

Russell OpenWorld®

Commodities investing



Access real assets through commodity investing

The recent rises and falls in commodity prices have been stunning. For example, Brent crude topped \$145 a barrel in 2008 before falling over 70% later that year; in August 2009 the price climbed back over \$70. Despite the sharp declines, commodity indices have posted healthy returns over the last decade, with the Dow Jones-UBS Commodity Index increasing 7.4% p.a. in the ten years to 31 July 2009, compared to 6.1% p.a. for global bonds and 1.8% p.a. for equities¹.

Unsurprisingly, commodities have received much attention, with the current discussion embracing a wide range of issues. Has the commodity price bubble burst? How will commodity prices behave in the longer term, in a world with constrained supply an inexorable global economic development? How will commodity prices affect the cost of food and energy worldwide?

Moreover, following the turbulence in equity and bond markets over the last year, investors are looking to assets such as commodities that can provide alternative sources of growth and diversification to traditional assets. Commodities have the added benefit of providing plentiful opportunity for active managers to add value and their inclusion may help investors' portfolios outpace inflation. Interest in this asset class has been further boosted by the development of commodity indices and the growth in number of credible providers.

In this brochure we look at the benefits of commodity investing, examine the drivers of future growth of commodity prices and summarise how investors new to this asset class can sensibly approach markets in which prices demonstrate high volatility in the short term, but whose fundamental return characteristics are quite attractive.

Commodities can be a superb complement to bonds and equities.

As a long term investment, commodities offer the potential for attractive returns, can reduce risk through improved diversification and may help portfolios to outpace inflation.

¹ Source: Factset and Russell. All Total Return indices in USD. Bonds represented by the Barclays Global Aggregate Index and equities by the Russell Global Index. Past performance is not necessarily a guide to future performance.

THE COMMODITIES MARKET

Market trading in commodities has been occurring for centuries. The Industrial Revolution encouraged the formalisation of exchanges for trading in metal and other commodities. Trading in commodity futures began in the 1800s and the Chicago Board of Trade, the oldest derivatives exchange, was founded in 1848.

Today, commodities cover a wide range of different types of real assets, both in the developed and developing world. See examples in the table below.

So, how big is the commodities market? Looking at commodity futures alone, from publicly available data

published by Bloomberg LP and the US Commodity Futures Trading Commission, you can extrapolate roughly \$300 billion in commodities futures open interest as of December 2008. However, this figure may be a fraction of the market: compare the \$115 billion related to oil-related commodities to BP's published figure of 1,332 billion barrels of proven oil reserves, which at \$60 a barrel implies a market of over \$79 trillion for oil alone.

In contrast, the market capitalisation of the Citigroup Global Aggregate Index (bonds) and the Russell Global Index (equities) in July 2009 were both just over \$30 trillion.

Energy	Industrial Metals	Precious Metals	Agriculture	Livestock
Crude Oil	Aluminium	Gold	Wheat	Live Cattle
Brent Crude	Copper	Silver	Red Wheat	Feeder Cattle
Unleaded Gas	Lead	Platinum	Corn	Lean Hogs
Heating Oil	Nickel	Palladium	Soybeans	Fat Hogs
Gas Oil	Zinc		Cotton	Pork Bellies
Natural Gas	Iron		Sugar	Greasy Wool
			Cocoa	

THE CASE FOR INVESTING IN COMMODITIES

We believe the strategic case for commodities investing is predicated on three major benefits:

Attractive long-term return prospects

Commodities prices are governed largely by demand and supply conditions for physical assets. Prices are, of course, heavily influenced by changes in expectations of near-term economic growth. However, over the longer timeframe we expect continued and increased demand for commodities from rapidly emerging economies like China and India. Global growth in population, estimated to average 65 million people per year, will also support commodity growth via an increased demand for energy, food and infrastructure.

Diversification

Commodities can be an important component of an investor's allocation to the general category of real assets, alongside investments in real estate and infrastructure. Commodities are used to feed and clothe us, to build bridges and buildings, and to power our homes and cars. They are physically scarce, and as such can experience positive price shocks even when other assets, such as equities, are selling off.

Ultimately, as with other real assets, higher commodities prices translate into higher costs for corporations just as they represent higher costs for households. As such, when commodity prices rise, manufacturers feel it in their bottom line and consequently financial markets suffer, and vice versa. The diversification potential of commodities is logical and permanent; as such, the benefits associated with adding real assets to a portfolio of financial assets should not be isolated to any particular period.

Help portfolios to outpace inflation over the long term

Commodities and other real assets form a material portion of the cost basis of production and household expenses, so it is reasonable to assume that they can offer an element of inflation protection.

However, investors should note that inflation and commodity prices do not move in lock-step. While the price of gasoline may rise in line with crude oil prices,

the price of airline tickets, cruises, and taxi rides may not. The price of corn, soybeans, and wheat should affect the prices of groceries, but such price increases may be delayed by contracts, slow realisations of cost increases due to food processor hedging practices, or simply reluctance by retailers to alter prices on a frequent basis. Ultimately, prices tend to be sticky and may take time to respond to changes in inputs. As such, while the relationship between inflation and commodities is strong over the long term, over the short term it will be potentially lagged and volatile.

Over the long term, we expect continued and increased demand from rapidly emerging economies like China and India.

THE KEY DRIVERS

China's ascent: China has focused its attention on making significant inroads into Latin America's resource rich economies. Her construction and energy companies have undertaken a wave of mergers and acquisitions within Chile, Peru, Brazil and Mexico. In particular, they have sought out companies involved in the production of iron ore and copper so that they have the materials to build the infrastructure required for the next commodities boom.

Asian expansion: as Asia's "tiger" economies continue to develop, their demands for infrastructure – and the raw materials necessary to meet this demand – will increase markedly. The Asian Development Bank concluded that developing economies in East Asia will need to spend an estimated total of \$165bn per year between 2006-2010 in certain infrastructure sectors, namely electricity, telecommunications, major inter-urban roads, rail routes, water and sanitation.

The "petrodollar": in the Middle East, the flow of petrodollars is driving a huge amount of investment. In Russia natural resource revenues flowing from the country's deep oil and natural gas resources look set to be funnelled into diverse infrastructure projects, including improving access to the Black Sea resort of Sochi in time for the 2014 Winter Olympics. Substantial work is also under way on Russia's railways and the country's "second electrification".

Demographic change: the expansion of the middle classes in developing markets like China and India has seen growing consumption of meats (particularly pork) and processed foods in the former, while the latter's 'fats and oils' consumption has increased. The rise in hogs' prices was arrested by an outbreak of swine flu in April, but the focus simply shifted to alternative foodstuffs. The world's largest salmon farmer, Norway's Marine Harvest, leapt over 100% in the early months of 2009 on this basis.

Climate change: despite the fall in commodity prices late in 2008, strong economic growth over the past few years has granted resource-rich governments' significant capital to dedicate towards infrastructure investment. These economies generate disproportionate demand, needing hard commodities such as steel, nickel, tin and copper, for their industries and soft commodities, such as cocoa, potatoes, wheat and barley, to feed an increasingly urban population.

INFLUENCES ON PRICES

Environmental: Environmental influences are significant, especially for the agricultural and energy sectors. Desertification and increasing contamination of water tables is likely to put pressure on agricultural commodities, while energy commodity fundamentals must include a consideration for environmental impacts.

Geopolitical: There are almost daily-emerging factors which can expose the world commodity markets to abrupt price changes. Examples include soaring soybean prices following poor harvests in Argentina, Brazil and Paraguay after a series of droughts; the fall in hog and rise in salmon prices following the outbreak of swine flu; and the kidnappings of oil workers in Nigeria driving up the price of oil over supply concerns.

Currency: Many commodities are priced in US dollars and, in 2008, some commentators attributed much of the run-up in crude oil prices to the declining value of the dollar. Elsewhere, precious metals, most notably gold, have occasionally been treated by investors as alternative currencies. This has led to a significant negative correlation between the metal's price and the value of the dollar.

Demographic change: Demographic shifts, including population growth, increasing global wealth and changing diets – particularly in the developing world – have had a dramatic impact on global demand for foodstuffs and building materials. Explosive demand has led to increased prices and significant concern over the prospect of current and future shortages for some commodities, including wheat, rice, and oil.

Technological change: Technological change can have a material impact on commodity prices, particularly with respect to energy. Oil supplies are diminishing and prices could increase as extractive processes become ever more complex, making alternative energy more necessary. This could potentially put upwards pressure on prices for materials associated with the production of nuclear power, solar panels and wind turbines.

GAINING EXPOSURE TO COMMODITIES

Given that holding physical commodity inventories (also known as spot commodities) is impractical for investors other than the end users of the commodities, investors have traditionally sought exposure to commodities through futures markets or by a thematic investment in commodity-related equities.

The primary method for obtaining an exposure to commodities is via collateralized commodities futures (CCFs). CCFs generate returns in three ways:

- › spot return, which is the return associated with changes in current commodities' price levels;
- › roll yield, which is the return from replacing futures contracts as they near expiration; and
- › collateral management, which is the return on the collateral required for the futures contracts.

Investors can also gain commodities exposure through commodity-related equities or other securities, often pulled together into thematic equity products. For example, some commodities such as uranium require equity market participation to gain exposure. Certain equity sectors possess commodity market exposure, such as:

- › shipping, ground transportation, and storage securities;
- › agri-business, timber production or timberland;
- › energy infrastructure, mining, nuclear power generation, integrated oils or energy services; and
- › construction, fabrication, materials securities.

For all intents and purposes, these investments are no different to other equity sector funds.

PASSIVE, ACTIVE AND SOMEWHERE IN-BETWEEN

For indirect exposures via commodity equity funds, investors have the same passive or active management options as in traditional equity funds. These are usually available via specialist sector funds, such as energy and metals. The options available via CCFs are less familiar.

Passive CCF exposure

While passive investments in commodities have been around since the 1980s, the proliferation of commodities indices over the last 10 years has expanded the options for investors seeking diversified commodities exposure. The indexes differ in their construction methodology, the number and types of commodities they include and their weighting to different sectors, with energy dominating many indexes. There is no consensus on the most appropriate index but the S&P Goldman Sachs Commodities Index and the Dow Jones AIG Commodities Index are among the most popular.

Investors can gain passive exposure to commodities by investing in a basket of futures, through Exchange Traded Funds and Exchange Traded Notes, or via index swaps. The costs of investing passively in commodities can be more expensive than passive strategies in other asset classes.

Active CCF strategies

Active commodity management is no longer the exclusive domain of Commodity Trading Advisors², and today there are dozens of sophisticated managers employing a variety of fundamental and quantitative strategies. Active investing is a natural fit with commodities due to the periodic bursts of price volatility and the participation of non-economic players (physicals buyers and sellers or "hedgers"). Because hedgers are motivated by production and consumption goals, skillful active managers (economic players) have multiple sources of alpha to exploit.

Be they long-only, long-neutral, long-short or CTAs, managers can employ a variety of trading strategies to capture the alpha available in commodities. While not a complete list, the following trading methods provide an idea of the variety of strategies available to active commodity managers.

²Commonly regarded as a type of hedge fund, CTAs are active managers that focus primarily on trends in commodities and other financial futures markets. They can take leveraged long and short positions in individual futures contracts.

Directional trades: In a benchmark-relative portfolio, individual commodity positions can be implemented as either over or under weights relative to their weight in the index.

Spread trades: These strategies look to exploit relative value opportunities between different contract months, exchanges or commodities. These spread trades include inter-month (e.g. April/August wheat), inter-market (e.g. Brent vs. WTI crude) and inter-commodity positioning ('crack spreads' such as crude/gasoline). Spread trades are typically implemented by taking a long position in one commodity or contract month while shorting another. Spread trades are the basis for the majority of absolute return managers' strategies.

Commodity volatility trades: Volatility trades are typically used to express a manager's directional outlook for a commodity, his expectations for future volatility, or to structure relative value trades similar to those via outright spread trading. Volatility trades are generally implemented via the options market and can include the sale or purchase of options based on commodities futures.

Managers can also add value by 'smart' timing of futures rolling and enhancing the returns on collateral investments via cash plus strategies. Enhanced index managers usually focus their attention to these strategies.

Technical trading strategies

Finally, there are strategies which might be considered a hybrid of active and passive management. For example, theoretical and empirical evidence demonstrates that managers can systematically add value above standard long-only commodity indices by following a momentum strategy. This advantage exists because of the structural characteristics of the commodity market, such as storage costs and inventory levels which encourage serial correlation of commodity prices. Such a trend-following strategy can be implemented by managers following a naïve index-construction process which follows a different construction methodology to the main indexes available. Several examples of such indices are available, and skill is required to select the most appropriate construction methodology in much the same way that care should be taken when selecting an active manager of commodities.

MANAGER UNIVERSE

While the first active managers with a focused and systematic process for commodity investing emerged in the 1980s, the number of providers has increased substantially over the last five years. The current universe of enhanced index managers consists of ten or more; active long-biased managers and long-neutral managers number roughly two dozen; and the collection of fully active long/short and CTA managers is extremely large, possibly in the hundreds.

While active management opportunities are plentiful in the commodities markets, the risk and difficulty can be considerable. Commodity prices are highly volatile and the long-term success of a commodities programme is dependent on the skill and discipline of the management team. Of particular importance when hiring any manager who trades in CCFs is a robust understanding and experience of the commodity futures market, and relevant actual trading experience in that market.

CONCLUSION

Despite the recent volatility experienced in commodities markets, we believe that many investors should consider a strategic allocation to commodities in the context of their long-term investment portfolios. Commodities can generate significant returns to investors, offer significant diversification benefits and their inclusion can help portfolios to outpace inflation over the long term.

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