Birth of a new asset class

Events in the first half of 2009 showed that commodities met the three criteria required of an asset class: scale, liquidity and correlation with other asset classes. These three considerations are crucial in underpinning any portfolio and play a large part in determining asset allocation.

SCALE Dependent on the size of the markets, scale is important because investment opportunities are obviously limited without it. In 2008 total turnover on the London Metals Exchange (LME), the world's leading metal trading forum, rose 7% over the previous year to $10.24 trillion. The number of lots traded was up 22% at 113 million, the fourth successive record. This pattern was replicated across many exchanges, commodities and contracts. When world economic growth resumes, and with the voracious appetite for raw materials of the BRIC nations (Brazil, Russia, India and China) showing no sign of diminishing, commodity markets are likely to deepen further.

LIQUIDITY Closely related to scale, liquidity is nevertheless a distinct element. Aluminium, for example, trades about three times the volume of copper, but liquidity in the respective three-month LME contracts (which have to be closed out or settled in three months' time) is similar.

Liquidity partly comes from the number of participants in a market and the size of the funds they commit to it. But increasingly it also comes from derivatives, which are financial instruments based on the underlying commodity but trading as contracts in their own right. Copper is not an especially big commodity in global terms, but derivatives trading in the metal is about 50 times the value of physical trading, creating abundant liquidity. In recent years, commodity market liquidity – in gold especially – has been greatly boosted by the dramatic growth of exchange-traded funds (ETFs), as explained in Box 1.

CORRELATION Scale and liquidity are intimately bound up with correlation with other asset classes. This does not mean that commodities behave as a matter of course differently from (negative correlation) or identically to (positive correlation) other asset classes. There is some evidence that commodities are more often negatively correlated. For example, inflation tends to push up commodity prices and depress bond prices. In the second half of 2008, however, nearly all asset prices collapsed under the weight of the crisis, producing a highly unusual mass positive correlation. Gold was the main exception, its price benefiting from its safe haven status.

Oil is an outstanding example of another kind of correlation. In the US, investors in ETFs represented about 10% of the open interest in the New York Mercantile Exchange West Texas Intermediate crude oil contract. This investment probably owed at least as much to perceptions of geopolitical risk as to a view of what oil was fundamentally worth. In other words, oil was a hedge against something quite separate from its own dynamics. At times, oil has also been positively correlated with other assets such as equities, the logic being that a rising equity market signals a strengthening economy and inflation.

WHAT DOES IT MEAN FOR CORPORATE TREASURERS? Gold and oil are particular instances of commodity correlations with other assets. But the critical point is that the behaviour of commodities as a group allows a corporate treasurer to allocate resources across a wider range of asset classes in a way that uses resources more efficiently and reduces exposure to risks.

Executive summary

- Commodity markets now offer the necessary scale, liquidity and correlation with other asset classes to act as asset classes in their own right. Treasurers can use commodities to hedge against price risk, ensure the supply of raw materials, comply with carbon regulation, and search for yield.

IN THE CONCLUDING HALF OF A TWO-PART FEATURE, **PETER G SELLARS** DRAWS OUT THE IMPLICATIONS FOR TREASURERS OF THE RISE OF COMMODITIES AS AN ASSET CLASS.

There are also compelling reasons why companies should take advantage of this new asset class:

- hedging against price risk;
- ensuring materials supply in an era of just-in-time inventory control;
- being a "compliance" buyer or seller of carbon credits;
- searching for yield; and
- acting positively rather than allowing a commodity strategy to develop by default.

■ **Hedging** A major source of risk is the volatility of commodity prices. Despite the crash in commodities during 2008, long-term price volatility may not have changed greatly over the last 30 years. The bust of 2008 was similar to reversals in the 1970s and 1980s. The peaks and troughs of the cycles bear roughly the same relation to each other. But within a given cycle, shorter-term volatility may have increased. This poses special problems for businesses now that so many operate on thinner margins. The impact of commodity price swings is magnified and can spell the difference between profit and loss. The potential cost of failing to manage exposure has grown. At the same time, however, the benefits of managing exposure successfully have also grown. Central banks have learned from their mistakes in the early part of the century when they largely ignored rapidly rising asset prices and so missed warnings that the credit bubble was about to burst. Companies can do the same. Being able to compare commodities with other asset classes and switch between them gives treasurers more flexibility than they have generally enjoyed in the past. They can spot the signals and act accordingly.
■ **Inventory management** Commodity price fluctuations affect many business sectors. Just-in-time inventory management can accentuate the risk and offset the apparent savings from not having capital tied up in stock. Ensuring a timely supply of essential inputs is likely to become more demanding as competition grows for materials, especially when they originate in emerging economies.

Box 1: Exchange-traded funds

Exchange-traded funds (ETFs) track the price of an underlying asset, either by reference to the physical commodity or an index. ETFs are available on a wide range of assets, including equities. They can be bought and sold on exchanges in the form of shares, which trade at roughly the net asset price of the underlying assets. ETFs combine characteristics of a mutual fund, which can be redeemed at the end of the day at net asset value, and those of a closed-end fund, whose price relative to net asset value may fluctuate during the day. The liquidity and price transparency of ETFs is attractive to institutional investors such as pension funds, which may be under legal and regulatory restrictions about how they can invest in commodities. Private investors have also embraced ETFs; they account for about 40% of investment in ETFs in the US.

Gold has been a major beneficiary of the boom in ETFs. Between January and October of 2009, $17bn flooded into the listed physically backed gold ETFs, compared with $4bn in the first half of 2008. In early October, the gold ETFs held about 1,750 tonnes of gold – collectively the sixth largest institutional gold holding.

To put that value into perspective, world mine production of gold in 2008 was 2,416 tonnes and gold scrap returning into the market totalled 1,215 tonnes. The increased liquidity that ETFs have created in the gold market goes a long way to explaining the behaviour of the gold price. Oil is another principal commodity that has attracted heavy investment in ETFs. In future, it is likely that we will see further ETF investment in base and precious metals, energy products such as US natural gas and agricultural commodities.

■ **Carbon credits** Regulations governing emissions will only get tougher and opportunities for trading will grow. Companies will have to comply with the law, so some may have to buy carbon credits while others will be sellers. In the longer term, all will have to become more energy-efficient. Contrary perhaps to appearances, developing a low-carbon economy goes to the heart of what a treasurer does.
■ **Yield** A key part of the treasurer's job is to maximise financial efficiency. The search for yield can now extend to commodities, through reducing risk and including commodities in the portfolio across which resources are allocated.
■ **Acting positively** All this means that a commodity management strategy should not be allowed to develop by default. A lesson from the financial crisis is that some boards did not seem to be fully aware of what was being done in their name. As commodities find their place in the hedging and investment firmaments, there is a legitimate concern that understanding will lag behind use.

Corporate treasurers and other specialists will need to work closely with boards, other senior executives and advisers to ensure that the consequences of a given strategy for taking advantage of the commodities asset class are recognised. Treasurers and boards must make an active call on whether and to what extent commodities are built into their everyday running of the business; benign neglect is no longer enough. The premium on good management grows all the time, and managing the new commodities asset class is a key part of it.

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