Russell Investments

Viewpoint

Russell Research

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Asset Class: Commodities

Originally written as part of a series for our global institutional clients, this asset class viewpoint provides an overview of the asset class and the role it could play in a portfolio.

What is the asset class?

Commodities are raw materials that may be part of a portfolio's real asset allocation. Typical commodities include oil and other energy products, metals (both precious and industrial), "softs" (cotton) and "ags" (including grains, feedstock, and pork bellies). Commodity investing may be either physical commodities (e.g. buying gold bullion or storing wheat in a silo) or commodities purchased on futures exchanges as a broad basket of items or equities. These futures track movements of underlying assets but investors do not have to manage inventories or pay for storage. Investors who hold a futures contract may participate in the price change from contract inception to close.

What is the role of Commodities in a portfolio?

An important benefit of commodities is that they add diversification to an investment portfolio. Historically, commodities have exhibited low (0.00-0.35) correlations to traditional asset classes such as stocks and bonds[1]. The benefits of diversification include the potential for lowering a portfolio's volatility. In addition to reducing volatility via low correlations, commodities may help a portfolio's inflation protection over long time periods.

Among real assets, commodities have historically had the lowest correlation to an equity and bond mix versus infrastructure and real estate[2]. The historically low correlation and relatively high returns have rendered commodities an excellent diversifier. Historically, commodities returns have been higher than bonds over long periods of time.

[1] Commodities (Dow Jones-UBS Commodity Total Return Index[SM]), U.S. stocks (Russell 3000® Index), bonds (Barclays Capital U.S. Aggregate Bond Index) during sample period February 1991 – March 2011 (reflective of the available history for the Dow Jones-UBS Commodity Total Return Index[SM]).

[2] Commodities (Dow Jones-UBS Commodity Total Return Index[SM]), U.S. stocks (Russell 3000® Index), bonds (Barclays Capital U.S. Aggregate Bond Index), listed infrastructure (S&P Global Infrastructure Index from December 2001-current, UBS Global Infrastructure & Utilities Index prior), real estate (FTSE EPRA/NAREIT Developed Index), during sample period February 1991 – March 2011 (reflective of the available history for the Dow Jones-UBS Commodity Total Return Index[SM]).

How are commodities accessed?

Commodities exposure may be gained through physical purchase (which requires an understanding of storage, insurance, delivery methods, etc.) or through a variety of financial instruments including collateralized commodities futures (CCFs). To avoid taking physical delivery, investors may purchase futures contracts. In the case of CCFs, investors attempt to replicate (or actively manage for additional returns) well known indexes such as the Dow Jones-UBS Commodity Total Return Index℠ (DJ-UBS) or the S&P Goldman Sachs Commodity Index (S&P GSCI®). Both of these indexes are implemented using positions in short-term "near month" contracts. Futures contracts are traded on a centralized exchange that has margin requirements and promotes price discovery via uniform contracts. The exchange acts as the clearing house between buyers and sellers for a particular commodity and provides an essential role for both hedgers (producers and consumers of physical commodities) and speculators.

Because CCF indexes emphasize front-month contracts that expire within 1 or 2 months, investors must "roll" the contract prior to expiration to avoid taking physical delivery. The total return on CCFs is a combination of a cash return from the collateral (usually a T-bills return) plus the return of the rolled futures contracts that are purchased. Typically the return on the rolled futures contracts is further divided into "spot" and "roll." The roll return is the difference between the return of the rolled futures contracts and the returns of the spot commodities contracts. Investors often carefully track this difference between spot and roll; however, since spot is not attainable, such attention is somewhat superfluous.

Other ways to gain commodities exposure without purchasing futures include commodities exchange traded funds (ETFs), swaps, specialized mutual funds and commodity-linked equities (these are equities of a commodity producer whose stock price is driven by commodities prices.) Existing commodity ETFs are generally passive, index-oriented vehicles, but commodities funds are also fertile ground for active management. For individual investors interested in holding a diverse portfolio of commodities, Russell believes the DJ-UBS index is a good choice. It is designed to reflect performance of all commodities market segments including energy, agriculture, metals and soft commodities and is highly liquid and well-diversified. The other prevalent index is the S&P GSCI® index. Its large allocation to energy (70%) makes it less attractive for investors desiring broader diversification in commodities.

Additional things to consider

Compared to equities and fixed income, exogenous macroeconomic factors tend to have a greater influence on commodities prices relative to other asset classes. These factors may include environmental issues (such as weather on agricultural commodities), geopolitical concerns (policy towards the Middle East or other energy producing nations), currency effects due to where a commodity is produced or traded (although most are traded in U.S. dollar), demographic changes and technological changes (industrialization drives up costs of industrial metals such as copper).

For institutional investors desiring exposure to commodities, a variety of active strategies is available. In addition to listed commodities, commodities are also accessed through private investments that often sacrifice liquidity for the possibility of enhanced return and allow access to market segments that are not well-represented on exchanges. Private commodity investment options may include: timberland, oil and gas fields, privately owned mines and commercial farms. These investments require high capital availability, long time frames and specialized skills to evaluate.

Individual investors seeking an investment in commodities securities may want to consider diversified funds that have some ability to improve upon index returns.

For more information:

Call Russell at **800-787-7354** or

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Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Diversification does not assure a profit and does not protect against loss in declining markets.

Commodity futures and forward contract prices are highly volatile. Trading is conducted with low margin deposits which creates the potential for high leverage. Commodity strategies contain certain risks that prospective investors should evaluate and understand prior to making a decision to invest. Investments in commodities may be affected by overall market movements, and other factors such as weather, exchange rates, and international economic and political developments. Other risks may include, but are not limited to; interest rate risk, counter party risk, liquidity risk and leverage risk. Potential investors should have a thorough understanding of these risks prior to making a decision to invest in these strategies.

Dow Jones-UBS Commodity Total Return Index℠ is an index composed of futures contracts on 19 physical commodities.

The Russell 3000® Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

Barclays Capital U.S. Aggregate Bond Index is an index, with income reinvested, generally representative of intermediate-term government bonds, investment-grade corporate debt securities, and mortgage-backed securities.

S&P Global Infrastructure Index provides liquid and tradable exposure to 75 companies from around the world that represent the listed infrastructure universe. The index has balanced weights across three distinct infrastructure clusters: utilities, transportation and energy.

UBS Global Infrastructure & Utilities Index, a free float-adjusted, market capitalization-weighted index designed to track the performance of globally listed infrastructure.

FTSE EPRA/NAREIT Developed Index tracks the performance of listed real estate companies and REITS worldwide.

S&P Goldman Sachs Commodity Index (S&P GSCI®) is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully collateralized basis with full reinvestment.

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