

The case for commodities

Prisma, Zurich Life's fund platform, focuses attention on the building of risk rated portfolios for your clients. Diversification across asset classes is essential in portfolio construction and the Prisma Platform gives your clients access to all investment sectors.

We asked **Berdibek Ahmedov of PIMCO** to explain why investors might consider adding commodities to their portfolio, as well as some of the strategies for investing in commodities.

Commodities are the raw materials used to create the products consumers buy, from food to furniture to petrol. Commodities include agricultural products such as wheat and cattle, energy products such as oil and petrol, and metals such as gold, silver and aluminum. There are also "soft" commodities, or those that cannot be stored for long periods of time, which include sugar, cotton, cocoa and coffee.

The commodity market has evolved significantly from the days when farmers hauled bushels of wheat and corn to the local market. In the 1800's, demand for standardised contracts for trading agricultural products led to the development of commodity futures exchanges. Today, futures and options contracts on a huge array of agricultural products, metals, energy products and soft commodities can be traded on exchanges around the world.

Why commodities? Diversification and Inflation Protection

The secular transformation of the global economy is altering the drivers of economic and financial relationships. This raises questions about the long-term effectiveness of traditional asset allocation approaches, which tend to equate asset class diversification with risk diversification. Traditional diversification approaches could leave investors short of their objectives and their portfolios potentially exposed to unintended, often concentrated, shocks. This is further compounded by the potential for greater inflation due to continued central bank policy actions to stimulate economies. In this environment, commodities may provide investors with an attractive source of portfolio diversification and inflation-hedging potential.

Commodities offer low correlation to equities and bonds

Commodities represent a distinct asset class with returns that have historically been negatively correlated with those of equities and bonds. This is because commodity prices are often driven by supply side factors related to weather conditions, labour force strikes, dwindling reserves, geopolitical risks and rising incremental production costs. Therefore, adding broad commodity exposure may help diversify a portfolio of equities and bonds, while offering the potential to improve the risk/return performance of a portfolio.

Commodities as a source of inflation

Investors increasingly view commodities as a potential inflation-hedging asset class. In fact, commodities such as food and petroleum products, which make up a large share of the consumer price index (CPI) baskets, often are a source of inflation. In the case of the eurozone, food and energy commodities typically account for 20% to 25% of the CPI basket. Therefore, commodities like oil and corn tend to show higher correlation to inflation than commodities such as industrial metals and therefore, as inflation increases, so does the price of commodities.

Investing in commodities

Investing in commodities is not new. For centuries, gold and silver have been used as a store of value – long before the introduction of financial assets, such as equities and bonds. However, investing in a broad basket of physical commodities such as petroleum, wheat, copper and coffee is impractical as this presents logistical challenges and costs associated with delivering, storing and insuring physical commodities.

The innovation of commodity-futures-based indexes in the 1970s helped investors to overcome these challenges. These indexes assume a notional investment in a variety of commodity futures contracts, which are then rolled periodically according to preset rules (“rolling” refers to investors rolling money out of an expiring contract and into another one, and the process can affect returns regardless of whether underlying commodity prices are rising or falling). In order to ensure there is no leverage, the index assumes an amount of cash, equaling the market value

of the futures contracts, is set aside in U.S. Treasury Bills. The rules-based structure of the indexes allows them to be replicated relatively easily via investment vehicles such as exchange-traded funds (ETF) and investment funds.

Investors seeking to incorporate the benefits of commodities in their portfolios could consider the CommoditiesPLUS Strategy Fund. This actively managed fund tracks the Dow Jones-UBS Commodity Index Total Return, an index of a diversified basket of commodities, but eliminates some of the structural inefficiencies related to both congestion around index roll days and negative roll yield. Furthermore, the collateral backing the commodity positions are managed actively in high quality short-term fixed income securities to achieve positive real yields.

In conclusion

Commodities are a distinct asset class with returns that are largely independent of stock and bond returns. Therefore, adding broad commodity exposure may help diversify a portfolio of equities and bonds, potentially lowering risk and boosting return. Faced with an uncertain and extremely fluid multispeed global investment landscape, which is framed by unconventional central bank monetary policy, investors should take a critical view of their portfolios and ask themselves: “Am I invested to tap into the potential for positive returns while mitigating inflationary risks – and if not, should I consider the case for commodities?”

To learn more about the CommoditiesPLUS Strategy Fund and how it fits within the Prisma Platform, just speak to your local Zurich Life Broker Consultant.

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Source: PIMCO Europe Limited as at 30 November 2012

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The value of your investment may go down as well as up.