Generating outperformance in broad commodities

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Capitalising on commodities in the recovery phase

We are moving headlong into the recovery phase of the economic cycle. Commodities are often a late-cycle performer that do well in the late stages of a recovery and the early stages of a recession in contrast to equities, which tend to roll over at that stage. In our recent survey1, however, 29% of investors said they don't invest in commodities. We believe a broad, diversified exposure to the commodity market can help investors make the most of the sunset of the economic cycle.

Introducing PCOM

For years, WisdomTree has been the European leader in commodity investing. In 2022, we launched the WisdomTree Broad Commodities UCITS ETF (PCOM) to disrupt the delta 1 broad commodity space. This ETF is an innovative solution for investors who wants to enhance their commodities performance while maintaining a low tracking error versus the benchmark represented by the Bloomberg Commodity Total Return Index (BCOMTR Index). PCOM's proposition leverages WisdomTree's unrivalled expertise in physical precious metals and is quite straightforward, substituting the synthetic gold and silver exposure of the Bloomberg Commodity Index ("BCOM") with a physical replication (see Figure 5).

Physical or synthetic?

The core idea behind the fund draws inspiration from a fundamental question in commodity investing: how should an investor seek exposure to commodities?
Investing in commodities differs from other assets due to operational complexities. Two main methods are commonly used: direct physical investments and commodity futures contracts.

While buying commodities directly seems intuitive, operational challenges, perishability and storage complexities make it generally impractical. Broad commodity indices encompass numerous commodities, each requiring specialised storage facilities, rendering physical investment costly and logistically challenging. Futures contracts often boast greater liquidity than physical commodities and present fewer regulatory hurdles.

However, certain exceptions exist, such as precious metals. Their high value and durability permit cost-effective storage, especially in secure bank vaults. Despite the theoretical underpinning of Keynes' normal backwardation hypothesis, which suggests investors earn a premium for synthetic exposure to commodities, empirical research2 covering the period 1980 – 2005 found no evidence of a risk premium in gold futures over spot prices. This discrepancy is attributed to the limited hedging activity by gold miners, diminishing the value of gold futures to producers. This prompts the question of whether direct investment in precious metals might prove a better option than utilising futures contracts.

Physical vs. futures gold and silver

Historically, physical gold and silver have outperformed their synthetic counterparts. Table 1 and figures 1 and 2 below show the historical outperformance of the spot price of gold and silver compared to a fully funded synthetic exposure for investment. Since 2007, gold and silver delivered an overperformance of 0.95% and 1.24% per annum respectively.

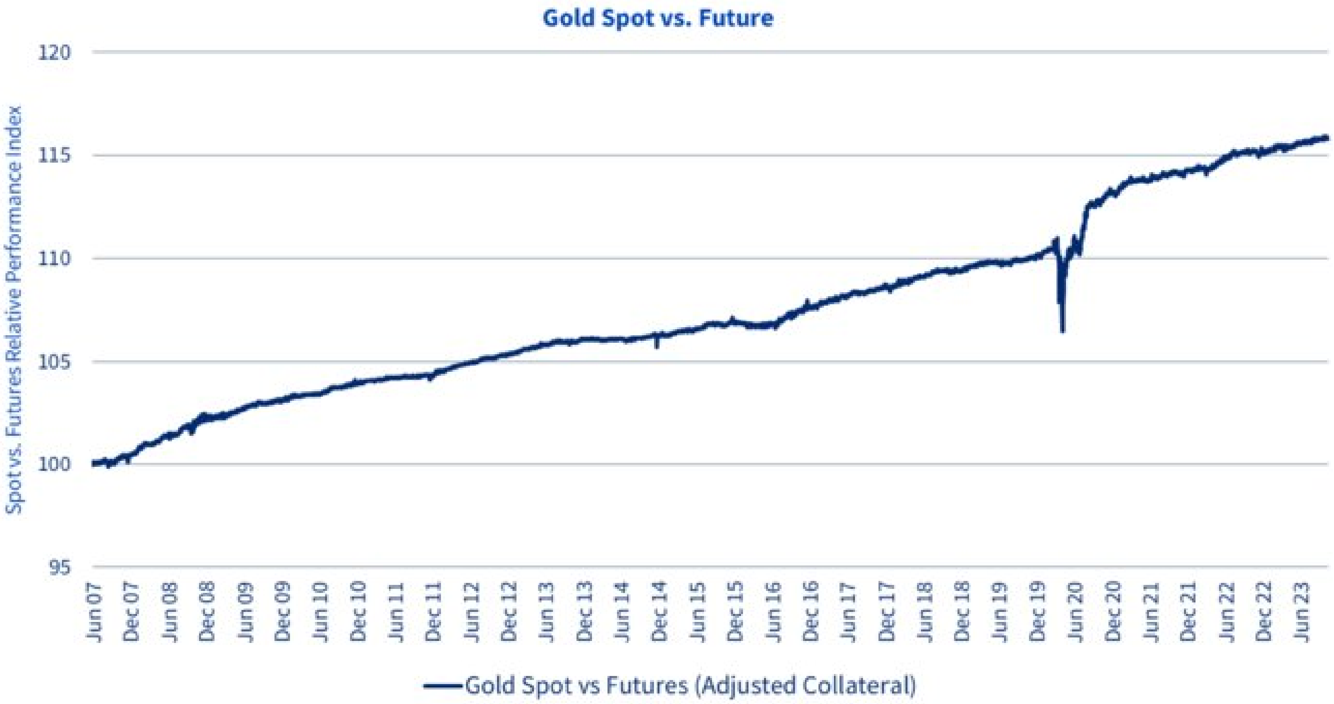
	ytd*	1y	3y	inception
Gold Spot vs. Future	0.58%	0.92%	0.81%	0.95%
Silver Spot vs. Future	**0.47%**	**0.13%**	**0.65%**	**1.24%**

Source: Bloomberg, WisdomTree. Start date: 04/06/2007, end date: 31/10/2023. *Year-to-date (ytd) performances are not annualised. **Historical performance is not an indication of future results and any investments may go down in value.**

For both commodities, the spot price has steadily outperformed over the last 15 years. The only interruption occurred in 2020, right after the pandemic outbreak. COVID-19 disruptions caused logistical challenges in moving physical precious metals during lockdowns, creating a temporary gap between spot and futures-based gold prices. As these issues were resolved, the futures curve returned to normal. Since PCOM's launch, physical precious metals kept overperforming the futures-based ones (Figures 3 and 4).

In short, investing in physical precious metals has generated a consistent premium over the last 15 years.

Figure 1: Gold spot overperforms gold futures over long term



Source: Bloomberg, WisdomTree. Start date: 04/06/2007, end date: 31/10/2023. **Historical performance is not an indication of future results and any investments may go down in value.**

Figure 2: Silver spot overperforms silver futures over long term

Figure 3: Gold spot overperforms gold futures since PCOM's launch

Source: Bloomberg, WisdomTree. Start date: 04/12/2021, end date: 31/10/2023. Historical performance is not an indication of future results and any investments may go down in value.

Figure 4: Silver spot overperforms silver futures since PCOM's launch

Source: Bloomberg, WisdomTree. Start date: 04/12/2021, end date: 31/10/2023. Historical performance is not an indication of future results and any investments may go down in value.

WisdomTree Broad Commodities UCITS ETF (PCOM)

The fund combines:

- a synthetic exposure to the ex-precious metals component of the Bloomberg Commodity Index, where it invests indirectly (through a swap) in a portfolio of future contracts that returns the Bloomberg Commodity Ex-Precious metals Excess Return (BCOMXPM Index) and earns interest on a portfolio of 12 T-bills with various maturities, rolled bi-weekly, and with an average duration of 84 days.
- a physical exposure to gold and silver through investments in physically backed ETPs3.

PCOM's management fees amount to 19 basis points (bps), while the swap fees are 12 bps, but are only paid on the swap portion of the ETF, which has averaged slightly less than 80% over the analysed period. Hence, effectively PCOM pays less than 10 bps in swap fees.

Invesco Bloomberg Commodity UCITS ETF (CMOD)

Almost 2 years after launch, we decided to compare our product with the biggest product in the broad commodity space, the **Invesco Bloomberg Commodity UCITS ETF (CMOD)** and see how our strategy compared.

The structure of CMOD is that of a standard unfunded synthetic ETF. The fund invests in a swap that returns the BCOM excess return and earns an interest on the relative collateral. The collateral composition is similar to PCOM's collateral composition. CMOD swap fees are 15 bps.

Figure 5: Comparing PCOM and CMOD structures

Source: WisdomTree.

WisdomTree Broad Commodities UCITS ETF outperformed the Invesco ETF by almost 0.5% since launch.

Figure 6: PCOM vs CMOD attribution

Source: Bloomberg, WisdomTree. Start date: 04/12/2021, end date: 31/10/2023. Historical performance is not an indication of future results and any investments may go down in value.

Above we show the breakdown of the dollar attribution of PCOM vs CMOD since PCOM's inception. As we can see, since its launch, PCOM delivered on its promises, overperforming CMOD by 42 bps since its inception (see Figure 6). We can see that the bulk of the overperformance comes from Gold. Physical Gold's premium has been the most stable over time and, more importantly, has been the most stable since PCOM's inception (see Figures 3 and 4). Further, gold's average weight has been 15.7%, so gold makes up a significant portion of the full portfolio. Silver, whose average weight over the period has been 4.6%, added 6 bps to the total overperformance. The third positive contribution comes from the swap fees, which contributed to 11 bps overperformance.

Overall, the overperformance of the physical vs the synthetic is persistent.

In conclusion, PCOM enhanced the return of a broad commodity exposure in a simple and robust way. Substituting a synthetic exposure with a physical one captures the physical premia on precious metals; this has generated a sustained historical overperformance.

1 WisdomTree, Censuswide. Pan-Europe Professional Investor Survey Research, Survey of 803 professional investors across Europe, conducted during August 2023.

2 Xu, H., Lin, E. C. & Kensinger, J. W., 2013. On the estimation of risk premium in the gold futures market: using the Goldman Sachs Commodity Index (GSCI) approach. Research in finance. Vol. 29., pp. 103-118.

3 When it comes to the implementation of an investment in physical commodities and physical precious metals, in particular,

investors can: 1. Own/rent a vault to store gold/silver bars: this solution is only available to extremely large investors, the cost of storage and the cost of insurance can be high and organising safe movement and delivery of large chunks of gold or silver is extremely difficult. 2. Invest in a physically-backed exchange-traded product (ETP): securities are backed by physical bars of the relevant metal and usually held by the custodian within a secure vault and regularly inspected by an independent entity. Exchange-traded commodities ("ETCs") are operationally very easy to use. They are listed on exchange and trade like shares during market hours.

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