MYTH-BUSTING: TOP 6 MISCONCEPTIONS ABOUT COMMODITIES

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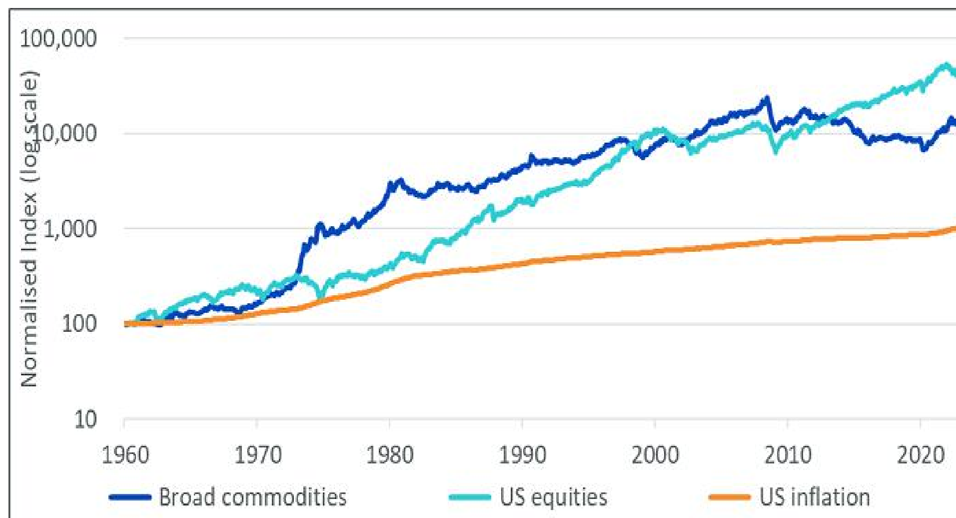
WisdomTree has long-standing expertise in commodities, and this asset class constitutes a core part of our business. We aim to debunk several myths that surround commodity investing[1].

Myth 1: Commodities are only a tactical instrument

Some believe that commodities trade in a range and do not outperform over the long term. Furthermore, they think commodities only outperform in an 'up' phase of a commodity 'super-cycle'.

Physical commodities are the fundamental building blocks of our society. Therefore, it is no surprise that their price movements largely explain inflation and tend to at least match inflation over the long term.

Figure 1: Long-term outperformance of commodities and equities vs inflation



Source: WisdomTree, Bloomberg, S&P. January 1960 to July 2023. Calculations are based on monthly returns in USD. US Equities stands for S&P 500 gross TR Index. Broad commodities stands for Bloomberg commodity TR index. US Inflation stands for US Consumer Price Index Urban Consumers Seasonally adjusted.

Historical performance is not an indication of future performance and any investments may go down in value.

Furthermore, commodity investors most often invest in futures contracts, not physical commodities. Futures contracts have been designed as hedging tools to allow commodity

producers and miners to hedge their production forward, making their businesses sustainable and allowing them to invest because they are insulated from the commodity prices' short-term volatility.

Producers are willing to pay for this hedge, just as they would pay for insurance. Therefore, investors who provide this hedge by buying futures contracts receive an insurance premium that allows them to beat inflation over the long term. This 'insurance' is a permanent feature of commodity futures and doesn't fall away through economic cycles. Thus, commodity futures are suitable for consideration as a strategic investment, not just tactical investments.

Commodities futures provide a positive risk premium, driven by their intrinsic link to inflation and embedded 'insurance premium'. While upward phases of commodities' super-cycle are historically advantageous for commodity investors, future-based broad commodity investments can deliver a risk premium in any part of a super-cycle.

Myth 2: Losses are guaranteed when commodities are in contango

Contango (negative roll yield) and backwardation (positive roll yield)[2] are used to describe the state of the futures curve. It describes the relative position of the current spot price and the futures contract price. Drivers of roll yield include storage costs, financing costs, and convenience yield. Backwardation is often associated with demand strength when people are willing to pay more for immediate delivery than lock into a contract for later delivery at a cheaper price. Some believe that, because contango is the opposite state of backwardation, losses are guaranteed as a corollary.

The fact that Keynes' theory is called 'normal backwardation' has caused some terminology confusion. However, what is described by Keynes is that futures contracts are generally priced at a discount to the expected spot price at expiry. It has nothing to do with the current spot price. In other words, the curve can be in contango, and the future price can still be at a discount to the expected spot price at maturity, that is, be in normal backwardation as well.

Using a numerical example, let's say that WTI Crude Oil is worth $50 today. The market expects WTI Oil to trade at $55 in a month (expected spot price) because of storage and other costs. Keynes' theory hypothesis is that the 1-month futures contract will be priced at a discount to $55, let's say $54, to incentivise speculators to provide the hedge to producers. In this situation, the curve is in contango ($54>$50), and the expected risk premium is still positive at $1.

So, a curve in contango and a positive risk premium can coexist.

While the shape of the curve has an impact on the performance, it is not a good predictor of future performance.

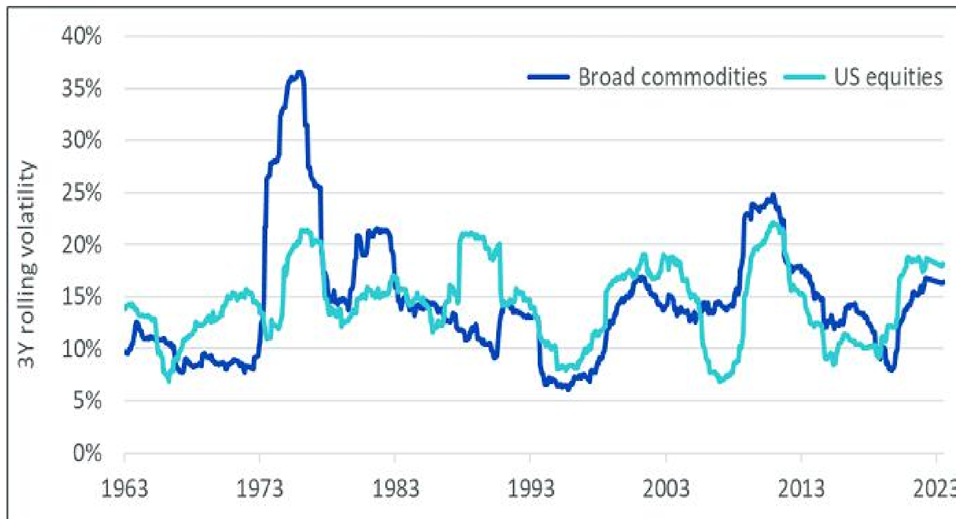
Myth 3: Commodities are riskier and more volatile than equities.

There is a common perception that commodities are riskier than equities.

Equities and commodities are similar asset classes statistically. Their historic returns and volatility are quite close. Historically, commodities have exhibited higher volatility than equities in 42% of the 3Y periods since 1960. However, in a larger number of periods (58%) equities have shown higher volatility.

More importantly, the two assets' distributions differ from a normal distribution with a significantly higher skew. But commodities have the advantage. They exhibit a positive skew (a tendency for higher-than-expected positive returns), when equities are known for their negative skew (their tendency to surprise on the downside).

Figure 2: Commodities and equities 3Y annualised rolling volatility over time



Source: WisdomTree, Bloomberg, S&P. January 1960 to July 2023. Calculations are based on monthly returns in USD. US Equities stands for S&P 500 gross TR Index. Broad commodities stand for Bloomberg Commodity TR index.

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Commodities have exhibited lower volatility than equities in 58% of the time rolling 3-year periods we studied and benefit from positive skew.

Myth 4: Commodities stopped being an effective diversifier after the 2008 Global Financial Crisis presented a structural break in commodity price relationships

Markets are becoming more and more efficient. With those changes, assets have become more correlated. Looking at Figure 3, it is clear that commodities have been more correlated to equities in the last 10-20 years than before. However, this is true of most asset pairs as well. US equities are more correlated to global equities. Equities are more correlated to high yield bonds. In a globalised world where correlations are more elevated, commodities still stand out for their lower level of correlation.

Figure 3: Correlation over different time horizons between main asset classes

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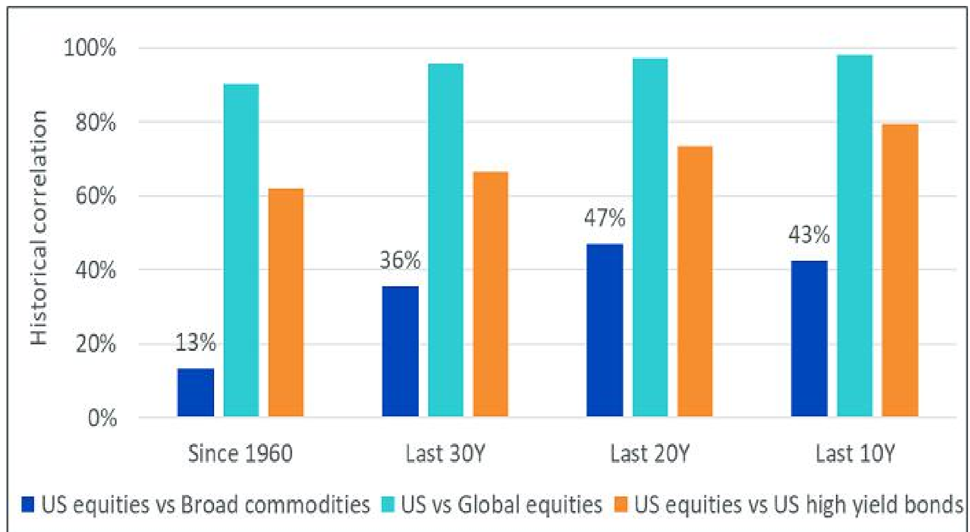

Source: WisdomTree, Bloomberg, MSCI, S&P. January 1960 to July 2023. Calculations are based on monthly returns in USD. Broad Commodities (Bloomberg Commodity total return index) and US Equities (S&P 500 gross total return index) data started in Jan 1960. Global equities (MSCI world gross total return index) data started in Dec 1969. US high yield bonds (Bloomberg US corporate high yield total return unhedged USD index) data started in July 1983.

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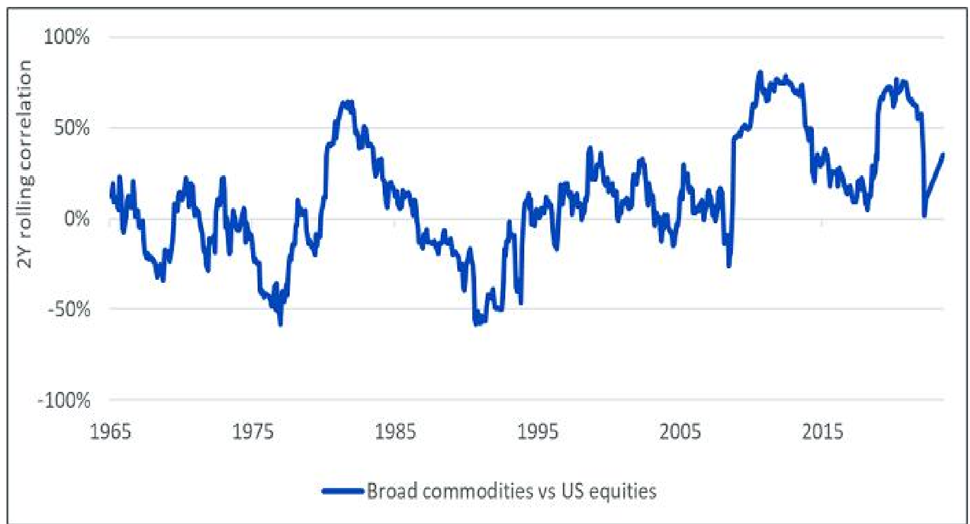
Note, commodities have continued to provide a cushion against equity and other asset crises in recent periods. For example, in 2022, commodities rose 16%, while US equities[3] fell 18% and bonds[4] fell 16%.

While 2008 marked an all-time high for the correlation between equities and commodities, their correlation has always oscillated. There have been earlier spikes of similar magnitude in the 1960s and 1980s. In 2020, we saw a similar spike in correlation, but correlations have more than halved since in 2023.

Figure 4: 2Y rolling correlation between broad commodities and US equities



Source: WisdomTree, Bloomberg, S&P. January 1960 to July 2023. Calculations are based on monthly returns in USD. Broad Commodities (Bloomberg Commodity total return index) and US Equities (S&P 500 gross total return index) data started in Jan 1960.

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Commodity vs equity correlation tends to oscillate and has remained within normal historical ranges.

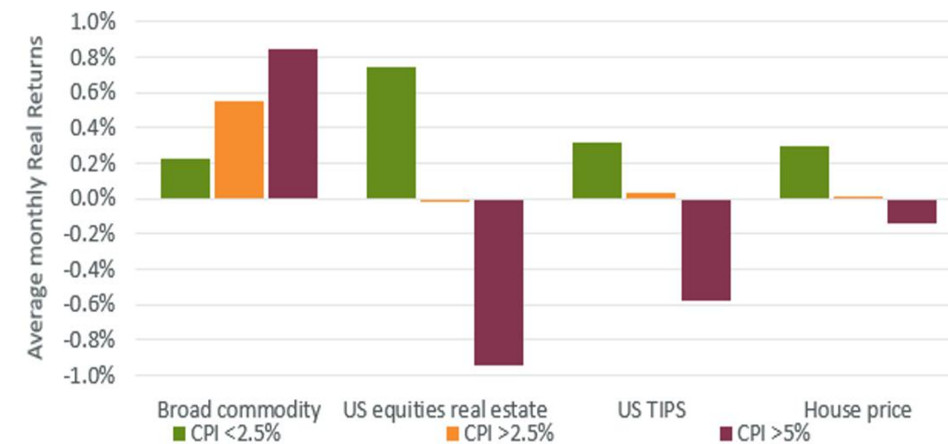
Myth 5: Inflation linked bonds are better than commodities at inflation-hedging

Some assets are often considered good inflation hedges, such as inflation-linked bonds (TIPS) or real estate. However, it is surprising that more people don't recognise the superior inflation-hedging properties of commodities.

The beta to inflation (US Consumer Price Index (CPI)) of inflation-linked bonds and real estate, historically, is significantly lower than that of commodities (2.4[5]): US TIPS (0), US Equity Real Estate Sector (1), House Prices (0.4). Furthermore, while broad commodities' average monthly performance tends to increase when the CPI increases, this is not the case for other assets. The performance of TIPS appears to be relatively unrelated to the level of CPI. The performance of real estate, being equities or real assets, seems to worsen when the CPI increases.

The ability for commodities to hedge unexpected inflation is what separates the asset class from others (see [Sensitivity of asset classes to inflation](#)).

Figure 5: Asset class performance in varying inflation regimes



Source: WisdomTree, Bloomberg, S&P. January 1960 to July 2023. Calculations are based on monthly returns in USD. Broad Commodities (Bloomberg Commodity total return index) and US Equities (S&P 500 gross total return index) data started in Jan 1960.

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Real estate suffers from the fact that, while rental incomes are linked to inflation (rents are part of the CPI basket, for example), the capital values themselves are not, and yet have a larger impact on the asset's price. Similarly, inflation-linked bonds are linked to inflation, but their price is also tied to real yields changes (through a duration multiplier) which tends to dilute the relationship to inflation itself.

Historically, commodities have been a better hedge to inflation than TIPS or real estate assets.

Myth 6: Futures are the best way to access gold for institutional investors

Futures markets tend to be extremely liquid and offer very low transaction costs. Therefore, investors assume that, if they can, it is always the most efficient way to implement a trade.

However, futures markets respond to their own constraints where banks tend to provide most of the hedging. Recently, banks have suffered from increasing regulation and operating costs that they have translated into their pricing of futures contracts, leading to significant tracking differences with the physical asset. Sometimes futures contracts are the only way to access a commodity, but for precious metals this is not the case.

For gold, this cost has, historically, represented 0.9%[6] per year on average compared to owning gold bullion. Physically backed exchange-traded commodities (ETCs) have many advantages: limited operational burden, reduced tracking difference, cheap and liquid.

Figure 6: Gold ETC and futures contracts comparison

	Physically Backed ETC	Futures contracts
Legal Structure	Listed Debt Instrument	Listed Derivative Contract
Funding Requirement	100%	Margin of 5 to 10%
Tracking Error	Effectively zero	Depends on market condition and supply and demand dynamics in the future markets
Trading	On-exchange or Over the Counter (OTC)	On-exchange or Over the Counter (OTC)
Transaction Costs	Commission and bid-offer spread on entry and exit	Commission and bid-offer spread on entry and exit as well as on roll every two months
Holding Costs	Total Expense Ratio	Depends on market condition and supply and demand dynamics in the futures markets
Operational Constraints	Similar to equity shares	Margin monitoring and rolling of contracts six times a year

Source: WisdomTree. September 2023.

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With low fees and very liquid trading, physically-backed precious metals ETCs very often outperform investments in futures.

It is clear that commodities are a frequently misunderstood asset class, and many misconceptions remain today. For a fuller description of the fundamentals of commodity investing, please see The Case for Investing in Broad Commodities.

Sources

[1] These myths were all addressed in The Case for Investing in Broad Commodities, November 2021, which takes a deep dive into commodity investing. This blog summarises and updates data addressing several of the 'misconceptions' listed in the piece.

[2] For more information on contango and backwardation, see our educational ETPedia hub (specifically the 'Costs and Performance' tab).

[3] S&P 500 TR.

[4] Bloomberg GlobalAgg Index (government, corporate and securitised bonds, multicurrency across developed and emerging markets).

[5] Source: WisdomTree, Bloomberg, S&P, Kenneth French Data Library. From January 1960 to July 2023. Calculations are based on monthly returns in USD. Broad commodities (Bloomberg commodity total return index) data started in Jan 1960. US TIPS (Bloomberg US Treasury Inflation-linked total return bond index – Series L index) data started in March 1997. US Equity Real Estate (S&P 500 Real Estate sector total return index) data started in October 2001. US House Price (S&P Corelogic Case-Schiller US National Home Price seasonally adjusted index) data started in January 1987. **Historical performance is not an indication of future performance and any investments may go down in value**

[6] Source: WisdomTree, Bloomberg. From 4 June 2007 to 31 July 2023. The Performance of the physical Gold was observed at 1.30 PM Eastern Time to match the BCOM sub-index calculation time. **You cannot invest in an Index. Historical performance is not an indication of future performance and any investments may go down in value.**

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