

What is the Best Way to Invest in Commodities?

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Central Issue of the Paper

In the paper titled “Oil Price Movements and Risks of Energy Investments,” Brown, Chan, Hu and Zhang attempt to answer the above question. Investments in commodities provide investors with certain risks and benefits. For instance, commodities are supposed to be linked to business cycles and therefore should provide investors with a positive return during economic expansion. In addition, commodities are believed to be effective hedges against inflation. On the other hand, commodities tend to be highly volatile and display substantial drawdowns. The central question studied in this paper is the comparative performances of various methods of accessing the commodity space.

Investors who wish to gain exposures to commodities have a number of choices of investment products:

- Direct investment in commodities. This requires the investor to buy and store the commodities, which makes this strategy less attractive to institutional investors such as pension funds and endowments.
- Indirect investment through futures and swap contracts. This approach is perhaps the most popular and least costly approach. The availability of various commodity indices makes this strategy attractive to institutional investors.
- Indirect investment through equities of publicly traded firms that focus on commodities. Most investors already have such allocations to commodities through passive or active equity strategies.
- Indirect investment through private equity of firms that focus on commodities. Next, to direct investment in commodities, this approach is the least accessible strategy.

The present paper focuses on the energy sector and compares performances of hypothetical investments in private and public equities.

Approach Employed by Paper

The authors use three data sources to compare the performances of private and public equities in energy

focused firms to that of an energy focused commodity index. The data covers June 1986 through June 2015.

- Goldman Sachs Commodity Index, Energy sub-index (GSCI-E) to capture movements in energy prices very broadly. In addition, they use the market price of West Texas Intermediate Crude Oil to capture movements specific to oil prices.
- As a proxy for energy focused public equity, the authors utilize the value weighted index of public U.S. stocks in the energy sector. Specifically, they use the index constructed by Ken French (and available on his website) which is constructed as one of 10 industry portfolios that span all NYSE, AMEX, and NASDAQ listed stocks.
- As a proxy for energy private equity (PE) returns, the authors utilize two sources provided by Burgiss and Adams Street Partners.

Using these sources, first, the authors examine the correlations among the performances of these investment products. Next, they examine short run and long run risk-return properties of these investments. These properties are examined separately for each product over different stages of business cycles, including the 2008-2009 financial crisis.

Findings of the Paper

The authors report that while commodities have relatively low correlations with broad equity markets, they are positively correlated with both public and private equities of energy focused firms. This means, investors are able to obtain exposure to energy commodities indirectly through equities.

The authors are able to show that investments in energy focused private equity offer diversification benefits relative to similarly focused public equity and direct energy commodity investments. However, it is unclear how much of these potential diversification benefits are because private equity returns may be smoothed.

The authors find that public equity investments perform better than direct investments in energy commodities. Energy-focused private equity outperforms energy-focused public equity. The paper reports the presence of a nonlinear relationship between the returns on energy-focused equity investments (both public and private) and energy prices over multi-year investment periods. This suggests that equity investments may capture more upside exposure to energy prices over sufficiently long holding periods. This effect, which may be related to the real and financial options embedded in equities, appears stronger for private equity.

The paper concludes that that investors with a liquidity preference may want to consider energy-focused public equities to direct energy commodity investments. On the other hand, investors willing to tolerate lower liquidity and preferring greater diversification may want to consider increased allocation to energy-focused private equity.

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