An Excellent Addition

Commodities enrich portfolios due to their low correlation to other asset classes - and they are still cheap

Naguib Sawiris hardly knows anyone in this country. But recently, the billionaire was in the headlines in his native Egypt. The reason: He spent half his fortune – about $5.7 billion – buying gold and precious metal stocks. Sawiris got wealthy in North Korea establishing telecommunications and in Egypt with investment banking. While he buys gold many do not believe in the entire commodities sector as an asset class. The Egyptian is not wrong.

There was no such thing for a long time: commodities as the top asset class. So far this year, they are off to a great start. Up almost 23% in the first third of 2018, commodities are in the lead. Gold follows with around 10% performance. Behind it are emerging markets stocks, US stocks, the rest of developed countries shares and, far behind, US bonds and real estate shares (see chart).

But how can that be? Aren't rising interest rates poison for gold and other commodities? It's not that easy. On the contrary, rising bond yields can even imply rising commodity prices. Today's environment even argues for diversifying portfolios of commodity investments. Investors have a variety of vehicles available. One can investment in precious metals via physically deposited Exchange Traded Commodities (ETCs) such as Xetra-Gold. There aren't many physically deposited ETCs on individual commodities but rather Exchange Traded Funds (ETFs) on indices of commodity stocks and commodities.

Commodities, the latecomers. A look at the development of individual commodity prices shows that the asset class has not just been sought after recently. Since the beginning of 2016 there has been a strong upward movement. In retrospect, these price advances are easy to explain. The boom in electric vehicles brought high demand for battery metals such as nickel. Copper, the infrastructure metal par excellence, was supported by strike-related and weather-related production losses as well as rising demand due to the good global economy. Palladium in turn profited as a gasoline engine catalyst metal as diesel engines continued to diminish in popularity. The strong demand for petrol and OPEC's supply constraints once again added to the price of oil. Gold and silver were driven by geopolitical worries and inflation fears.

With ten-year US government bond yields around 3%, the price increase in commodities is not yet over. After all, rising interest rates go hand in hand with a strong economy and corresponding stimulus demand for raw materials.

Beware, roll costs! Anyone who wants to bet directly on commodity prices can usually do this conveniently with ETCs. However, these open-ended certificates are based on commodity futures. This solves the problem of time-limited futures by rolling them into the next expiry futures when they expire. If a market such as oil is currently in a backwardation phase, this is not a problem. Because then the future prices are lower than current ones. The purchase of the next contract is therefore cheaper. Traders call these roll profits. However, the case of higher commodity futures prices in the future, called contango, is more common. Among other things, financing and storage costs are the reason for this. Rolling losses occur when the commodity prices are in contango.

There are, however, index funds and certificates that mitigate this problem. Enhanced or roll-optimized ETCs do not always use the next due futures when rolling, but are based on different maturities. BNP Paribas has issued an entire enhanced ETC family. BNP uses the RICI (Rogers

International Commodity Index) developed by Jim Rogers as the basis for its broad-market ETCs. However, there are also ETCs on individual commodities like copper, lead and WTI. The different maturities of the futures mitigate roll losses.

BNP goes one step further with its EasyEnergy & Metals Enhanced Roll ETF. The ETF is based on an index of futures on the commodities WTI and brent crude oil, gas, gasoil, heating oil, aluminum, zinc, nickel, copper, gold and silver. In order to minimize roll losses or to optimize roll profits, BNP selects the optimal futures with maturities of up to 43 months.

Investors who take Jim Rogers's advice to heart (see interview) use the Market Access RICI Agriculture ETF. This includes 38 agricultural products such as corn, wheat, cotton, coffee and cattle. "The weight of each commodity in the ETF depends on the global consumption of each product," explains Danny Dolan, Managing Director of China Post Global, the issuer of this ETF.

Producers in the depot. Investors can also diversify their portfolio with stocks of commodity producers, as commodity price rises are generally accompanied by rising stock prices of mining and oil companies. Often, the stock price moves even more than the commodity price. The VanEck Vectors Natural Resources ETF gives investors the opportunity to participate in the performance of companies worldwide that earn more than 50% of their revenues from the production and distribution of commodities and commodity-related products and services. Sectors involved include agriculture, alternative raw materials (water and renewable energy), base and industrial metals, energy, forestry and precious metals. The VanEck Vectors Global Mining ETF, on the other hand, is a little narrower. It is based on the EMIX Global Mining Constrained Weights Index, which comprises 160 metals and miners from 24 developed and emerging markets, with products ranging from lithium and cobalt to oil and coal to copper, iron ore and gold.

Currently investors are still underinvested in commodities. However, especially in the final phases of economic upturns, raw materials prove to be good diversification because they offer hedging and stabilization for many portfolios due to their relatively low correlation to other asset classes.

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Cheap raw materials

Investments in raw materials are currently neglected. This shows the ratio of stocks to commodities. Dividing the S&P GDCI Commodity Index by the MSCI World Stock Index gives you a ratio that currently is at an all-time low. That means commodities are undervalued relative to equities.

Longer price upswing

Fuelled by the rising price of oil, the entire commodities sector - represented by the S&P GSCI - is in a strong upward move. In the past 50 years, there were long commodity upswings, which often resulted in an index appreciation of more than 100%.

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Wide dispersion helps

As a rule, commodities as an asset class correlate little with other asset classes. Over a 5-year period, the price movements are most closely aligned with emerging market equities. This comes from the sometimes-strong raw material orientation of some emerging markets. There are also big differences within the commodity class. Thus, oil prices are much more sensitive to the economic cycle than the prices of agricultural goods.