



Max Bublitz

We're all Swensenians now

The appeal of commodities used to be the equity-like returns combined with low correlation to stocks and bonds. That all changed once the commodities bandwagon started rolling

Back in 1971, Richard Nixon uttered the now-famous “We’re all Keynesians now”, a phrase, it turns out, he lifted from Milton Friedman. In an effort to get a handle on what’s happening with commodity prices these days, I thought it might be helpful also to borrow the phrase again, albeit with a twist. Let’s start by replacing the name of John Maynard Keynes with that of David Swensen, the chief investment officer at Yale. Swensen, you’ll recall, is renowned for his pioneering work in the practical application of Modern Portfolio Theory through asset class diversification. Stay with me on this one.

Early this decade, about the same time that Swensen’s stellar performance began to attract wider attention, a couple of academics – Gary Gorton and Geert Rouwenhorst – published what at the time was the seminal study showing the benefits of commodity futures as an asset class. The paper demonstrated that the risk premium of this new-found asset class was similar to that of equities, with the added benefits of being negatively correlated to stocks and bonds while at the same time being positively correlated with various forms of inflation. It seemed like manna from heaven for large money managers wanting to move out the efficient frontier.

With Swensen as the spiritual leader and armed with the Gorton/Rouwenhorst paper, managers of other massive pools of capital quickly jumped on board the commodities-as-an-asset-class bandwagon. First in line were other large predominantly long-only investors, like pensions and endowments, soon to be followed (inevitably) by retail investors via exchange-traded funds, as well as the investment community’s new 800-pound gorilla, sovereign wealth funds. It seemed that everyone wanted to be like David Swensen.

One consequence of this new interest was the thorny issue of how these new entrants might actually be digested by the various commodity markets. Turns out we all very quickly became conversant in some new words, words that make English majors wretch, like con-tango and backwardation. We also learned that while bidding up

financial assets is kind of fun when your retirement account swells, bidding up stuff like commodities isn’t that great for your daily budget; not to mention that it tends to attract all sorts of loathsome creatures like speculators and politicians.

Shared interests

But what the commodities-as-an-asset-class movement really did was turn and begin consuming the very premise for investing in the asset class in the first place. Remember, commodities were being added into portfolios of financial assets because they were expected to produce equity-like returns with largely uncorrelated risks. I posit that the uncorrelated risks existed in large part because, during the time covered by the study, they had very different investor bases. Those who invested in paper assets tended not to be the same as those who bought stuff, and vice versa. As these newly ‘paper-ized’ commodities became increasingly purchased by the same type of investors who traffic in financial assets, their previously diverse motivations began to merge.

Further, since many commodity prices have gone ballistic of late, it reasonably follows that expected returns have fallen markedly. So what most but the earliest adaptors are left with are lower expected returns than those produced by the Gorton/Rouwenhorst paper, along with higher correlations.

How it all will play out is, of course, never certain. Like most perceived anomalies, the results often end up being far less impressive than the masses expect. As for the fear that speculators are behind the commodity price rise and that a political fix is needed, let’s hope those so inclined take a deep breath and allow market forces to play out. In this low expected return world, it would be more productive to focus on what seemingly non-correlated things can be morphed into tradeable paper.

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