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Commodities as an
asset class

Are commodities the new El Dorado for institutional investors?

There are sufficient reasons for the re-evaluation of this asset class even without the significant increase in oil prices in recent years. For institutional investors there are aspects that are much more important than short-term speculative gains, such as the interesting potential of the commodities asset class in terms of correlation, diversification and protection from inflation.

F. Weber Even in the case of negative correlation between stock and bonds, diversification between equities and government bonds is often not sufficient to achieve the return objectives within the targeted fluctuation bandwidths. In the current phase of low interest rates, the absolute return on government bonds is also no longer sufficient to allow for the interest earned on the capital to be in line with that targeted by most institutional investors over the long term without a positive contribution from the equity portfolio. In recent years, more and more in-

vestors have therefore decided to supplement their traditional investments with alternative asset classes in accordance with the scope permitted by law, so as to improve their diversification. The popularity of commodities has increased in parallel with the sharp rise in oil prices. Alternative asset classes promise returns that have a low or even negative correlation to the traditional asset classes of stocks and bonds.

Optimizing your portfolio with commodities

The statistical characteristics of commodities are very attractive. For example, since 1970 the Goldman Sachs Commodity Index (GSCI TR) – which comprises solely futures contracts – has posted an annual return of 12.4% with volatility of 18.7%. The MSCI World Index lagged behind over the same period, with a gain of 10.6% and volatility of 14.4%

(chart 1). In addition to their attractive performance from the historical perspective, the trend in commodities is largely independent of traditional investments, as the correlation figures in Table 2 show. Adding commodities to a portfolio therefore results in a significant diversification effect.

Excellent diversification properties and inflation protection

Historical data shows that the performance of commodities has been particularly good when other asset classes have been experiencing a marked correction. The diversification effect is

therefore at its greatest when it is really needed! Hence, the inclusion of commodities in a traditional strategy makes it possible to reduce the downside risk for the overall portfolio. The negative correlation can be explained in economic terms. Commodities represent a classic hedge against inflation. While the stock and bond markets have performed particularly bad in inflationary phases and when growth is overheating, the commodities markets tend to be the winners in such periods and often even the cause of inflation. The correlation between inflation and commodities prices is therefore positive over the longer term, by contrast with equities and especially bonds, where it is negative. Energy prices in particular have in the past been factors that have led to

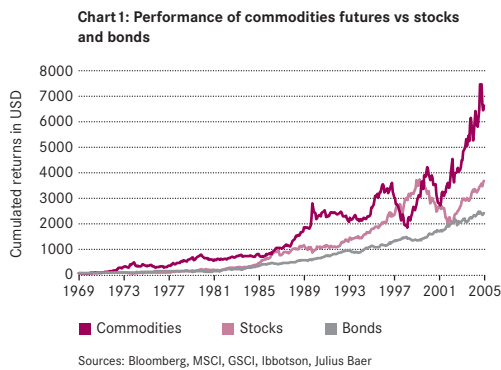


Table 2: Historical correlation of commodities, with other asset classes and inflation

Asset class	Correlation
Commodities	1.00
Stocks	-0.23
Bonds	-0.28
Inflation	0.27

Annual data, from 31.12.69 to 31.12.2005

Sources: Bloomberg, MSCI, GSCI, Ibbotson, Julius Baer

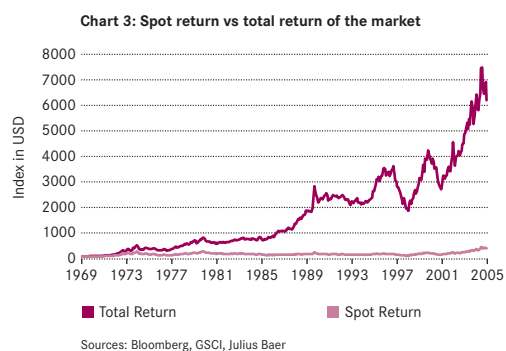
economic slumps and surges in inflation, which proved to be anathema for the stock markets and bond markets alike.

Price trend only marginally responsible for performance

The historical performance of the GSCI index is only marginally attributable to the development in the prices of the underlying commodities. Chart 3 shows a comparison of the GSCI TR Index (which comprises exclusively commodities futures) and the GSCI Spot Index. This shows that the bulk of the historical performance is not attributable to an increase in commodity prices, but instead to the returns generated on the rolling of futures contracts and holding

the corresponding cash position. Over the period from 1970 to 2005, the GSCI Spot Index shows a higher volatility than the GSCI TR, but only compensates the investors with a modest annual return of 3.58% for the greater risk.

Thanks to their construction, commodities indices profit from a negative forward curve (backwardation), which is typically seen in the case of commodities that can only be stored with difficulty, if at all. This means that in light of the strongly fluctuating prices, commodities producers are often prepared to accept a discount in the price if someone is prepared to guarantee that they will take receipt of the goods at a certain point in time. The prices of the futures are then cheaper than the spot prices. Given that it is practically impossible to sell physical commodities short, there is no arbitrage trading. In the case of such an inverted structure, the rolling of fu-



tures contracts by an index leads to a systematic gain, given that the purchases are made at lower prices than the sales. This could be seen in the past in the case of energy commodities in particular, which are heavily weighted in most commodities indices.

On many commodities markets in recent months, however, there has been a change observable in the forward curve towards a contango structure (positive forward curve). The exact reasons for this development are still difficult to identify, but it may be attributable in part to the growing interest in commodities in asset allocations and in hedge fund strategies. The transition to a positive forward curve has led to the futures index offering a somewhat poorer return relative to the spot market than was the case in previous years. Over the short term, therefore, the possibility of the futures market continuing to slightly

underperform the spot market cannot be ruled out. However, the difference in returns – as in the past – is likely to remain in a narrow bandwidth.

The crux of implementation

A purely quantitative portfolio optimization shows that a commodities weighting of 10% to 15% of the overall portfolio (comprising equities, bonds, commodities and cash) would be optimal for many investors. The immediate investment alternative of investing directly in commodities themselves is hardly practicable for the usual financial investor. The second common form of investing in commodities is to invest in shares of companies that produce or trade commodities. Here we must take into account the fact that the performance of commodity-related shares only correlates to a limited extent with the development of the underlying commodity. Although stocks from the commodities sector would outperform in the scenario of a slump in share prices and rising com-

modities prices, they would probably not be unaffected by the weakness of the stock markets. In addition to the developments on the commodities markets, the investors would also be exposed to the unsystematic risks of stock selection, such as financial data, valuations and the quality of management. Against this backdrop, the optimal means of implementation is to invest in financial products that are based directly on commodities, in particular commodities futures, options and swaps, as well as in structured products as a combination of these. The sensible approach is for the investor to choose actively or passively managed investment funds

that invest in the afore-mentioned instruments. In addition to the better diversification, this approach also obviates the need for continual rebalancing and the rolling of the derivatives contracts. Julius Baer plans the launch of an actively managed commodities product under Luxemburg fund law. The investors should thus benefit from the interesting portfolio effects mentioned in this article and so participate in the upside potential of the commodities markets.

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