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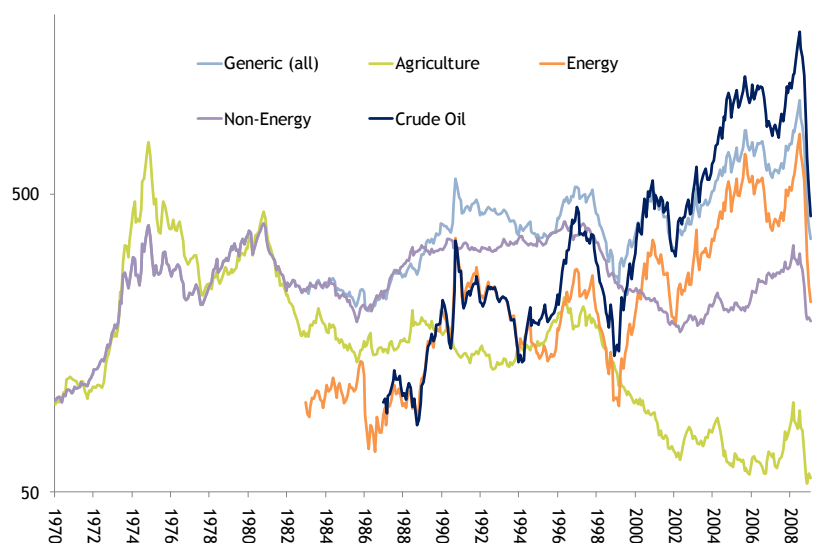
Lessons for commodity investors

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Over the decade leading up to 2008 institutional investors exhibited an unprecedented interest in gaining exposure to commodity investment vehicles. The volumes of capital invested in new commodity indices (such as the S&P GSCI) and in specific commodity futures were at record levels by the beginning of the current financial crisis. This shift in the profile of commodity investments can at least partly be explained by widespread beliefs about the diversification benefits and robust excess returns offered by commodity based assets. Recent (and existent) Barrie & Hibbert research examines the rationality of such beliefs; this insights note summarises some key lessons on appropriate assumptions for models of commodity investment risk.

Lesson 1: Neither empirical evidence nor economic theory conclusively demonstrate that a risk premium is, or should, be earned on commodity investments over the long term. There is little economic rationale for the presence of a risk premium on a commodity investment over the long term; whilst this may seem rather surprising to some, given the robust increase in commodity returns from the late 1990's to mid 2008, the abrupt commodity price collapse that occurred last year supports such a conclusion (see exhibit 1).

Exhibit 1
 S&P GSCI Excess returns indices (semi-log scale)



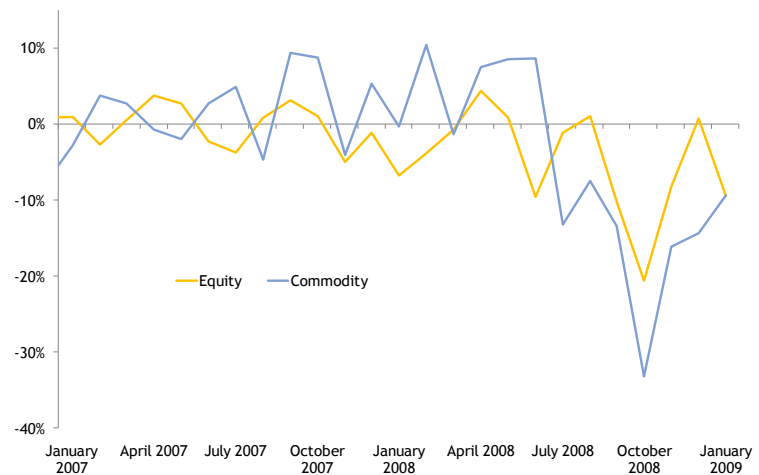
Over the long term, on average, we would not expect to observe a risk premium on commodity investments...

Lesson 2: In the short term and during periods of wider market stress commodity investments may not prove to be a good hedge. Academics as well as financial institutions have carried out extensive work investigating the dynamics of commodities as a diversifying asset class and have, on the whole, presented evidence suggesting negative correlation with the returns on other asset classes. Exhibit 2 demonstrates that such an assumption was not appropriate for investors wanting to liquidate their equity and commodity positions in 2008. In the second half of the year, as it became evident that the real economy could not be insulated from expanding toxicity in financial markets, investors were confronted with the breakdown of what were previously viewed as concrete mechanisms of diversification and market segregation.

Exhibit 2

Excess returns on a generic portfolio of commodities compared to excess returns on the S&P 500 index

In 2008 commodity investments did not provide diversification benefits.....



Data source: Bloomberg derived

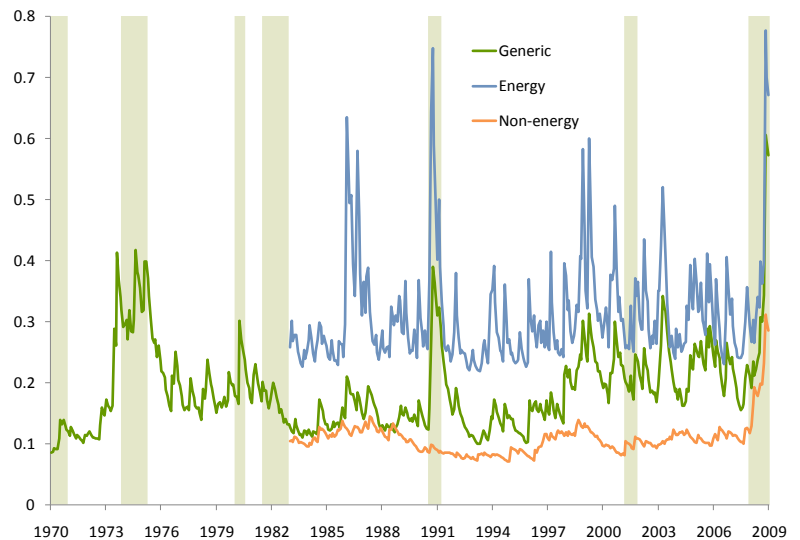
The past year has made it abundantly clear that in terms of commodity risk modelling, it is crucial to consider projection horizon when setting cross asset correlations. It is our view that commodities are a good hedge over the very long term, but it is clear that such properties are entirely conditional on the projection horizon¹. In the short term diversification can break down; indeed from the beginning of 2007 to now correlation between the S&P GSCI and the S&P 500 was close to 60%.

Lesson 3: The volatility of returns on commodities can be highly unstable over the short and medium term. Commodity vehicles can exhibit significantly elevated levels of volatility over short horizons, thus, the risk profile of these assets will vary depending on the horizon over which it is being considered. Exhibit 3 demonstrates the temporal instability of commodity market return volatility and shows volatility spikes in recessions due to heightened uncertainty. Note that the current recession is the only one in our sample which appears to have significantly impacted the conditional volatility of returns on non-energy commodity investments.

¹ You can read more about our methodology for modelling commodities in a research report by H. Hibbert (2009), 'Real-world Commodity Calibration: Short term price behaviour and diversification benefits' and H. Hibbert (2009) 'Real-World Commodity Calibration: Making long-term assumptions about commodity prices'.

Exhibit 3

GARCH (BEKK) conditional volatilities of S&P GSCI log excess returns indices (NBER dated recession periods highlighted)



Data source: Bloomberg derived

The risk profile of commodity investments can be highly unstable over the short term...

There have been some fundamental failures to understand the true risk profile of commodity investments. These were the failures of active asset managers and, to some extent, of regulators.

The widely held belief was that the underlying properties of global commodity demand were being transformed on a permanent basis. The erroneous perception of *structural* price expansion came from parallels being drawn between robust and persistent growth in Asia and rising demand for commodities. It was thought that fundamental changes were resulting to growth of commodity prices and would continue to drive this over the long run. In March 2007 the Financial Services Authority published a report entitled 'Growth in commodity investment' in which they state:

'...this [commodity] boom has mainly been caused by dramatic growth in demand (particularly from the rapidly developing economies of China and India); i.e. it is underpinned by what seem to be long-lasting fundamentals. It is widely stated that institutional investors will stay for the long term²..

Writing two years later, this assertion seems somewhat void.

² Financial services Authority, Market Infrastructure Department, E. Doyle, J. Hill, I. Jack, March 2009, 'Growth in commodity investment: risks and challenges for commodity market participants' P22-23.

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