would be distorted in both absolute price and in the structure of their forward curves by the sheer volume of money flowing into small markets have been valid throughout. Did I mention the inevitable consequences of higher prices for physical commodities, higher production and moves toward substitution and conservation on the supply and demand sides, respectively?

When The Wall Street Journal ran a story last week noting how pension funds were throwing in the towel, a colleague asked me whether I felt vindicated. No, I replied, not only hadn’t I won anything, I had failed to discourage the herd from charging into a predictable fate.

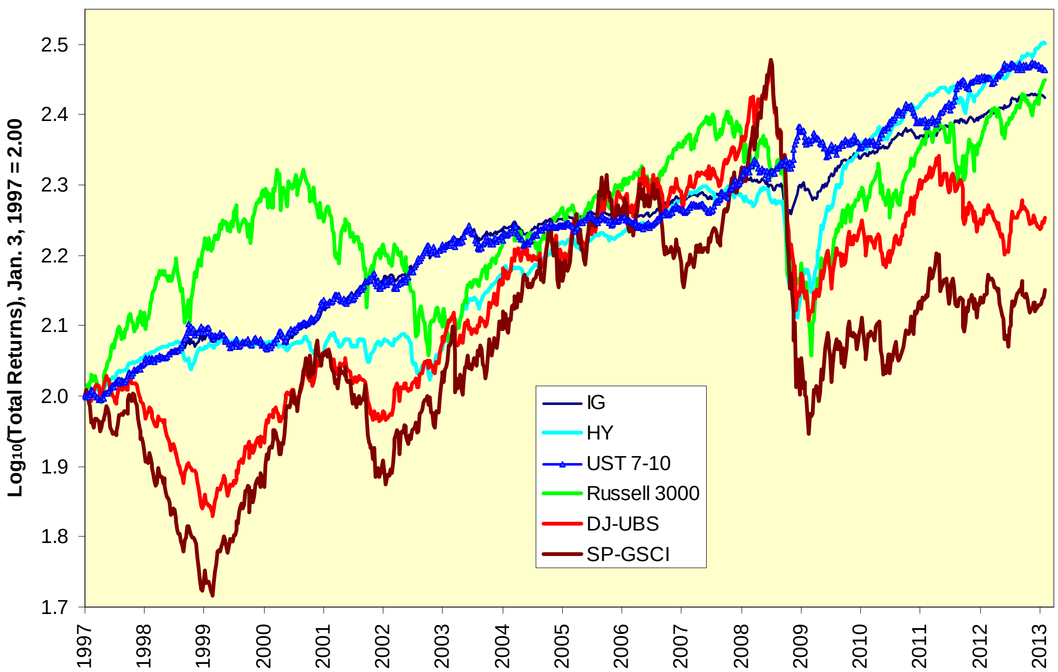
As an aside, I have been on another long-term campaign to tell investors TIPS cannot provide any greater total return than nominal Treasuries unless the sellers systematically underprice the implied insurance against inflation. I will report back to you with my successes.

Comparative Returns
Years of experience have taught me two things:

1. Returns are not everything; and
2. Nobody believes that

If we compare the total returns for two major commodity indices, the S&P-GSCI and the Dow Jones-UBS to those of investment-grade and high-yield corporate bonds, 7-10 year Treasuries and the Russell 3000, we see the commodity indices have brought up the rear after sixteen years of trying. As inflation and dollar depreciation affect all indices equally, this means commodity indices offer less protection against both.

Comparative Returns



If we look at the correlation between markets over this period, we do find the commodity indices' correlations with the financial markets are lower than they are between themselves or between the bond indices with each other, but they are not appreciably different than the correlations between the Russell 3000 and the bond indices. Besides, when you are trying to sell diversification against return, you will lose.

Weekly Correlation, Jan. 1997 - Jan. 2013

	IG	HY	UST 7-10	Russell 3000	DJ-UBS	SP-GSCI
IG	1.000					
HY	**0.929**	1.000				
UST 7-10	**0.988**	**0.922**	1.000			
Russell 3000	**0.675**	**0.791**	**0.642**	1.000		
DJ-UBS	**0.830**	**0.795**	**0.784**	**0.656**	1.000	
SP-GSCI	**0.654**	**0.600**	**0.591**	**0.568**	**0.943**	1.000

Where Next?

I do think commodities have a great place on your radar screen, just not as a unified index traded on a long-only basis. You need to go both long and short and you need to focus on individual markets or on focused indices such as just grains or just industrial metals. You should also look at the world of trading opportunities presented by commodity options and take advantage of the opportunities created by physical commodities' forward curves. I will address those issues soon.