
BROAD COMMODITIES: DOES AN OPTIMISED STRATEGY STILL MAKE SENSE?

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Investors in broad commodity ETFs have been well rewarded over the past year with the Bloomberg Commodity Index, a popular benchmark for these strategies, up over 7% since last June. This reflects strengthening commodity fundamentals with global demand still robust and supply tightness evident in some metals. Given the resulting backwardation in some commodities, does an optimised commodity strategy still make sense for investors?

Dissecting broad commodity strategies

As a quick recap, there are typically two types of broad, diversified commodity strategies:

- **Front-month strategies**, such as the Bloomberg Commodity Index (BCOM), which derive exposure to futures at or close to the front of the futures curve
- **Optimised strategies**, such as the Optimised Roll Commodity Index, which pick the most optimal futures contract per commodity to invest in based on implied roll yield

Since front-month strategies allocate to futures closest to the front of the curve, they typically display higher sensitivity to spot price movements relative to optimised peers. By contrast, optimised strategies focus more on managing roll yield by positioning further out in the futures curve for commodities in contango, and nearer the front of the curve for commodities in backwardation.

In theory, front-month strategies should outperform when commodity prices rally sharply but underperform when commodity prices crash. But just how have these strategies performed recently given the strong price appreciation across commodities?

The Bloomberg Commodity Index (BCOM) was up 7.4% since June 2017, benefitting from the strong rebound in oil prices and industrial metals. However, the Optimised Roll Commodity Index, an optimised version of the BCOM, was up 8.7% over the same period, outperforming by 130bps.

Managing roll yield to boost returns

Why did the BCOM index underperform despite the bullish environment for commodities?

To answer this, we can look at Figure 1.

Figure 1: Implied roll yield for BCOM commodities

Commodity	Futures Contract Month																							
	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	
Energy	WTI	2.3%	2.2%	1.1%	1.0%	0.9%	1.0%	0.9%	0.8%	0.7%	0.7%	0.8%	0.7%	0.6%	0.6%	0.6%	0.5%	0.6%	0.6%	0.6%	0.5%	0.5%	0.5%	0.6%
	Brent	0.3%	0.3%	0.4%	0.3%	0.6%	0.6%	0.7%	0.6%	0.7%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.5%	0.5%	0.5%	0.5%	
	Heating Oil	0.0%	-0.3%	-0.3%	-0.2%	-0.2%	-0.2%	0.1%	0.4%	0.7%	0.4%	0.2%	-0.2%	-0.3%	-0.4%	-0.2%	-0.2%	-0.4%	-0.7%	0.0%	-0.3%	0.3%	0.3%	
	Gasoline	1.3%	0.9%	5.6%	1.4%	0.9%	0.2%	-0.2%	-0.6%	-7.7%	0.0%	0.7%	1.1%	1.2%	1.4%	7.1%	1.2%	0.3%	0.2%	-0.3%	-0.8%	-8.5%	0.3%	
	Natural Gas	0.8%	-0.2%	-1.4%	-3.5%	-2.6%	1.2%	3.2%	12.3%	14%	-1.1%	-1.2%	-0.3%	0.3%	-0.8%	-2.0%	-4.5%	-3.2%	1.1%	0.2%	12.4%	1.1%	-1.1%	
Industrial Metals	Copper	-0.5%	-0.7%	-0.7%	-0.4%	-0.3%	-0.3%	-0.3%	-0.3%	-0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
	Aluminium	1.7%	-0.2%	-0.2%	-0.2%	-0.1%	0.0%	-0.1%	-0.1%	-0.1%	0.0%	0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	
	Zinc	1.0%	0.2%	0.3%	0.2%	0.1%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	
	Nickel	0.2%	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	
	Corn	-2.6%	-3.2%	-2.6%	-1.7%	-1.6%	0.2%	-1.3%	-2.4%	-1.5%	-1.3%	1.7%												
Agriculture	Soybean	-0.6%	-0.7%	-1.2%	-1.0%	-0.6%	-0.9%	-0.9%	0.0%	0.7%	0.2%	-0.6%	-0.2%	-0.4%	-0.8%	-0.1%	0.7%	1.5%						
	Coffee	-3.1%	-2.9%	-2.9%	-1.9%	-1.9%	-1.7%	-2.3%	-2.2%	-1.3%	-1.3%	-1.2%	-1.6%	-1.6%	-1.2%									
	Sugar	-3.2%	-5.4%	-0.7%	-0.8%	-1.3%	-3.7%	-0.2%	-0.3%	-1.4%	-2.5%													
	Wheat	-0.7%	-3.0%	-2.9%	-2.1%	-0.9%	-1.4%	-2.2%	-1.4%	-0.6%	0.2%													
	Kansas Wheat	-3.6%	-4.5%	-3.5%	-2.3%	-1.5%	-2.3%	-2.9%	-0.6%	0.6%														
Precious Metals	Cotton	0.2%	1.5%	0.3%	-0.1%	-0.1%	6.0%	2.4%	0.2%	0.7%	0.0%	1.6%	0.6%	0.2%										
	Lean Hogs	8.4%	27.9%	9.6%	-8.7%	-7.6%	-8.0%	-4.8%	0.7%	1.2%	20.0%	6.1%												
	Live Cattle	0.3%	-3.0%	-3.2%	-2.3%	-0.8%	6.5%	1.1%	-1.4%															
	Soybean Meal	0.5%	0.0%	0.2%	0.1%	0.6%	1.5%	0.4%	-0.8%	0.0%	0.1%	0.8%												
	Soybean Oil	-0.4%	-0.4%	-0.4%	-0.9%	-0.8%	-1.1%	-1.0%	-1.0%	-0.4%	-0.4%	-0.2%												
Precious Metals	Gold	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-1.5%	-1.5%	-1.5%	-1.4%	-1.4%	-1.4%	-1.3%						
	Silver	-0.6%	-0.7%	-0.7%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-1.3%	-1.5%	-1.3%	-1.5%	-1.2%									

Source: WisdomTree, Bloomberg. Data as of 30/06/18

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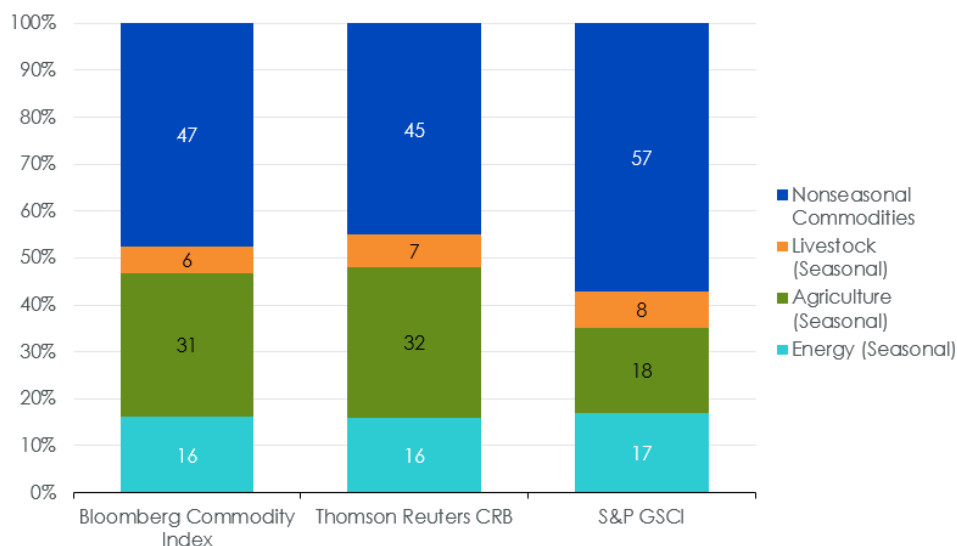
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Here, we showcase the implied roll yield for each commodity in the BCOM index as of June 2018 (calculated as the price differential between consecutive contract pairs). Commodities coloured green, such as WTI oil and zinc, are in backwardation, and have a positive implied roll yield. Commodities coloured red, such as copper, coffee and nickel, are in contango, hence incur a negative implied roll yield.

Across the basket, most commodities are in contango despite improving fundamentals. This means that roll yield still presents a drag on returns overall, and indeed was a drag on returns over the past year. For front-month strategies this drag would have been more pronounced since contango is typically steepest at the front of the futures curve where these strategies are positioned. An optimised strategy, by contrast, would have mitigated this impact by systematically positioning where roll yield can be minimised.

This is an important concept since many commodities almost always exhibit some contango due to seasonal demand and supply factors. This seasonality is present in the likes of natural gas, gasoline and grains for example, and can comprise roughly half of the basket of broad commodity strategies, as shown in Figure 2. Hence, managing this impact over time with an optimised approach presents a distinct advantage for investors irrespective of underlying market conditions.

Figure 2: 50% of broad commodity baskets are seasonal commodities



Source: WisdomTree, Bloomberg. Based on latest available index holdings as of 16/07/18.

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