The ultimate portfolio diversification revisited

Commodities continue to provide an opportunity for diversifying a portfolio to reduce risk and increase returns.

by David Derwin

TWO YEARS AGO, WE DISCUSSED COMMODITY investments as the ultimate portfolio diversifier.

We recommended allocating at least 20% of an investment portfolio to commodity-based investments (The ultimate portfolio diversification, *Canadian Treasurer*, April/May, 2003).

Since then, the Jim Rogers International Commodity Index has risen by 63%, the TSE Materials/Natural Resource Stock Index is up 50%, and the TSE Energy Stock Index is up 103%.

Risk management is about optimizing risk versus reward, and we all know that risk can be managed through diversification. However, many portfolios do not include enough commodity-based investments to achieve this true diversification. In times of extreme volatility (remember 1998 when the hedge fund Long-Term Capital Management blew up or 9/11), many seemingly diverse assets become very highly correlated.

Negative correlations, positive results: Many investments such as European stocks or real estate, among others, have often been used to diversify a portfolio. However, the only major investment class that has provided true portfolio diversification over the long-term is commodities (see Table 1).

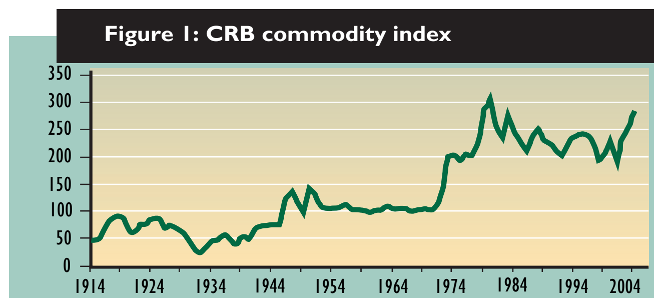
Risk vs. reward

The myth of commodity volatility: Commodities have long been considered a very volatile investment. But while commodities are typically more volatile than North American and European bonds, they are in fact much less volatile than stocks. Table 2 shows that commodities fluctuate only about half as much as North American stock indices.

So, the relatively low volatility as well as the negative-correlation benefits of commodities help to reduce portfolio risk.

Commodities are an effective tool to reduce risk and increase returns. They provide negative correlations, reduce portfolio volatility and offset the affects of inflation. As Figure 1 shows, commodity prices can move higher for periods of 10 years or more. We continue to believe commodities are at the beginning of a very large, long-term move higher and still recommend allocating at least 20% of an investment portfolio to commodity-based investments.

Figure 1: CRB commodity index



(Source: www.globalfinancialdata.com)

Table 2 : Annualized volatility

	10-Year Annualized Volatility
S&P 500	16%
TSE Index	17%
CRB Index	9%

(Source: Bloomberg)

Table 1: 30-year correlation matrix among major asset classes

	CRB Commodity Index	MSCI World Stock Index	TSE Composite Index	Gov't of Canada Long Bond	U.S. Treasury Long Bond	S&P 500	REITs
CRB Commodity Index		-46%	-37%	-58%	-62%	-45%	-28%
MSCI World Stock Index	-46%		97%	90%	85%	98%	40%
TSE Composite Index	-37%	97%		88%	81%	97%	49%
Gov't of Canada Long Bond	-58%	90%	88%		96%	92%	50%
U.S. Treasury Long Bond	-62%	85%	81%	96%		84%	46%
S&P 500	-45%	98%	97%	92%	84%		50%
REITs	-28%	40%	49%	50%	46%	50%	

(Source: Bloomberg) (Note: REITs correlation figures reflect only 20 years of data)

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