Recognize the Relative Advantages of Natural Resource Equities vs. Commodities

Investors look to the commodity market to provide three primary benefits: portfolio diversification, inflation protection, and equity-like returns. However, empirical data shows that over the last decade shifts in underlying fundamentals have undermined the role commodities are expected to play in a diversified portfolio, particularly relative to natural resource equities.

We contend there is a strong case for employing natural resource equities as a means of benefiting from favorable long-term secular trends and providing similar diversification benefits and more reliable inflation protection relative to commodities.

A Shift in Commodity Fundamentals

Most of the benefits historically associated with owning commodities have been a function of high real interest rates and the backwardation of the futures curves that once characterized over-supplied commodity markets. Shifts in commodity fundamentals that began in the late 1990s have had a direct impact on the benefits of investing in commodities over the last 10 years, particularly when compared to natural resource equities.

Two changes are especially significant:

- The supply/demand dynamic has been altered, decreasing spare capacity for many commodities.
- The marginal cost of supply (the cost of the next increment of production available) has increased. For example, oil reserves per well have declined more than 50%* over the last decade, significantly increasing the price required to generate future economic returns.

[Graphs and data visualizations are used to illustrate the decline in spare capacity and increase in marginal cost of supply.]

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* Source: Sanford Bernstein
Commodities vs. Natural Resource Equities – Understanding the Differences

Long-term increases in commodity prices are now driven less by supply shocks and more by low spare capacity and the rising cost of supply. As a result, correlations (a statistical measure of how securities move in relation to each other) between commodities and equities have changed. As shown below, commodities have become much more correlated with equities, particularly in down markets, which is exactly when diversification becomes paramount. Although supply shocks may result in brief periods of negative correlation, changes in commodity prices are being driven more by changes in demand, which are highly correlated with changes in Gross Domestic Product and the equity markets. Therefore, we expect down-market correlations between commodities and equities to remain elevated and to be a less meaningful point of differentiation with natural resource equities.

![Graph showing correlations of S&P GSCI Index with MSCI World Index in up and down markets](image)

Source: RS Investments, Factset

*Correlation ranges between -1 and 1. 1 indicates perfect correlation and -1 indicates perfect negative correlation.*

Natural Resource Equities – Providing a Potential Hedge Against Inflation

The shift in fundamentals has also impacted future price expectations, as best illustrated by the changes in the forward curves. If, in fact, the marginal cost of supply for commodities continues to rise and futures curves remain in contango more frequently than in the past, we believe natural resource equities may continue to outperform commodities and provide a better hedge against longer-term inflation (as shown in the chart below).
Natural Resource Equities Offer Differentiated Sources of Potential Returns

Finally, natural resource equities offer two unique and meaningful sources of potential returns that cannot be captured through direct investments in commodities and which typically are not exploited in diversified equity strategies. First, natural resource companies can create value independent of commodity prices and this value has historically compounded to the benefit of the long-term shareholder. Second, natural resource equity investors can invest in the producers of a number of attractive commodities that are not traded on futures exchanges. These sources of return allow natural resource equities to potentially offer much more attractive risk-adjusted returns than commodities while also providing additional diversification benefits to investors.

The Long-term Role of Natural Resource Equities in a Diversified Portfolio

Many long-term investors use investments in real assets to protect the purchasing power of their assets as opposed to defending against temporary price spikes. The data suggests that natural resource equities can be more effective than commodities for investors looking to create a permanent allocation to real assets as a means to diversify portfolios and protect against longer-term inflation. For all of the above reasons, we expect real asset allocations to continue to evolve as more investors seek out those strategies that actually create value across a commodity price cycle.

Investments in companies in natural resource industries may involve risk including changes in commodities prices, changes in demand for various natural resources, changes in energy prices and international political and economic developments.
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1 A theory proposing that as a futures contract approaches expiration, the contract will trade at a higher price compared to when the contract was further away from expiration.

2 A situation in which the futures price is above the expected future spot price. This is the opposite of backwardation.

3 The S&P GSCI® Index is used in this paper to illustrate the risk and returns of an investment in commodities. The S&P GSCI® is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. Three S&P GSCI indices are published: excess return, total return and spot. The S&P GSCI Total Return Index measures the returns accrued from investing in fully-collateralized nearby commodity futures; the S&P GSCI Excess Return Index measures the returns accrued from investing in uncollateralized nearby commodity futures; and the S&P GSCI Spot Index measures the level of nearby commodity prices. The implied roll yield and collateral income contributions presented in this paper were derived by RS Investments using the S&P GSCI indices. These implied contributions are meant for illustrative purposes only and are not intended to represent any particular index or available investment.

4 The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of June 2007 the MSCI World Index consisted of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

5 The Dow Jones-UBS Commodity Index (DJ-UBS) is used in this paper to illustrate the risk and returns of an investment in commodities. It is composed of futures contracts on 19 physical commodities. The commodities in the index are traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME).

6 The Thomson Reuters/Jefferies CRB (RJ-CRB) Index maintains broad diversification through 19 commodities representing all commodity sectors. Commodities are equitably distributed whenever feasible, though exposure to selected markets, in particular those within the petroleum sector, are modified to create a liquid and rational index.

7 The S&P North American Natural Resources Sector Index™ (NANRSI), which is not covered by the report of independent accountants, is a modified capitalization-weighted index of companies involved in the following categories: extractive industries, energy companies, owners and operators of timber tracts, forestry services, producers of pulp and paper, and owners of plantations. Index results assume the reinvestment of dividends paid on the stocks constituting the index. Index results assume the reinvestment of dividends paid on the stocks constituting the index and do not include any transactions costs, management fees or other costs. As of December 31, 2007 the fund has changed its benchmark from the Lipper Natural Resources Fund Index to the S&P North American Natural Resources Sector Index because the S&P North American Natural Resources Sector Index is composed of securities of companies in the natural resources sector while the Lipper Natural Resources Fund Index is composed of mutual funds that invest in the natural resources sector.

8 The MSCI World Commodity Producers Index (MSCI-WCP) is an equity-based index designed to reflect the
performance related to commodity producers stocks. The MSCI World Commodity Producers Index is a free float-adjusted market capitalization-weighted index comprised of commodity producer companies based on the Global Industry Classification Standard (GICS®).

Not all funds or share classes are available at all firms. Please check with your financial advisor or representative for details.

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