

Why Commodities?

A Forgotten Asset Class Deserving of a Strategic Allocation

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Current allocations to commodities are well below what has historically been considered optimal. As of January 2024, the global allocation to commodities stood at 1.7% of total portfolios. This is well below the 4%–9% range that recent Bloomberg analysis—based on Sharpe ratio, risk profiles and historic returns from April 2003 to March 2024—considers ideal.¹ In general, during periods of higher structural inflation than we have seen in the post Global Financial Crisis (GFC) period, commodities have typically shown positive returns with important features that distinguish their return drivers from stocks and bonds.² As inputs into economic production, commodities have a high correlation with inflation shocks or surprises. They do not generate cash flows, and are therefore not valued the same way as stocks and bonds. As a result, we believe investors will be well-served to understand the key building blocks that justify an allocation to commodities, including:

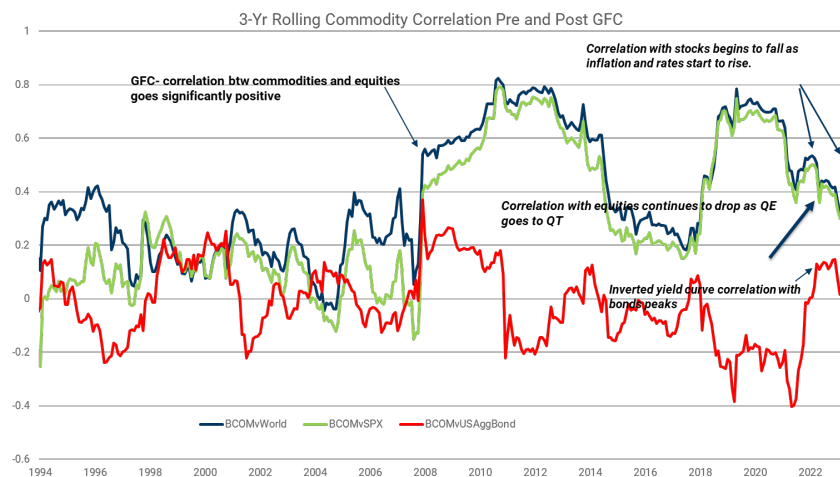
- Diversification benefits
- Supply disruption and response to inflation
- Supply growth and scarcity
- Geopolitical risk

We discuss each of these in the remainder of this paper and then address why active management is the preferred approach to add value.

Diversification Benefit from Commodities

We believe the recent drop in commodity correlation with stocks and bonds marks an inflection point for the asset class and brings back a very important feature for portfolio diversification. Since the GFC, commodities have traded at abnormally high levels of positive correlation with equities. Commodities resumed their low correlation with bonds after an initial short-term spike in the immediate aftermath of the GFC, when correlation spiked for all assets but cash. As bonds were the main instrument of monetary policy, correlation between commodities and bonds resumed and then remained at traditionally low levels. Today's markets have indicated a return to commodities as a diversifier given that commodities' correlation with equities appears to be stabilizing toward pre-GFC, low-correlation levels (Exhibit 1).

Exhibit 1: Three-Year Rolling Commodity Correlation Pre- and Post-Global Financial Crisis



As of 31 May 2024
Source: Bloomberg

Liquid Diversification

Unlike many alternative investments that are often touted as diversifiers, commodities tend to provide not only diversification, but also high daily liquidity. Average daily trading volumes are close to \$750 billion a day in futures trading. We believe liquidity becomes increasingly important against a backdrop of heightened market risk and fund redemption.

Illiquid assets can show illusory low correlation to other asset classes, but this is likely to be a feature of infrequent trading rather than true diversification. In addition, forced sales of illiquid assets can lead to significant price impact discounts for asset owners, and the price of commodities is observable on an intraday basis.

Supply Disruption and Inflation: Geology and Geography Matter

Since commodity assets are valued differently than stocks and bonds, understanding supply and demand fundamentals is needed to understand the value proposition the asset class represents. For commodities, both supply and demand can be impacted by many factors, including inventory levels, production costs, regulation, weather, war, and heightened geopolitical risk. These are just a few of the many external factors that can affect the price of a given commodity.

Two additional long-lasting factors affecting the supply of commodities are geologic and geographic factors. In metals and energy, geology is an especially important aspect impacting a producer's ability to extract a specific commodity. Not all geology is similar, which limits a producer's ability to realize uniform returns on capital for the same commodity. Another challenge is geography: A large component of commodity production comes from less business-friendly governments subjecting commodity producers to heightened royalty, regulation, and licensing risk.

In today's environment of significantly heightened geopolitical risk, we have seen higher for longer commodity prices, some having hit record highs due to supply disruption or the perception of a heightened market risk environment as some local regimes have moved to take a larger portion of the profit.

Slower Supply Growth Leads to Supply Scarcity

Demand for higher returns on capital, more responsible environmental investing, and tighter permitting have led to slower commodity supply growth and ultimately, supply falling below demand. If we layer the challenges from geology and geography mentioned above, the drop in the commodity supply below current demand levels can create upward pressure on commodity prices.

Money normally invested in new capacity would be spent on existing supply resulting in a consolidation and eventual scarcity of supply. Examples of this consolidation can be found in the recent transactions of Exxon Mobil buying Pioneer Natural Resources for \$60 billion, or Chevron's planned acquisition of HESS for \$53 billion and the \$39 billion bid by BHP for Anglo American.

Capital seeks to pursue the easiest path to higher return. Recent transactions in both the oil and metals markets may imply that commodity producers believe it is more efficient to buy existing supply that has already been permitted, scrutinized, and vetted by bondholders, governments, and equity investors. In this sense, supply expands only for the acquiring company, not the commodity market in its entirety. When one considers the increased length of time it takes to explore for and develop new capacity in commodity supply, less money spent on exploration and development can imply longer lead times, tighter inventories, and higher prices required for future commodity supply.

Geopolitical Risk Impacts

Geopolitical risk has exacerbated the already tight supply demand imbalance in the commodity market. The commodity allocation benefit was brought into the spotlight in 2022 when Russia invaded Ukraine. Inflation hit 40-year highs and US interest rates rose from 7 to 432 basis points. Commodities, as captured by the Bloomberg Commodity Index Total Return, were up over 16%, while equity and bond markets declined significantly (Exhibit 2).

Exhibit 2: Commodities Outperform During Periods of Heightened Geopolitical Risk

	1 Year Return (%) as of 31 Dec 2022
Bloomberg Commodity Index Total Return	+16.09
Bloomberg US Aggregate Bond Index	-13.01
Bloomberg Global Aggregate Bond Index	-16.25
Bloomberg Developed Markets Aggregate Total Return Index	-18.05
S&P 500 Total Return Index	-18.11

As of 31 December 2022

Source: Bloomberg

STRUCTURAL DEMAND TRENDS

It appears commodity demand has not diminished. In fact, it has grown faster than supply as new markets have developed. We see the following areas as significant drivers of commodity demand over the long term:

Infrastructure: The need for global infrastructure investment is forecasted to reach \$94 trillion by 2040. An additional \$3.5 trillion will be needed to meet key sustainability initiatives set out by the United Nations.²

Electrification: Electric Vehicles require 4x as much copper as combustion engine vehicles. Copper demand is also expected to be driven by the increased demand for upgrades to power and electricity grid. Copper demand is forecasted to rise by 45% from 2020 to 2040; yet no new mine plans are underway. Wood Mackenzie estimates that average project lead times are 12 years for copper mines and 8-12 years for nickel mines.³

Artificial intelligence (AI): AI is driving innovation and earnings expectations for the new economy. While efficiency gains from AI have yet to be fully understood, it is clear that AI power consumption is likely exponentially higher than where data centers currently operate. Estimates are that a ChatGPT query requires 10 times as much electricity to process than a Google search.⁴

Grain and Fertilizer Demand for Food and Fuel: As the population continues to grow, so too does demand for grain and fertilizers. Weather and war have disrupted grain supply globally, and global hunger estimates continue to rise. The UN estimates that while global hunger rates have not increased since 2022, they are still at 9.2% of the world population, well above the 7.9% seen in 2019.⁵ It is not just food: We are also seeing increased demand for biofuels such as biodiesel and blue ammonia, adding to upward pressure on prices.

Why Active Management?

While the downward trend in commodity correlation with stocks and bonds continues, we believe there is tremendous opportunity to enhance commodities' benefits and provide potential alpha through active management. We believe an active, empirical approach to commodity investing is more appropriate than some of the other offerings out there today, including passive exchange-traded funds (ETFs), passive index overlay strategies that lever collateral, single commodity ETFs, trend-following strategies, and enhanced roll ETFs. We believe an active approach that involves exposure to both listed and non-listed commodities provides us with a broader perspective and an enhanced ability to identify alpha opportunity.

We believe the following factors are critical in optimizing exposure to the asset class and maximizing the potential for both diversification and alpha generation:

- **Understanding the impacts of supply and demand**

Active coverage of the commodity producers and respective commodities enable the investor to be better informed about the risks and opportunities associated with commodity as well as the implications for commodity trading. We analyze specific commodities based upon forecasted supply and demand fundamentals obtained through active research of price relative to marginal cost of production, potential supply and demand risks of the specific commodity, and other factors. Single-commodity ETFs are prone to single-commodity risks, which are intensified when assumptions are made about price and contract execution.

- **Choice of an investment vehicle: Commodity contract vs. commodity-related equity**

Having formulated an investment view on a commodity, the next crucial question for the investor is an opportunity cost of owning the specific commodity. In other words: Should you own the specific commodity future or should you invest in a commodity-related equity? Knowing the answer to this question can help investors make better allocation decisions and achieve better performance.

- **Direct and indirect commodity exposure**

A drop in the price of a specific commodity could mean lower feedstock costs for producers of non-listed commodities, e.g., chemicals. By not owning a commodity that is falling in price, and owning instead a company that consumes that commodity as feedstock for the production of a non-listed commodity, investors can potentially exploit the drop in the commodity price. This results in higher margins for the non-listed commodity producer.

- **More complete commodity exposure to both listed and non-listed commodities**

In our view, a blended approach between commodities and commodity-related equities can add alpha with lower volatility and more complete exposure to commodities, potentially providing enhanced alpha opportunities with less complex derivative exposure.

Footnotes

1. “The Power of Commodities Allocation: A Little Goes a Long Way,” Bloomberg (2024)
2. [“Commodities: a structural allocation for the next decade?”](#) Schroders (2024)
3. [“Global Infrastructure Outlook.”](#) Global Infrastructure Hub and Oxford Economics (2017)
4. “The energy transition starts and ends with metals!” Julian Kettle of Wood Mackenzie (2023)
5. “AI is poised to drive 160% increase in data center power demand,” Goldman Sachs (2024)
6. [“A wake-up call to fight hunger.”](#) United Nations (2023)

Important Information

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The Bloomberg Commodity Index Total Return is composed of futures contracts and reflects the returns on a fully collateralized investment in the Bloomberg Commodities Index. The Total Return index combines the returns of the Bloomberg Commodities Index with the returns on cash collateral invested in 3-month US Treasury Bills. The index is unmanaged and has no fees. One cannot invest directly in an index.

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The Bloomberg Global Aggregate Bond Index provides a broad-based measure of global investment-grade fixed-income debt markets, including government-related debt, corporate debt, securitized debt, and global Treasury. The index is unmanaged and has no fees. One cannot invest directly in an index.

The Bloomberg Developed Markets Aggregate Bond Index measures the performance of global developed market investment-grade fixed-income securities, including government, corporate, and securitized bonds. The Bloomberg Developed Markets Aggregate Bond Index Total Return is a variation that accounts for both price changes and income from interest payments. The indices are unmanaged and have no fees. One cannot invest directly in an index.

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