

MARK HULBERT

Not necessarily a risky business

Study of commodities trading debunks stereotypes

By Mark Hulbert, MarketWatch

Last Update: 11:43 PM ET Jan. 25, 2005

ANNANDALE, Va. (MarketWatch) - Commodities have gotten a bum rap.

They have been stereotyped as inherently risky, for example. If you are a “responsible” analyst, you devote yourself to studying stocks and bonds. Those who invest in commodities are considered loose cannons, the cowboys of the investment arena.

As with many stereotypes, of course, this one has the germ of truth. Jim Rogers, perhaps the most famous champion of commodity investing, is probably even better known as the guy whose idea of investment research is motorcycling around the world. He no doubt would find life as a stock or bond analyst intolerably boring.

But the stereotypical view of commodity investing is also wrong in almost all major respects. And it’s important to discard it, especially if the next several years prove to be as difficult for the stock and bond markets as many currently suspect it will be. In that event, commodities may be the one asset class that provides attractive returns.

Consider a study completed last year by two finance professors: Gary Gorton of the University of Pennsylvania and K. Geert Rouwenhorst of Yale. Entitled “Fact and Fantasies About Commodity Futures,” the professors paint a picture about commodities that is significantly at odds with the stereotype.

Let’s start with the notion that commodities are risky. This is just not true, according to the professors, who constructed a comprehensive index of commodity futures contracts covering the period from mid 1959 through March 2004. As judged by the volatility of this index’s returns, commodities over this 45-year period were some 19 percent less risky than the S&P 500.

The professors also found that there were significant differences in the kind of volatilities experienced by these two asset classes. For example, a disproportionate amount of stocks’ volatility came from months in which they lost big, while an outsized portion of commodities’ volatility came from months in which they scored big gains. As a result, the professors conclude that stocks have greater downside risk than commodities.

On a related subject, the professors found that commodities are negatively correlated with stocks. This means that they often are zigging when stocks are zagging, and vice versa. So diversifying a stock portfolio into commodities has the potential to reduce risk by a large amount.

The bottom line: Commodities are not inherently risky. The source of commodity futures’ much-vaunted risk therefore is not the commodities themselves, but the ability to invest in them on very little margin.

What about the notion that commodities produce better returns than other asset classes? The professors say that this is not so. Over the last 45 years, their commodity index produced returns that were almost identical to that of the S&P 500.

... continued from page 1

To be sure, it's impressive that commodities were able to match equities' returns while nevertheless reducing risk by 19 percent. As a result, they outperformed stocks by a significant margin on a risk-adjusted basis.

Still, this result is a far cry from some of the claims made on commodities' behalf. Fellow MarketWatch columnist Marshall Loeb recently quoted Rogers as saying that "you would have made more money in the last 45 years in commodities than in stocks and bonds." The professors' research shows that this is accurate about bonds but not about stocks.

What if you become convinced that commodities deserve a place in your portfolio? Can you just as well invest in the stocks of companies that are involved in the production of commodities?

Many think that you can. Loeb, for example, quotes the manager of the T. Rowe Price New Era Fund Charles Ober, as recommending commodities equities.

But the professors found that commodity futures have provided far superior returns than such stocks.

Over the last four decades, their commodity futures index more than tripled the cumulative performance of the average stock involved in the production of those commodities. The professors conclude: "an investment in commodity company stocks has not been a close substitute for an investment in commodity futures."

Any way you approach it, therefore, it looks as though commodities deserve a prominent place in your portfolio.

Past performance is not necessarily indicative of future results. The risk of loss exists in futures trading.

Mark Hulbert is the founder of Hulbert Financial Digest in Annandale, Va. He has been tracking the advice of more than 160 financial newsletters since 1980.