TD Asset Management

Investor Knowledge 10 Minutes

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Investing in commodities or commodity equities?

At TD Asset Management Inc. (TDAM), we believe commodities play an important role in portfolio construction, with the potential to offer inflation protection, portfolio diversification and positive expected returns over time.

In a prior paper we authored titled Anticipating a New Commodities Super-Cycle >, we highlighted the benefits of including commodities in a diversified portfolio. Specifically, we showed how adding commodities, which exhibit low correlation to traditional asset holdings and offer a high beta (the volatility of a security or portfolio against its benchmark) to inflation and improves portfolio risk-adjusted returns, particularly in environments of elevated inflation. Since then, many investors have taken this thinking a step further and are now asking if an allocation to commodity-related equities would yield the same benefits garnered with investing in commodity derivatives?

Commodity derivatives preferred over commodity related equities in optimal portfolio construction

Our research shows that investing in commodity derivatives can be superior to commodity equities for portfolio construction – specifically, commodity derivatives provide better diversification and inflation protection than commodity equities. Let's look at why.

Low correlation

The first question we ask is how well correlated commodity equities are to the underlying commodities? The answer is: not highly. Importantly, we find that there are pronounced periods where oil and gas equities in particular look more like equities than the commodity that some investors are looking to proxy via their equity exposure.

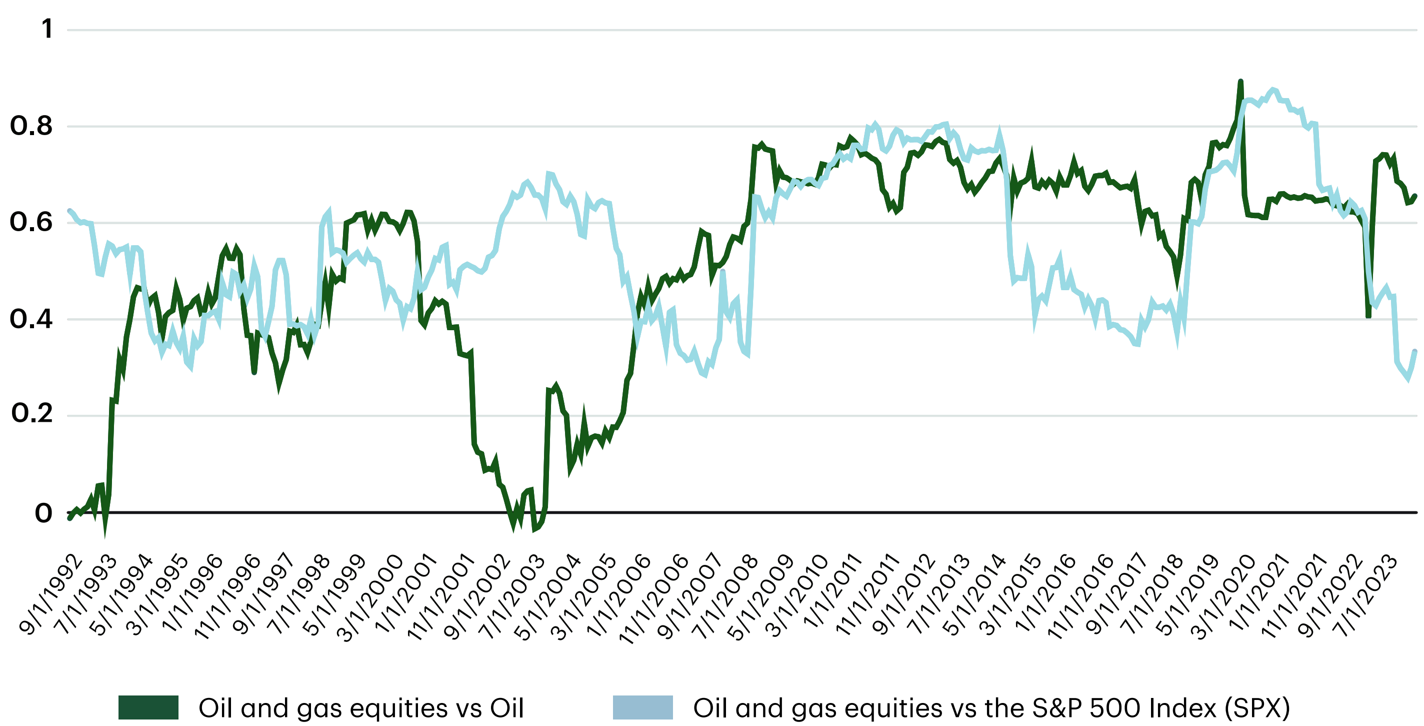
To determine this, we first look at the Bloomberg Commodity Index that includes 24 commodities. The challenge here is that most of these commodities do not have associated "pure play" equities that we can analyze to assess the relationship between the commodity derivative and the equity. For this analysis, we will focus on energy specifically.

We focus on energy equities as it is a deep and broad sector with a long history that is unmatched in the commodity world. It is difficult, if not impossible, to find an equally robust equity sector across other commodity subsectors. There are very few miners who are long lived, and the mining sector has an infamous history of poor capital discipline and idiosyncratic risks that far outweigh the influence of the underlying metal.

Comparing the performance of the S&P 500 Oil & Gas Total Return Index to the front-month WTI contract over the last 30 years reveals a correlation of .56, and a rolling 36-month correlation that varies significantly through time.

Energy equities often look more like broader equity market and less like oil

Rolling 36 month correlation



Source: Bloomberg Finance L.P. Data as of April 30, 2024. Oil is represented by the Bloomberg WTI Crude Oil TR index. Oil and gas equities is represented by the S&P 500 Oil & Gas Total Return Index.

Over the same time frame oil and gas equities exhibited a higher correlation of 0.58 with the S&P 500 Index.

Correlation through the decades

	Since 1990	1990–2000	2000–2010	2010–2020	2020–today
Oil and gas equities vs SP 500 Index (SPX)	0.58	0.47	0.52	0.61	0.66
Oil and gas equities vs oil	0.56	0.38	0.38	0.69	0.66

Source: Bloomberg Finance L.P. Data as of April 30, 2024. Oil is represented by the Bloomberg WTI Crude Oil TR index. Oil and gas equities is represented by the S&P 500 Oil & Gas Total Return Index.

We believe we are in the early stages of the investment phase (what we also like to call a “super cycle”) of the commodity cycle. The correlation of oil and gas equities was higher to equities and lower to oil through the last investment cycle (2000-2012). **Said differently, energy equities looked more like equities (or the broader equity market) and less like commodities through the last investment phase or “super cycle”.**

Correlation during investment phase or “super cycle”

	Correlation	
	Investment phase	since 1992
Oil and gas equities vs SP 500 Index (SPX)	0.62	0.58
Oil and gas equities vs oil	0.54	0.56

Source: Bloomberg Finance L.P. Data as of April 30, 2024. Oil is represented by the Bloomberg WTI Crude Oil TR index. Oil and gas equities is represented by the S&P 500 Oil & Gas Total Return Index.

Another factor that will likely continue to contribute to a lower correlation moving forward is cleaner energy initiatives. Though difficult to model, we flag that oil and gas companies have started to diversify away from oil and gas. In a recent strategy update[1], Beyond Petroleum (BP, previously British Petroleum) noted that they see their capital expenditures on non-hydrocarbon segments of their businesses rising to 50% by 2030, from 19% in 2021. Other large energy producers have made similar commitments.

For example, both Shell and Total Energies have outlined plans to spend 20 to 30% of their capital expenditures going forward on low carbon solutions[2].

For varying reasons, including ESG considerations, energy companies have increasingly opted to return capital to shareholders via higher dividends and buybacks, instead of deploying that capital to grow their production. Through time, it’s possible that energy equities will look even less like the commodity.

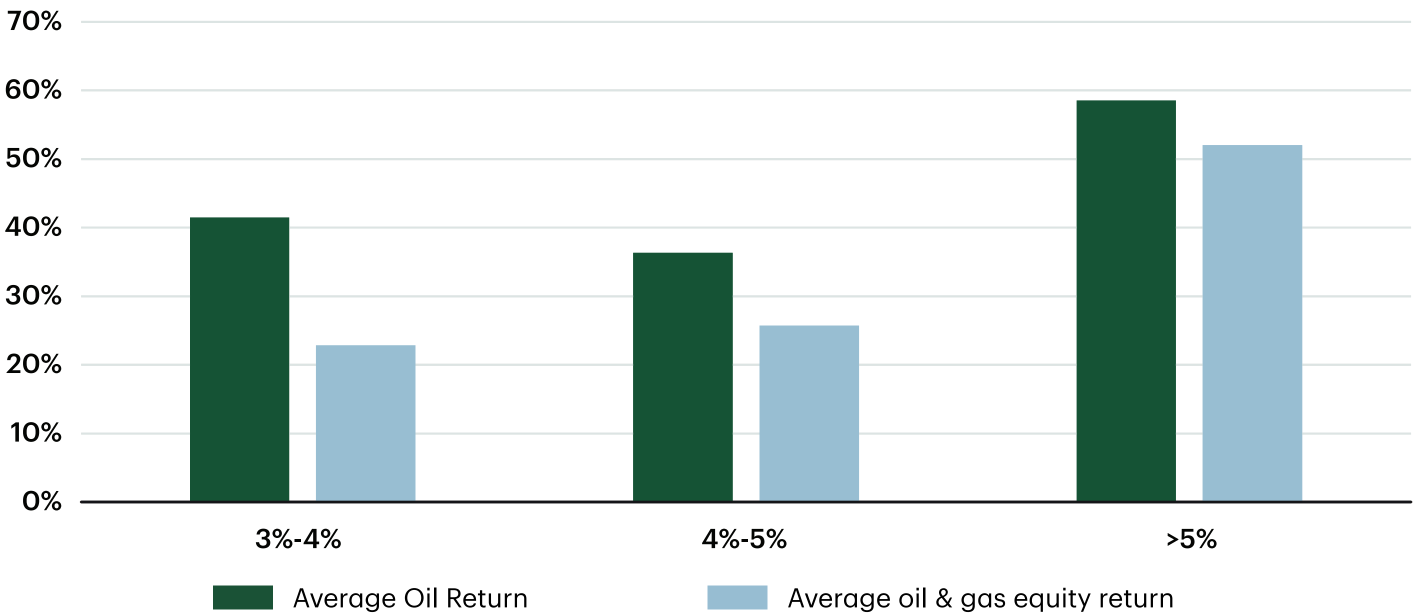
Inflation

The second main motivation to hold commodity derivatives in a portfolio rather than the equity equivalent relates to inflation and specifically, inflation-protection. Looking back at the last 30 years we find that in higher inflation environments, oil and gas equities tend to fare better than the broader market but tend to underperform the commodity. In high inflation environments, where CPI is greater than 3%, holding oil futures resulted in average annual outperformance of 12% when compared to energy equities.

Diversify

[1] BP: 2022 Financial Results & update on strategic progress.
[2] Shell: 2024 Annual ESG Update, Mar 27 2024.

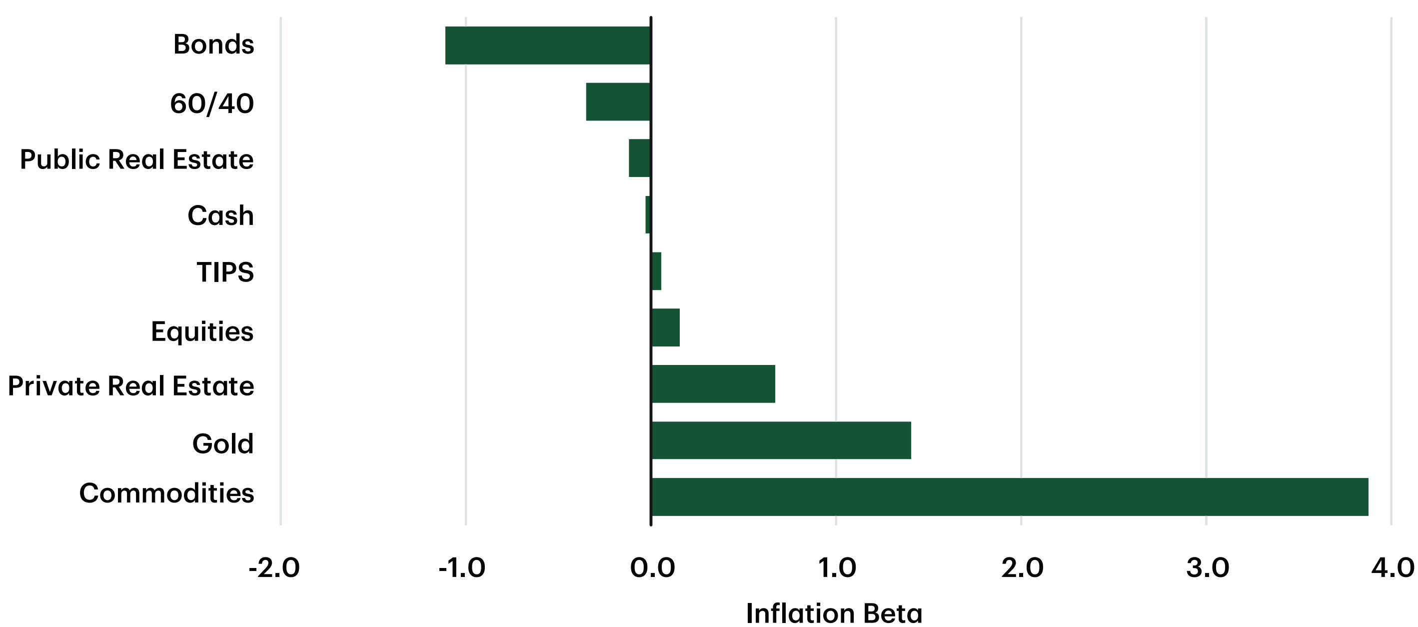
Oil and gas equity returns vs. oil returns within different inflation ranges



Source: Bloomberg Finance L.P. Data as of April 30, 2024. Oil is represented by the Bloomberg WTI Crude Oil TR index. Oil and gas equities is represented by the S&P 500 Oil & Gas Total Return Index. Average returns are calculated on a rolling 12 month basis.

The outperformance of commodities in inflationary environments is clear but it is worth emphasizing how meaningful the beta of commodities is to inflation (sensitivity of commodity prices to inflation). Historically, you need far less notional commodity exposure in your portfolio to hedge inflation than you do Treasury Inflation-Protected Securities (TIPS), equities, real estate or gold. As seen in the chart below, if inflation rises by 1%, then commodity prices have gone up by almost 4%.

Price sensitivity relative to the change in inflation



Source: Bloomberg Finance L.P., FRED, MSCI, TDAM. Data from Jan-1978 to Dec-2023. Equities, bonds, commodities, gold, public real estate, private real estate, and cash are represented by the MSCI USA Index, the Bloomberg U.S. Aggregate Bond Index, the Bloomberg Commodity Index, the Bloomberg Gold Subindex, the FTSE NAREIT All REITs Index, the NCREIF Property Index, and the ICE BofA 3-Month Treasury Bill Index, respectively. TIPS are represented by the Bloomberg U.S. Treasury Inflation Notes Index. The TIPS data series starts in Jun-1997. The 60/40 portfolio is comprised of 60% equities and 40% bonds and is rebalanced quarterly. Inflation beta is calculated by regressing quarterly asset returns on quarterly changes in seasonally-adjusted YoY inflation.

Final thoughts

Notwithstanding the fact that it would be very difficult to replicate the commodity complex using equities, we have shown that in the rare case where it is most viable, the energy space, equities are an inferior way to accomplish the goals of diversification and inflation protection. If you want to build a more durable portfolio, one that is better diversified and better protected against inflation, commodity derivatives can be a more optimal choice compared to commodity equities.■

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