<u>New investment opportunities emerge in commodity hedge funds</u>

<u>By Patrick Ghali</u>

For years, commodity indices have shown highly volatile and lacklustre performance. However, investments in commodity hedge funds could offer pension funds more diversification and higher returns, says Patrick Ghali, managing partner at hedge fund adviser Sussex Partners.

Institutional investors have traditionally looked at commodities from the 'cheap' beta perspective.

The institutional access vehicle of choice has been a commodity index like the S&P GSCI (formerly the Goldman Sachs

Commodity Index). However, long-only commodity investors have been subject to unwanted roll risk*

We advise institutional investors to focus on the uncorrelated alpha that commodities can generate instead.

Long-short commodity investing, in particular, offers investors uncorrelated returns and less efficient markets compared with 'priced-to-perfection' fixed income and equity markets.

Low correlation

In our view, an allocation to commodity hedge funds should be based on the inefficiencies inherent in commodity markets rather than any macro view investors may have, as these are notoriously difficult to predict correctly.

While inefficiencies have largely been arbitraged out of other liquid markets, they remain in each of the specialised commodity markets that are large enough to provide the liquidity institutional investors require.

The inefficiencies exist partly because of the uniqueness of each commodity market, the zero-sum positions in futures markets and the variety of market participants.

The large presence of indexed money, commodity trading advisors, exchange-traded funds and hedges feeds the inefficiencies in commodity markets.

The lack of correlation commodities have with other strategies further adds to the appeal of the asset class, especially when commodity-related equities are excluded from the portfolio in order to express a purer view of the asset class.

The simple correlation matrix below highlights the lack of correlation commodity managers have to broader markets and other hedge fund strategies. It shows, for example, that over the past 10 years, the correlation between the HFRX Macro Commodity

Index and the MSCI World Index was only 0.10, which clearly highlights the diversification benefit of commodities versus broad global equities.

More interestingly though, the correlation between the S&P GSCI (TR) Index – the aforementioned long-only index of choice for many institutional investors – and the HFRX Macro Commodities and the HFI Fund of Hedge Funds Commodities indices was only 0.27 in both cases. This highlights how long-short commodity strategies are not correlated to a long-only commodity strategy.

On the other hand, the correlation between the S&P GSCI (TR) Index and the MSCI World over the same time period is much more significant at 0.56, the data show.

	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	0.50	0.04	0.31	1.00			
MSCI World	0.56	0.58	0.10	0.40	0.96	1.00		
Barclays US Agg Bond Index	-0.07	0.09	-0.04	0.00	0.03	0.08	1.00	
SG Commodity Trading	0.15	0.07	0.10	0.01	-0.05	-0.03	-0.01	1.00

Source: Data as of July 31 2016. Calculations based on data made publicly available by index providers

Sentiment shifts

Return-seeking investors have already reallocated assets from other investment buckets, especially from 'no yield' fixed income, to commodities.

Indeed, the hedging attributes of commodities can help investors deal with inflation, geopolitical risk and changes in cycles.

In our opinion, the recent surprise US presidential election result only further strengthened the rationale for investing in commodity hedge funds. They add a dynamic policy component to the mix, which includes environmental, global trade and national security issues.

The ramifications of the result on the markets can already be seen in the remarkable sentiment shifts that have taken place since the election. However, there are some interesting trading opportunities for commodity hedge fund managers.

There seems to be a clear expectation among seasoned market participants that the size and duration of moves, especially those triggered by policy shifts, may produce significant investment returns.

That said, commodity markets have high barriers to entry.

We believe established players who have robust and diversified trading teams in place should benefit most from the recent developments; the increase in market volatility and the alpha opportunities it creates.

We advise institutional investors to either invest in a basket of non-commodity hedge funds through a managed account platform that can offer both diversification and centralised risk management and centralised risk management.

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