Implementation Insight

DNA of a Manager Search: Commodities

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bfinance is an award-winning specialist consultant that provides investment implementation advice to pension funds and other institutional investors around the globe. Founded in 1999, the London-headquartered firm has conducted engagements for more than 300 clients in 33 countries and now has eight offices in seven countries. Services include manager search and selection, fee analysis, performance monitoring, risk analytics and other portfolio solutions. With customised processes tailored to each individual client, the firm seeks to empower investors with the resources and information to take key decisions. The team is drawn from portfolio management, research, consultancy and academia, combining deep sector-specific expertise with global perspective.

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Why read on?

Commodity investment is back in the spotlight.

After a decade of poor performance, many commentators delivered a more bullish outlook for commodities during the first quarter. Such predictions are buoyed by global economic growth and some helpful market dynamics, such as the reduction in **contango** (page 5). Goldman Sachs, for instance, announced on February 1st that it expects returns of 15% on its commodity index (GSCI) over the next six months and claimed that the environment for commodities was "the best [seen] since 2004-2008." Prices have surged, fallen amid the equities rout and risen again.

Several large investors have signalled their intention to enter this often-controversial space, drawn not only by the investment outlook but by the sector's inflation hedging characteristics. The recently announced 5% allocation by the influential UK National Employment Savings Trust (whose Deputy CIO is quoted above), for example, was hailed with praise in some quarters and derision in others. A popular national newspaper claimed that the "wild west of commodities is no place for NEST's members" and criticised the "fetish" for "so-called uncorrelated returns."

At bfinance, we have observed notable changes in client demand. Investors with passive commodity exposures are showing greater interest in **enhanced (active) systematic commodity investing**, although to date we have not seen a resurgence of appetite for pure-play commodity hedge funds. We are also seeing strong appetite for **Alternative Risk Premia, CTA** and **Systematic Macro** strategies, many of which also involve commodity investments with a similarly systematic approach, but as part of a multi-asset schedule (see *The Changing World of Alternative Beta*).

With commodities back in focus, this paper – part of the DNA of a Manager Search series – explores one pension fund's hunt for an enhanced commodity overlay manager. It addresses both the different strategies and the variety of implementation structures that investors can consider in that sector. We hope that this case study provides asset owners with insight on the choices and challenges involved in implementing commodity futures investments.

Investor insight

"Commodities look attractive relative to their long-term historic prices. As the world's population grows and incomes in the developing world rise, we expect increasing demand for commodities. We want our members to benefit from these long-term trends… We also think that it will provide some inflation protection."

John St Hill, Deputy CIO, NEST, speaking to Financial News in January 2018.

Latest news

The Bloomberg Commodity Index (BCOM) posted a near-flat return for the first quarter of 2018, taking the one-year performance figure to +3.71% and the five-year figure to -8.32% per annum.

Commodity hedge fund closures continue. Recent firms to shut up shop include Jamison Capital Partners ($1.5 billion) and Astenbeck Capital Management. Macro commodity hedge funds returned an average of 0.01 percent in 2017 according to HFR, making it one of the worst-performing strategies last year.

One investor's challenge

In late 2017, a European pension fund sought a new approach to commodity investment.

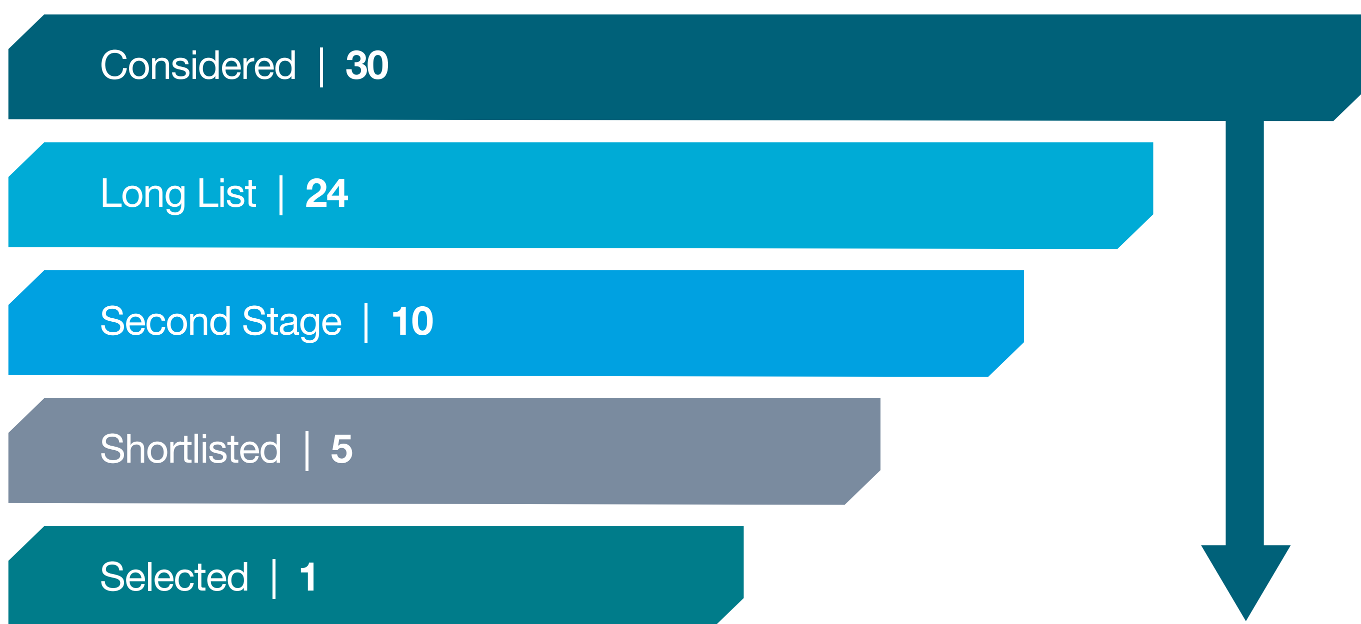
To date, the team had run a passive portfolio of commodity futures, implemented through a swap arrangement with a major investment bank. They wanted to make this allocation work harder for the benefit of the portfolio, without moving away from their core pro-passive implementation philosophy.

Enhanced commodity overlays therefore provided a potentially attractive route. These strategies offer the prospect of adding value while maintaining some "passive-like" qualities: a fully systematic investment approach, total transparency of process and positions, liquidity and low cost (c.15bps more than pure passive). The investor wanted a strategy to outperform the BCOM index by 1.5% per year with a tracking error of no more than 5% - an intentionally generous stipulation, with most strategies falling in the 3-4% range.

With plenty of experience in implementing such strategies directly, the team was willing and able to consider different approaches, ranging from commingled funds and segregated accounts to swaps and certificates. As such, bfinance was able to throw a wide net around provider types: traditional asset managers, large-scale and smaller (>$1 billion) boutiques, banks and specialist index houses. In the case of boutiques, many were managers with highly active commodity strategies that have launched a cheaper, more systematic product on the side.

In addition, the investor strongly preferred systematic versus discretionary strategies, in keeping with their desire for a transparent process. This is highly representative of our client base at present, with investors evidently still in the "love" stage of the quantitative love-hate meta-cycle. One notable limitation was the requirement for pure long-only commodities exposure, eliminating long/short relative value strategies as well as commodity-related equity strategies.

Figure 1: Search at a glance



Source: bfinance manager analysis, Q1 2018

In theory:
assessing the strategies

Key to success in this search was a systematic investment approach that was clearly supported by established economic theory.

There are **three major levers** that managers can employ in their efforts to "beat the index" – in this case, the BCOM (the Bloomberg Commodity Index, more diversified and less energy-heavy than the Goldman Sachs Commodities Index).

The first is **contract selection**: which sectors to use and at which maturities. There are 22 sectors in the BCOM and most proposals involved implementation across those markets, but some elected to use a restricted subset or include non-BCOM commodity markets. As for contract maturity, the client preferred a maximum of six months: some providers tap into longer maturities but the investor was concerned about potential liquidity and event risk involved.

The second is **backwardation** – a strategy which has struggled until relatively recently due to the number of commodity futures markets in contango. The third is **pre-roll**, where managers may deliver a modest excess return by timing their purchase of futures ahead of the BCOM's scheduled roll dates.

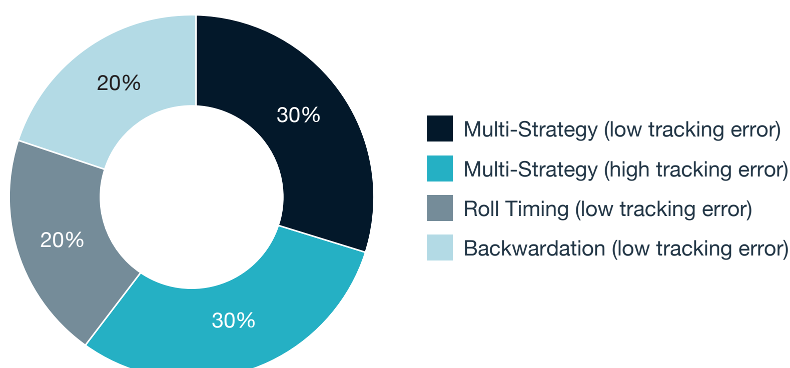
The 24 offers comprising the long list spanned both low tracking error (c.2-3%) and higher tracking error (4%+) solutions. While several focused more heavily on either pre-roll or backwardation, the majority use both ("multi strategy"). The latter was viewed by the client as a more all-weather approach, since it avoids reliance on a single source of excess return generation. The shortlist ultimately included at least one example of each type.

Jargon buster:

Backwardation and Contango
"Backwardating" commodity futures increase in value as the contract moves towards expiry ("positive roll yield"). This can be the result of various factors, such as supply /demand dynamics where hedgers are prepared to pay a premium ("convenience yield") for near term supply. Commodity futures in "contango," on the other hand, decrease in value as you hold them ("negative roll yield"), which can reflect costs of storage or insurance encountered in holding these commodities physically.

Pre-roll
The rules governing commodity indices mean that expiring futures contracts are "rolled" via a predetermined schedule in order to maintain exposures. "Pre-rolling," i.e. rolling your portfolio before the index turns over, is a potential source of added value versus the index due to the avoidance of congestion around these dates. This is also known as "roll timing."

Figure 2: "Second Stage" offers, categorised by strategy type



Source: bfinance manager analysis, November 2017

In practice: implementation differences

The providers fall into two main groups: fund-type structures (including segregated accounts) and OTC swap-based solutions.

Funds (and segregated accounts) buy and hold futures, whereas the latter involve implementation via a Total Return Swap (TRS). The vast majority of investment banks proposed an OTC swap arrangement, with a small minority offering a segregated mandate, while most asset manager proposals involved segregated mandates. Index provider proposals leaned towards OTC swaps.

It's worth noting that swap arrangements potentially introduce more counterparty risk, as well as additional operational burden for the investor in terms of collateral management, but are often preferred due to efficiency of funding.

Swap-based solutions were, on average, slightly less expensive than fund-based solutions once all costs are taken into account (including custody and administrative charges for funds). Yet the gap between the two is not substantial. Trading costs, it's worth noting, represent the largest single element of expense in all cases.

The fee negotiation phase indicated that managers had considerably more room to manoeuvre than banks, largely reflecting the more aggressive pricing from the latter group.

Toby Goodworth
Managing Director – Diversifying Strategie

Weighing the options

Enhanced commodity overlays are far from commoditised. This search illustrated the major differences in the options available to investors, ranging from simple index-based solutions to sophisticated proprietary systematic and discretionary approaches.

The returns from enhanced roll and backwardation commodity strategies have been more muted lately than in former years. Yet there are still uncorrelated return streams which can be accessed in a straightforward and low-cost manner.

The core tenets for allocation to commodities – inflation protection and diversification – still hold true. Yet some market participants have cited a long-term turning point in the decorrelation between commodities and equities in early 2017, with the two markets appearing to be more positively associated through the last year. With potentially weaker diversification characteristics, investors with passive commodity exposure may be more inclined to consider an active approach.

Key takeaways

Enhanced commodity overlays offer the prospect of adding value while maintaining some "passive-like" qualities: a fully systematic investment approach, total transparency of process and positions, liquidity and low cost (c.15bps more than pure passive).

There are three major levers that managers can employ in their efforts to "beat the index": contract selection, backwardation and pre-roll. The returns from backwardation and pre-roll have been somewhat muted lately but still represent a notable uncorrelated return stream

There are two routes for implementation: fund-type structures (asset managers and boutiques) and OTC swap-based solutions (banks and some index providers). Swap-based solutions tend to be slightly less expensive on an all-in basis.

Related reading:

Managing Currency Risk
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How Have Alternative Risk Premia
Strategies Performed?

Manager Intelligence
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Contact details
Toby Goodworth, Managing Director – Diversifying Strategies, tgoodworth@bfinance.com
Kathryn Saklatvala, Director – Investment Content, ksaklatvala@bfinance.com

Office locations

Amsterdam
Symphony building – 26th Floor
Gustav Mahlerplein 109-115
1082 MS Amsterdam
The Netherlands
T +31(0)20 794 61 00
www.bfinance.com

Chicago
220 N. Green Street
Chicago IL 60607
USA
T +1 (312) 829-4353
www.bfinance.com

London
36 Queen Street
London
EC4R 1BN
England
T +44 20 7747 8600
www.bfinance.co.uk

Montréal
1250 René Lévesque Blvd. W
Suite 2200, Montréal QC
Canada H3B 4W8
T +1 514 393 4899
www.bfinance.ca

München
Promenadeplatz, 8
D-80333 München
Deutschland
T +49 89 55 29 59 00
www.bfinance.de

Paris
49, avenue d'Iéna
75116 Paris
France
T +33 1 45 02 64 00
www.bfinance.fr

Sydney
Level 13
135 King Street, Sydney
Australia
T +61 2 8973 7503
www.bfinance.com

Toronto
WaterPark Place
88 Queens Quay West, Suite 2500
Toronto ON M5J 0B8
Canada
T +1 (416) 560-7275
www.bfinance.ca