Commodity futures in your investment portfolio -- Is there really any future for individual investors?

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Commodity futures in your investment portfolio:Is there really any future for individual investors?*The Skilled Investor's* previous article, "Be wary of the new investment asset classes," voiced skepticism about many supposedly new asset classes. This article delves into the financial science behind this skepticism, as it relates to one of these supposedly new asset classes. In this article, we focus on whether commodity futures really are a good candidate for long-term holdings in the portfolios of individual investors. Particularly since the dot com crash, there has been a lot of talk about commodity futures as an appropriate asset class for investors for the long-term. It seems that returns from the traditional stock-equity asset class just have not met some investors (perhaps unreasonably inflated) return expectations. It also seems that the securities industry is always willing and eager to offer supposed help to those investors who want higher returns. However, is the industry doing individual investors any favors by promoting commodity futures as an asset class for individual investors' portfolios?To look more closely at the newly touted commodity futures asset class, you could read "The Tactical and Strategic Value of Commodity Futures" by Claude B. Erb of the Trust Company of the West and by Campbell R. Harvey of Duke University (January 12, 2006). In this study, Erb and Harvey dissect the sources of commodity futures returns and analyze investment strategies that might make appropriate use of commodity futures. They conclude that commodity futures can play a role in tactical investment price insurance strategies, when conducted by very sophisticated traders and investors. This is a role that commodity futures have filled for hundreds of years. Erb and Harvey state in their conclusion that "the goal of this paper is to explore both the strategic and tactical opportunities that these assets present to investors." (page 55) A key question is whether commodity futures tend to provide a "risk premium" for a long term passive buy-and-hold strategy, just as equities have exhibited. Is it appropriate to re-purpose commodity futures and make them a new asset class within the long-term portfolios of individual investors? (For more information on securities market returns, see *The Skilled Investor's* articles in these categories: Returns and Risk Premiums [10 articles] and Securities Valuation [4 articles].)   Erb and Harvey conclude that "a number of studies have argued that commodity futures are an appealing long-only investment class because they earn a risk premium similar to equities. Our paper argues that there are reasons to wonder what this is supposed to mean. Does the average (of) commodity futures have ‘equity-like’ returns? Our research suggests that this has not been the case: the average returns of individual commodity futures contracts have been indistinguishable from zero. "Might portfolios of commodity futures have “equity-like” returns? Here the answer seems to be a definitive “maybe”. A commodity futures portfolio might have “equity-like” returns if it is able to achieve a high enough diversification return. The diversification return is a reasonably reliable source of return. Or a commodity futures portfolio can have “equity-like” returns by skewing portfolio exposures towards commodity futures that are highly certain to have positive roll or spot returns in the future. The challenge for investors, though, is that while spot and roll returns might be high in the future, there is really nothing in the historical record to give investors comfort that future spot and roll returns will be substantially positive." (page 55)In their paper Erb and Harvey also discuss the development of a variety of commodity indexes by major investment banks and securities rating services. Unlike capitalization weighted equities indexes, these relatively new commodity indexes employ a variety of rather subjective and judgmental weighting factors. Whenever objective criteria for developing benchmark indexes are lacking or are not followed, data mining opportunities arise and ethics are put to the test. Data mining involves statistically analyzing a broad range of historical trends and then selecting only those that allegedly demonstrate superior historical trends that would have beat-the-market in the past. After reading this paper, it is easy to be concerned about the role of data mining in the construction of prominent commodity futures indexes. This paper goes into extensive detail about the construction of the three major commodity futures indexes and their arbitrary modifications over time. Erb and Harvey suggest that the three main commodity indices are investment strategies rather that stable benchmarks. In Section 2.4 of this paper they state that: "Asset weights and asset returns drive portfolio returns. The return and risk differences amongst these three commodity indices can partially be explained by the different weights of individual commodity futures contracts in each of the indices. ... The higher returns of the GSCI (Goldman Sachs Commodity Index) and the DJ AIG (Dow Jones AIG Index) can be seen as a pay-off to overweighting individual commodity futures which turned out to have above average returns. The composition of these three indices differ from one another because there is no agreed upon way to define the composition of the aggregate commodity futures market as there is with the aggregate equity market or the aggregate bond market. ... Lacking a market capitalization based portfolio weighting scheme, commodity indices can best be thought of as commodity portfolio strategies." (pages 10-11) If this new commodity futures asset class for investors' portfolios lacks a long-term, buy-and-hold risk premium payout, then an investor would have to speculate successfully and pick winners to have a positive return. Barring luck, your expected net return may be zero. If the reference benchmark indexes are jerry-rigged through selective data mining, you cannot be certain whether there really was anything economically significant from the outset about these, perhaps, arbitrarily selected price trend indexes. The industry certainly wants to draw your eye to these historical commodity futures indexes and to sell you some commodity futures to hold going forward. The past is presented as prologue for the future. Are there solid economic fundamentals to back up commodity futures as a new buy-and-hold asset class? Or, are these indexes just a selective reading of the past that plays to individual investors' naive habit of extrapolating past trends? Is this just more bait for performance chasing investors?To paraphrase Gimli son of Gloin, the dwarf in the *Lord of the Rings* movies: "High investment risk. Maybe zero likelihood of any return. What are we waiting for?"   (Gimli actually said: "Certainty of death. Small chance of success. What are we waiting for?")