

# Intelligent Money



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## Special Notes of Interest:

- From 1970 through the end of June 2003, the Goldman Sachs Commodity Index has returned 11.7% annually while the S&P 500 has returned 11.0%
- According to Standard and Poors, core earnings for S&P 500 companies in 2003 will be 20% less than the operating earnings those same companies disclose to the media in press releases.

*Current thinking from Haven Financial Advisors*

## Commodities as an Investment Option

Last month I made the case for small cap stocks as a component of a diversified investment portfolio. Equity in smaller companies offers price returns that are likely to improve an investment portfolio's overall risk-adjusted performance. Recent news items and research have focused investor attention on the investment characteristics of commodities. Basic resources such as energy, metals, and farm products comprise a large fraction of the world economy. One might reasonably ask, whether direct participation in these product markets provides meaningful benefits to investors.

I'll offer my recommendation up front: *Stay away from commodities.* But not because they are too risky.

### Review of Commodities Markets

The scope of this treatment of commodities markets will be restricted to investable instruments that do not require storage facilities. After all, we're looking for practical solutions for individual investors. In short, we'll be looking at futures markets. Futures contracts are both liquid and require little more than collateral to participate. One of the most attractive aspects of commodity investment today is that there are now a number of passive indexes that are fully investable. The most notable is the Goldman Sachs Commodity Index (GSCI). The weights assigned to commodities in this index are based on a five year moving average of world production.

There are a handful of other commodity indices but their characteristics make them difficult or costly to replicate in the real world. Some indices cap the weightings of

commodity sectors. Others require too much rebalancing to be readily investable.

Futures are considered derivative securities. Derivatives are ordinarily inappropriate for retail portfolios – with good reason. Positions in futures markets are far more volatile due to the leverage they afford the investor. It is important to note here that any investment in futures that we consider be fully collateralized. We measure only the true returns to commodities and not the effects of leverage. As an example, to purchase a five ton cocoa futures contract at \$1800 per ton, the investor allocates \$9000 from his portfolio to support the position.

Just as diversification in equity markets is characterized by weighting stock investments by their market capitalization, commodity investment should be broad based. As stated earlier, the GSCI is weighted by worldwide production so it reasonably satisfies this requirement.. Energy, by far, is its largest constituent. Agricultural products are also important. The GSCI sector breakdown is as follows:

### GSCI Components and Dollar Weights (Oct 7, 2003)

Energy	66.0%
Industrial Metals	6.6%
Precious Metals	2.4%
Agriculture	16.9%
Livestock	8.1%

Energy related commodities have similarly generated the highest returns with the highest volatility among the various commodity sectors. That begs the

## Commodities (continued)



question of whether commodity returns can be captured cheaper through investment in the publicly traded energy companies.

### Empirical Results

The empirical data compiled since 1990 says no. Monthly price movements in energy stocks have virtually no relationship to the energy commodity prices movements within the GSCI. More generally, data compiled by multiple sources indicates that correlation of the unlevered commodity futures with the S&P 500 is anywhere from zero to slightly negative.

The low correlation of the GSCI with equity markets is promising with respect to its diversification properties. On its own, however, the GSCI is a risky investment. Since 1990, it has been 20% more volatile than either US or foreign stocks. The takeaway here is that commodities are best employed only as a hedge against more conventional investments.

Research has revealed that the addition of commodity exposure to a portfolio otherwise diversified in conventional asset classes has positive effects. Portfolios with commodities offer comparable returns with lower variability than portfolios comprised only with conventional asset classes.

There is a cautionary note, however. Much of the beneficial effects of an unlevered investment in the GSCI are

attributable to outsized gains in the price of oil in the early 1970s. After that period, the GSCI's benefits are substantially reduced. Here's an illustration:

### 50/50 Stocks and Bonds

	Return	Volatility
1970s	6.6%	12.1%
1970-2001	11.1%	11.2%

### Substitute 10% Commodities

	Return	Volatility
1970s	8.3%	10.1%
1970-2001	11.2%	9.4%

### Practical Options

The theoretical results are promising. The problem is that retail investors have few options to participate in any commodity indices without trading futures themselves. And these options are expensive.

PIMCO and the Oppenheimer group offer commodities products in a mutual fund wrapper. None of the funds currently available are very large and their track records are short. The empirical evidence supporting unlevered commodity investments is positive but not compelling. The management fees of these options swamp any portfolio benefits that they might deliver. See the table below for details.

I remain hopeful. The time is ripe for an indexed commodity product. A major player in the ETF world told me that they have received numerous requests for one. When an inexpensive ETF becomes available, it will get some serious consideration.

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### Investing Today in Commodity Products is Very Expensive

Fund Name	Ticker	Inception Date	Sales Load	Expense Ratio
Oppenheimer Real Asset Fund A	QRAAX	Mar-97	5.75%	1.68%
Oppenheimer Real Asset Fund B	QRABX	Mar-97	0.00%	2.45%
Oppenheimer Real Asset Fund C	QRACX	Mar-97	0.00%	2.45%
PIMCO Commodity Real Return Fund A	PCRAX	Jun-02	5.50%	1.24%
PIMCO Commodity Real Return Fund B	PCRBX	Jun-02	0.00%	1.99%
PIMCO Commodity Real Return Fund C	PCRCX	Jun-02	1.00%	1.99%
Rogers Raw Materials Index Fund	*	Aug-98	5.00%	2.25%