INSTITUTIONAL INVESTING IN COMMODITIES

PGIM

Webinar Summary

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Commodities can serve an important role in a multi-asset institutional portfolio, both strategically, as a diversifying asset class or as an inflation or growth hedge, and tactically, as a return enhancer. Thought leaders from PGIM's Institutional Advisory & Solutions (IAS) group and QMA's multi-asset solutions team recently got together to discuss the challenges and possible opportunities for institutional investors investing in commodities. Following is a summary of their recent webcast.

- **Benchmarking the Benchmarks:** One vital issue CIOs face when making a strategic decision to invest in commodities is identifying a commodity benchmark that is best suited for their investment objectives. It can be a difficult decision given the wide array of benchmarks to choose from – both standard, off-the-shelf options, or customized benchmarks. The decision will often revolve around two important benchmark characteristics: the commodities selected and how they are weighted. Research from IAS shows there is remarkable diversity in commodities in terms of risk and expected return. As a result, broad-based commodities indices can show wide variations of risk and return depending on the choice of commodities included in the benchmark. Likewise, regarding weighting schemes, there is wide variety for CIOs to consider and there are other potentially attractive alternative weighting schemes that may serve the CIO well.
- **Selecting Commodities Based on Macroeconomic Sensitivities:** Using IAS' Real Asset Sensitivity Analysis (RASA™) framework, investors can construct real asset benchmarks and portfolios that may be better aligned to their investment objectives. That's important because macroeconomic sensitivities differ across individual commodities, so a pre-constructed benchmark may not be consistent with a CIO's specific investment objectives. An investor seeking high inflation exposure, for instance, can first select commodities with high CPI betas and then weight those commodities using previously discussed weighting schemes like risk weighting or production weighting. But doing so can still lead to sector concentrations and, more importantly, ignores the uncertainty inherent in beta estimation. CIOs can use the RASA framework to construct a bespoke benchmark to achieve a desired investment objective (target inflation/growth beta) with a specific investment horizon and accounting for beta estimation uncertainty. Investors might also allocate to an active commodity overlay strategy.
- **The Role of Commodities in a Multi-Asset Portfolio:** Volatility within individual commodities can spike significantly over short periods of time, as was seen in the first quarter of this year, and risk management is a vital part of an allocation to the asset class. Commodities are a unique asset class that can be used both strategically and tactically, and from a CIO's perspective it is worth looking at commodities as a source of alpha, along with their strategic properties. Commodities can offer return dispersion; some, such as gold, are very defensive, while others, such as crude oil, are cyclical. Still others, such as wheat, are influenced by idiosyncratic weather events. This all can create an opportunity to generate alpha by identifying commodities poised to do well, and those that are likely to suffer. A systematic investment framework that harvests risk premia and behavioral mispricing can generate an attractive return profile in such a market.

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