Broad commodities: an often-overlooked source of diversification

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Commodities have outperformed every major asset class in the last two years by double digit margins[1]. This was particularly impressive in 2022, when every major asset class posted large losses, while commodities posted substantial gains[2]. 2022 was a clear cut case for diversifying a traditional portfolio of stocks and bonds with commodities. Beyond tactical opportunities, academic research has highlighted the advantages of using broad commodities as a staple component in long-term strategic asset allocations. However, close to half of investors recently surveyed have no exposure to commodities[3]. Recent impressive performance is changing the mood rapidly, with 45% of those not invested in commodities now considering investing[4]. We believe, whether you look at recent or long-term data, the case for broad commodity inclusion in a portfolio is compelling. In this blog series, our objective is to lay out the many factual reasons why a broad commodity investment can be additive to a portfolio, starting with its potential diversification superpowers.

Quantitative analysis 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 (-0.49[5] 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 (+0.85[5]), 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 2022, an energy crisis catalysed by the Ukraine invasion sent the price of natural gas, oil, oil products, and agricultural products higher. This directly benefited broad commodity indices which included these raw

materials. Conversely, broad equity indices suffered as profit margins were being squeezed as input costs were rising rapidly. While Europe seems to have been lucky with a mild winter – which has allowed it to reduce energy consumption and build inventory – the Ukrainian war is far from over and further energy price shocks can't be ruled out.

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

Source: WisdomTree, Bloomberg, MSCI, S&P. January 1960 to January 2023. 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.

In the initial phases of the COVID-19 pandemic, correlations of many assets rose. Panic selling, followed by indiscriminate buying fuelled by quantitative easing, drove those correlations higher. However, in the past year, the correlation between commodities and equities has fallen again to normal levels. Looking at daily correlations over the past year, the correlation between US equities and broad commodities is back to 14%[6].

The correlations between commodities and emerging market equities (19%[6]) with US Treasuries (5%[6]) and US corporate bonds (9%[6]) have also remained extremely low. These low correlations once again make a compelling case for commodities as a diversification tool.

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

Source: WisdomTree, Bloomberg, MSCI, S&P. January 1960 to January 2023. 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.

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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 since 1960. 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 Bloomberg Commodity Index (BCOM) 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 12 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 January 1963. 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.

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On top of being a historically excellent diversifier, the next instalment will highlight how broad commodities could complement equities in different parts of the cycle.

[1] Between 10/02/2021 and 10/02/2023, Bloomberg Commodity Index has outperformed Bloomberg Global Aggregate Bond by 38%, MSCI ACWI (Global Equities) by 35%, S&P 500 (US Equities) by 19%, FTSE EPRA NAREIT Developed (Real Estate) by 24%, Bitcoin by 63%. Source: Bloomberg.

[2] Between 31/12/2021 and 31/12/2022, all the assets in footnote 1, fell by more than 12%, while the Bloomberg Commodity Index rose close to 12%. Source: Bloomberg.

[3] 46% of investors surveyed in September 2022 said they did not invest in commodities. The survey, conducted by CoreData Research an independent research agency, polled 600 professional investors across Europe, ranging from wholesale financial advisory firms to wealth managers and family offices. The investors surveyed are responsible for approximately €710bn in assets under management.

[4] 21% of all survey respondents replied “No, but are considering”, while 25% responded with a hard “No”.

[5] Source: WisdomTree, Bloomberg, S&P. January 1960 to January 2023. 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.**

[6] Source: WisdomTree, Bloomberg, MSCI, S&P. December 2021 to December 2022. Calculations are based on daily returns in USD. **Historical performance is not an indication of future performance and any investments may go down in value.**

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