Long-Only Commodities Add Return? That's Bull…..

Exchange-traded and other long-only commodity funds have grown fast in numbers and assets. Here is a timely discussion of this topic by Ira Kawaller, the founder and president of Kawaller & Co. and managing partner of Kawaller Fund, a commodity pool. The firm assists commercial enterprises in the use of derivative instruments.

Mr. Kawaller has a PhD in economics and was vice president-director of the New York office of the Chicago Mercantile Exchange before he started his firm. He has held positions at J. Aron & Company, AT&T and the Board of Governors of the Federal Reserve System.

Ira Kawaller

"In effect, a long-only commodity program makes a persistent bet that the consensus forecast … chronically under-estimates … any prospective price change. "

If you're one of those investors who've bought into the view that you should own commodities as a way to diversify an otherwise traditional investment portfolio, you've been duped. The fact that funds with this orientation boast gains over extended periods – even extraordinary gains – is no justification. Every dog has his day, and this strategy is a dog.

The selling point for including any alternative asset in an investment portfolio is that it enhances the yield or lowers the risk of the overall portfolio. Critical to this goal is
(a) that the expected returns from this addition will be higher than that of the portfolio without it, and
(b) the returns from this class are largely uncorrelated with the other assets.

It is the first condition that's problematic. I don't think it's appropriate to expect a long commodity position to necessarily add return – let alone incrementally higher return.

My skepticism derives from the fact that most of these programs rely on futures contracts to satisfy their objectives, but they fail to recognize the inherent nature of futures. Understanding how futures work exposes the lie in the promise of these programs.

Futures vs. Spot Prices

The appeal of futures is understandable. They're actively traded with the attributes of great liquidity (for major commodity categories) and extraordinary price transparency, but that just isn't enough. For the vast majority of non-financial commodities (precious metals being a notable exception), futures pricing reflects consensus expectations as to where spot prices will be as of the futures delivery date(s).1

Thus, a long (short) position in a commodity futures contract doesn't reflect the view that spot prices will necessarily rise (fall). Rather, a futures position reflects a contrarian view relating to consensus expectations.

At the start of the transaction, the difference between the futures price and the spot price – henceforth, the basis – reflects the prevailing consensus as to the expected spot price change over the remaining life of the futures contract. A futures price trading at a premium to its associated spot price reflects a consensus view that the spot price of this commodity will rise. Similarly, a futures price trading at a discount to spot reflects a consensus view that spot prices will fall.

Buying or selling the futures contract is a bet related to the size of this forecast spot price change. For instance, suppose you bought the futures contract at, say, 105 when the spot price was 100. If held to expiration, this trade becomes profitable only if the spot prices rise by more than 5. The short futures position, on the other hand, wins only if the spot price doesn't rise by more than 5. If the spot price change equals 5, you break even.

Clearly, when basis conditions are at or near zero, one might be tempted to disregard this concern; but most commodities aren't like that. Strong seasonal patterns exhibited in many markets (e.g., virtually all agricultural markets and most energy markets) makes this consideration paramount.

In fact, every futures trader must necessarily be a contrarian. Long futures traders must believe the consensus forecast reflects a forecasted price that is too low; short futures traders must believe the consensus forecasted price is too high. Without a willingness to challenge the consensus, there's no reason to trade.

Long-Only Bets

Interestingly, the preponderance of academic literature supports the view that futures markets are unreliable predictors of future price moves. More pointedly, the current spot market price is generally seen to be a superior forecast of the coming spot price, relative to the current futures price. Put another way, if you had to pick either the spot price or the futures price as the better forecast, the academic literature says to go with the spot price.

Accepting this premise leads to viewing the basis as a useful tool in choosing whether to buy or sell. The futures price trading at a premium to spot offers the short position an edge; and similarly, the futures price trading at a discount to the spot offers the long position an edge.2

I'd be the first in line to say that it's not reasonable or appropriate to apply this trade selection processes blindly or indiscriminately. (I've actually made that mistake!) The basis is certainly important, but it may not be overriding.

My own fund is sensitive to these basis considerations, but it takes the concept one step further. The basis considerations described above serve as a preliminary determinant of our positioning. Our portfolio, however, restricts positions to long options on futures. Specifically, when the basis offers an edge to long futures, we buy call options. When the edge favors short futures, we buy put options. In both cases, though, our trading criteria further require that the basis considerations (which necessarily are favorable to our positions) dominate relative to the prospective loss from option time decay.

With these criteria, we have the starting condition (known with certainty) that if the spot market remains unchanged, our option positions will appreciate. Thus, we enjoy the typical attributes of options – i.e., limited risk with unlimited gain potential – while at the same time having the added benefit of reliably being able to make gains when spot market prices remain stable.

The heart of my criticism of the long-only commodity funds is that they take long positions irrespective of any consideration of the basis. In effect, a long-only commodity program makes a persistent bet that the consensus forecast implied by the futures basis chronically under-estimates the magnitude of any prospective price change. That's patently ridiculous.

While the neophytes to the market may be excused for not appreciating this issue, I'm less charitable to market professionals who should know better.

Notes:

[1] The spot price it the price of the commodity relevant for imminent delivery, while the futures price reflects a price appropriate for a prescribed, more-deferred delivery date.

[2] This same issue applies to hedgers as well as traders. The short hedger able to sell futures at a premium to spot enjoys an incremental benefit from hedging, as does the long hedger who is able to buy futures at discount. In contrast, the long hedger facing market conditions that require buying at a premium and the short hedger facing selling at a discount suffer an incremental cost.