Commodity Alpha and Beta in Institutional Portfolios

Institutional investors' interest in commodity and natural resource investments has increased substantially since the early 2000s. The potential for adding uncorrelated performance, protecting the value of investments during inflationary environments, and the prospect of participating in a "secular bull run" originating from aging resource production infrastructure and burgeoning demand from emerging economies in Asia have captured the attention of investors and financial media alike. Swollen central bank balance sheets and anxiety over the debasement of fiat currencies have also contributed to institutional investor interest in commodities.

In general, institutional investors appear to prefer to access commodity exposure in their portfolios through commodity "beta." There is no consensus on what commodity beta precisely is, or if commodity beta exists at all, but for the purpose of this report, commodity beta is defined as long exposure to one of the passive long-only commodity indices such as the S&P Goldman Sachs Commodity Index ("S&P GSCI"), Dow Jones UBS Commodity Index, Rogers International Commodity Index ("RICI"), or others.

While passive long-only commodity indices provide investors with inexpensive long exposure to natural resources, there are substantial disadvantages to the beta approach to commodity investing of which investors must be aware. Most notably, long-only indices can be extremely volatile and are susceptible to large losses. The S&P GSCI, DJ UBS Commodity Index, and RICI all experienced peak-to-valley losses of 50 to 70 percent during the financial crisis of 2008. Further, passive long-only indices may not offer balanced exposure to different commodity sectors. For example, the S&P GSCI allocates over 70 percent of the index to energy, and the other indices tend to be lopsided as well. Last, negative roll yield in commodity future (accessing commodity exposure through physical commodities tends to be prohibitively expensive and problematic due to storage and other reasons) in contango can also be detrimental to the performance of the passive long-only indices.

Despite these weaknesses, passive long-only commodity index investing is relatively commonplace, with institutional investors typically turning to total return swaps, exchange traded funds or notes, index futures, or futures-based index.

Institutional investors wishing to avoid the inherent shortcomings of passive commodity indices may instead access the natural resources space through commodity "alpha," which for the purposes of this article, is defined as actively managed exposure to natural resources with the flexibility to take long, short, neutral, or spread positions. Examples include natural resources-focused hedge funds and commodity trading advisors, natural resources fund of funds and multi-manager portfolios, and actively-managed or semi-passive natural resource index products.

Commodity alpha offers investors the potential benefits of active management, namely the ability to take advantage of opportunities on both the long and short side, as well as the ability to deploy relative value or niche strategies. These qualities often result in uncorrelated performance which can enhance portfolio diversification and help to dampen volatility. Alpha investments also typically actively manage risk in response to changing market conditions, so their volatility and susceptibility to large losses tend to be better controlled than for the passive long-only indices.

The potential benefits of commodity alpha do come with additional costs. Alpha managers typically charge higher fees, and may only partially capture the upside of passive long-only indices, limiting the investor's ability to participate to the fullest extent possible in commodity bull markets. It may also be difficult to understand the timing of, reasons for and degree to which different alpha managers or investments capitalize on price moves. The investor is also subject to the additional costs of manager sourcing, selection, due diligence and monitoring, all of which require specialized expertise.

Investors seeking a more balanced approach can combine commodity alpha and beta investments to meet their own objectives or risk and return preferences. This can be done by focusing on sector specialists, creating different blends using commodity beta and alpha investments, or by building structured products, all of which may have customized correlation or risk properties relative to the passive long-only indices. An investor could, for instance, create a portfolio that offers high correlation to one of the passive long-only indices but with lower risk.

Commodity alpha investments offer institutional investors an alternative to beta plays using passive long-only indices to gain commodity exposure. Actively managed commodity alpha strategies provide investors with exposure to the asset class with the added benefits of opportunistic trading from both the long and short side, active risk management, and the potential for decreased volatility and losses. The allure of additional diversification alpha investments may offer, and the value that they can add through active management, may make them a compelling way to access the assets class.

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