

Value of Portfolio Diversification with Commodities Reaffirmed!

PIMCO, one of the largest specialty fixed income managers in the world recently commissioned a study by Ibbotson Associates entitled, *Strategic Asset Allocation and Commodities*.

The study reaffirmed a number of previous studies on the value of diversifying an investment portfolio with commodities. For a review of previous studies read pages 5-13 in *Modern Portfolio Theory: Dynamic Diversification for Today's Investor*:
http://cta.visionlp.com/pdf/gen/Modern_Portfolio_Theory.pdf

Historically, Ibbotson found that commodities have provided high returns, diversification, a hedge against inflation and an improved risk/return profile in strategic asset allocation.

Ibbotson studied annual return data from 1970 to 2004. Over that 35-year period, commodities provided the highest return of any asset class in the study, including U.S. equities. Commodities also had a negative correlation to the other asset classes in the study, and tended to produce relatively high returns when traditional assets performed poorly and superior returns from commodities were needed most. For example, over the 35-year period covered in the Ibbotson study, there were eight years when U.S. equities produced negative total returns. During those eight years, commodities as measured by Ibbotson's composite index provided the highest return of any of the other assets included in the study. Commodities also had the highest return during the two years that U.S. bond returns were negative.

Because commodities produced high returns with low correlations to other assets, the Ibbotson study found that including commodities in a strategic asset allocation opportunity set produced returns that were significantly higher at any given level of risk relative to returns when commodities were excluded from the opportunity set. Over the common range of portfolio risk, a standard deviation range of approximately 2.4% to 19.8%, the average improvement in historical return at each risk level was approximately 133 basis points, and the maximum improvement was 188 basis points.

Finally, the study found that commodities were positively correlated to both the rate of inflation and to changes in the rate of inflation, supporting the notion that commodities provide a hedge against inflation and can provide real purchasing power. In fact, during the period of the study when inflation was high, from 1970 to 1981, commodities far outperformed other asset classes.

Optimal size of an allocation to commodities

Ibbotson projected future commodity returns using three different methods: the capital asset pricing model, the building-blocks method and a combination of the first two methods.

The optimal allocation to commodities varied depending on the method. At the 10% standard deviation level—a moderate risk level similar to a standard portfolio of 60% stocks and 40% bonds—the optimal allocation to commodities ranged from about 22% using the capital asset pricing model to as large as 28.9% using the building-blocks method. Even at the conservative 5% risk level, optimal allocations to commodities were relatively large, ranging from about 9% up to nearly 14%.

Past performance is not necessarily indicative of future results. Futures and options trading involve substantial risk of loss and is not suitable for all investors.

The entire 61 page study is posted on the Internet at:
<http://www.ibbotson.com/download/research/Strategic%20Asset%20Allocation%20and%20Commodities%20v1.1.pdf>
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