Portfolio Manager Viewpoint

David Donora
Head of Commodities

The concept of and approaches to responsible investment are well developed in some asset classes, not least public equities, but the debate around what it means to be a responsible investor in commodities is often seen as more challenging. The following summary offers an insight into how we see things.

As both a longstanding responsible investor and investor in commodities, our approach to the asset class has had time to develop and evolve. Many commentators have sought to address the question of responsible investment in terms of ESG integration akin to that seen in equities but, in practice, such an approach can only really be relevant where a commodity strategy encompasses real, physical or corporate assets.

This highlights the first key question influencing how a responsible investment approach needs to be framed and integrated into the investment process – the nature and type of strategy being used:

Figure 2: An assessment of the scope to integrate ESG in commodity-related strategies

	Possibility to mitigate ESG risks by selecting investments	Possibility to mitigate ESG risks by engaging with producers and other value chain actors	Risk of damaging the real economy and returns in other asset classes**	Possibility to actively contribute to sustainable development through allocation of capital	
COMMODITY DERIVATIVES	Low*	Low	Low-medium	Low*	**CTI Approach**
PHYSICAL COMMODITIES	Low*	Low	Medium-high	Low*	
REAL ASSETS	High	High	Low	High	
INVESTMENT IN COMPANY DEBT/EQUITY	Medium-high	Medium-high	Low	Medium-high	

*Would be higher in case a system to trace the source of commodities and ensure ESG criteria are met could be implemented.
**eg, by taking physical commodities away from productive use or contributing to price volatility.

Source: "The Responsible Investor's Guide to Commodities: An Overview of Best Practices Across Commodity-Exposed Asset Classes" (2011), PRI, The Global Compact, on Values and Schweizerische Eidgenossenschaft.

Our commodity investment activities focus on commodity derivatives, mostly futures. While the scope to integrate ESG into our commodity strategies may, therefore, appear limited according to the table above, in practice responsible investment considerations are integral to the process. The difference is in how they are approached relative to what asset owners are perhaps more familiar with in equity strategies.

In framing how we approach this in practice, being clear about the purpose and objective of our commodity strategies is important. The starting point for this is found in strategic asset allocation. Commodities provide optionality and a distinct asset class that offers good returns, hedging benefits and diversification potential, providing a valuable form of portfolio insurance for asset owners. Our approach is framed within the context of the value in bringing diversification benefits to asset owners, both for return and hedging purposes, in keeping with their fiduciary duties. Commodity futures are uncorrelated with the return on equities; at the same time, historically, they offer a similar return and Sharpe ratio to, say, US equities[1].

Given the fundamental and fiduciary motivations for using the asset class, ensuring a proper understanding of the risks as well as the implications in terms of maintaining a responsible approach is then important.

By focusing our approach on the use of commodity derivatives, the negative associations (and need for related mitigation) arising from investment in real assets and commodity companies can be avoided. These typically relate to issues around labour rights, human rights, land/resource rights, waste, water scarcity and pollution levels in assets, such as forests and agricultural land, or to companies throughout the supply chain.

At the same time, thought needs to be given to other potential impacts of such an approach, such as for associated physical markets, which has been an area of debate. Concerns have been expressed about the potential risks that excessive speculation in futures markets might have in disrupting the underlying markets' role as a price discovery and risk hedging tool. Since the commodity price spikes seen in 2007/08, this issue has become particularly sensitive in relation to food commodities given the potential impacts on farmers, food producers and food prices.

Before tackling the key issue of food commodities though, it is worth closing off how managing potential impacts of a commodity derivatives approach is structured and therefore enables issues such as these to be addressed. There are two elements to this, with both relating to the control of the type and nature of the exposures involved:

- The first relates to counterparty exposures taken in commodity derivatives themselves. Framing the standards and values around which counterparties are assessed is key to this. Quality issues, ESG standards, controversies and adherence to global norms are all part of the approach. Reviewing approved counterparties at regular intervals is important, particularly given the nature of the financial counterparties used and the need for a proper understanding of the developments around and exposure to the extensive legacy issues there have been in the banking sector is integral to this.
- The second relates to the nature of the commodities themselves and their markets. In this regard, a positive inclusion process – requiring instruments and assets to be pre-approved as investable – provides the most effective starting point. This allows for the proactive management of issues, as opposed to an exclusionary approach where anything is allowed unless/until specifically excluded. This helps ensure active consideration of sensitive issues and management of potential risks. One aspect of this is the risk associated with liquidity and the limitation or avoidance of investments in smaller, more illiquid commodity markets, which is integral to the investment process.

  Also within this element of the strategies, a number of commodities are specifically not approved for investment, including: physical commodities and real assets or, by extension, physical delivery (ensuring direct intervention in the underlying markets is avoided). Similarly, commodities such as palm oil (associations with deforestation), diamonds (association with conflict diamonds), tobacco (associated health impacts) or coal (association with pollutants) are examples of commodities that are not approved for inclusion.

Commodity markets are individual and distinct with unique characteristics that constantly change and evolve over time. Linked to the treatment of coal, looking to the future as an active commodity investor, we anticipate being in a good position to continue adjusting our approach and portfolios over time as policy change linked to climate change continues and global energy transition progresses. A switch in focus from oil to gas, the growing role of renewable energy sources, the potential impacts of effective carbon pricing and ultimately the diminishing role of hydrocarbons are all real themes. In the meantime, for asset owners already seeking to reduce their exposure to hydrocarbons in their equity and/or bond portfolios, an active commodity derivatives strategy provides insurance against potential associated impacts, providing a hedge that helps mitigate financial risks without reversing the reductions in physical exposures or carbon footprint management.

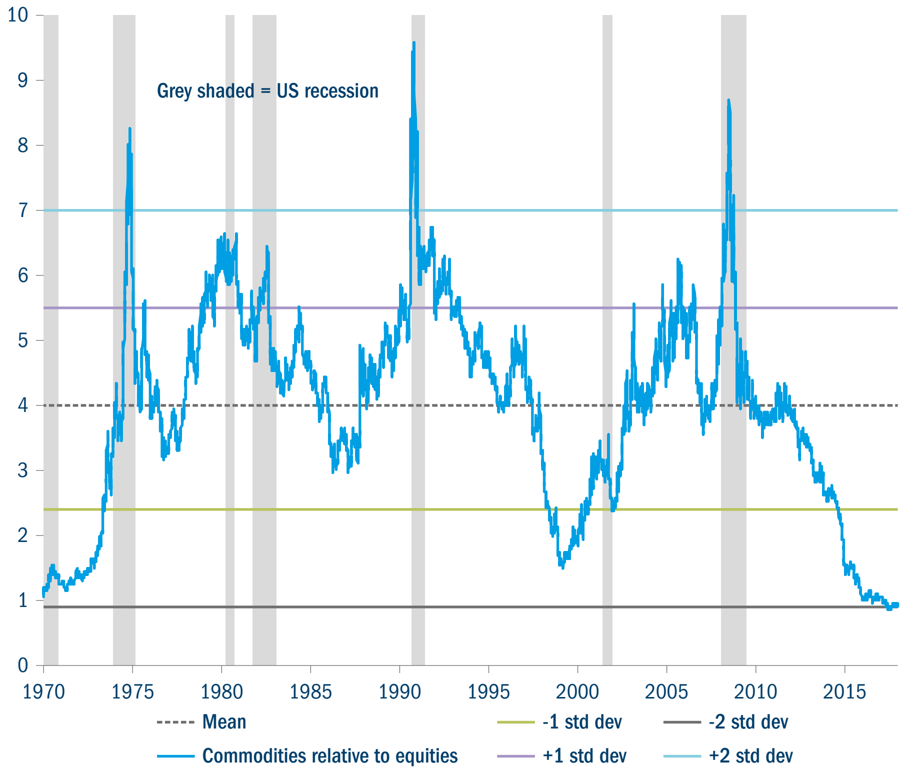
So, what about food commodities? As noted earlier, the food price spikes seen in 2007/08 brought a particular focus to the debate around commodity investment, making it an emotive and sensitive issue for many. The strong assertions made around food commodities underline the importance of following an evidence-based approach. This means looking past lobbying positions, to the in-depth research that has been undertaken around the drivers of commodity prices and the effects of 'financialization' of commodity markets.

An example of this can be found in the World Bank's "Long-Term Drivers of Food Prices" (2013).[2] This research used annual data from 1960-2012 for five food commodities (maize, wheat, rice, soybeans, and palm oil) to assess the relative contribution of various factors to their respective price changes. The impact of the drivers on post-2004 food price movements was also specifically assessed separately given the 2007/08 spike. Ultimately, it was found that the drivers of price changes included energy pricing, chemical input prices, the expansion of biofuels, freight rates, weather, supply & demand factors, policy interventions, as well as US dollar exchange rates.

There is a canon of in-depth research focussing on these issues- some examples are included in the 'Further Reading' list at the end of this article – that supports these findings and helps counter the more assertion-based positions that are sometimes seen. It is by virtue of this supporting evidence that we have determined it is not inconsistent with our responsible investment approach to invest in food commodities, whether specifically, as part of dynamic real return strategies, or in the context of asset allocation. However, we are equally able to tailor our solutions for individual clients to exclude food commodities where sensitivities persist and investment would conflict with their needs and values.

Why is this important now? With inflation and interest rates starting to trend upwards as we head into 2018, one of the more striking valuation measures is the chart below of commodities, collectively, against equities. Against a general index of commodities (S&P GSCI Total Return Index), equities have significantly outperformed. However, the relative ratio of the two indices is now just below 2 standard deviations. Prior extremes (i.e. on or close to 2 standard deviations) have signalled the beginning of commodity super cycles. In particular, both the early 1970s/late 1960s and 1999/2000 registered similar signals.

Figure 3: Commodities relative to US equities (S&P GSCI total return index relative to S&P500)



In developing an approach to commodities, early recognition of potential issues and impacts from the approach taken does warrant attention. With the relevance and importance of commodities in asset allocation once again firmly on the agenda, we hope these insights and explanations help frame how and why responsible investment can and should form part of the discussion.

Further Reading

- "The Responsible Investor's Guide to Commodities: An Overview of Best Practices Across Commodity-Exposed Asset Classes" (2011), PRI, The Global Compact, onValues and Schweizerische Eidgenossenschaft.
- "Unravelling the underlying causes of price volatility in world coffee and cocoa commodity markets" (2011), UNCTAD.
- "Bubbles, Food Prices and Speculation: Evidence from the CFTC's Daily Large Trader Data Files" (2013), NBER.
- "Why speculation is not a prime cause of high and volatile international agricultural commodity prices: An economic analysis of the 2007-08 price spike" (2011), HFFA Research GmbH.
- "A Note on Rising Food Prices" (2008) World Bank Policy Research Working Paper, 4682.

Sources:

1 "Facts and Fantasies about Commodity Futures Ten Years Later", May 2015, SummerHaven, Yale & NBER

2 The World Bank, Policy Research Working Paper 6455

Important Information: For internal use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients). Past performance is not a guide to future performance. The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. This means that an investor may not get back the amount invested. The research and analysis included in this document has been produced by Columbia Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice and should not be seen as investment advice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. This document is not investment, legal, tax, or accounting advice. Investors should consult with their own professional advisors for advice on any investment, legal, tax, or accounting issues relating to an investment with Columbia Threadneedle Investments. The mention of any specific shares or bonds should not be taken as a recommendation to deal. This presentation and its contents are confidential and proprietary. The information provided in this presentation is for the sole use of those attending the presentation. It may not be reproduced in any form or passed on to any third party without the express written permission of Columbia Threadneedle Investments. This presentation is the property of Threadneedle Investments and must be returned upon request. This document includes forward looking statements, including projections of future economic and financial conditions. None of Columbia Threadneedle Investments, its directors, officers or employees make any representation, warranty, guaranty, or other assurance that any of these forward looking statements will prove to be accurate. Issued by Threadneedle Asset Management Limited. Registered in England and Wales, Registered No. 573204, Cannon Place, 78 Cannon Street, London EC4N 6AG, United Kingdom. Authorised and regulated in the UK by the Financial Conduct Authority Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies.