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RESEARCH BRIEF
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FOOL ME TWICE...

History doesn't repeat itself, but it does rhyme.
– Unknown

In the last five years, commodity allocations in model portfolios have moved from being exotic to commonplace. The benefits being sought by such allocations typically include protection against inflation and diversification. While we recognize that commodity allocations can serve both of these roles handily, the manner in which some clients are implementing these strategies potentially reduces, or removes entirely, these sought after benefits. ▸▸

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That is, by choosing an active commodity strategy (including the variety of "active indexes" which are being promulgated at an astounding rate), clients are investing in strategies which include significant deviations from the benchmark (e.g. underweighting or eliminating contracts based on term structure properties or momentum characteristics). In many cases, these strategies also invest the underlying collateral in a very aggressive manner. In contrast, the inflation protection and correlation relief which motivates these allocations are typically based on index returns. In many cases, it is hard to reconcile the bets taken in these active strategies with the intended purposes of the allocation. In fact, a lesson can be learned from an eerily similar situation in recent memory, namely, the allocation to fixed income in institutional portfolios.

▸▸ FOOL ME ONCE

Most asset allocation studies for institutional clients done in the last ten years use the Barclays Capital US Aggregate Index as a proxy for bond portfolios. This proxy has historically demonstrated low volatility and displayed remarkable diversification properties versus equity investments (commonly expressed as "when stocks go down, bonds go up"). Based on these characteristics, a very common asset allocation for defined benefit plans was 60% equity / 40% fixed income. However, once this allocation was determined, a funny thing happened. Instead of hiring bond managers with low tracking error or with mandates restricted to index securities, institutional clients increasingly invested in so-called "Core Plus" mandates. These strategies, while benchmarked to the Aggregate Index, were allowed to invest in risky, out-of-index sectors (junk bonds and risky mortgage bonds), to use leverage to various degrees (long /short basis trades, synthetic cash), and to aggressively underweight the Treasury sector, due to its perceived "low return" characteristics. While these choices are all defendable in a total return sense, many clients never examined the impacts these active decisions had on the correlation and volatility properties which underlay their investment in this asset class.

In 2008, the diversifying and low volatility properties of fixed income were called upon, and, true to expectations, the broad bond index delivered. While the S&P index dropped -37.0%, the Barclays Capital US Aggregate Index returned 5.2%—indeed, when stocks dropped, bonds went up. However, investors in Core Plus did not even remotely experience index returns. PIMCO, BlackRock and Western Asset Management, the three largest bond managers in the US, had Core Plus strategies which delivered returns of, respectively, 3.8%, -1.8%, and -9.9% (i.e. "excess returns" of -1.5%, -7.0%, and -15.2%).[1] Although a large part of the damage was incurred by investing in risky, non-index securities, as much was incurred by the strategic underweight to the "low return" Treasury sector, which ended up being one of only a handful of asset classes to appreciate over 2008. To be clear, we are not critical of these money managers. They were managing the bond portfolios to risk characteristics provided by their clients. What we want to emphasize is that through the pursuit of total return, Core Plus mandates failed to

[1] P&I / eVestment Alliance; "Bonds triumvirate dominance erodes", Aug 24 2009, Pension & Investments; http://www.pionline.com/article/20090824/PRINTSUB/308249944

deliver the diversification and volatility behavior that motivated most institutional investors' allocation to bonds in the first place.

LESSONS FOR COMMODITIES

What can be learned from the above? First, if an investor decides to go active in an asset class, then it is imperative to ensure that this action does not undermine the desirable properties that are being sought from that asset class. Far too many commodity strategies have concentrations in a handful of contracts, while holding zero weights or short positions in others. It is easy to construct scenarios in which such strategies will not provide inflation protection, especially if inflation is first expressed in the underweight contracts. Second, obvious underweights to “low return” index components are not always rewarded over the long haul. Similar to Treasuries in bond portfolios, we see selection algorithms which may cause near-static underweights to various commodity sectors and contracts. While these decisions are sensible in a total return context, they seem to do so at the expense of the long-term inflation protection or diversification properties of the asset class. Third, if asset allocation decisions are based on index behavior, then deviations from the benchmark should be well understood. If these deviations are too extreme, then the commodity strategy should be back-tested anew to see if it has indeed sacrificed inflation protection or low correlation in its pursuit for total return. Mainstream commodity benchmarks assume collateral is invested in T-Bills, while many active managers instead invest these monies in TIPS, emerging market debt, or currencies. It is doubtful that these investment decisions do not have some impact on how the commodity strategy will perform in times of equity market declines. This highlights the fact that many investors make their asset allocation decisions separately from their active/passive decisions. This separation can undermine the intended benefits from the asset allocation process at those times when they are needed most.

The PPA Structured Commodity Strategy focuses on diversification within the commodity asset class and low portfolio volatility. This broad based exposure seeks the benefits of the commodity asset class in a transparent, rules-based manner. Avoiding surprises, both positive and negative, lowers the chance of being twice fooled.

ABOUT PARAMETRIC

Parametric is an industry-leading provider of structured portfolio management, headquartered in Seattle, Washington. Parametric and its affiliate, Parametric Risk Advisors, offer a variety of structured portfolio solutions, including customized core equity portfolios (U.S., Non-U.S., global), options strategies, and overlay portfolio management.