

Broad Commodities, the portfolio's super diversifier?

Publié le 1 décembre 2021

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There is a commodity renaissance in the making. After years of under-performance and under-appreciation from investors, interest in the asset class started to return in 2020 and has strengthened since. Beyond tactical opportunities, academic research has highlighted the potential advantages of using broad commodities in strategic asset allocations. However, many investors' surveys typically still show that many of them do not invest in broad commodities. In this blog series, our objective is to lay out the many factual reasons why a broad commodity investment can be an additive to a portfolio, starting here with its diversification superpowers.

Analyses show that broad commodities are a very powerful source of diversification in a multi-asset portfolio:

- Broad commodities are positively skewed when equities are negatively skewed.
- They exhibit low correlations to most of the traditional asset classes.
- They remain uncorrelated in crisis and can provide relief to a portfolio in geopolitical crises.

Positive skew, protection against exceptional events

Looking at the distribution of monthly returns of the Bloomberg commodity total return index and the S&P 500 total return index since January 1960, we observe that:

- The returns of commodities and equities deviate from a normal distribution
- The returns of equities are negatively skewed (+0.43 instead of zero for a normal distribution), meaning that the distribution has more weight on the negative side of the distribution. On the contrary, commodities are positively skewed (+0.901), meaning that large positive returns tend to be more common for commodities than large negative returns when it is the contrary for equities.

Overall, this means that historically we can observe that commodities' losses have been less deep, and large gains more frequent than for equities.

In September 2021 as an energy crisis was brewing, companies' profit margins were being squeezed by rising energy costs. The difficulty in securing fuel supplies in some jurisdictions meant that bringing products to market became very difficult. The S&P 500 fell by 4.7% in the month as a result of this pressure². Meanwhile the Bloomberg Commodity total return index, which had close to 40% exposure

to the energy sector at the time, rose 5.0%³. This example illustrates how differently commodities and equities can behave when exposed to the same shock.

While performance distributions are important, the relative relationship between those two distributions is even more important for investors

Commodities offer diversification from the main asset classes

Broad commodity futures contracts indices show very low correlations with most of the main asset classes. Commodities are negatively correlated to US treasuries and US corporate bonds. They also offer a low correlation to equities and US high yield bonds.

It is worth noting that this very low correlation has been observed by academics as well. Low correlations have been observed by (Bhardwaj, et al., 2005), (Edwards & Liew, 1999) and (Levine, et al., 2018) among others.

Figure 1: Correlation between main asset classes

	US equities	Global equities	EM equities	US treasuries	US corporate bonds	US high yield bonds
Broad commodities	12%	18%	38%	-14%	-3%	25%
US equities		90%	67%	5%	34%	60%
Global equities			73%	2%	33%	60%
EM equities				-17%	26%	59%
US treasuries					79%	3%
US corporate bonds						55%

Source: WisdomTree, Bloomberg, MSCI, S&P. January 1960 to October 2021. Calculations are based on monthly returns in USD. Broad commodities (Bloomberg commodity total return index) and US equities (S&P 500 gross total return index) data started in Jan 1960. Global equities (MSCI world gross total return index) data started in Dec 1969. EM equities (MSCI emerging market gross total return index) data started in Dec 1987. US treasuries (Bloomberg US treasury total return unhedged USD index) and US corporate bonds (Bloomberg US corporate total return unhedged USD index) data started in Jan 1973. US high yield bonds (Bloomberg US corporate high yield total return unhedged USD index) data started in July 1983.

Historical performance is not an indication of future performance and any investments may go down in value.

We are arguably living in very unusual times, with unprecedented levels of monetary stimulus potentially pushing higher the correlations of many asset classes. However, looking at daily correlations over the past year, the correlation between US equities and Broad Commodities has only risen to 22%⁴. The correlations between commodities and Emerging Market equities (30%⁴) with US Treasuries (-15%⁴) and US corporate bonds (-10%⁴) have even become more negative over the past year.

Increased diversification in crisis

While its low correlation with equities has always been a strong argument for proponents of commodity investments, critics have historically argued that this low correlation does not hold in periods of crisis. Figure 2 shows the correlation between different asset classes during the months when US equities are down -5% or more to test this hypothesis. It is worth noting that the correlation matrix is not significantly different to Figure 1. Commodities and US Treasuries still offer the most diversification versus other asset classes. The correlation between commodities and the various asset classes remains very low, which should blunt most critics from that angle.

Figure 2: Correlation between the main asset classes when US equities are down more than -5% in a month

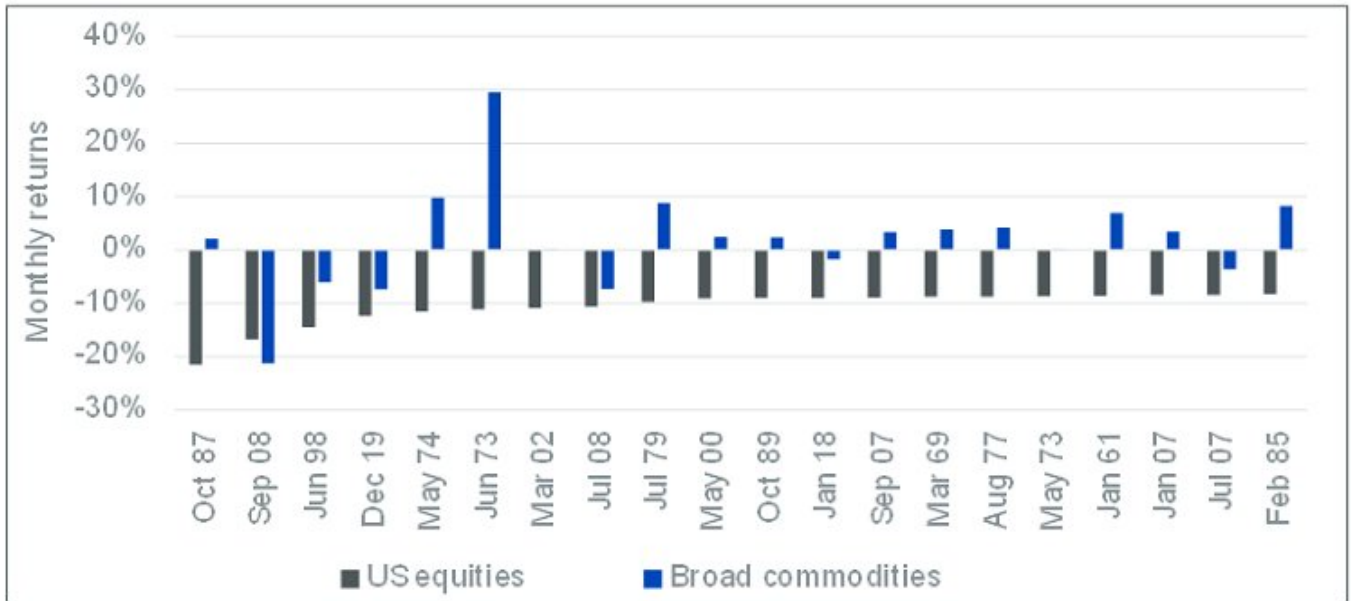
	US equities	Global equities	EM equities	US treasuries	US corporate bonds	US high yield bonds
Broad commodities	19%	35%	48%	-11%	28%	49%
US equities		80%	69%	-25%	10%	44%
Global equities			82%	-20%	28%	62%
EM equities				-4%	49%	63%
US treasuries					55%	-25%
US corporate bonds						56%

Source: WisdomTree, Bloomberg, MSCI, S&P. January 1960 to October 2021. Calculations are based on monthly returns in USD. Broad commodities (Bloomberg commodity total return index) and US Equities (S&P 500 gross total return index) data started in Jan 1960. Global equities (MSCI world gross total return index) data started in Dec 1969. EM equities (MSCI emerging market gross total return index) data started in Dec 1987. US treasuries (Bloomberg US treasury total return unhedged USD index) and US corporate bonds (Bloomberg US corporate total return unhedged USD index) data started in Jan 1973. US high yield bonds (Bloomberg US corporate high yield total return unhedged USD index) data started in July 1983.

Historical performance is not an indication of future performance, and any investments may go down in value.

Digging further into the relative behaviour of commodities in periods of equity crisis, Figure 3 illustrates the performance of the Bloomberg Commodity Total Return Index in the worst 20 months for the S&P 500. We observe that commodities have offered very strong differentiation to an investor. Taking the example of the worst month for equities in the last 60 years or so, US equities lost -21.5% in October 1987, following “Black Monday”. During that same month, the BCOM index gained 2.1%. This would have provided incredible help to any investor during that month. In fact, commodities have outperformed equities in 19 out of those 20 months. In 14 months, commodities have even performed as positively as they did in October 1987.

Figure 3: Broad commodities performance in the worst 20 months for the S&P 500 since 1960



Source: WisdomTree, Bloomberg, S&P. January 1960 to October 2021. Calculations are based on monthly returns in USD. Broad commodities (Bloomberg commodity total return index) and US Equities (S&P 500 gross total return index) data started in Jan 1960.

Historical performance is not an indication of future performance and any investments may go down in value.

1 WisdomTree, Bloomberg, S&P. January 1960 to October 2021. Calculations are based on monthly returns in USD. US Equities stands for S&P 500 gross TR Index. Broad commodities stands for Bloomberg commodity TR index. Historical performance is not an indication of future performance and any investments may go down in value.

2 S&P 500 Total return index between 31/08/2021 an 30/09/2021 using Bloomberg data.

3 Bloomberg Commodity total return index between 31/08/2021 an 30/09/2021 using Bloomberg data.

4 WisdomTree, Bloomberg, MSCI, S&P. October 2020 to October 2021. Calculations are based on monthly returns in USD. **Historical performance is not an indication of future performance and any investments may go down in value.**

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