

An Argument for Commodities and What To Be Aware Of from Different Investment Options

MANY INSTITUTIONAL INVESTORS HAVE BEEN CONSIDERING ADDING INVESTMENTS TO COMMODITIES TO ENHANCE PORTFOLIO DIVERSIFICATION – BUT WHY?

Commodities tend to respond directly to changes in the economy that produce inflation. For example, we are all familiar with the effect of supply and demand on commodities prices with our regular trips to the gas pump. If there is a depleting supply or even if the supply is held constant, then increased demand will lead to increased prices. This relationship holds true for other commodities as well.

Increased demand from established and emerging market economies for commodities and limited supplies of natural resources at some point will result in rising prices. Combine rising commodity prices with an expanding

money supply to fight the global recession and many argue it is not a matter of if, but when inflation will increase. Simply put, financial theory suggests that investing in commodities will provide an inflation hedge. Additionally, commodities have offered a low historical correlation to stocks and bonds (see Tables 1 and 2), meaning they can lower overall portfolio volatility and enhance long-term risk adjusted returns. As you can see, in the last 10 years, the blended index in (Table 1) “50 percent S&P 500 / 40 percent BarCp Agg / 10 percent DJ UBS Commodity” has a higher return, lower standard deviation and higher Sharpe ratio than its counterpart “60 percent S&P 500 / 40 percent BarCap US Agg Bond” due to the inclusion of commodities.

Table 1: Return / Standard Deviation / Sharpe Ratio 10 years ending 03/31/2010			
Name	Total Ret Annlzd 10 Yr	Std Dev 10 Yr	Sharpe Ratio 10 Yr
50% S&P 500 / 40% BarCp Agg / 10% DJ UBS Commodity	3.16	8.77	0.09
60% S&P 500 / 40% BarCap US Agg Bond	2.41	9.61	0.02
BarCap US Agg Bond TR USD	6.29	3.83	0.91
S&P 500 TR	-0.65	15.93	-0.13
DJ UBS Commodity TR USD	5.73	17.57	0.25



Table 2: Correlation 10 years ending 03/31/2010

		BarCap US Agg Bond	S&P 500 TR	DJ UBS Commodity
1	BarCap US Agg Bond	1.0	-	-
2	S&P 500 TR	-0.05	1.0	-
3	DJ UBS Commodity	0.08	0.33	1.0

Nonetheless, even if investors buy into the prior theory, they may be somewhat hesitant to move forward due to the complex nature of commodities investing. Unlike a portfolio of stocks or bonds, commodities do not lend themselves to be easily grouped into a portfolio. Imagine how impractical it would be to hold a portfolio of cattle, soybeans or oil in their physical form. As a result, investors commonly gain access to commodities through separate accounts, mutual funds and exchange traded funds or notes. While these products may seem like good investments for diversification and inflation protection, each comes with advantages and disadvantages.

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Exchange Traded Funds (ETF):

One of the easiest ways to invest in commodities is through Exchange Traded Funds (ETFs). Some of these investments are designed to reflect the returns of a specific commodity like gold, while others reflect the returns of a basket of commodities. As an example, Morningstar's database of exchange traded funds and notes includes 79 distinct commodities related funds, 13 of which represent a broad basket of commodities, while the remaining fall into the agricultural, energy, industrial

metals and precious metals categories. For instance, the "broad basket" iPath Dow Jones-AIG Commodity Index ETN follows the Dow Jones-AIG Commodity Total Return index, which covers 19 specific commodities, representing approximate weightings of 35 percent toward energy, 28 percent agricultural, 18 percent industrial materials, 10 percent precious metals, and nine percent in livestock.

ETFs are not without their disadvantages. More often than not, the underlying investments of these funds are commodities futures contracts or are linked to an index based on commodity futures contracts that may give rise to tracking error relative to the spot price of a commodity. As we've seen the last few years, funds that are invested in futures contracts don't always keep up with the price of the actual underlying commodity spot price. The majority of these funds buy the near-month future contract, selling it before expiration and buying the next month's contract, and so on. If the price of the next month's contract is higher than the current month's, this is called contango, and the investment could lose money when the contracts are rolled over. A negative roll yield – contango – could cause the net asset value (NAV) of a fund to deviate even further from the spot price of its underlying commodity. The opposite situation is backwardation. In general, funds that reflect the returns of futures contracts do not claim to track the spot price of their respective commodities.

Exchange Traded Notes (ETN):

ETNs generally are senior, unsecured, unsubordinated debt securities designed to provide investors with access to the returns of various commodities benchmarks. A potential drawback to these investment vehicles is that you are really buying the promise of an entity to pay you that return, so in reality, you are buying a corporate note. Let's say you want a seven percent exposure to commodities but have a policy guideline of no greater than five percent in any single corporate issuer, by buying an ETN from one vendor, you have exceeded that guideline. Investing via ETNs also puts the Trustee or Plan Sponsor in the role of understanding the credit quality of the ETN issuer, as ETNs are not rated. Additionally, the value of the ETN can be affected by the issuer's credit rating. For instance, the price of the ETN may drop in value following a ratings downgrade of its issuer.

Below are some similarities and differences between ETFs and ETNs.

	ETN	ETF
Liquidity	Daily on exchange	Daily on exchange
Registration	Securities Act of 1933	Investment Company Act of 1940
Recourse	Issuer credit	Portfolio of securities
Principal risk	Market and issuer risk	Market risk
Institutional size redemption	Daily to the issuer	Daily via custodian
Short sales	Yes, on an uptick or a downtick	Yes, on an uptick or a downtick

Mutual Funds:

According to Morningstar's database of mutual funds there are roughly 18 distinct "broad basket" commodities funds. Although the bulk of the return from these funds comes from commodities-related investments, most

funds also hold fixed income securities to support their commodities portfolio. As with other investments relying upon commodities futures, mutual funds may fail to provide the same gains that are seen in the spot market. Factors affecting performance include management fees, and the necessity for funds backed by futures to invest collateral in a variety of bonds (which introduces another source of risk and return).

In addition to commodity oriented mutual funds, there are "natural resource" funds that buy only commodity related stocks. The idea is that the stocks will do well based on the price of the commodity, but in reality, investors must also take into account the management of that company, which may have nothing to do with the price of the commodity (think BP Oil and its stock price in the wake of the large oil spill in the Gulf).

Separately Managed Commodities Funds:

These funds may suffer from many of the same disadvantages of ETFs, ETNs and mutual funds, and are generally not available to smaller investors. Most require very high minimum levels, lock-ups (illiquid) and are designed for the very large institutions. (These typically require a qualified investor status – total assets over \$25 million) and have minimums of \$25 - \$50 million. Most institutional investor guidelines put a limit on the percentage of the portfolio that can be invested in commodities, for example, no more than 10 percent of a portfolio, so institutions interested in a separately managed portfolio would need to be in the \$250 to \$500 million range. The benefit of separately managed accounts is that the investor can create very strict guidelines on the amount of risk (leverage, collateral, diversification) they are willing to assume. In addition, the managers may actively invest in multiple types of instruments that would be excluded from 40 Act Funds or ETNs.



Additional Considerations:

In addition to understanding how the underlying investments of a fund may affect fund performance, investors need to understand how fund assets will be managed to achieve commodity like returns. For instance, some commodity managers actively seek excess returns by taking advantage of (or avoiding) term structures and the shape of the futures curve, betting on current trends (i.e. corn used to produce ethanol and supported by government subsidies), or events (for example when Hurricane Katrina caused large production gaps between the refinement of crude oil into and gasoline), while other managers and funds are quantitatively driven

Another common management technique used to

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increase potential return is to leverage the portfolio, which also increases risk. Institutional investors concerned primarily with just gaining exposure to commodities need to be aware of any leverage. Awareness of if and how much the portfolio can be leveraged is a key factor to controlling risk. Additionally, it is important to understand how the manager invests the cash or collateral for the futures contracts. Knowing how conservatively the cash/collateral is invested in a commodities fund should eliminate any secondary surprises. It is critical to have these guidelines in writing before making an investment.

Some managers, whether mutual fund or separately managed, will employ a hybrid approach, allocating say 50 percent of the portfolio to commodity related stocks and the remaining portfolio to commodity futures and swaps. The advantage of a hybrid approach is that the funds are actively managed, somewhat more

diversified among issuers of the swaps and notes, and can move between these instruments and equities as markets become under or overvalued.

History:

As with any investment, it is critical to understand the historical volatility of the asset class and be prepared for history to repeat itself.

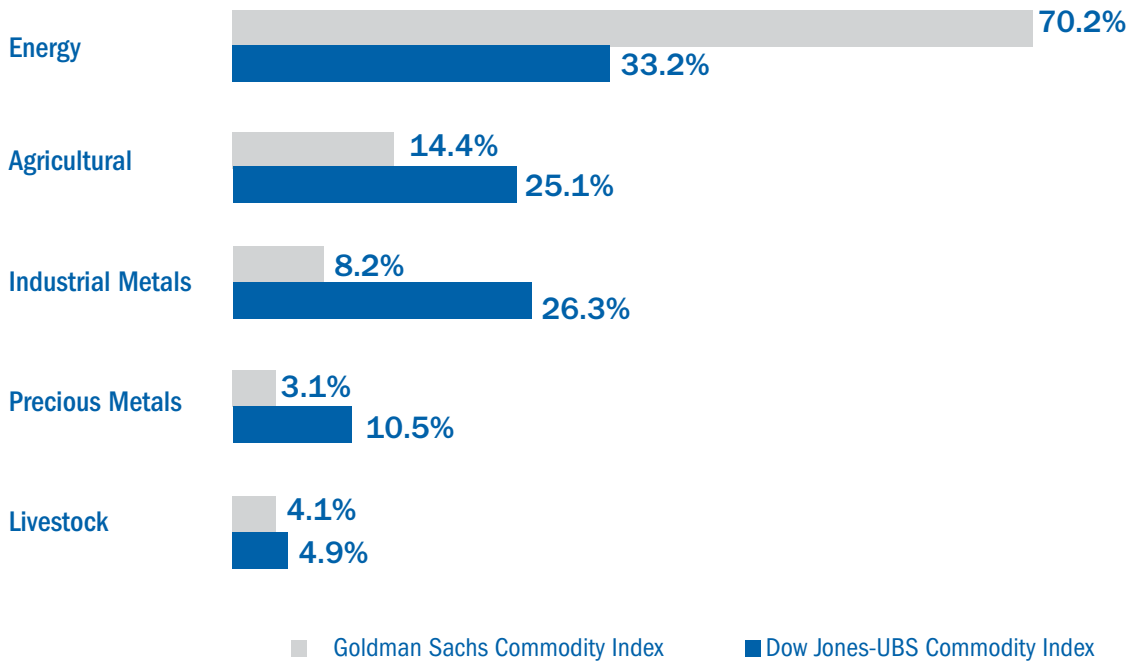
In 1972, during the oil embargo, energy related commodities were up 183 percent, yet during the 2007 financial crisis (Oct. 07-Feb 09), they were down 60.3 percent (S&P GSCI Energy) compared to the S&P, which was down 50.95 percent in the same time frame. Gold was down -44.84 percent during the 1980's stagflation era (Nov. 80-July 82). Commodities historically have moved differently from US equities eight out of 10 times, but investors cannot always count on negative correlation as we saw in the 2007-08 financial crises.

There are managers that offer to short commodities, but experience and strong risk controls are essential to avoiding significant downside risk. Commodity prices can move very quickly based on unknown events, and a short can be very risky. A key factor is to understand philosophically whether the manager is using shorts to increase return or reduce volatility.

When considering investing in commodities, the DJ UBS Commodity Index and the S&P GSCI index are the two oldest and widely recognized benchmark indexes. From the chart on the following page, you can see that these indexes are very different. The DJ UBS Commodity Index is designed to be a more diversified index, while the S&P GSCI index tracks economic significance (as measured by liquid data and dollar-weighted production data of a particular commodity).



Commodity Index Sector Weights



In conclusion, it is vital to do the homework up front to understand what is inside a commodity fund portfolio. Not all funds are created equal and not all managers have the skill, experience and risk controls in place to properly manage an institutional portfolio. Investors need to determine what benchmark they will be using to measure the managers success. New indexes have been developed that may be more meaningful, but they do not have the track record to provide appropriate historical statistical data. As products are considered, asking the right questions upfront will avoid surprises down the road.

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