

Blending commodities: a new hot portfolio strategy

The unprecedented equity returns of the 1990s led many investors to conclude that holding stocks along with bonds and cash would result in steady upward portfolio growth. One assumption underlying this was that optimal diversification could be achieved simply through exposure to stocks and bonds since they always outperformed other asset classes. The downturn in the equity markets over the last few years has cast doubt upon such traditional investment strategies. At the same time, dramatic gains in commodity prices have demonstrated the potential benefits of commodity exposure in a long-term asset-allocation plan.

Today, as investors become increasingly familiar with the features of commodities as an asset class, this type of investment is gaining widespread acceptance. Over the past 18 months, there has been significant growth in demand for commodity-linked investments from private banks, pension funds, asset management companies and retail networks.

Commodities as a diversifying asset class for investment

The recent commodity boom has increased investor interest in this asset class and generated a surge in the volume of commodity-linked financial products.

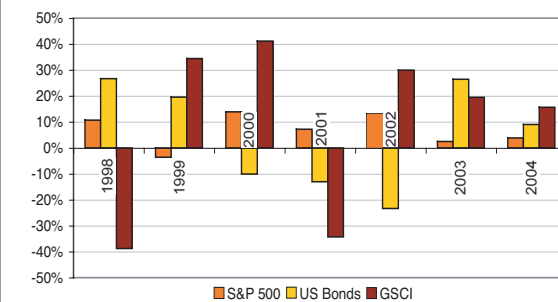
Commodity investment can be seen as either 'view-driven' or 'effect-driven'. View-driven investors aim to take views on future price movements in the underlying commodity in an attempt to take pure commodity exposure, whereas effect-driven investors seek diversification in the commodity asset class as part of a diversified portfolio comprising a mix of asset classes. Investors can also buy commodities as a hedge against inflation (particularly when inflation is high).

Investors can obtain commodity exposure in different ways. The first is to buy and store physical commodities, which can be cumbersome and offers little pricing transparency. One can also invest in commodity equities, but this is a poor substitute for direct investment. Commodity futures offer the best liquidity and may be considered reference investment products, along with commodity indices, which track the performance of a basket of rolling commodity futures. Reference indices, e.g. the Goldman Sachs Commodity Index, are both liquid and transparent.

By taking positions in futures on physical commodities, investors aim to take advantage of three distinct features that make commodity assets an indispensable tool in portfolio management:

- 1) Commodities have historically been negatively correlated with stocks and bonds (see graph 1),
- 2) Historical returns on commodities are commensurate with stocks,
- 3) Commodities lower a portfolio's overall volatility.

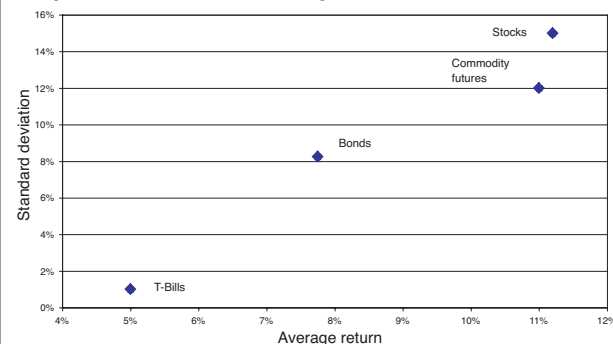
Graph 1: Annualised performance of commodities vs. other asset classes



Source: Bloomberg / BNP Paribas

Contrary to equity returns, which are driven by the expected ability of companies to generate profits in the future, the return on commodity futures is driven by the demand and supply of commodities in the next few months. As a result, commodities are firmly tied to the business cycle. In a peaking business cycle, higher demand for commodities might increase the returns on this asset class, while equities might underperform in expectation of lower profits in the future. In addition,

Graph 2: Annualised monthly returns vs. risk 1959-2004



Source: Bloomberg / BNP Paribas

commodity futures perform better during periods of inflation, especially unexpected inflation when stock and bond returns generally disappoint, and they provide a good hedge against geopolitical instability and the dollar risk during periods of dollar weakness.

The historical risk premium on a diversified portfolio of commodity futures is comparable to the risk premium on stocks and greater than that on bonds (see graph 2). However, commodity futures are less risky than stocks, both in terms of volatility and downside risk.

Therefore, portfolios comprising commodities may successfully generate above-benchmark performances and provide more stable long-term returns.

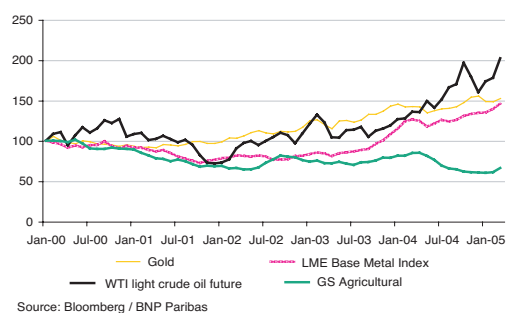
Commodities as yield-enhancement investments

Investments in commodities have yielded exceptionally high returns in the past three years, mostly due to the outperformance of energy and metal commodities. Years of under-investment in infrastructure, along with a material increase in production costs, have resulted in severe capacity constraints across commodity sectors and, consequently, have driven commodity future prices up.

Although the commodity cycle has recently shown signs of weakening demand, many analysts believe this is still a good time to take commodity exposure given that fundamentals continue to reflect strong performance and rising trends.

There will be ups and downs, but the strength of certain major commodity markets may be here to stay for at least another decade. Indeed, commodity consumption is structurally linked to population size as well as GDP growth and industrial development, which are most likely to remain on the uptrend in many countries. China, for example, has become the world's largest consumer of steel and second largest consumer of crude oil. In recent years, Chinese demand for commodities has contributed to drive up prices. China is expected to remain a major demand factor in the future for key commodities, relayed by India.

Graph 3: Evolution of main commodity markets since 2000



As far as oil prices are concerned, some experts forecast that they could surge in the near future to levels way above the current trading range. Indeed, we are currently in a just-in-time supplied market configuration, meaning that further oil demand increases will require new additional capacity rapidly, hence the risk that oil may not be produced on time. As a result, price spikes could occur, offering investors good profit-taking opportunities.

Products and underlyings

Contrary to financial assets, commodities are not homogenous in terms of quality or grade, and a variety of references exist to price real assets (e.g. crude oil, refined products such as gasoil, gasoline, jet fuel, etc). Therefore, a range of commodity derivative instruments has been created on standardised commodities that trade on exchanges (such as the NYMEX or the IPE for oil prices).

The most liquid underlyings on which BNP Paribas can construct derivative instruments are as follows: energy derivatives (crude oil and products, natural gas, coal), base metal derivatives (steel, non-ferrous metals, LME and Comex Index, basis transactions), precious metal derivatives (gold, silver, platinum, palladium), main third-party commodity indices and tailor-made indices tracking commodity futures.

Different strategies, from the simplest to the most complex, can be implemented to trade views on commodities. BNP Paribas (Crude Oil House of the Year 2005, #2 OTC Derivatives Dealer on US Natural Gas 2004, #1 Crude Oil Futures Broker on the IPE 2004) has developed the capacity to structure many products that allow investors to receive any payoff linked to commodity assets – they can be adapted to specific risk profiles and offer full or partial principal protection.

The first range of products offers pure commodity exposure. These products are designed for investors seeking to (1) participate in the growth of the commodity markets with no downside risk through baskets or indices, (2) receive regular commodity-linked returns, or (3) make a quick profit on the commodity markets. With BNP Paribas' Commodities Stellar, you receive variable annual coupons linked to a diversified basket of equally weighted commodities. Coupons are capped at a high level but this structure can offer minimum returns.

Another range of solutions would be hybrid investments with embedded commodities. By providing exposure to assets from different classes, hybrids offer investors the opportunity to take advantage of the different economic cycles of each asset class. They provide optimum performance in any market conditions by lowering overall portfolio volatility and achieving diversification when the underlying assets are loosely correlated.

Investors can choose between many different structures on multi-asset class baskets to achieve efficient diversification and optimise the risk-return, depending on their particular objectives. For example, BNP Paribas proposes exposure to the best investment strategy out of three risk profiles through its Profiler. Profiler is a five-year, 100% capital-protected note whose performance is the best of three portfolios including a mix of diversified assets (equities, commodities, bonds, cash) with different risk profiles (aggressive, balanced, defensive).

The features of the commodities asset class make it an efficient tool for portfolio diversification and yield enhancement. To jump on the bandwagon of commodities, investors can choose among numerous structures to benefit from rising trends. ●

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