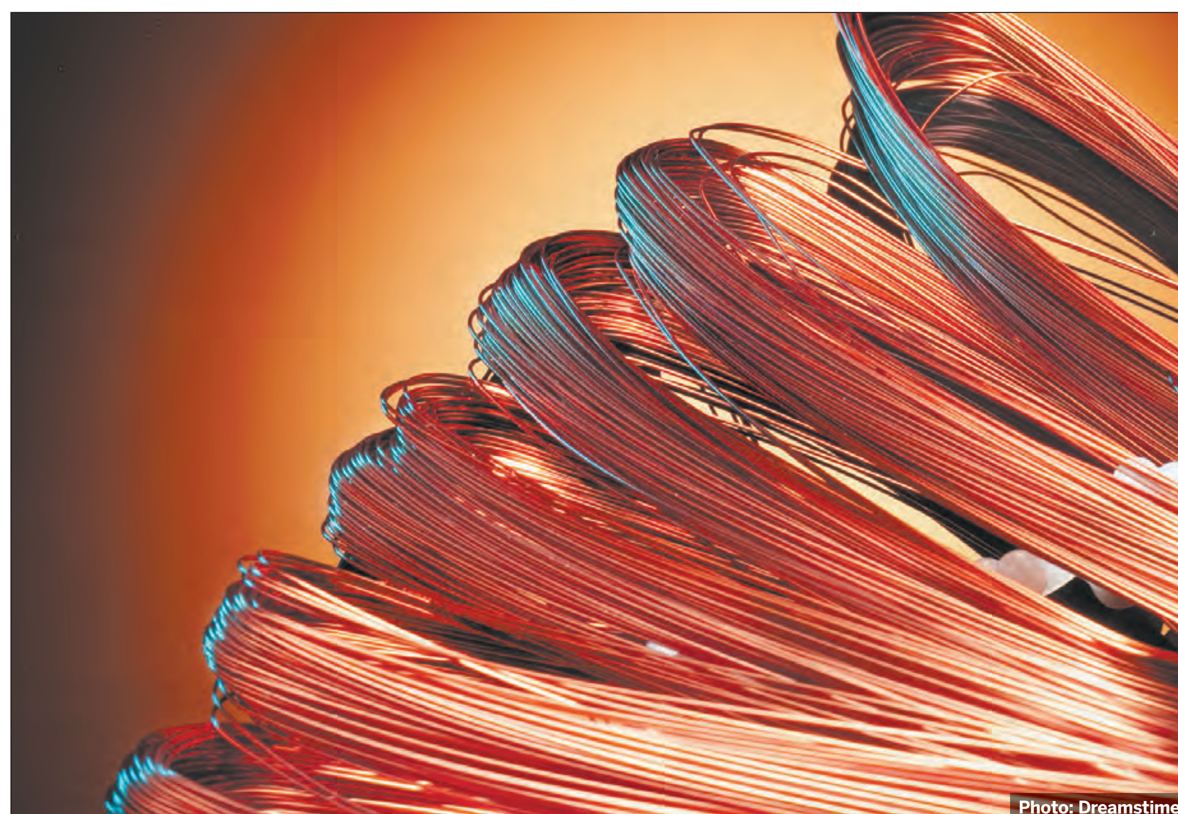
FTfm Investing in commodities

Enthusiasm wanes as regulators sharpen claws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Overview

Investment flows have slowed and speculators are in the line of fire, writes **Pauline Skypala**

The commodity supercycle is the story that has powered much of the move by institutional investors into commodities in the past decade. The growth of emerging markets, particularly China, and the accompanying demand for raw materials, along with supply constraints, was the fuel behind the huge rise in commodity prices seen in the years up to the financial crisis, according to the standard analysis.

Investment consultants added a narrative about diversification – that investors needed to expand the asset classes they held to reduce risk and find additional, preferably uncorrelated, sources of return.

Others, however, maintain that, although Chinese growth kicked off the bull market, the unprecedented strength and staying power of this bull cycle owed much to an influx of speculators into the commodities markets.

These included both institutional investors such as pension funds taking buy and hold positions in commodity indices and investment banks and highly leveraged hedge funds trading in and out.

Total assets under management in commodities were $439bn at the end of September, according to data from Barclays Capital, up from $160bn in 2008, and just $10bn at the turn of the century.

Speculators, who are necessary to provide liquidity in futures markets, used to comprise 20 per cent of the market, with hedgers being the main market participants. Now, the situation has reversed, with speculators making up 70-75 per cent of US commodity markets, according to Mike Masters, founder of Better Markets, a non-profit organisation, and of Masters Capital Management, an investment management group.

This high level of participation means speculators have gone beyond providing liquidity and are affecting price formation, he told a conference organised by Finance Watch in October.

Mr Masters pointed to the Commodity Futures Modernisation Act of 2000 in the US as the turning point, as it deregulated the over-the-counter derivatives market and opened up the OTC market as "a viable alternative to listed exchanges".

Prodded by growing concern about volatility in oil and agricultural commodity markets in particular, regulators in both the US and Europe are seeking to gain greater oversight of commodity markets and make sure they operate to serve the real economy by allowing hedging activities but not over-speculation.

Speaking at the Finance Watch conference, Maria-Teresa Fabregas, head of unit, securities markets, at the European Commission, said the Commission acknowledged that supply and demand fundamentals and strong growth in emerging markets had a big role in driving developments in commodity markets, "but it is not these [factors] alone that drive [them]".

The financialisation of commodity markets had seen markets grow in volume and participants "and fluctuations and volatility of prices has appeared in a more evident and frequent way", Ms Fabregas said.

Among other controls, regulators propose to bring in position limits for big commodity traders. Such a rule was due to come into force in the US in October, but was blocked by a court decision, which the commodities regulator, the CFTC, is appealing against.

Trade associations representing commodity traders and other financial groups deny there is any link between the weight of money going into commodity markets and higher price levels or volatility. They say fundamentals drive markets in the medium and long term, and while investors may intensify short term trends, they do not create them.

Kevin Norrish, commodities strategist at Barclays, says the idea that investor flows affect prices is "an attractive argument for interest groups and regulators to promote", but that there is "a mountain of evidence" to show it is not the case.

The debate continues but, whatever the pros and cons, investors are less enthusiastic about commodities than in the past. Flows have fallen from $66.1bn in 2010 to $11.6bn in 2011 and $14.5bn for the first three quarters of 2012, according to Barclays.

Flows into broad-based commodity indices have slowed markedly in the past 18 months, turning negative in 2012. Mr Norrish points out that flows into most risk assets have not been good this year on concerns about the outlook for the global economy.

> Regulators in the US and Europe want to gain greater oversight of markets and to make sure they operate to serve the real economy

In addition, commodities have become more correlated with other assets, and with each other, which was not the case in the past.

The faltering China growth story is another negative for commodities, although analysts are wary of confirming that a slowdown in China should necessarily signal the end of the supercycle.

"The debate about whether the supercycle is over has been spurred by the slowdown in China's growth and the idea that China is moving from an investment-driven development phase to a consumer-driven one," says Mr Norrish.

Industrial metals, such as steel, zinc and to a lesser degree copper, would be particularly affected by that change, but gold would benefit from higher consumer demand, as would aluminium, which is used widely in consumer-oriented applications.

Oil, which has already slowed in terms of growth in barrels per day production, could do better than industrial metals, benefiting from the expected strong growth in car sales in China. "The number of cars on the road could double," says Mr Norrish.

So on the demand side, the story is complex. On the supply side, the development of shale oil and gas has had a big effect, with gas prices at a fifth of their peak levels and some easing in the oil price.

However, there has not been much progress in easing supply constraints in many other sectors. Some have been dealt with, including a lack of new copper mines and oil deposits, but there is a lag in infrastructure development.

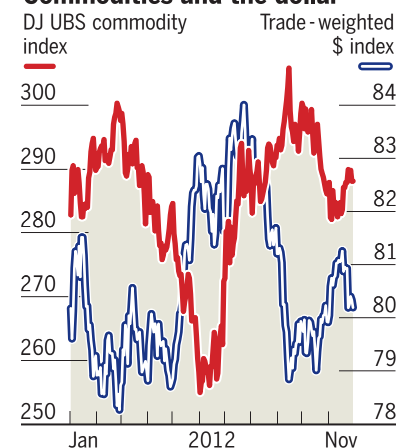
As for the oil price, in the US it is so low because the oil is getting stuck in the system, says Mr Norrish, concluding that the debate about the supercycle is "nuanced".

Investment consultants still point to commodities as one of a number of sources of "niche return" and "meaningful diversification", as Alasdair Macdonald, head of investment strategy, UK, at Towers Watson, puts it.

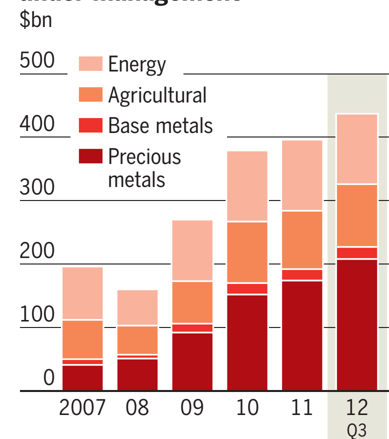
He says pension funds have been moving into commodities for some time, but "these things go in an 'S' curve": in 2009, pension fund allocations were at the middle of the curve, now they are at the top right.

Generally, institutional investors are in for the long term rather than looking to jump in and out, Mr Macdonald adds.

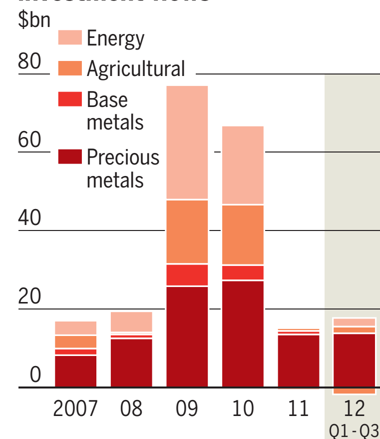
Commodities and the dollar



Commodity assets under management



Commodity investment flows



Sources: Thomson Reuters Datastream; Barclays

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Position limits split traders and lawmakers

Regulation

Speculators are under attack in US and Europe, says **Madison Marriage**

The debate around commodities speculation is proving a heavy burden for asset managers and investors worldwide as they struggle to cope with slow-burning regulation.

Regulators in the US and Europe have paid close attention to commodities trading since the 2008 financial crisis as food shortages and soaring oil prices intensified the debate on speculation and cash prices.

Many groups believe regulators need to take a firmer hand with speculators. The Commodity Markets Oversight Coalition (CMOC), a non-profit US group, wrote in October: "Excessive speculation only leads to increased hedging costs and diminishes confidence that commodity prices fairly reflect actual supply and demand factors.

"Speculative bubbles certainly can and do cause financial crises, as was the case in 2007 and 2008, when food prices were at record highs and oil reached $147 per barrel."

But among lawyers, asset managers and academics, there is strong opposition to position limits on trades, an avenue being pursued by US and European regulators to reduce price increases and volatility.

Matthew Kerfoot, a partner at law firm Dechert, says: "Every time a commodity such as oil increases in price, suddenly there is a clamour among politicians concluding that commodities speculation is responsible. This is a knee-jerk reaction from politicians who point their fingers at the commodities market, but there is no evidence ever cited to support that conclusion."

Anjun Zhou, head of multi-asset research at San Francisco fund firm Mellon Capital, says: "By attempting to make the market more transparent and efficient, the regulators intend to reduce price volatility and lower trading costs.

"However, these rulings, in particular on commodity position limits, may cause liquidity to decrease, which could result in increased price volatility [and] increased trading and risk management costs."

Mr Kerfoot agrees. He says position limits would "impede the ability for market participants to properly hedge their investments. This risk will ultimately be born by the general public and their public pension plans".

Regulatory U-turns add to the industry's pain. The US Commodities Futures Trading Commission (CFTC) released proposals in January to place firm position limits on 28 agricultural, metal and energy products. In September, after months preparing to comply with the new rules, a federal court judgment overturned the CFTC ruling.

Mr Kerfoot says this is a "very good example" of how regulatory uncertainty creates unnecessary financial burdens. "[Firms] had to prepare for the implementation of position limits [which] required extensive internal and external resources. This was a huge waste of time and money for managers and dealers."

The CFTC's quest to impose position limits, however, is far from over. The commission is expected to appeal against the court's decision in December. If this fails, it could take the appeal to the US Supreme Court.

> For want of a real investigation into the effects, many institutions are getting out

Europe's regulators are just a few steps behind the US in terms of finalising rules. In March the European Parliament rapporteur, Markus Ferber, published his proposals for amendments to the Markets in Financial Instruments Directive (Mifid II), recommending stronger position limits for commodity derivatives trading.

In October, having pored over more than 2,000 proposed amendments, the European Parliament finally published an updated report on Mifid II.

Eva Joly, rapporteur for the committee on development, wrote: "[There is] a growing body of evidence [that] highlights the major potential distortive and disruptive role played by the financialisation of commodity trading".

Ms Joly acknowledged, however, "a large consensus on the lack of comprehensive and granular information [on the subject]".

For want of a thorough, independent academic investigation into the effect commodities speculation has on prices, many institutions and investors are pre-emptively distancing themselves from commodities related products to prevent reputational damage.

Several European banking groups have withdrawn from commodities linked funds, while the Illinois Teachers' Retirement System, one of the largest US pension funds, recently ended all commodities investment.

"[In the face of] uncertainty, while some investors may do business as usual, others simply choose to wait and see," says Mellon Capital's Ms Zhou.

"While the immediate impact of [regulation] on the efficacy of our strategies appears small, the long-term ramifications on the market and the asset management industry remain unclear," she adds.

Philippe Zaouati, deputy chief executive of Natixis Asset Management, says better research is vital. "We need strong academic insight into this issue. There have been a lot of studies into this area but markets are evolving rapidly. If we use 20-year data for a study, its conclusions will not fit with the current market."

Laura Cox, regulation partner at PwC, agrees. She says: "Whilst the majority of academic opinion suggests speculation does not drive up commodity prices, there is nothing conclusive.

"Policy makers should focus on the cost of further regulation of these markets versus the likely benefits, supporting these policy decisions with robust research."

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Seams like a good idea: miners drilling at an Anglo Gold Ashanti mine in South Africa – some analysts say the gearing effect is a potential boost for equity prices Bloomberg

Buyers weigh virtues of futures and stock

Commodity equities

Opting for shares of producers might provide bigger returns, writes **Brian Bollen**

Buying gold-mining companies rather than gold, or oil exploration and production companies instead of oil futures, could be a better way to play the commodity supercycle over the next decade.

This is the view confidently expressed by Steve Shafer, chief investment officer and portfolio manager of Oklahoma City-based Covenant Financial Services.

Commodity prices have boomed as part of a supercycle that began in earnest in 2003, but shares of companies producing commodities have lagged behind.

Mr Shafer thinks this could be about to change, as yield-hungry investors shift their focus to stocks in these undervalued (by historic standards) companies.

"Stocks will return to favour as economic fundamentals reassert themselves, which they must eventually do," he argues. "They could perform strongly over the next 10 years."

Richard Robinson, of Jersey-based Ashburton, nominates the gearing effect as a potential booster for equity prices.

"If the price of your product is $500 and your costs $400, you make a profit of $100," he says. "But if your price doubles and your costs remain unchanged your profit rises sixfold."

Earnings are thus geared into commodity price moves.

Going one remove further, Mr Robinson points to the possibilities of investing in the suppliers of goods and services to the miners and other explorers.

He calculates that from February 2009, while buying a future would have served investors well, they could have done better investing in equities. He adds the caveat that careful thought must be given to the selection of the right energy exchange traded product to avoid relatively disappointing returns.

"The MSCI global energy index, an index that includes oil producers (who were hurt by the increasing costs of oil extraction) rose a relatively meagre 53 per cent," he notes.

"But if we look at companies involved in offshore oil extraction like SeaDrill, Petroleum GeoServices or Subsea7, we can see that they rose by between 290-500 per cent."

Coutts' Henry Lancaster (top) and Steve Shafer of Covenant

Chris Wheaton, analyst and portfolio manager for the oil and gas sector at Allianz Global Investors, lists several further reasons why energy equities represent an attractive investment in comparison with trading futures.

First, they typically deliver a dividend. Secondly, they are US dollar-backed. Thirdly, there is no contango or negative roll effect. Fourthly, they offer significant optionality, from major oil companies to medium-sized oil companies, infrastructure companies and service suppliers. Finally, they offer a much broader and more leveraged exposure to oil prices.

He refers to his own recent performance to underpin how his theory translates into perspective. "My fund is up 31 per cent from September 2011 to September 2012," he says. "In that time the oil price has gone up by, say, 20 per cent, while coal and gas are both down."

> Clients will tend to look to commodities to hedge against inflation and other economic and political risks

Not everyone in the market agrees, of course.

Neil Shah, director of research at Edison Investment Research, highlights what he perceives as flaws in the theory that buying commodity producer equities will generate a higher return.

He concedes the possibility of greater upside in that the equity price can outstrip the pace of any rise in the price of the underlying commodity.

But, once important considerations such as sovereign risk, political risk, geographical risk and operational risk, not to mention liquidity risk, are taken into account, the potential reward does not compensate, he says.

"At some point, yes, gold mining equity valuations will be cheap enough to reflect the risk of the revocation of licences or production shortfalls caused by matters beyond their control, but we are not there yet," says Mr Shah. "We believe that for gold, at least, the preference will continue to be for futures rather than equities."

Henry Lancaster, an investment analyst at Coutts Wealth Management, broadly shares this view. He argues that clients will tend to look to commodities to hedge against inflation and other economic and political risks.

"Buying commodities directly rather than equities linked to commodities will isolate those attributes effectively," Mr Lancaster says. "Buying an equity will dilute exposure to the commodity, and subsequent attempts to counter that dilution could see risks accumulate, unbalancing a portfolio."

Clive Burstow, fund manager of the Baring global mining fund, is very much a fan of equity, which one would expect of a firm which sees its core skill as stock picking.

"Although volatility in the mining sector is likely to remain high over the year ahead, we do believe that a focus on the fundamentals, which are the key driver of the sector, will reassert itself," he says.

There is of course no compulsion to favour one approach over the other. At a time of rising risk appetite induced by central banks' quantitative easing policies, basic resource equities often outperform commodities, observes Nick Brooks, head of research at ETF Securities. "My experience of asset allocation is that they are complementary investments, rather than mutually exclusive."

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Do not count on many happy returns this year

Strategies

Popular routes to extract alpha have disappointed amid choppy conditions, says **Chris Flood**

Commodity investors have faced a challenging year in 2012 as choppy market conditions have disrupted key investment strategies and blunted returns.

Nicholas Brooks, head of research at ETF Securities, says this year has been particularly tricky, as multiple trends have influenced commodity prices, making it difficult for any single investment strategy to work effectively.

The S&P GSCI index, the most widely followed benchmark in commodities markets, delivered a -0.7 per cent total return between January and October and -33.8 per cent over the past five years, underlining the difficulty of pursuing a passive long-only strategy.

The main sub-sectors of the headline S&P GSCI index have produced mixed results this year. Total returns from crude oil are down 15.9 per cent, energy returns have shrunk 3.9 per cent and industrials metals are down 3.8 per cent. The precious metals and combined agricultural and livestock sectors have both returned just over 9.7 per cent.

As commodity indices invest in futures, one of the main issues facing investors is the costs incurred to maintain an exposure as it shifts from an expiring futures contract to a longer dated futures contract.

This process, known as "rolling", can have a negative impact on overall returns when a commodity futures curve is upward sloping in "contango", effectively forcing an investor to "sell low, buy high" to maintain an exposure.

Since all commodity markets experience periods of contango, index providers have devised products to mitigate its impact on returns.

However, products which shift exposures further down the curve (into more mature futures contracts) have failed to outperform the broad benchmark in 2012 after delivering significant outperformance in the previous five years.

Indices which employ dynamic rolling mechanisms designed to take into account whether a commodity futures curve is upward or downward sloping have also struggled to cope with rapid changes in market conditions.

So in the US natural gas market, where seasonal swings in consumption often result in periods of contango, price spikes because of rising demand for air conditioning in hot weather have resulted in unexpected periods of "backwardation" when the curve is downward sloping.

> Mean reversion, momentum and carry strategies have all posted negative returns

Similarly, the futures curve for corn has registered unexpected periods of backwardation as severe drought conditions in the US resulted in big changes to production forecasts.

Price reversals such as these had an impact on momentum strategies that rely on trending markets.

Michael Lewis, commodity strategist at Deutsche Bank, points out that this is the first year that three of the most popular routes to extract alpha from commodities (mean reversion, momentum and carry strategies) have all posted negative returns. Deutsche has been tracking the performance of these different strategies for 12 years.

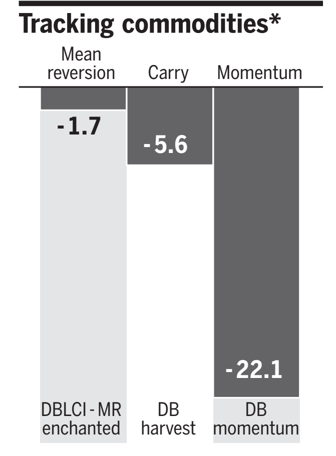
"This is unusual as these strategies tend to exhibit a low or negative correlation with each other most of the time," said Mr Lewis.

He predicts that carry strategies could start to perform better in the fourth quarter as recent strength in agricultural prices starts to fade and if energy and industrial metals prices struggle in the absence of a convincing improvement in the outlook for US and Chinese growth.

For Kevin Norrish, commodities strategist at Barclays, price action this year has demonstrated that fundamentals are responsible for driving commodity markets, not investor inflows.

"Changes in supply and demand, weather shocks and geopolitics, all the 'classic ingredients' have played their part in driving commodity markets this year," says Mr Norrish. Providing advice on strategies in these market conditions has been tricky, says Mr Norrish, but it is still a "good general approach" to invest in a broad basket of commodities that can provide asset class exposure and diversification benefits to a portfolio of stocks and bonds and then to complement that with other strategic overlays, depending on a client's appetite for risk.

Kevin Norrish: hard work for investors to achieve alpha



* Performance to 26 Sep 2012
Source: Deutsche Bank

Mr Norrish says: "Alpha is available in commodity markets but investors will have to work harder and in different ways to secure those returns in future."

Bradley George, head of the Investec Asset Management's commodities and resources team which manages $5.5bn in commodity assets, says investors need to take care when choosing between active or passive commodity strategies.

He notes that passive benchmarks for equity markets are unlike those used in commodities where the use of non-market capitalisation weights leads to active views being embedded within indices.

Mr George employs an active approach when selecting commodity futures and Investec extends this investment universe by including resource equities in its funds.

"This approach should allow diversification across a wider set of commodities, such as iron ore, steel, oil services, alternative energy, fertiliser and agricultural equipment not available in commodity indices," says Mr George.

Using this approach has helped Investec's global commodities & resources (GCR) strategy, which takes both long and short positions, to generate gross annualised returns of 9.6 per cent since the funds inception in January 2007.

Pros and cons of getting physical with ETPs

Industrial metals

Brian Bollen on two issues for the experts to debate

At least two interesting storylines lie ahead for industrial metal exchange traded products (ETPs), suggests Nick Brooks, head of research at ETF Securities.

The first is based on consideration of the potential impact of physical industrial metal ETPs on the underlying industrial metals markets, current and potential.

The second is centred on the question of what makes investors choose to access commodities exposure via futures ETPs rather than via physically backed ETPs.

Addressing the second point, Neil Shah, director of research at Edison Investment Research, explains the attraction of physical ETPs by pointing to the reasons why investors remain so bullish about gold. Investors do not trust fiat currencies any more, he asserts. They want a physical asset to protect against inflation and are converting money into real assets to preserve value.

Mr Brooks, by contrast, says investors who buy industrial metal ETPs are generally focused on tactical and cyclical economic factors, buying the instruments on an expectation that rising demand and constrained supply will push prices higher.

In contrast, he believes most investors who buy gold ETPs are aiming to preserve wealth and hedge against the potential decline in the real purchasing power of currencies such as the US dollar, euro or sterling. Gold and silver have proved they can be stores of value in the very worst case scenarios. Industrial metals are different – investors are looking for returns.

Not everything runs as smoothly in the non-precious ETP world as some would like. JPMorgan and iShares, for instance, have been trying to launch physical copper ETPs but have run into opposition from suppliers of the metal, who see nothing but potential for artificially induced surpluses and shortages.

JPMorgan's arguments for being allowed to proceed with its plans are expressed in a letter sent on its behalf by law firm Davis Polk to the US Securities and Exchange Commission earlier this year.

"In passing the Exchange Act [of 1934], Congress explicitly recognised the important and pervasive role of the securities markets to the public," the letter says. "Today, over half of Americans invest in stocks. Many of these investors consider investments in non-traditional asset classes, such as commodities, to be an essential element in portfolio diversification."

The creation of new types of securities products that provide access to asset classes other than stocks and bonds is critical for such investors, Davis Polk goes on to say.

For many people, it adds, securities products such as physical metal exchange-traded vehicles. which can be held in traditional brokerage accounts just like stocks and bonds, have become an important investment option.

In spite of JPMorgan's desire to enter the market, it is best not to overhype the emergence of physically-backed industrial metal ETPs. Mr Brooks estimates that more than two years after ETF Securities launched the world's first physical industrial metal ETPs, the total amount invested in them globally amounted to just $22m, compared with $150bn globally in gold ETPs.

> 'If you're worried about the financial crisis, why buy an economically sensitive asset?'

Barclays notes that while September was a good month for precious metals inflows, agriculture and base metals saw very modest inflows of less than $500m each.

"On this basis, there is little evidence that physical industrial metal ETPs have, and are highly unlikely in the future to have, an impact on the underlying industrial metals markets," says Mr Brooks.

If Henry Lancaster, an investment analyst at Coutts, is correct, this is unlikely to change significantly. Tin, lead and other non-precious metals are unlikely to be reliable as stores of value. They are subject to the eternal pressures of supply and demand, which in turn can be affected almost in an instant by a wide range of social, economic and political factors that are wholly unrelated to an industrial cycle. And the cost of storage will be the same for non-precious metals as for precious metals.

Put simply, a cost that will be tiny in relative terms for gold will be a significant percentage of tin's underlying value. Along with the impact of backwardation, this makes futures trading more attractive than physical possession.

"It's easier and often cheaper to own metals via futures," adds Mr Lancaster. "And, if you're worried about the financial crisis, why buy an economically sensitive asset? Why own physical copper when demand for electrical goods, houses and anything using copper in its production will suffer if there is a drop in demand. In such a scenario, the attraction of owning base metals is even less."