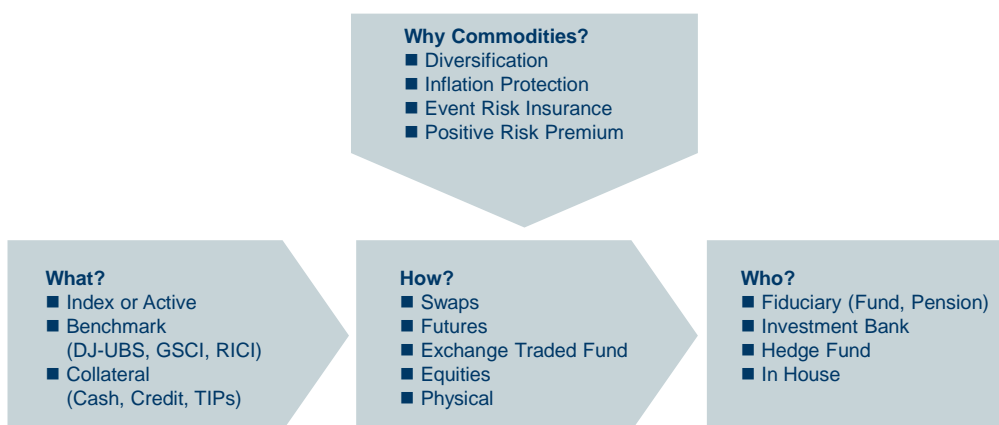


## Commodities As An Asset Class

Q1 2013

### Buying Commodities Questions



Increasingly investors spending more time on how to gain exposure to the asset class.

## Why Invest In Commodities?

A positive return over time

- Similar return and risk profile to equities
- A positive forward-looking risk premium

Portfolio diversification

- Low correlations with other asset classes

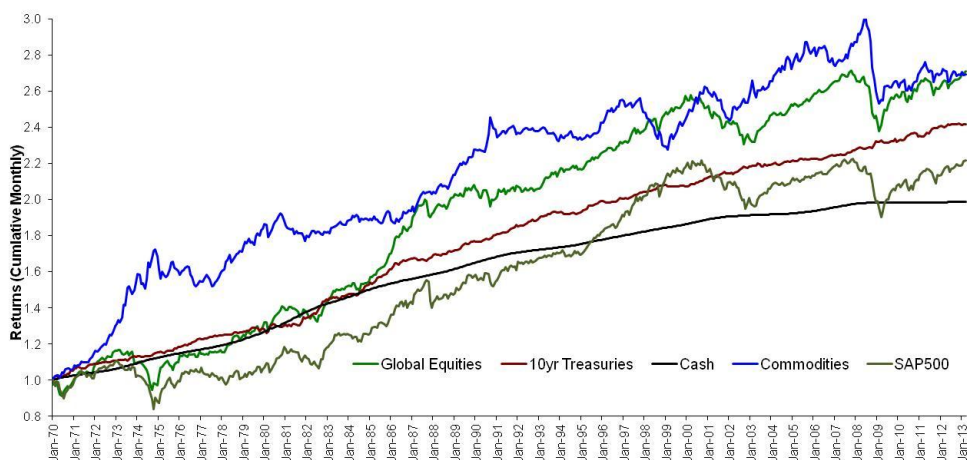
Portfolio protection

- Hedge against rising inflation
- Hedge against event risk

Liquid and transparent

- More transparent & liquid than “traditional” alternative investments
- No leverage required to gain benefits

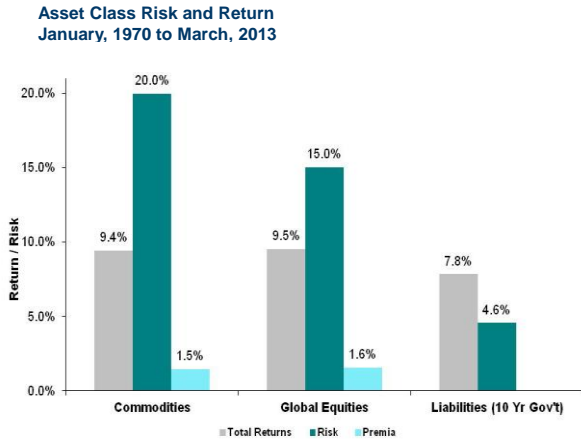
## Cumulative Returns January, 1970 to March, 2013



Source: World Equities is the MSCI World Equity Index, S&P500 is the S&P 500 Index, Bonds is the Barclays 10 Year US Government Index, Cash is the Bloomberg 3 Month Treasury and Commodities is the Standard and Poor's GSCI Total Return Index

Risk Return Profile Since 1970

- Commodities historical returns outperform liabilities
- Commodities risk adjusted returns are on par with those of equities
- Commodities historical volatility is higher than equities

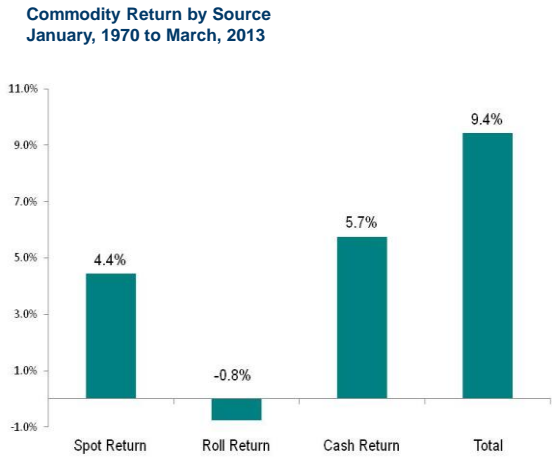


Source: World Equities is the MSCI World Equity Index, S&P500 is the S&P 500 Index, Bonds is the Barclays 10 Year US Government Index, Cash is the Bloomberg 3 Month Treasury and Commodities is the Standard and Poor's GSCI Total Return Index

Return By Source Since 1970

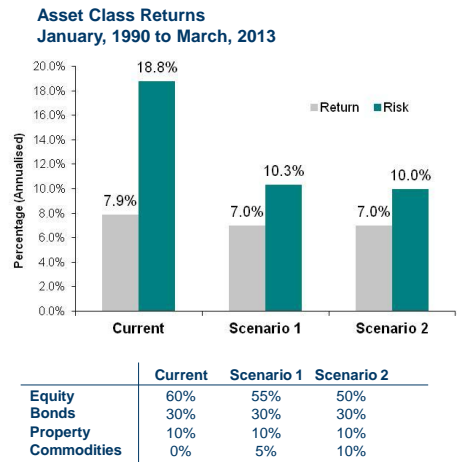
- Definitions:
  - Spot Return: Price appreciation
  - Collateral Return: Short-term cash rates
  - Roll Return: Cost to maintain exposure, it can be positive or negative
- Roll yield is highly correlated with economic cycle
- Low correlation between all three sources of return

	Spot	Roll	Cash
Spot		-0.14	0.03
Roll	-0.14		0.12
Cash	0.03	0.12	



Source: Standard and Poor's GSCI Total Return Index, Excess Return Index and Spot Return Index.

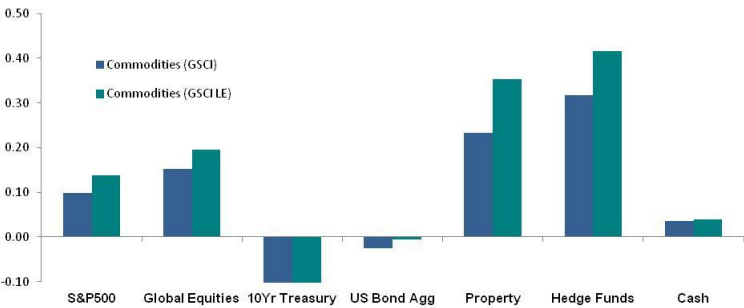
## Adding Commodities to a Strategic Asset Allocation



- Commodities though volatile can actually reduce overall portfolio risk
- Commodities can add returns while reducing risk

**Source:** World Equities is the MSCI World Equity Index, Bonds is the Barclays 10 Year US Government Index, Cash is the Bloomberg 3 Month Treasury, Property is the FTSE EPRA NAREIT Property Index and Commodities is the Standard and Poor's GSCI Total Return Index.

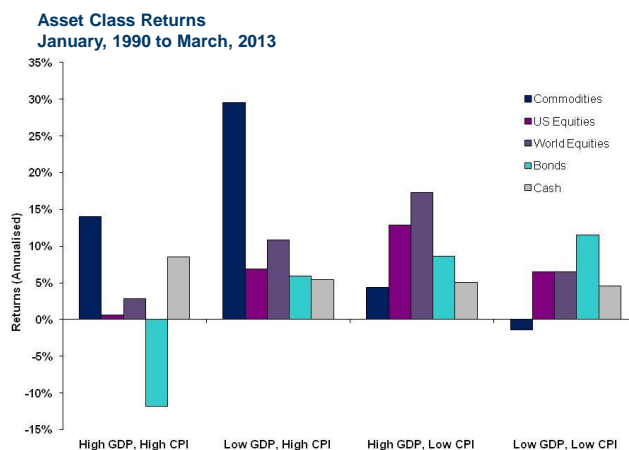
## Commodity Correlation



- Commodities have a low correlation with other asset classes
- Commodities offer diversification

**Source:** World Equities is the MSCI World Equity Index, 10Yr Treasury is the Barclays 10 Year US Government Index, US Bond Aggregate is the Barclays US Aggregate Index from 1976, Cash is the Bloomberg 3 Month Treasury, Property is the FTSE EPRA NAREIT from 1990, Hedge Funds is the HFRI Fund Weighted Composite from 1990 and Commodities is the Standard and Poor's GSCI Total Return Index.

## Commodities and Inflation Regimes



- Commodities outperform other asset classes during high inflationary periods

**Source:** World Equities is the MSCI World Equity Index, US Equities is S&P500, 10Yr Treasury is the Barclays 10 Year US Government Index, Cash is the Bloomberg 3 Month Treasury and Commodities is the Standard and Poor's GSCI Total Return Index.

## Inflation and Risk Perception

- An academic study on risk perception of lava flows and active volcanoes:

“Public and perhaps official understanding of specific lava flow hazards from renewed volcanism ... are **proportional to the time lapsed since the most recent eruption.**”

Gregg, C.E.; Houghton, B.F.; Johnston, D.M.; Paton, D.; Swanson, D.A. 2004. “The perception of volcanic risk in Kona communities from Mauna Loa and Hualalai volcanoes.”

- An academic study on eight centuries of debt and defaults:

“Many observers ... have concluded that ‘this time is different’ and that inflation will never return. We certainly agree that there have been important advances in our understanding of central bank design and monetary policy . . . but as in the case of debt default, **experience suggests that quiet periods do not extend indefinitely.**”

Reinhart, Carmen M. and Rogoff, Kenneth. “This Time is Different: Eight Centuries of Financial Folly.”

**Source:** Hermes, Journal of Volcanology and Geothermal Research, Reinhart and Rogoff.



## Commodities Themes

### Urbanisation Increases Energy Demand

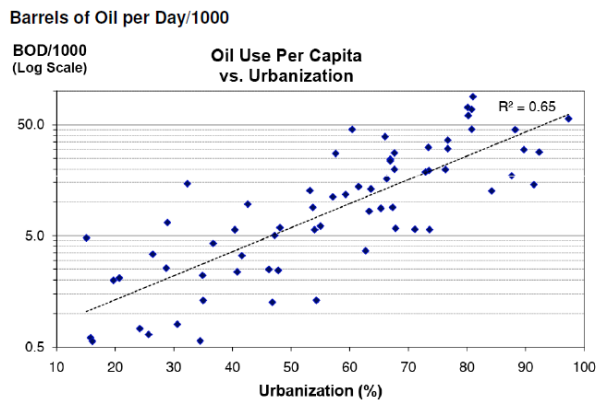


Image: Shanghai

Source: PIRA

## Energy Demand from Increased Auto Consumption

Explosive Growth of Vehicle Sales in China / India / Brazil

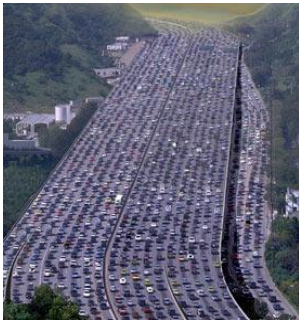
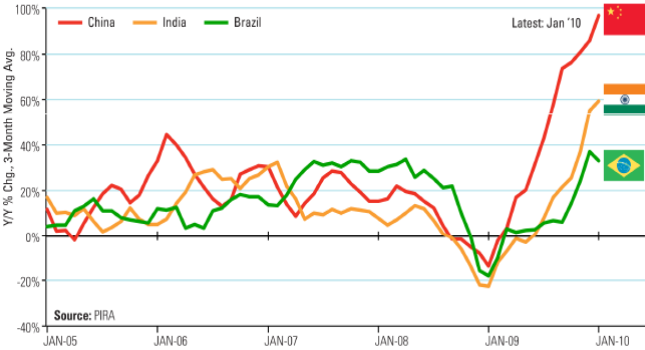
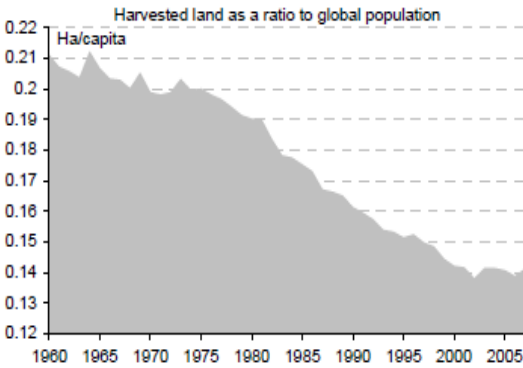


Image: Motorway connecting Beijing and Tibet

Source: PIRA. Data from Jan 2005 to Jan 2010.

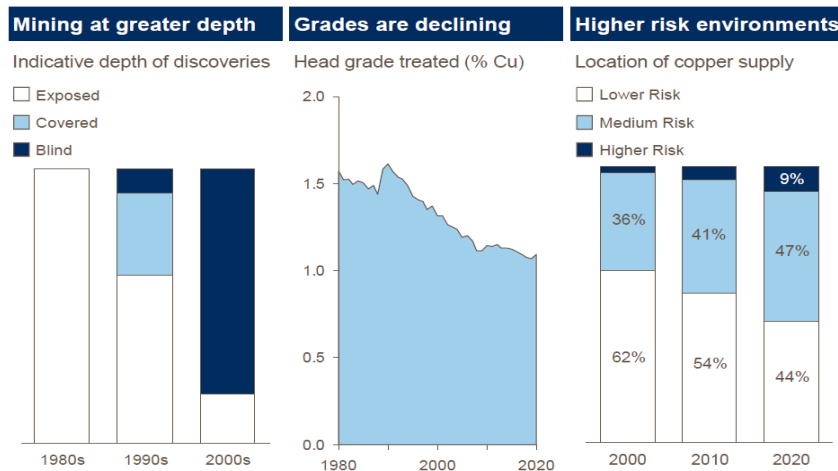
## Scarcity of Land will Pressure Prices



- Relative to 1970 we are using 26% more land to feed 80% more people – this downward trend is unsustainable

Source: USDA, BofA Merrill Lynch. Dates from Jan 1960 to Jan 2010.

## Supply Constraints: Structural Changes in Copper



Source: Rio Tinto, 2010. \* Forecast.

## Investing in Commodities Today

### Why Commodities Now?

For	Against
<b>Persistent inflation</b> <ul style="list-style-type: none"> <li>Higher money supply, negative real rates</li> <li>Future inflation expectations</li> <li>Relative value of USD</li> </ul> <b>Emerging market demand</b> <ul style="list-style-type: none"> <li>Accelerating urbanisation</li> <li>Buying power and relative incomes increasing</li> </ul> <b>Supply bottlenecks</b> <ul style="list-style-type: none"> <li>Arable land scarce</li> <li>Yields under pressure</li> <li>Ore degradation</li> <li>Crude oil under-investment</li> </ul>	<b>Inflation is tepid</b> <ul style="list-style-type: none"> <li>Non-core inflation low</li> <li>Demand pressure low in developed markets</li> </ul> <b>Stage in economic cycle</b> <ul style="list-style-type: none"> <li>Expectations stage prefers equities</li> <li>Emerging economies hard landing</li> </ul> <b>Technological innovation</b> <ul style="list-style-type: none"> <li>Game changers just around the corner</li> <li>Shale oil, bio-fuels, ethanol</li> </ul>





## Appendix:

## Other Commodity Themes

### Liquidity Providers Proportion of Overall Market



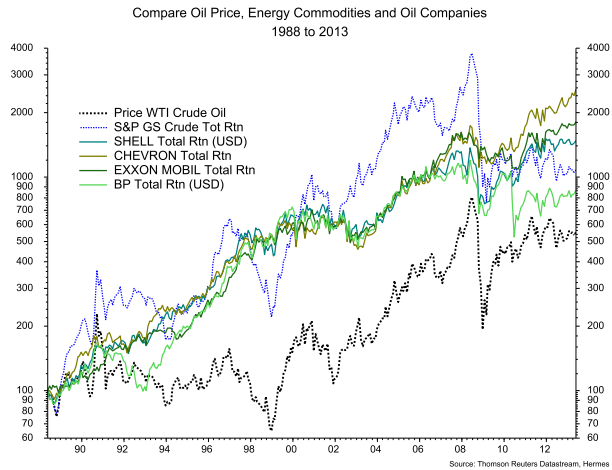
Investors represent less than 15% of the commodity market

The major presence of producers and consumers supplies the premium to investors

Source: Hermes, CFTC and Barclays Capital. Data from September 2011 to September 2011.

## Compare Equity Commodities and Commodity Futures

- Oil majors behave like equities
- Oil Majors Betas:
  - Local Equity (SAP500, FTALL) Mkt = 0.72 to 0.85
  - Oil Price Future (WTI) = 0.09 to 0.19
- Why?
  1. Company capital structure (equity/debt)
  2. Company management
  3. Company hedging policy
  4. Company cost structure
- Share vs. Future
  - Commodity Equity → Expected Value
  - Commodity Future → Value Now

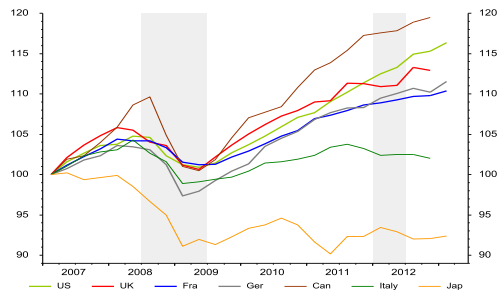


Source: Hermes, Thomson Datastream. S&P GSCI Crude Oil Total Return from Standard and Poor's. Correlations are based on 1 week returns from January, 1986 to March, 2013.

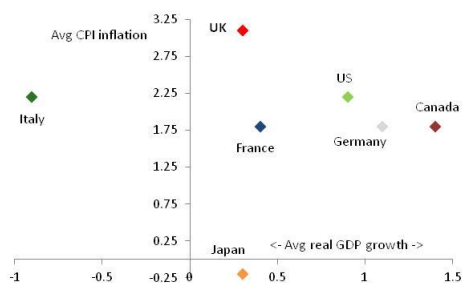
## Inflation and Nominal Growth Comparing G7 Recovery

- Since the GFC G7 nominal growth has been relatively strong
- The UK has outgrown most of the G7 on a nominal basis; neck-and-neck with US
- UK has had wrong kind of nominal growth
- Only Italy has worse combination

G7 Nominal Growth

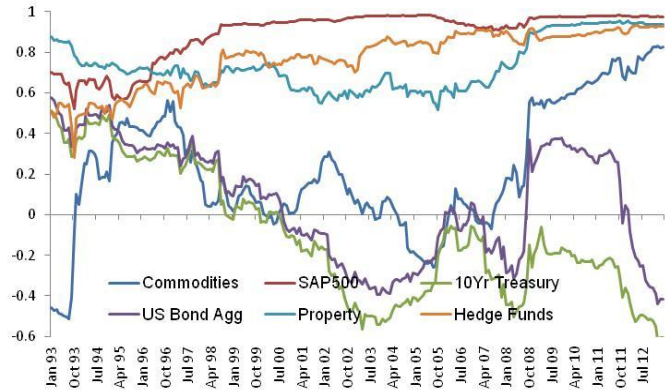


G7 Real Growth vs Inflation



Source: Hermes Fund Managers Ltd, Thomson Reuters Datastream, based on national data.

**Compare Asset Class Correlations**  
**Global Equities Three Year Rolling (Jan-90 to Mar-13)**



- Commodity Correlations with:
  - Equities recent spike otherwise low
  - Fixed interest low despite recent markets
- Equity Correlations with:
  - International equities relatively high
- Diversification now harder:
  - Commodities and fixed interest most diversifying
  - All alternative (Hedge Funds, Property and Commodities) spike with equities

**Source:** World Equities is the MSCI World Equity Index, 10Yr Treasury is the Barclays 10 Year US Government Index, US Bond Aggregate is the Barclays US Aggregate Index from 1976, Cash is the Bloomberg 3 Month Treasury, Property is the FTSE EPRA NAREIT from 1990, Hedge Funds is the HFRI Fund Weighted Composite from 1990 and Commodities is the Standard and Poor's GSCI Total Return Index.

**Appendix**  
**Important information**

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