L/S Commodity Investment for Diversified Portfolios

An attractive proposition

JIM NEUMANN, PARTNER AND PABLO URRETA, PARTNER AND HEAD OF RESEARCH, SUSSEX PARTNERS

The global search for uncorrelated returns continues as institutional investors deal with "priced to perfection" fixed income and equity markets in a risk on/risk off binary environment subject to economic and geo-political headlines. Various stages of Quantitative Easing ("QE") have led to a rally in most asset prices as well as growing correlations between their seemingly unrelated return streams, against a backdrop of uncertain economic fundamentals. In this environment, those seeking to add a true alpha strategy should take a fresh look at the uncorrelated commodity sector. More specifically, a compelling opportunity exists in long/short commodities accessed via a discretionary commodity-specific multi-manager platform. This multi-manager approach produces superior risk/return ratio versus more diversified funds of hedge funds. It provides access to talented managers, some of whom are not otherwise available, that are able to profit from the inefficiencies in the various commodity sectors regardless of direction. Long/short commodities are one of the few areas which remains highly underinvested by institutions and offers a sustainable source of alpha with little correlation to other assets.

Commodities are attractive for a variety of reasons, the most important of which is the lack of correlation that the sector has to other strategies, especially when commodity-related equities are excluded from the portfolio in order to express a more pure view of the asset class. In fact, investors have been reallocating from other buckets, particularly "no yield" fixed income, into commodities for both correlation and returns. There is much evidence of the hedging attributes commodities provide to portfolios in dealing with inflation, geo-political risk, and changes in business cycles; indeed multi-managers should be screened to ensure very low or negative correlation when conducting a search. This simple correlation matrix highlights the lack of correlation exhibited by commodities managers to broader markets and other hedge fund strategies.

Many investors' familiarity with commodities stems from commodities indices or perhaps more recently from "single manager" commodity hedge funds. Those investors who have used commodities in their portfolios have done so in very small percentages, primarily for hedging or diversification purposes. Since the access vehicle was often an index like GSCI (now S&P GSCI), this long-only strategy investor became subject to unwanted roll risks. In fact the contango/"normal" backwardation (longer maturity futures price above/below expected future spot price) effect has been put forth as being the main driver of returns (see *Financial Analyst Journal's* July/August 2016 article "Conquering Misconceptions about Commodity Futures Investing"). Most investors seeking commodity exposure also eliminate trading in physical commodities themselves as too infrastructure intensive. Investing indirectly via commodities-related equities is generally also not a pure way to garner commodities exposure and is likely achieved via an equities manager if desired. While the historical return derived from commodities via an index is near zero, this is not indicative of the inefficiencies and seasonalities that can be exploited for return by adept managers. With the luxury of hindsight, the way commodities exposure has been accessed by investors in the past has created more problems than solutions. Fortunately, other avenues of access have continued to evolve and are now available to institutional investors.

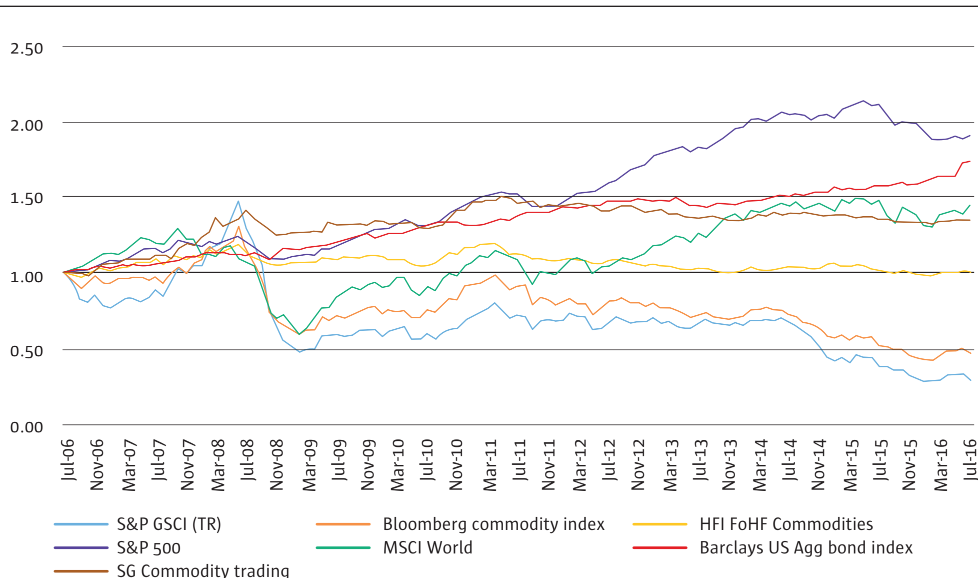
While the correlation benefit of long/short commodities is very attractive to investors, the real draw is finding a reliable return stream not dependent on bull markets in a relatively liquid market. As investors "barbell" their exposures between liquid and illiquid, the liquid bucket seems harder to fill. The inefficiencies have largely been

Fig.1 10 year correlation matrix

	S&P GSCI (TR)	Bloomberg Commodity	HFRX Macro: Commodity	HFI FoHF Commodities	S&P 500	MSCI World	Barclays US Agg Bond	SG Commodity Trading
S&P GSCI (TR)	1.00							
Bloomberg Commodity	0.91	1.00						
HFRX Macro: Commodity	0.27	0.33	1.00					
HFI FoHF Commodities	0.27	0.33	0.33	1.00				
S&P 500	0.50	0.51	0.34	0.59	1.00			
MSCI World	0.56	0.58	0.10	0.40	0.58	1.00		
Barclays US Agg Bond Index	-0.06	0.10	-0.01	0.00	-0.14	0.07	1.00	
SG Commodity Trading	0.15	0.07	0.10	0.01	0.13	-0.03	-0.01	1.00

*Data as of 31 July 2016.
Calculations based on data made publically available by index providers: S&P Dow Jones Indices, Bloomberg, HFR, MSCI, Barclays Indices, SG Prime Family of Indices

Fig.2 10 year cumulative returns



*Data as of 31 July 2016.
Calculations based on data made publically available by index providers: S&P Dow Jones Indices, Bloomberg, HFR, MSCI, Barclays Indices, SG Prime Family of Indices

Fig.3 10 year correlations between commodities markets

Source: BCOM TR sub-commodity indices

	BCOM Grains	BCOM Industrial Metals	BCOM Livestock	BCOM Nat. Gas	BCOM Petroleum	BCOM Precious Metals	BCOM Softs
BCOM Grains	1.00						
BCOM Industrial Metals	0.38	1.00					
BCOM Livestock	-0.01	0.15	1.00				
BCOM Nat. Gas	0.26	0.17	0.08	1.00			
BCOM Petroleum	0.38	0.52	0.23	0.33	1.00		
BCOM Precious Metals	0.34	0.40	0.02	0.17	0.32	1.00	
BCOM Softs	0.54	0.45	0.04	0.23	0.36	0.38	1.00

**Data as of July 31st 2016.*

Calculations based on data made publically available by index providers

arbitraged out of other liquid markets, but remain in each of the specialized commodities markets that are large enough to provide the needed liquidity. Some of this is due to the uniqueness of each market, the zero-sum of positions in the futures markets, and the variety of participants with differing aims. Just the large presence of indexed money, CTAs, ETFs, producers, and hedgers feeds the exploitable inefficiencies in the markets. As can be seen in Fig.2, the returns in the SG Commodity Trading Index[1] are quite attractive on a risk adjusted basis when contrasted with long-only exposures and the broader markets.

While commodity speculation both long and short is not new, historically concentration in just one manager, in one commodity or sector, or in one specific trade type (e.g. natural gas calendar spreads), has produced a high level of volatility. As a result, many investors have developed an aversion to the boom/bust profile of commodity investing of the past and are instead finding better risk adjusted returns via portfolios of commodities exposures. Long/short commodity managers, as a diversified group, have access to a much broader, deeper tool set from which to construct robust portfolios than any long-only strategy. As an example, with prices of commodities on the move again, position taking via options/option related instruments has surged relative to pure futures positioning. The employment of tools available helps create an asymmetric payout profile with much less volatility. The Holy Grail is to capture this uncorrelated alpha with solid downside control.

Single commodity managers often lack the breadth of experience to provide a well-diversified portfolio and thus tend to stick to what they know, be it energy, agricultural products, etc. The result can often be a very concentrated portfolio with the possibility of great volatility, which seems to surprise mostly the downside. The history of single managers, even those with enviable pedigrees prior to fund launch, is of running into difficulties related to this concentration, along with the usual hedge fund risks of style drift and poor risk management. The five plus year viability rate of even the most celebrated single commodity managers is very low, while the volatility of returns during the period of operation is very high. Trying to build a diversified portfolio across commodities and strategies from among those commodities managers has proven quite difficult for even the most well-resourced investors. Allocating to single managers has been fraught with unwanted risk and timing the exit to avoid problems has proven challenging. On the other hand, specialized commodity multi-manager portfolios have the distinct advantage of diversification which helps to mute the volatility while providing both the return and correlation benefits to portfolios. Sourcing, portfolio construction, risk management, and the investment vehicle structure are essential elements required to create/maintain/continually evolve a successful platform.

Manager sourcing and selection in commodities is paramount to investing in the commodities long/short space and requires a very specialized set of attributes from a multi-manger platform. The uniqueness of each commodity, including its forward curve and all the exogenous factors that affect the price of the commodity or spread, requires a very differentiated skill set amongst constituent managers.

The multi-manager building the portfolio has to have the experience, network, and business acumen to be able to navigate the sourcing, vetting, and engagement of talent. The universe of adept managers is finite and thus there is often competition from other multi-managers, hedge funds, producers, hedgers, etc. It is improbable to be able to consistently attract high calibre talent without a well-respected, long tenured, and well-funded presence in the market. While the lure of having one's own fund will hold sway for some of the most pedigreed managers/traders, the concept of a turn-key source of stable capital has an important place in the fragmented commodity manager world. Even those managers who go the single manager route are often willing to set up separate vehicles for respected capital. Investors should seek multi-managers who have effectively positioned themselves as a trusted advisor to managers/traders in the industry as it often leads to an "early look" when they are seeking to make a change. This is particularly important, as capacity is usually limited and the early mover may be able to effectively lock up that capacity, cutting off other potential investors from attractive return streams. It also pushes one towards multi-managers that have a ten year plus track record during which they have established networks and earned trust/respect amongst the manager pool. The multi-manager needs to have significant accessible capital and be prepared to deploy it in a tight, turn-key format that is attractive to portfolio managers. In practice, the pool of portfolio managers has become well aware of where to turn for capital that can react quickly and is able to provide enough flexibility to meet the needs of a particular manager's or group of managers' situation. Judging from our conversations with multi-managers, the current environment is rich with talent and opportunities for the allocator, as the dislocations in the commodities markets, notably outside the energy complex, has left some of the most experienced and talented portfolio managers without a home or capital. While the pendulum between portfolio manager and allocator does swing, it seems that the allocator currently has the advantage and therefore it is likely a good time for the allocators, networked to see the compelling opportunities, to lock-down deals with favorable terms. Deployment of capital during this period should help the multi-managers outperform in the coming cycle, particularly if downside volatility returns to the major markets.

Another attribute impactful to the long/short commodities space is the ability to access return streams predominantly via managed accounts. Sophisticated long/short commodities multi-manager platforms have evolved from investing in co-mingled funds into a specialized platform of diversified, bespoke mandates often exclusive to them. This structure, which exists at several well-known mega-managers, is quite powerful when applied to a discretionary commodities-only sub-set. The large multi-strategy managers may have commodities sleeves, but they are often dwarfed by equities and fixed income. Particularly in difficult markets, the commodities correlation/hedging benefit gets lost in the mix. The creation of a virtual long/short commodities firm with customized mandates and multi-level risk controls is the way to bring commodity alpha to more portfolios in a targeted, lower volatility fashion.

With bespoke managed accounts investors will not only benefit from full transparency but also from flexible margin allocation (capital efficiency, seasonality effects etc.), adjustable margin levels (risk management), and from an easier and faster capital reallocation process. Not unlike some of the large multi-strategy firms, these discretionary-only commodity multi-managers can demonstrate that this active second layer of management provides an additional source of alpha versus more traditional static fund allocations. Given the nature of the commodities markets, a wide dispersion of returns amongst managers is to be expected, but with an active management of these exposures, including mitigating concentrations, a steadier return stream can be achieved without suffering through significant drawdowns. The multi-manager also has the distinct advantage of designing and implementing a mandate that may be exclusive to them including concentration limits, risk parameters, and drawdown controls. In some cases the mandate may be a sub-set of what is offered to other investors or a strategy not offered to any other investor. The resulting portfolios are unique, dynamic, and very difficult to replicate.

The current environment in commodities is ripe with exploitable opportunities for the adept, often single-commodity or commodity-sector focused manager. The problem of how to access attractive return streams in a diversified, risk controlled fashion has largely been solved by the evolution of discretionary long/short multi-manager platforms. The portion of the investment community that has embraced the correlation, return, and hedging benefits of adding commodities exposure now have a much refined way to do so in a neat, fee efficient package. Conversations with institutional investors reveal the scepticism derived from index investing and the volatile single manager experience has been replaced with an opportunistic, enthusiastic reception to the multi-manager approach. There exists a small universe of multi-managers with discretionary only commodities exposure that can meet historical return hurdles, have exhibited solid drawdown control over multiple cycles, and which have low or negative correlation. These multi-managers are themselves seeing an unusual imbalance between trading talent and available capital resulting in a deep, diversified opportunity set which does not exist in other asset classes. Given that the commodity space is largely underinvested by institutions, the interest in accessing these uncorrelated returns available in an intelligent manner is likely to grow exponentially over the coming period. **THFJ**

FOOTNOTE

1. The SG Commodity Trading Index (Trading) ("SG COM") (formerly known as the Newedge Commodity Trading Index - Trading Strategies) is a sub-index of the SG Commodity Trading Index that covers trading-orientated strategies, typically involving the trading of physical commodity products and/or of commodity derivative instruments in either directional or relative value strategies.