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Academics stand by theory of correlativity

By Gregory Meyer in New Haven, Connecticut
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In 2006, Gary Gorton and K Geert Rouwenhorst published an influential paper.

The two academics examined 45 years of performance of commodities and found they "work well when they are needed most": when stock market returns are disappointing.

The paper's view was embraced en masse by institutional investors and helped to transform commodities from a niche investment into a proper standalone asset class.

But the diversification benefits of commodities have become increasingly tenuous as prices in the years following the report's publication moved in tandem with other major asset classes, including shares and bonds.

As stock markets plummeted worldwide in 2008, commodities fared just as badly. And last year both bottomed in March, challenging the notion that they respond to different phases of the cycle.

These correlations have proven nasty for investors, such as pension funds, that piled into commodities as a way to broaden portfolios and spread risk.

"There have been some questions raised about whether commodities provide that diversification," says Michael Lewis, head of commodities research at Deutsche Bank in London.

Last summer the correlation between the S&P 500 and the benchmark S&P GSCI commodity index rose to almost 0.8.

In spite of this recent close correlation between commodities and other asset classes, Profs Gorton and Rouwenhorst are standing by the paper's conclusion.

Sitting in Prof Gorton's paper-choked office on a day when both the S&P 500 and GSCI were each falling more than 3 per cent, the finance experts at Yale University say the volatility of the past two years fails to undermine their findings that, over a long period, commodity futures returns match equities but with a negative correlation, indicating commodities usually go up when equities fall.

"You can argue whatever you want about the last three years, two years, one year, six months," says Prof Gorton, 58. "That's not how we do research," he says in an interview with the Financial Times.

Their paper, “Facts and Fantasies about Commodity Futures,” was commissioned while they were consultants to AIG Financial Products, the insurance company subsidiary better known for its fateful push into credit default swaps.

The scholars compiled an equally weighted index of commodity futures and studied its returns between 1959 and 2004 to discover “simple properties of commodity futures of an asset class”.

The research found that futures, with Treasury bills as collateral, offered the same return as equities over the period.

More tempting for investors, the historical risk of the commodities market was “relatively low” compared with stocks.

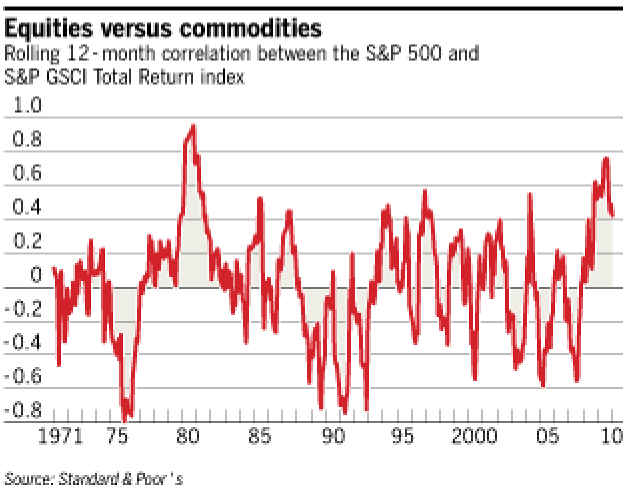
“Commodity futures returns have been especially effective in providing diversification of both stock and bond portfolios,” they wrote.

“Undeniably, Rouwenhorst’s and Gorton’s paper had a tremendous impact on commodities as an asset class,” says Christiaen van Lanschot, who runs commodity hedge fund VOC Capital Management.

Lately the rewards from diversification, from investments tracking commodity indices at least, have been elusive.

As the S&P 500 lost 38 per cent in 2008 amid the worst recession since the 1930s, the GSCI fell 46 per cent.

Prof Gorton says: “So if you’re an investor, what do you conclude from that? That I shouldn’t be in stocks or commodities, that I should just put my money under my bed?”



Investor inflows into commodities have come after central banks increased money supply to stimulate the economy. That has also drawn investors into commodities, especially gold – which recently hit a record above $1,200 an ounce – and oil as inflation hedges.

The professors' paper also found commodities nicely track unexpected inflation, a risk Prof Gorton highlights with a 10bn Zimbabwe-dollar note framed on his office wall.

But Prof Rouwenhorst, 49, warns of the relative volatility in commodity markets. "Commodity prices do this," he says, chopping the air with his right hand. "Inflation does this," he adds, lifting his arm in a gentle upward slope. "Over the short run, there's just no hope."

After commodity indices faltered in the recession, a record $68bn in investor money flowed into commodities last year, according to Barclays Capital.

The researchers say they once sought data from the Commodity Futures Trading Commission, the US regulator, to examine the impact of traders' positions on commodity markets, but their Freedom of Information request was denied.

"We haven't pursued this because it's pretty clear that it's become a political question and no one cares about the evidence," Prof Gorton says.

Since "Facts and Fantasies" appeared, large investors' approaches to commodities have spread beyond passive strategies into more deliberate approaches. Another of the papers the scholars co-authored says "commodity trading advisers", a type of hedge fund, showed dubious performance.

Prof Gorton says it is hard to know if commodity markets are inefficient and thus ripe for active trading strategies. "You have to think there's low hanging fruit out there in active strategies. But I wouldn't recommend to any institutional investor that they do an active strategy unless they really understand that it's riskier."