

COMMODITY EXPOSURE THROUGH SWAPS: Risk & Cost Considerations

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INVESTMENT STRATEGY:

- Seeks to avoid the concentrations that occur in mainstream commodity indices by investing broadly across commodity types and sectors.
- Maintains target weightings and allocation through regular rebalancing, in order to get a broad, long-only representation of all commodity sectors.
- Remains aware of implicit and explicit trading costs, so the benefits of the commodity asset class accrue to the investor.

ABOUT PARAMETRIC:

- Registered Investment Advisor based in Seattle, Washington
- Leader in structured portfolio management
- More than 20 years' experience specializing in structured portfolio management
- 92% ownership by Eaton Vance Corp

In recent years, more and more institutional investors have added an explicit commodity allocation to their investment policies, providing a much needed inflation hedge to their portfolios. For many, the choice has been made to maintain this allocation at a strategic level, with the plan looking to simply capture the broad performance of the commodity asset class, and not pursue additional alpha through active management. As such, a common solution is to gain exposure via a total return swap, under the rubric of investing in the asset class in an efficient manner while avoiding extreme tracking error. However, several costs and risks inherent in utilizing swaps tend not to receive proper consideration. This causes us to ask the question, then, is it really true that swaps are less expensive or less risky, when all things are considered?

1) Tied to Broken Indexes

Index providers have struggled when it comes to defining a metric similar to that of market capitalization for equities. The mainstream indexes are, simply put, very explicit commodity trading strategies based on arbitrary metrics for measuring the importance of a commodity. This has resulted in indexes which have significant concentrations (e.g. S&P GSCI® has close to 50% in two crude oil contracts) and overly explicit trading rules which allow front running by more active market participants. The majority of commodity swaps are based on these mainstream indexes, which exposes the swap user to these risks. While many swap users have moved from the "vanilla" varieties of these indexes to their more nuanced relatives with longer roll periods or which use back instead of front contracts, these still represent sub-optimal portfolios in terms of concentration risk. Further, any published index has to include their trading rule for rolling futures. Because of this, any index that gathers a large amount of swap-based AUM will be undermined by the front-running behavior of other traders. Parametric's Structured Commodity strategy is designed to utilize sector and commodity diversification to flatten out the arbitrary concentrations contained in most indexes. It also employs trading rules which are flexible enough to avoid prediction by third parties, and opportunistically takes advantage of the trading flows of passive mandates. By exploiting the concept of volatility capture, the Structured Commodity strategy seeks lower volatility than the mainstream indexes, over the long run.

2) Counterparty Risk

Swaps are over-the-counter derivatives, and because of this, swap users are exposed to significant counterparty risk. With 2008 still squarely in the rearview mirror, the events that unfolded dramatically highlight the fact that mitigating this risk is an almost impossible task. While the collateralization process ensures that the majority of mark-to-market gains are not lost when a counterparty goes bankrupt, a more serious concern is re-establishing exposure once such an event takes place. After the Bear Stearns and Lehman bankruptcies, former holders of these banks' swaps found it nearly impossible to re-establish similar swaps with new counterparties, or, at the very least, had to pay a large premium to do so. Because of this risk, Parametric's Structured Commodity strategy primarily utilizes futures for establishing its commodity positions. Given the clearinghouse mechanism present in the futures markets, all futures contracts face dramatically reduced counterparty risk when compared to swaps. In fact, futures remained liquid and low cost vehicles for commodity investing throughout the events of 2008.

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3) Cost

While swaps for mainstream indexes typically trade at very tight spreads, as soon as any customization is required, these costs increase dramatically. In discussions with counterparties we have seen costs for swaps based on 2nd contract and/or longer roll periods escalate to spreads of 60bps or higher. But this only accounts for the explicit spread costs – there are many unseen costs in running a swap program, including hidden trading costs/slippage, staff time spent monitoring counterparties and managing collateral, trading and portfolio management systems for derivatives, risk management, etc. Parametric acts like a strategic partner, providing a structured, but flexible, exposure to the commodity asset class, with fees meaningfully below that of many other solution sets.

4) Operational Burden

The world of over-the-counter derivatives is complex, and requires a large amount of operational support to be effective. Additional expertise in the form of swaps traders and ISDA specialists are essential, as well as additional layers of risk management to ensure that only appropriate investments are being maintained. Such issues are exacerbated by the over-the-counter nature of the swaps market. The lack of an exchange makes pricing of positions an uncertain exercise, while the cashless nature of initiating swaps adds a level of complexity to many plans' cash-flow based risk management practices. Indeed, there is a potential unlimited liability if a derivative trade is mis-communicated or mis-understood. Parametric's Structured Commodity strategy significantly reduces this burden, allowing the investor to leverage our tested operational capabilities.

After weighing the above factors, we return to our original question, whether swaps are really less expensive or less risky? When considering a broad commodity exposure, one finds that swaps are based on indexes which are poorly conceived, and which have high explicit costs for anything but a vanilla exposure. Even for those instances where a swap is offered at a low spread and is based on a sensible index, there are still the issues of counterparty risk and operational burden to consider. For most institutions, these risks are tangible, and undercut the very purpose of going the swap route in the first place. Because of this, we offer Parametric's Structured Commodity strategy as a compelling alternative to swaps for those plans looking for a low-risk, low-cost strategic exposure to the commodity asset class.

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