

COTTON, CORN AND COPPER: CAN COMMODITIES BENEFIT YOUR PORTFOLIO?

The Atlantic Trust Multi-Manager Investment Team

consists of dedicated analysts and strategists with expertise in traditional equities and alternatives, including hedge fund, private equity and private real estate investments. We conduct in-depth qualitative and quantitative analyses to select managers most likely to sustain strong long-term investment performance, as well as actively monitor performance of these recommended managers against their peers and appropriate market indices.

Until recently, investing directly in commodities typically had been a small part of investors' overall asset allocation. Many investors chose investing in equity or debt issued by companies involved in the exploration or production of commodities as the primary means of obtaining commodity exposure. But as more and more of the emerging world progresses toward developed world status, the need for everything from wheat and corn to feed the population to steel and energy, which are the backbones of infrastructure and transportation, has increased tremendously. Along with it, the importance of the asset class has also risen, leading to more significant allocations by investors.

It comes as no surprise then that as investors search for ways to improve the overall risk-adjusted returns of their portfolios they are looking more to commodities. In fact, roughly 35% of ultra-high-net-worth families intend to reallocate away from fixed-income and increase their allocation to commodities.¹ Given this interest, it's important that investors ask the right questions: What are the benefits and risks of commodities? What is the best way to gain exposure to this asset class? And what is commodities' long-term outlook?

What Are Commodities?

In its broadest sense, a commodity is a reasonably homogenous good or material, bought and sold freely as an article of commerce. Generally, a commodity can be classified as any natural resource or semi-finished manufactured good that has nutritional or industrial value in the production of finished goods.² In addition to the best known of all commodities – gold – commodities include other precious metals, such as silver; agricultural products, such as soybeans, wheat and cotton; industrial metals such as copper and aluminum; and energy products, namely, oil and natural gas.

Commodities are also fungible, meaning that the good is freely exchangeable for or replaceable by another of like kind. Simply put, orange juice is orange juice whether it comes from California or Florida. Lastly, commodities meet the following criteria.

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They are:

- **Liquid** – Each commodity should have an active market with buyers and sellers continually transacting with each other.
- **Tradable** – A practical investment vehicle to help trade it must be available. Most often, futures and swap contracts are used to facilitate trading.
- **Deliverable** – All the commodities need to be physically deliverable.

Because of the high costs involved in storing commodities and because most investors are not looking to take physical delivery of the commodity, futures-based commodity indices are used in order to gain exposure to the market. Atlantic Trust favors the Dow Jones UBS Commodity Index as a primary benchmark, chiefly because the index provides broad-based exposure through 19 diverse underlying commodities. Unlike another widely-used index, the S&P GSCI, which at times can contain 70% in the energy sector alone, the Dow Jones Index will cap the weights of individual sectors. (Please see the appendix for a brief description of the best known indices.) Suffice it to say, there are a number of indices to choose from, each different in its construction methodology and underlying commodities.

Supply and Demand as a Return Driver

Return drivers for commodities are quite different than those of stocks and bonds, and relate to individual supply-and-demand fluctuations. For example, favorable weather normally increases the supply of grains and cotton, with more being made available over a range of prices. With no increase in the quantity of product demanded, there will be movement along the demand curve to a new equilibrium price in order to clear the excess supply off the market. Consumers will buy more, but only at a lower price.

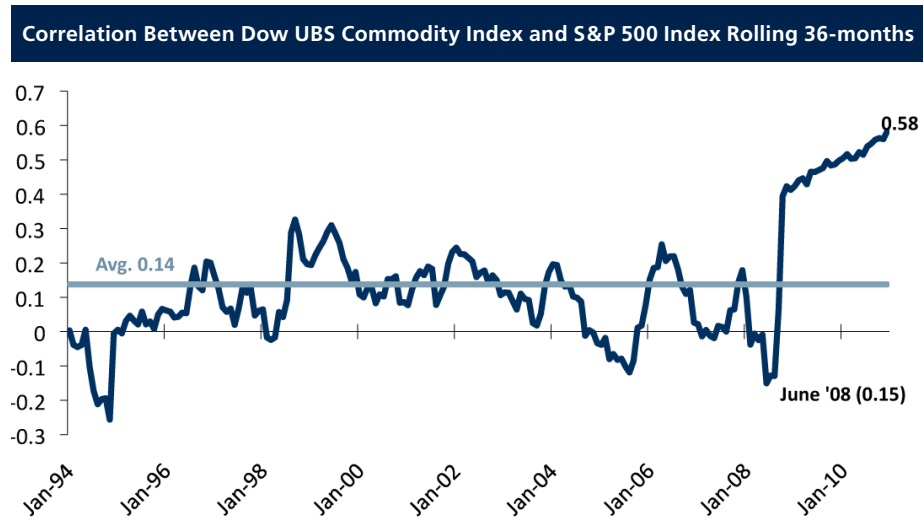
Conversely, poor weather can reduce the overall supply of agricultural products. Russia, for instance, recently experienced a terrible drought that crippled the country's wheat harvest. As a result, the country's leaders instituted a ban on exports in order to have enough wheat to meet domestic demand. This resulted in a decrease in world supply, sending wheat prices to historical highs. Similar issues occurred in Pakistan, where flooding decimated cotton crops and sent prices higher for clothing manufacturers.

Geopolitical issues can be key drivers of return, ranging from tariffs enacted by importing countries to terrorism in oil exporting countries. Fears of inflation or currency depreciation can send investors searching for a proxy to fiat currencies. Gold has recently benefitted from this phenomenon, sending bullion prices skyrocketing.

The Benefit Mix: Diversification, the Potential for Increased Risk-Adjusted Returns and an Inflation Hedge

The main benefit that investors have reaped from investments in commodities is non-correlated returns, leading to increased diversification in client portfolios. While more recently it has seemed that markets are all moving in the same direction, it hasn't always been that way. In fact, through June 30, 2008, the rolling 36-month correlation between commodities and the S&P 500 Index was negative 0.15. However, since that time, correlations have made a significant move upwards.

The great recession drove investors from riskier assets such as equities and tangible assets such as gold and silver and into perceived safe havens such as U.S. Treasuries. From July 2008 through February 2009, commodities and equities both suffered significantly. In addition, when the market rebounded in March 2009, commodities and equities again moved in the same direction as their price levels, and correlations rose significantly.



Source: Zephyr, Atlantic Trust Analysis, December 2010

While both stocks and commodities performed well in 2010, the correlation between the two remains high in the first quarter of 2011. We expect that correlations will slowly revert toward historical levels, which would further enhance the role of commodities as an attractive diversifying asset class.

Because adding commodities can reduce the overall volatility of your portfolio, it has the potential to also increase risk-adjusted returns. One way of evaluating the effectiveness of allocating to commodities in order to improve risk-adjusted returns is to observe the impact on the portfolio’s Sharpe Ratio.³ In the table below, we compare the rolling 36-month periods of two index blends. The first contains a 60%/40% blend of stocks and bonds while the second series adds a 10% allocation to commodities resulting in a 55%/35%/10% blend.⁴

Improvement to Portfolio Sharpe Ratio (January 1994 – December 2010)		
	60/40 Blend	55/35/10 Blend
Average Annualized Return	8.05	7.71
Standard Deviation	11.23	9.70
Sharpe Ratio	0.56	0.60

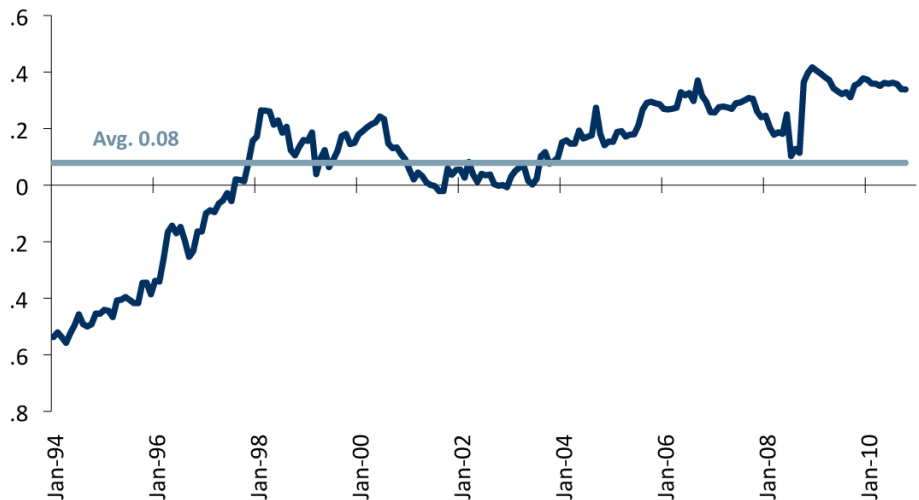
Source: Zephyr, Atlantic Trust Analysis, December 2010. Past performance is not a guarantee of future results. An investment can not be made directly in an index.

By adding commodities to the mix, the portfolio saw its overall risk fall by 14% while giving up only 4% of its annualized return, or 0.34% of relative return. As a result, the Sharpe Ratio of the commodity portfolio rose from 0.56 to 0.60 on average.

A common fear investors have when contemplating an allocation to commodities is that they are volatile. Even though commodities, in isolation, are roughly 41% more volatile than the original stock and bond portfolio, the fact that the correlation between the asset classes is less than 1 means that commodities have the potential to reduce the overall portfolio's risk.

Investors also look to commodities as a hedge against inflation. While academic research is split on how effective a hedge they actually are, there has been an increasing positive correlation between the seasonally adjusted Consumer Price Index (CPI SA) and commodities. Intuitively, it makes sense that as the constituents of the CPI rise in price, so too would the commodity markets. For instance, components of the CPI such as gasoline and fuel oil make up a significant portion of the DJ UBS Commodity Index. In addition, an increase in the price of new vehicles could have been preceded by a rise in manufacturing inputs such as steel, aluminum and plastic (a petroleum product).

Correlation Between DJ UBS Commodity Index and CPI S.A. Rolling 36-months



Source: Zephyr; Atlantic Trust Analysis, December 2010

Regardless of what the research tells us, over the past 15 years, the seasonally-adjusted CPI has risen 2.4% a year while the DJ UBS Commodity Index rose 6.1%, more than offsetting the rise in prices.

Gaining Commodity Exposure

Traditionally, the commodities sector has been more difficult for investors to access. More recently, a growing number of commodity-based funds and exchange traded products have been introduced. The strategies that have been made available range from those that invest in a single commodity such as gold or oil to products that invest in a diversified basket of commodities.

Investors may choose to take a passive approach, using unlevered commodity indices to offset risks in their portfolios from investments in other asset classes, such as equities or bonds. For these investors, exposure to a variety of commodity indices and sub-indices can be achieved by investing in exchange traded funds (ETFs), exchange traded notes (ETNs), publicly-traded partnerships and other structured products designed to track the performance of a specific commodities index. Some investors may also choose to run their own active strategy by utilizing single commodity ETFs in order to tactically set each commodity weight.

The use of exchange traded products has the advantage of allowing an investor to easily participate in the price movement of the underlying commodity. However, there are risks. One of the biggest risks, which many investors in oil ETFs recently discovered, is that moves in the commodity may not be reflected point-for-point by the underlying ETF. Because of the construction of the ETF, there are times when the ETF performance and the performance of the underlying commodity will diverge significantly. These conditions are called contango⁵ and backwardation,⁶ which refer to the shape of the futures curve. While beyond the scope of this paper, these conditions are very important to understand prior to investing in commodities through futures-based investments.

In regards to ETNs, divergence in performance is not an issue since the investment is ultimately in a note in which the performance is tied to the index. However, ETNs incur the credit risk associated with the issuer of the note, whose promise to pay is only as sound as the strength of the issuing company.

Taking a more active approach to commodity investing allows managers the flexibility to either use a tactical approach to weighting the underlying commodities within the index or construct a collateral portfolio using higher yielding investments. In addition, an active manager can help investors mitigate some of the issues inherent in the construction of the index, namely contango.

A Long-Term Secular Growth Story

What was once an esoteric investment strategy available only to the most affluent of investors, commodity investing is becoming a larger part of a foundation upon which to build a fully diversified portfolio. The rapid urbanization and industrialization of countries such as China and India has created a secular growth story that will fuel commodity demand for years to come. The drivers of supply and demand, which ultimately drive commodity prices, will continue to be subject to forces outside of our control and as such could provide much needed diversification. With globalization driving the correlation between domestic and international stocks and bonds closer together, this is no small benefit.

In addition, many global economies are flush with cash driven largely by the U.S. government's quantitative easing programs (QE1 and QE2). For this reason, many believe inflation is inevitable. If so, taking a position in commodities can be viewed as a prudent wealth preservation strategy. Historically, commodities have demonstrated their ability to perform well in periods of increasing inflation where stocks and bonds tend to suffer. While there are risks associated with commodity investing and they are by no means a cure-all for what may currently ail investors' portfolios, when used prudently and in conjunction with other asset classes their benefits can far outweigh the negatives.

Appendix A: Comparative Matrix of Commodity Index Construction Methodology⁷

	S&P GSCI	Dow Jones UBS Commodity Index	Bache Commodity Index	Rogers International Commodity Index
Type	Quantity-based	Quantity-based	Value-based	Quantity-based
Components Selected By	Liquidity measures	Liquidity measures	Liquidity measures	Significance in worldwide consumption
Weights Determined By	World production weighted over previous five years	Liquidity and production measures	Liquidity of the commodity	Contract liquidity and worldwide consumption pattern
Number of Components	24	19	19	36
Agriculture	8	6	6	18
Industrial Metals	5	3	3	7
Energy	6	6	6	6
Livestock	3	2	2	2
Precious Metals	2	2	2	3
Launch Date	November-1991	July-1998	January-2007	July-1998
Roll Period	5th to 9th	4th to 8th	Continuous roll	Over a three day period from the last business day of the month to the first business day of the following month
Rebalancing	Annual	Annual	Annual	Monthly
Average Maturity	Less than 2 months	Same maturity as SPGSCI for agriculture but longer average maturity for energy and metals as it holds every alternative month	Around 3 weeks more than average maturity of SPGSCI contracts	Same as the average maturity of the SPGSCI prior to roll period for contracts that are common to both RIC and SPGSCI except industrial metals. Average maturity of industrial metals is 3-months
Energy Allocation	Above 75% on April 30, 2007	Capped at 33%	Maximum allocation is set at 50%	44%
Liquidity	Highly liquid	Slightly less liquid than SPGSCI due to alternating energy contracts	Highly liquid	Most of the commodities are in the most liquid part of the curve. But some commodities in the index are illiquid with very low open interest
Outperformance	During rising energy process and when markets are in backwardation	Will outperform when price of agriculture and metals rise more compared to energy. When agriculture and metals are more in backwardation then energy	When markets are in contango it will beat most of the traditional indices. It will have smaller drawdown compared to any of the indices in declining markets.	Will outperform when the agriculture sector performs better than the energy and metals sectors. Will outperform when natural gas declines

¹ Empirical Research Partners, "The Money Management Industry: Recent Research" January 24, 2011 ² BusinessDictionary: "Commodity Exchange" ³ The Sharpe ratio is calculated by subtracting the risk-free rate - such as that of the 10-year U.S. Treasury bond - from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns. The Sharpe ratio tells us whether a portfolio's returns are due to smart investment decisions or a result of excess risk. ⁴ Theoretical portfolio values calculated on a monthly basis, using total returns for the DJ-UBS Index, S&P500 ("Stocks"), and Barclays Aggregate Bond Index ("Bonds"). ⁵ The situation where, and the amount by which, the price of a commodity for future delivery is higher than the spot price ⁶ A market condition in which a futures price is lower in the distant delivery months than in the near delivery months. ⁷ Comparing Commodity Indices: Multiple Approaches to Return, AIA Research Report, May 14, 2008. The Bache Commodity Index is a broad based index that includes 19 commodities in the energy, metals and agricultural sectors. The Rogers International Commodities Index is a broad based index of 35 commodities in the energy, metals and agricultural sectors, weighted by consumption patterns worldwide.

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