Commodity Blues

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The bad news about commodity prices and the exchange-traded funds that follow them just keeps coming. Over the year ending September 30 the S&P GSCI, a broad commodity benchmark, fell 42%. The devastation was widespread, with each of the dozen components of the indexes posting negative returns ranging from negative 53% for oil to negative 19% for livestock.

The immediate future also looks grim, according to the latest report from the World Bank, which projects all main commodity price indexes will end the year lower and remain fairly flat in 2016. Some argue that most commodities have been in a bear market for more than two years.

Investors in the 140 ETFs that follow commodities have responded to all the bad news by heading for the exits. In 2015 alone, the largest broad-based commodity ETF, the PowerShares DB Commodity Index Tracking Fund (DBC) saw outflows of $982 million through September 30, while SPDR Gold Trust (GLD) lost $606 million.

The level of pessimism is so bad that even glimmers of hope are dismissed as a fluke. In a press release issued in late August, TrimTabs Investment Research noted that commodity ETFs experienced inflows from investors during the summer, despite their dismal performance. “Most investors are awful buyers and sellers,” the firm observed. “From a contrarian point of view, this could be a warning sign that things will get a lot worse.”

Despite all this, a number of advisors interviewed by *Financial Advisor* maintain varying degrees of loyalty to commodity ETFs and ETNs. Some say that while they aren’t investing in these funds now, they wouldn’t rule out doing so in the future. Others are hanging on to positions even as prices decline.

Tim Courtney
Exencial Wealth Advisors
Courtney does not believe that commodities should have a permanent allocation in most portfolios, although he says he uses them at certain times to diversify. The only “real asset” allocation his firm currently invests in is global REITs.

“Over time, the expected returns of a basket of commodities is inflation,” he says. “Unfortunately, the volatility of commodities equals and often surpasses the volatility of stock markets, so the risk-reward of this asset is not attractive as a long-term investment.” He nonetheless values them

as an inflation hedge and says his firm's studies show that commodities can produce meaningfully positive real returns on average when inflation is 3% annually or higher. However, in periods of low inflation under 2%, the real returns of commodities have been strongly negative, on average.

Courtney doesn't see a substantial uptick anytime soon. "Our best guess is that commodity prices may not have more large moves lower but will likely not move higher until inventories, which are high in many commodities, are brought lower. These inventories, increasingly efficient supply methods and slower demand growth may mean prices stay relatively low for some time."

David Fabian
FMD Capital Management
While Fabian thinks that in tactical situations a small allocation to commodity ETFs can "serve a diversified portfolio well," the protracted downturn is keeping him out of the asset class for now, though he doesn't rule out moving back in the future. He reserves these investments for growth-oriented portfolios focused on long-term capital appreciation rather than conservative income or capital preservation portfolios, which are better off tapping available yield and dividend-oriented opportunities. At most, investors should have a 5% to 10% allocation to these commodity products, he says.

He emphasizes the importance of educating clients about the fickle nature of commodities and how prices can turn on a dime when unforeseen problems due to the weather or political wrangling come into play. "A lot of the commodity story for investors is having a comfort level with owning a non-traditional asset class that may zig when stocks or bonds are zagging," he says. "Self-examination of how you benchmark returns and risk tolerance should be of greater importance than catching the next 10% move on a commodities ETF."

Charles Self
iSectors
Self's firm, unlike the other two, provides investment models for financial advisors and is keeping a foot in the door of the commodities market. "All portfolios should have some commodity exposure," he says. "While owning commodities can drag down returns over the long term, we find that they tend to be the best-performing asset class when the stock market drops for prolonged periods. Investors are more likely to stay in stocks during tough times if there is a 5% to 10% allocation to commodities that offsets losses." He favors the Elements Rogers International Commodity ETN (RJI) for broad commodity allocations because it offers a more diversified mix of commodities than other exchange-traded products. At 75 basis points, its expense ratio is lower than those of many competitors.

For the firm's more aggressive portfolios, Self recommends a 5% tactical allocation to energy, even though the sector has been slammed over the last year. "We believe global demand will absorb supply sooner than many people think, and that prices will go up quickly when that happens," he says.

Financial advisors sitting on the commodity sidelines hoping to time a perfect re-entry point are playing a losing game, he adds. “The question you have to ask is when you’re going to get back into commodities,” he says. “By the time you realize it’s a good idea, it may be too late.”

Craig Ferrantino
Craig James Financial Services
Like Self, Ferrantino is hanging tough with client allocations to commodity ETFs by keeping them at around 5% to 10% of assets. But he prefers targeted exposure to specific commodity ETFs such as the SPDR Gold Shares fund instead of broad-basket commodity ETFs.

“Certain dominant sectors of the broad basket ETFs, such as energy, have taken an especially hard hit,” he says. “I think there is also a perception that gold is a store of value. And a lot of people are better prepared to sit through the volatility because they’ve seen gold prices move higher in the past.” To get exposure to the energy sector, Ferrantino prefers the stocks of energy companies because they are less volatile than oil prices. “The main thing is getting clients to understand that there are going to be more boom and bust cycles with a commodity ETF than normal equities,” he says.

Chris McMahon
McMahon Financial Advisors
As a longtime resident of Pittsburgh, McMahon has seen how commodities can change the entire character of a region. “Years ago, Pittsburgh was a depressed steel town,” he says. “After the discovery of the Marcellus shale, people who used to sew their own clothes began getting $100,000 a month royalties on their land. Now, companies have cut back production because of low gas prices.”

Commodities have had an impact on client portfolios as well, albeit a small one. About eight years ago, McMahon’s firm began using commodity ETFs for diversification and inflation protection. The firm’s allocations range from 2% for conservative portfolios to 7% for the most aggressive ones, and the firm focuses on broad-basket offerings such as the United States Commodity Index Fund (USCI).

McMahon, who sees another 12 to 24 months of depressed commodity prices, intends to hang on to his current positioning. “Some investors might see this as an opportunity to buy commodity ETFs at lower prices. We’re asset allocators. We aren’t going to try and guess when commodities will start to explode.”
Several of these advisors say they prefer commodity exchange-traded notes over exchange-traded funds in taxable accounts. The latter vehicles use futures contracts and are organized as partnerships, so their tax treatment is fairly complicated and they generate a Schedule K-1 tax form. By contrast, exchange-traded notes, which are unsecured debt notes issued by banks that promise to provide the return of a specific index, are treated for tax purposes like regular stocks and bonds.