

# The Case for Commodity Long-Short Investing

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## Introduction

Over the past several years many institutional investors have added an allocation to their portfolio variously labeled commodities, real assets, hard assets, natural resources or inflation protected investments. Regardless of the name, the goals of the allocation are generally to:

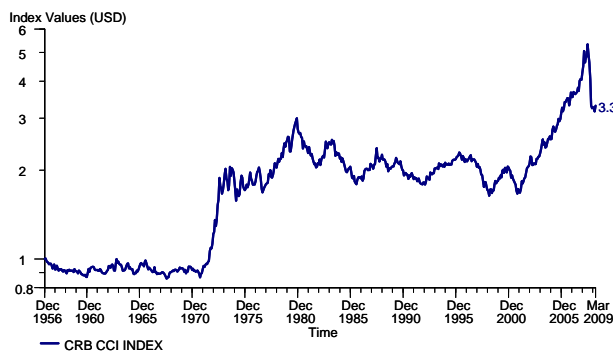
- Gain exposure to an uncorrelated asset class
- Provide a hedge in high inflation environments
- Diversify away from stocks and bonds

The allocation often takes the form of an investment linked to a long-only commodity index such as the Goldman Sachs Commodity Index (GSCI). Our research shows that there is a significantly better way to achieve these goals. By allocating to a collection of commodity trading advisors who invest both long and short, returns can be increased and volatility decreased without giving up inflation protection, diversification, and non-correlation.

## The Typical Approach

Many institutional investors seeking to add commodities to their portfolio follow the same steps: set a policy target, allocate to a long only index fund or an active manager and then hope that commodity prices go up. There are a number of problems with this approach.

First, commodity prices tend to be cyclical and can trade within a range for very long periods of time. As Graph 1 shows, commodity prices were range-bound for the 16 year period from 1956 to 1972 and for the 31 year period from 1973 to 2004.



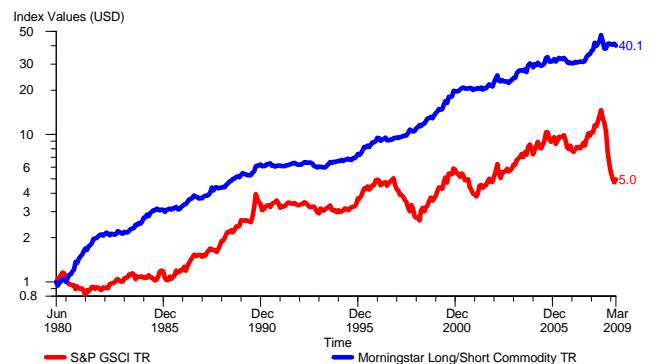
Graph 1. Long Term Spot Commodity Prices

This is in sharp contrast to stocks and bonds which exhibit a distinct upward drift over time. The reason for the cyclical nature of commodity prices is simple economics. For example, when demand pushes corn prices higher, farmers plant more corn. Then, as the supply of corn increases, the price falls. If the price of corn falls enough farmers switch to another crop, thus reducing supply. This same cyclical nature is seen in oil drilling and exploration, in the mining of copper, and in virtually all other commodities.

Another difference from stocks and bonds is that long only investors do not dominate commodity futures markets. In futures markets, for every long position there is a corresponding short. There is no cost of borrow, as in stocks, and there has never been a short sale ban. Unlike many bonds, and even some stocks, commodity futures markets are exceptionally liquid even in times of crisis. Exchanged cleared contracts have no counterparty risk. It is a market made for long-short investing.

## Long-Short Investing

A comparison of the long only GSCI to the Morningstar Long-Short Commodity Index shows the dramatic improvements available by adding a short component.



Graph 2. Long Only vs Long-Short Index Performance

The blue line in Graph 2 shows the performance of the Morningstar Commodity Long-Short Index. From its inception in 1980 to date it has risen over 40 times versus five times for the long-only GSCI. Volatility is also dramatically lower for the Morningstar Long-Short Commodity index.

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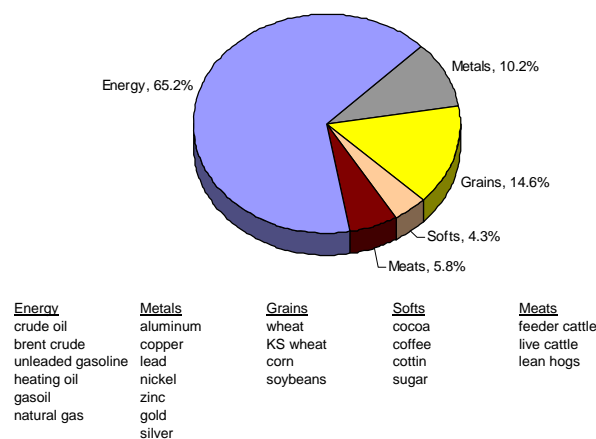
## The Commodity Investment Universe

The Morningstar Long-Short Commodity Index uses a fairly simple, systematic trend following strategy to establish long and short positions in 20 different commodities contracts. But there are over 60 commodities markets world wide with over 300 contracts. There is an investible universe of about 90 futures funds that ply this universe. These funds tend to be specialized by sector and by investment style.

## Balancing Exposures

The GSCI is composed of 24 commodity futures contracts across five sectors: energy, metals, grains, softs and meats.

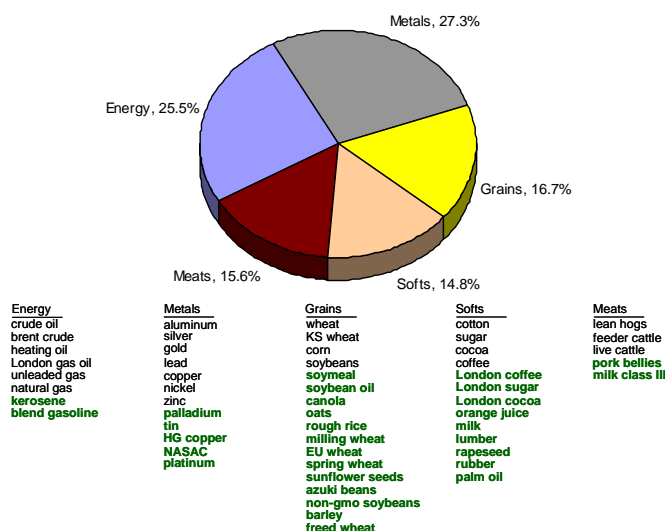
### GSCI Exposures and Contracts



The index is weighted by the total value of world wide production and it is dominated by energy. An investment in the GSCI basically amounts to a bet on oil. A much more prudent approach would be to invest with a more balanced sector exposure and across a wider variety of the 60 available markets. This would provide better diversification and more opportunities for a trend following system to find and exploit trending markets.

A carefully constructed portfolio of specialized commodity trading advisors can accomplish both of these objectives. The sample portfolio of managers shown in the following pie chart reduces an investor's energy exposure from 65% with the GSCI to 25%. This significantly moderates the bet on oil prices. The sample portfolio also invests across 55 markets, versus 24 for the GSCI, providing many more opportunities to identify and profit from trending behavior.

## Sample Commodity Long/Short Portfolio



In addition to balancing and expanding the sector exposures, there are three distinct styles employed by the commodity trading advisors.

**Systematic** strategies use quantitative systems to exploit the trending behavior of commodities markets over various time periods. They may also include some counter trend and mean reversion aspects. The Morningstar Long/Short Commodity Index is based on a systematic strategy.

The systematic commodity trading advisors can provide good up-capture when commodity prices are rising sharply, such as in times of inflation. They can also provide positive returns when commodity prices are trending lower by going short. They form the core of a multi-manager commodity long-short strategy.

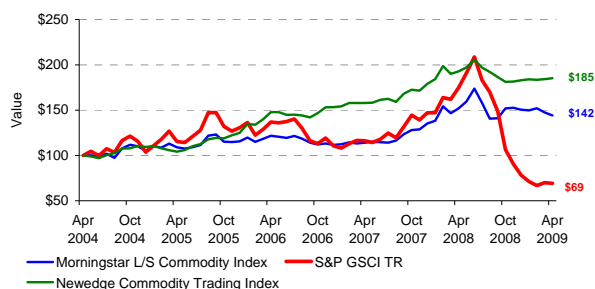
**Fundamental** strategies conduct deep research into the supply and demand factors that drive commodity markets and develop themes for changes in those drivers. An example of a theme would be the emergence of ethanol as a significant incremental demand driver for corn and the resulting impact on corn prices.

**Sector Specialists** employ specialized knowledge, in-depth analysis and fundamental information sources to gain an informational advantage in niche markets. A commodity trading advisor who specializes only in the metals markets, for example, can focus his resources on tracking the mines and the refiners and thus generate an informational advantage.

Fundamental and Sector Specialist commodity trading advisors add significant benefits when added to a portfolio of systematic traders. First, their returns tend to come in the form of alpha, driven by uncorrelated ideas often expressed through spread trades. Second, these trading advisors can anticipate and profit from trend reversals, an environment that is difficult for systematic trend followers. Third, the fundamental and sector specialists tend to reduce the volatility of the portfolio when combined with the systematic trading advisors.

### Performance Expectations

A commodity long/short portfolio that utilizes systematic, fundamental and sector specialists has the ability to produce returns superior to the GSCI.

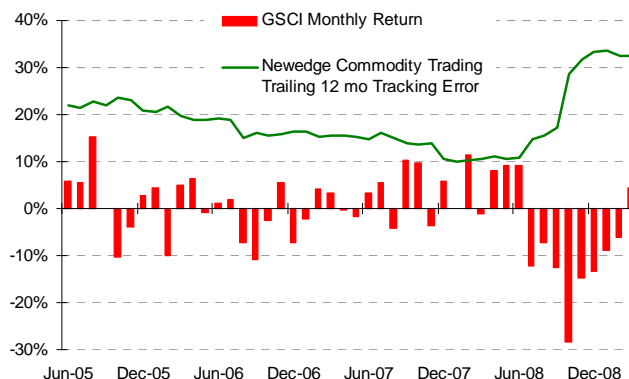


Graph 3. Systematic vs Diversified Strategies

The green line in Graph 3 shows the benefit of adding fundamental and sector specialist managers to the systematic advisors. The Newedge Commodity Trading Index includes specialist, fundamental and systematic strategies while the Morningstar Long/Short Commodity Index includes only systematic strategies. The benefit is particularly noticeable at the turn of the markets in July, 2008. The long only and systematic strategies both take a sharp dive when commodity prices reverse but the more diversified index weathers the storm with much less volatility and better returns.

### Tracking Error Only When You Want It

When commodity prices are rising a commodity long/short portfolio should have a relatively low tracking error. Conversely, when commodity prices fall an investor would like a high tracking error.



Graph 4. Tracking Error Changes with the Market

The red bars in Graph 4 represent the monthly returns of the GSCI. The green line represents the tracking error of the Newedge Commodity Trading Index to the GSCI. When commodity prices rose strongly from the middle of 2007 to the middle of 2008; the tracking error fell to around 10%. But when commodity prices starting falling in the second half of 2008 the tracking error jumped to over 30%. This indicates that the Newedge commodity long/short index successfully decoupled from the long-only GSCI index as the commodity markets fell in the second half of the year.

### A Better Way

A portfolio of specialized long-short commodity trading advisors provides pure commodity exposure with better risk and return characteristics than a long-only strategy. It preserves the negative correlation to stocks and bonds and can profit both when commodity prices rise and when they fall. It is diversified across sectors and styles and can provide a hedge to inflation. We believe a portfolio of specialized long-short commodity trading advisors is a superior investment strategy for a commodities, hard assets, natural resources or inflation hedge allocation.

*As with any investment program, commodity long-short investing involves risk of loss and is not intended as a complete investment program. Commodity trading is designed for sophisticated investors who are able to bear the risks involved with an investment in a commodity long-short trading strategy. There can be no assurance that an investment in a commodity long-short trading strategy will achieve its stated objectives and that its investors will not incur losses. An investor should carefully consider whether an investment in a commodity long-short strategy is a suitable investment in light of the investor's financial condition.*