

Commodity Investing: Alpha, Beta, And Something In Between

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Investors, including sophisticated investors such as pensions and endowments, are increasingly interested in investing in commodities to add diversification to their portfolios. This article examines the subject of commodity alpha and beta and also looks at a new class of commodity products that lies somewhere in between the two extremes. Before we delve deeper, we will clarify what we mean when referring to commodity alpha and beta.

Investment returns can be broken down and understood as a combination of alpha and beta, where beta is the portion of the overall return that is attributable to systematic risk factors and alpha is the portion of the return that is not attributable to systematic risk factors. In other words, the beta is the broad market return and the alpha is the value added performance of a strategy or index, over the broad market return. The returns of passive investment exposures (long only index strategy) are almost pure beta, whereas the returns of active (long/short strategy) investment strategies are a combination of beta and alpha. The more novel the approach, the larger the proportion of alpha in the returns.

stock (equity market direction, management, capital structure, earnings expectations, etc.) that are unrelated to the price of the actual commodities they produce. This is, at best, an indirect way to get commodity beta. We also observe that many of the 'commodity experts,' even some that manage 'commodity funds,' do not have any actual commodity experience and run funds based on resource stocks, not actual commodities. This in itself has misled many investors. The challenge appears to be that investors have become very comfortable investing in equities, whereas commodities are something that they don't fully understand.

Strategies that track long only commodity indices (first generation long only commodity indices such as the DJ-UBS, S&P GSCI) or are invested directly in commodities (physical or futures based), are extremely transparent and have very low fees. This is very attractive to investors, but the trade-off is that the commodity markets do not always deliver low correlations to equities and bonds. In fact, if we use the example of 2008, the commodity market and the traditional markets (equities and bonds) became very highly correlated right when non-correlation was needed the most. Many investors achieve beta

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Commodity Beta

Investors typically attempt to capture commodity beta in one of two ways – investing in resource equities (the stock of companies that produce commodities) or long only commodity investing and, most commonly, index tracking strategies.

Investing in resource equity is a weak approach to capturing commodity beta. Often, when asked about their appetite for commodity investing, portfolio managers respond that they believe wholeheartedly in the diversification benefits of commodities, only to learn that they only invest in resource equity. Unfortunately, this method provides high stock market beta (correlation) and often low commodity beta. This occurs because there are so many other factors that affect the price of the

by indexing. This is especially true in asset classes such as commodities where investment is outside the expertise of many portfolio and wealth managers.

Active long/short commodity strategies such as managed futures strategies (also referred to as commodity trading advisors or CTAs) arguably have the highest alpha component to them, but they are not pure alpha, they also include beta. The alpha is merely the icing on the cake. Most managed futures funds performed very well through periods of market turbulence, similar to 2008, largely due to their active approach to positioning (the ability to be long or short depending on the trend) and their dedication to active risk management. The trade-off is higher fees and less transparency in return for improved risk adjusted returns.

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'Enhanced Beta'

Alpha and beta are not absolutes: it is helpful to think of them as more of a continuum, with pure alpha at one extreme and pure beta at the other. As specific alpha strategies evolve and become well understood and quantifiable on their own, they undergo a transition from being pure alpha to being more beta-like. These strategies are referred to as enhanced beta or exotic beta. To generate enhanced beta, we borrow some of the elements that generate alpha, making them transparent and replicable. The benefits of enhanced beta are provided for a reasonable cost (index like fees not hedge fund like fees) while avoiding the volatility, deep drawdowns, and cross-market correlations that occur with pure beta strategies.

The following are some key strategies that differentiate enhanced beta strategies from pure beta strategies:

◆ Active Positioning

An example of this is a simple trend following strategy. This allows for positions to be long, short, or flat, depending on the direction of the trend as determined by a simple trend indicator such as a moving average. The returns from simple trend following strategies are very well-documented and are reproducible to the point where the returns

from this type of strategy can be thought of as a systematic risk factor and hence are no longer pure alpha strategies. Active positioning dramatically improves risk adjusted returns over long only strategies.

◆ Position Sizing and Rebalancing

Another aspect of enhanced beta includes position sizing, where positions are sized and adjusted based on the changes to the underlying volatility. As a result, position sizing provides lower drawdowns and less volatility which produces better risk adjusted returns.

◆ Roll Optimization

Trading commodity futures necessitates the rolling of futures contracts which can result in a negative or positive roll yield due to backwardation (downward sloping futures curve) or contango (upward sloping futures curve). By rolling the futures contracts in a way that maximizes the roll return, returns can be improved.

This is not meant to be a complete list and, as stated previously, enhanced beta is constantly evolving so over time it is expected to change.

Why Is It Enhanced Beta

By using some of the publically well-documented and simple elements that generate alpha to improve the efficient frontier, we are moving closer to the alpha side of the

continuum. If we are willing to offer transparency to the investing public and provide the methodology in the form of an index, the alpha becomes replicable and thus, enhanced beta. However, for pure alpha CTA funds, our strategies remain proprietary.

Enhanced beta is available to investors through exposure to so-called 'third generation' commodity indices. These are indices that take into consideration risk and reward and do not simply provide beta exposure. Third generation indices are the latest generation of commodity indices that incorporate elements of enhanced beta within them. This can be accomplished by:

- ◆ licensing an index from a third generation index provider
- ◆ running a managed account with a manager that specializes in enhanced beta
- ◆ investing in an ETF that tracks a third generation commodity index

Enhanced beta commodity strategies are well-suited to investors looking to add alpha-like commodity returns to their portfolios while maintaining transparency and low fees. ■

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