Lowe, Brockenbrough & Company

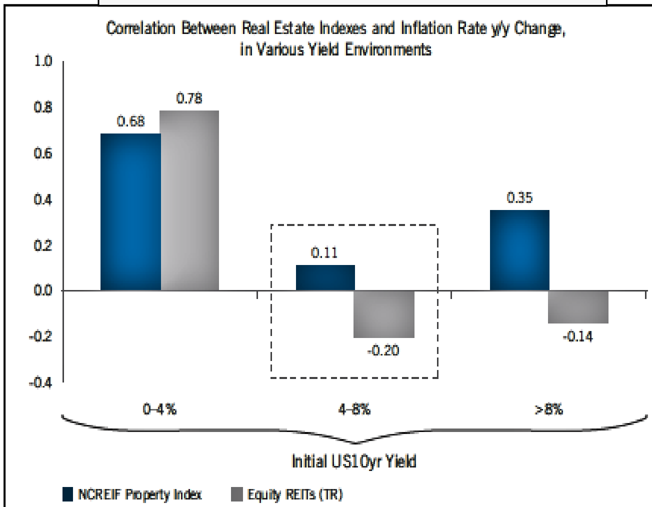
March 2010

Thoughts on Commodity Investing

The massive amount of monetary and fiscal stimulus injected into the global financial system over the last year has generated much discussion and speculation about the potential for higher future inflation. Predictably, we have been asked by many clients about the appropriateness of commodity investments in such an inflationary environment. In this quarterly review, we attempt to evaluate the pros and cons of commodity investing, while clarifying some firmly-held beliefs about their investment benefits.

Generally speaking, commodities deserve a place in most broadly-diversified investment portfolios. Historically, their inclusion has been for the inflation-hedging benefits they provide. In fact, commodities have outperformed inflation over the past 20 years, with about a 60% correlation. However, over longer periods of time the correlation is not stable enough to justify a large, strategic allocation to the asset class. Importantly, commodities do well in periods of higher inflation when equities and bonds tend to suffer. Their role as an inflation-hedge is more compelling relative to other alternatives during periods when interest rates are likely to rise, though they remain fairly closely correlated to inflation rates under all interest rate environments. Other common inflation protection vehicles, such as real estate, tend to exhibit poorer correlations as interest rates rise.

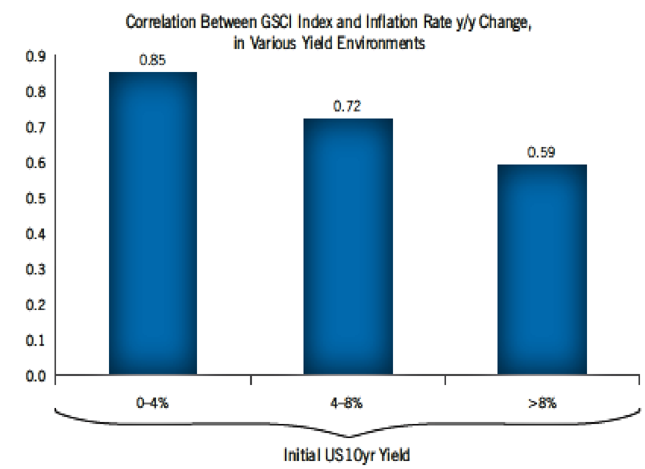
Short-term inflation-hedging power of real estate is often compromised by its interest-rate sensitivity...



Inflation rates measured by US CPI. Data from December 31, 1978 to December 31, 2009. Past performance is no guarantee of future results.

Source: Bloomberg, MSIM

...But the inflation hedging power of commodities has been strong across various yield environments



Inflation rates measured by US CPI. Data from December 31, 1978 to December 31, 2009. Past performance is no guarantee of future results.

Source: MSIM, Bloomberg

While we do not foresee an imminent acceleration in broad-based inflation, the massive global stimulus in the system, as well as underinvestment in commodity resource development during the past few years, should eventually push commodity inflation higher as global growth improves.

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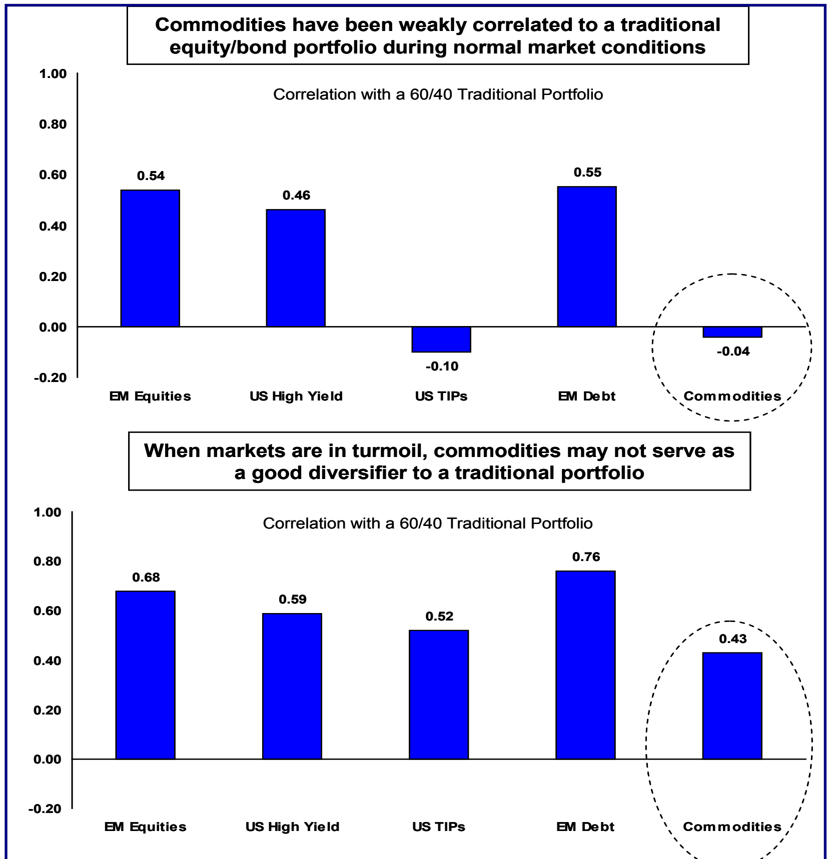
Commodities can also act as an important portfolio diversifier in many instances. Over longer periods of time, commodities have been uncorrelated to more traditional balanced 60% equity/40% fixed income portfolios. Commodities have historically had a modest correlation to equities and negative correlation to fixed income. The role of commodities as a diversifier of risk in overall investment portfolios is particularly strong in periods of geopolitical instability. However, the biggest criticism of commodities is that they have not been good diversifiers in periods of economic stress, as seen in 2008 and early 2009 when commodities underperformed in a poor period for risky assets. During downturns, the correlation with a 60/40 portfolio has gone from -4% to 43%, meaning commodity prices have tracked more closely with weakening equities. This adverse correlation can be explained by the fact that during downturns, inflation typically declines, which is anathema to commodity performance.

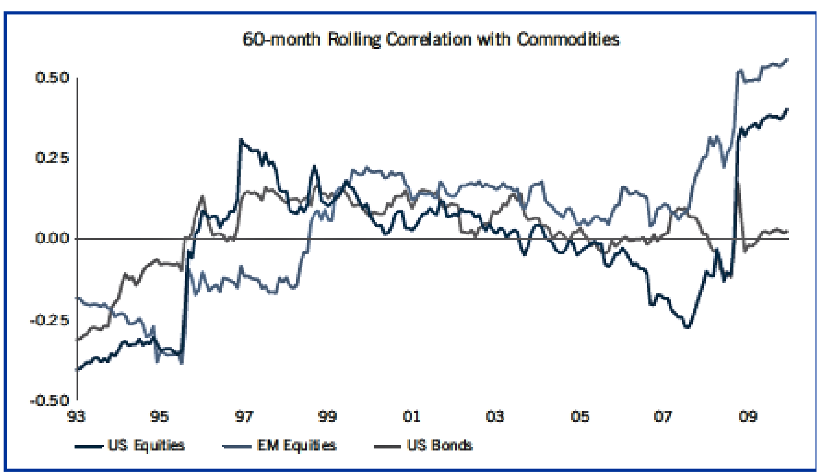
This can be seen in the charts to the right, which show the correlation of a 60% equity/40% fixed income portfolio to various asset classes, including commodities, in both normal economic periods and periods of economic weakness.

Over the past several years, commodities have become more positively correlated with equity markets, as changing macroeconomic conditions have been the dominant influence on trading and market direction. While the chart below suggests that correlations are likely to revert to lower levels over time, in periods of significant equity weakness, high quality bonds have proven to be a much more reliable source of diversification.



Data from 1/01/90 – 12/31/09. Source: Bloomberg, MSIM

Commodities are now increasingly correlated to equity markets, especially emerging market equities



Data from 1/01/93 – 12/31/09. Source: Bloomberg, MSIM

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From a tactical standpoint, commodity investment now looks attractive. Relative to equities, the CRB (Commodity Research Bureau) benchmark has been an investment laggard over the past six months. In addition, global economic growth and a developing socioeconomic transition in emerging economies may create upward pressure on global demand for commodities. In the years ahead, emerging markets will enjoy the greatest benefits of global economic growth. The shift of lower income households toward the middle class in those economies will result in growing demand for commodities. Commodity consumption tends to pick up quickly when per-capita income levels reach $5,000-$20,000, and there are 1.7 billion consumers in emerging markets that have moved to this income range. Monetary stimulus, while beginning to moderate in several countries, is still generally supportive across the globe. Also, most governments are still pushing forward expansionary fiscal policy. Lastly, rising capital and investment inflows into emerging markets are lending support to commodity prices, as these inflows support infrastructure and other commodity-intensive investment. On the downside, given their recent stronger correlation to equities, commodities can add additional volatility to investment portfolios.

In terms of actual investment vehicles, there are several options to consider aside from direct investment in actual commodities or commodity futures. Mutual funds, Exchange-Traded Funds (ETFs) and Exchange-Traded Notes (ETNs) generally provide broad diversification and good liquidity, but, depending on the particular vehicle, have some drawbacks as well. ETFs that invest directly in commodity futures are not tax efficient, as investors are taxed on appreciation every year regardless of whether the investment is sold in that year, and most are structured as partnerships, requiring the issuance of burdensome K-1s each year. ETNs track more closely to underlying commodities, and have a more favorable tax treatment, but are unsecured obligations of the issuer, raising questions of financial stability and credit worthiness. A more esoteric concern currently is the issue of "contango." Contango is a situation where the longer dated future price of a commodity is higher than more current futures and spot prices. Many of the aforementioned investment vehicles that invest directly in commodity futures regularly roll those futures from short term maturing contracts to longer dated contracts at higher prices, incurring a loss. Throughout the 1980s and 1990s, when commodities struggled as an asset class (spot prices higher than futures prices), investors enjoyed a positive return from this roll feature as longer dated contracts were cheaper than shorter maturing contracts ("backwardation"). In the current contango environment, returns on ETFs that roll commodity futures will likely trail spot prices and their respective indices.

Because of these peculiarities, and in order to further diversify risk, Lowe, Brockenbrough has focused its commodity strategy on investing in a basket of securities for those clients seeking commodity exposure: ETNs from only the financially strongest issuers, and mutual funds and ETFs that own the equities of the underlying producers of commodities (these ETFs do not suffer from the unfavorable tax treatment). Given their underlying exposure to equity markets, these last two investments are not as closely correlated to the performance of the underlying commodities, and may produce positive or negative variances to spot price movements. In all of the investments we use for clients, our focus is on instruments that have broad exposure to a large number of underlying commodities.

In summary, commodities make sense as a part of a broad asset allocation strategy. However, given their higher volatility, strong correlation with equity markets, and episodic diversification benefits, commodities should not account for a significant portion of a portfolio's overall allocation. Instead, a modest allocation should be tactical in nature, as part of a bucket of riskier assets that includes equities, global and high yield bonds.