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SE Portfolio

HD **How the staples can stabilise a portfolio**

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Commodities Investing in wheat, corn, **oil** or **gold** may lower your risk if rates jump.

Australian investors like to think they have good exposure to commodities: after all, BHP Billiton and Rio Tinto are heavyweights of both the global commodities world and the Australian sharemarket. The theory is BHP and Rio deliver great exposure to the **China** story, and all the commodities exposure an investor would need.

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The problem is that despite being big, diversified miners – and a petroleum producer in BHP's case – the pair don't give access to the return from commodities as an asset class, says Jodie Gunzberg, global head of commodities for S&P Dow Jones Indices, who was in Australia on a roadshow in October.

"The dry bulk commodities like **coal** and **iron ore** are not yet part of the global futures markets that make up the asset class," Gunzberg says. "Nor do these companies produce agriculture. Their correlation to the commodities asset class is actually quite low.

"There is a great barrier to overcome the perception the Australian sharemarket is highly correlated to global commodities."

Surprisingly, Gunzberg says, the US sharemarket is more than three times more correlated to commodities than Australia's.

This has implications for diversification – the major attribute that commodities investment delivers as an asset class (meaning investment in a commodities index that covers the futures markets for commodities). The other main reason for using commodities is as an inflation hedge.

"Commodity prices themselves are very sensitive to inflation. With things like 'soft' commodities, for example, the reason why **bread** gets more expensive over time is because commodity producers are able to pass prices on to the consumer," Alex Vynokur, managing director of exchange-traded fund (ETF) issuer BetaShares, says.

By including them in a portfolio in the form of an ETF, investors have the exposure to the underlying commodities and benefit as prices of those commodities rise with inflation, he says.

Vynokur says global commodity indices give different protection from local inflation in different markets, and while Australia's inflation protection is not as strong as that for Europe or the US, Australia still has an inflation beta of more than 10 to the S&P GSCI commodity index.

"That means that a $10 investment in a commodity index ETF that follows that index can give you close to $100 worth of inflation protection in the Australian market," he says.

"Which means a 10 per cent allocation to commodities could shield the whole portfolio from inflation risk."

Traditionally, Australian investors have sought commodity exposure through stocks, Tim Bradbury, executive director of ETF Consulting and Portfolio Solutions, says .

"That has been largely broker-driven, and brokers tend to think about stocks when they think of a commodity. For example, if they like the idea of **gold**, they might **buy** a **gold** stock, but while that does give you exposure to **gold**, there are a whole lot of considerations that are specific to that stock: management, **business** risk, mine life, hedging policy, geopolitical risk, etc. It's by no means precise exposure."

Nor is an actively managed fund that buys and holds resource stocks: like all active funds, it could certainly outperform the market, but can also underperform.

Exchange-traded products (ETPs) have given investors a simple, cheap and transparent means of gaining exposure to commodities, through a single listing on the ASX. The first Australian ETP, the **Gold** Bullion Securities (ASX code **GOLD**), launched by ETF Securities in March 2003, was the world's first exchange-traded commodity, allowing retail investors to **buy** securitised ownership of **gold**, without having to own actual bullion. Each **GOLD** security gives the investor ownership of one-tenth of an ounce of **gold** bullion, held in the London vaults of custodian bank HSBC Bank USA. The price of a **GOLD** unit is one-tenth of the $A **gold** price.

The GOLDs were quickly followed onto the ASX by the Perth Mint **Gold** Quoted Product (PMG), which give the investor the right to **buy** one-hundredth of an ounce of **gold** on, or before, 31 December, 2013. The PMGs trade under the ASX code of PMGOLD: at any time, their price is simply one-hundredth of the $A **gold** price.

Investors find these "trackers" more simple to use than bullion and less risky than **gold company** stocks: there are no **company**-specific factors like mine life, resource security or hedging activity to complicate matters. The stocks simply track the $A **gold** price very closely, and may be **sold** at any time on the ASX. There is normal brokerage on the **purchase** or **sale**, and the management expense ratio (MER) of the investment is 40 basis points (0.40 per cent) a year. The next step was ETPs over physical silver, platinum, palladium and a basket of the three, plus **gold**. But the development that really fostered the view of commodities as an asset class was the introduction in 2011 of "synthetic" ETPs, which use derivatives – for example, indices over futures contracts or swaps – to generate returns.

Vynokur says synthetic was the only way the "broad asset class" of commodities could be accessed. "You can do the precious metals through ETPs, because it's possible to physically hold the **gold** or silver, for example, to back them. But in most of the commodities that make up the major commodity indices – the agricultural commodities, the industrial metals, the **energy** commodities – a retail investor cannot own the physical commodity, so you have to do it through derivatives.

"You can't own and store the agricultural commodities – wheat or corn or soy beans, or even livestock – and that's why you get exposure through commodity futures, and that's why they're called "synthetic". Same with the **energy** commodities: it would be totally cost-prohibitive to deal in the physical commodities, to take delivery of cargoes and store them. But having those commodities is what gives your portfolio the diversification and the protection against inflation," he says.

Andrew Spence, senior investment adviser at Hillross CBD in Sydney, uses the BetaShares broad-based currency-hedged ETP (with the ASX code QCB) – which gives exposure to **energy**, agriculture, industrial metals, livestock and precious metals – as a portfolio diversifier and inflation hedge.

"We have it in our 'alternatives' bucket, where we put anything that shows low or negative correlation to the core building blocks of the portfolio, which are equities and fixed-interest. We were getting that exposure through a long-short fund, but we found that didn't deliver, and we were looking for something that was more simple, cheaper and more diversified," he says.

Most of Spence's clients are SMSFs, but the portfolio also serves non-super wealth accumulators.

He says Hillross wants an "alternatives" allocation that will "hold the portfolio together", and make it more robust in a downturn or a left-field event like the GFC.

"The story for us is one of low-to-negative correlation, and protection from inflation. We don't expect the current low-interest-rate environment to prevail much longer: we wouldn't pretend that we could pick when, but at some point in the near future, interest rates will start to rise, and we think commodities will give some protection from that," he says. "We've got a 'best-of-breed' portfolio and we're using the QCB in that, currently about 3 per cent of the portfolio." Over the past 18 months the return from the strategy has been negative, he says, but he expects that when US interest rates start to rise it will come into its own. "We'd expect to look at lifting that allocation when that happens," Spence says.

Bradbury of ETF Consulting and Portfolio Solutions says this kind of use is "what ETPs were built for", but it's "still rare" in the Australian market.

"There's a lot of choice of ETPs in the commodity space, but really, there has not been a lot of take-up. There are 22commodity ETPs listed, with a bit over $500 **million** of assets, but of that, $430 **million** is in the **GOLD** ETP. It is one of the exposures people across the **board** understand better than most, and there is a pretty strong attachment to **gold** on the part of a lot of investors. Apart from that, there's not a lot of interest spread across the other products." The major problem, he says, is that the education on how to use them "doesn't seem to have penetrated to the right parts of the buying market".

"The variety of exposures is certainly there, but it's hard to get investors to take some of them up. They're all valid exposures, but they probably tend to be more of a trading-type exposure – you can slice into a whole range of precious metals, industrial metals, gas, **oil**, agricultural commodities, but they probably look more like short-term trading ideas or portfolio 'tilts' than perhaps a long-term allocation."

Advisers need to understand how ETPs might be used, he says. One, they need to have an asset allocation that caters for commodities, they have to understand how to use those products, whether it's strategic long-term or tactical – the tactical advisers tend to be more broker-oriented, and they're often coming out of morning meetings with a trading idea based on the in-house research. They then look for the tool to implement that and in many cases the ETP is the best one.

"The long-term story, of diversification and inflation protection, is not as well-understood as it should be – because broad-based commodities exposures have a role to play in portfolios," Bradbury says.

Vynokur says the conversation about commodities is a "pretty timely one".

"We're finding a lot of adviser interest in the broad commodity-basket products, with asset flows starting to pick up, coming off a couple of quiet years on that front. The key things that advisers are starting to see is low correlation to equities and fixed income. If you allocate 5 per cent to 10 per cent of the your portfolio to commodities, we say you will see a significant improvement in risk-adjusted return, with lower volatility."

Inflation expectations are also driving interest, he says.

"We've gone through a very significant period of quantitative easing, of very accommodating monetary policy, the US has just ceased but Japan is still pumping money into the system, and one of the natural consequences of that is inflation." Whether it's as a diversifier or as an inflation hedge, he says commodities "fit the picture".

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