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Hedge funds shift gears on commodities

Investors have flocked back to commodities. And while analysts believe this will continue, hedge fund managers see traditional investor profiles changing

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- Commodities registered positive gains for the first time in six years in 2016; the S&P GSCI commodity index increased by 11% and the Bloomberg Commodity Index by 11.4% over the course of the year.
- Investment flows returned to the sector as a result, totalling $11.48 billion in 2016 compared with $0.01 billion in 2015.

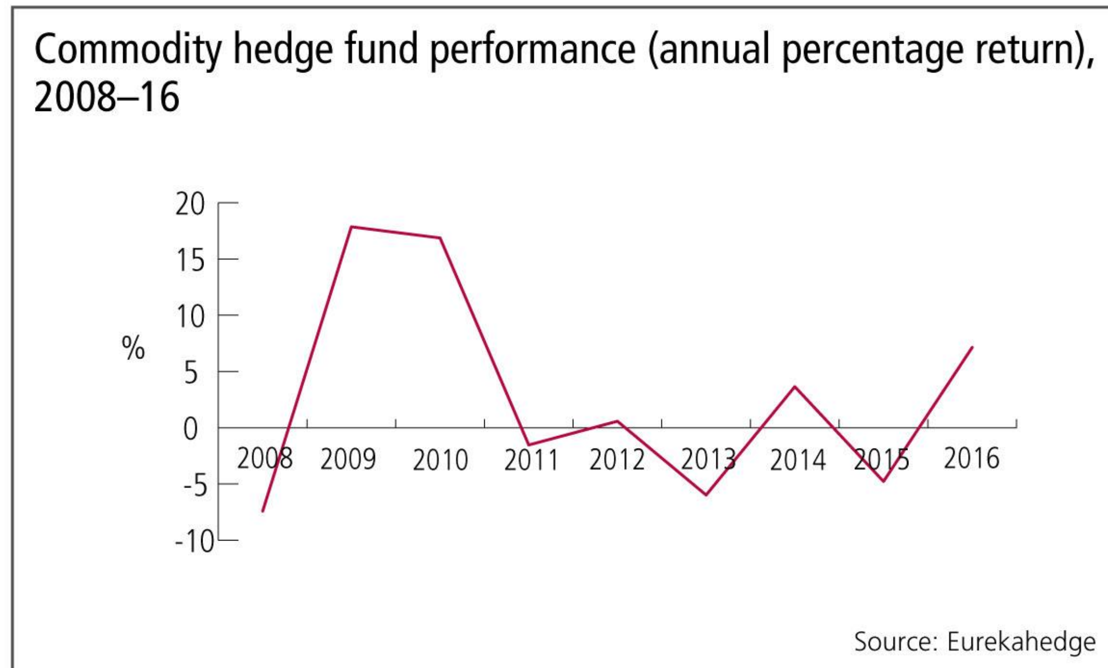
- Commodity funds returned more than 6% in 2016 and analysts expect investment interest in the space to continue on the back of a positive outlook for three of the four main commodity subsectors (Energy, industrial metals and precious metals) in 2017.
- While many investors are simply trying to gain exposure to this upswing in prices via oil, metals and gold trades, some fund managers have detected growing demand for new kinds of strategies that are based on a more diversified approach to trading and designed to profit as commodity markets become more fundamentally-driven.

After years of poor performance, an increasingly positive commodity price outlook has piqued investor interest in commodity hedge funds, causing a substantial shift in allocations back into the asset class in 2016. While many investors simply want to gain long-only access to rising prices in markets such as crude oil, a number of fund managers have detected growing demand for more diversified offerings and are developing new strategies in response.

Commodities registered the first positive gains for six years in 2016, with major indexes showing double-digit increases – 11% for the S&P GSCI commodity index and 11.4% for the Bloomberg Commodity Index. Market analysts have become decidedly more bullish across the complex. Ongoing infrastructure demand from China has boosted the outlook for metals, as has US president Donald Trump's campaign promise to spend $1 trillion on an infrastructure programme. Gold prices have also risen as a result of the political uncertainty cast over Europe by Brexit. In crude oil markets, output cuts agreed by Opec and non-Opec members last year could lead to "meaningful global oil stock draws", according to Mark Keenan, head of commodities research for Asia at Societe Generale. In an email to *Risk.net*, he said this could push West Texas Intermediate (WTI) to an average of around $60 per barrel by the final quarter of this year. "Our analysts at SG are bullish about three of the four major commodity subsectors on a six to 12-month basis," he says. "Energy, industrial metals and precious metals are expected to outperform their respective six to 12-month forward prices."

Unsurprisingly, investors are now heading back to commodities in droves after years of poor performance by hedge funds in this space. "Over the last 12 months, there has been a considerable increase in positive sentiment towards commodities as an asset class," Keenan adds. "This has led to the beginning of

meaningful shifts in capital allocation towards commodities – particularly in the long-only space."



Investment flows to commodity hedge funds totalled $11.48 billion in 2016, up from $0.01 billion in 2015, according to figures from data provider eVestment. In a report on year-end hedge fund asset flows, eVestment pointed out that the allocation process began in mid-2015 "when commodity funds were at the tail-end of a 19-month drawdown". Commodity funds went on to return more than 6% over the course of 2016. Figures from hedge fund data provider Eurekahedge rank commodities as the second-best performing strategy of 2016, behind only distressed debt. This is the first time the strategy has placed this highly since 2010.

The current influx of investor interest into the commodities space is similar to that seen in previous commodity price upswings, according to Kristoffer Houlihan, managing partner at asset management advisory firm Armilla Partners, which is based in Newport Beach, California. "I have seen the same interests from 2010 returning, I see the same [investor] risk profile that I saw seven years ago coming back into the fold," he says. And Vincent Elbhar, who launched the GZC Strategic Commodity Fund in 2010, believes investors have been most interested in returning to long-only funds, particularly those focused on the crude oil market. "I think as far as inflows are concerned, the biggest went to funds that have embraced the idea that commodities were going to rebound from the lows of last year and go on strongly from there," he says.

Investor interest in commodity hedge funds has continued into this year and Keenan believes it is likely to increase. “Sentiment has improved, which significantly facilitates capital raising. Combined with a price outlook that is largely positive, and with commodities becoming more fundamentally driven, this also acts to enhance their diversification benefits in a portfolio,” he says. Using principal component analysis (PCA) to determine the main drivers in the asset class, Keenan says fundamentals currently explain 88% of overall variance, compared with approximately 55% on average for most of 2015 and 2016. “As commodities become more fundamentally driven, or idiosyncratic, markets become more differentiated, volatility rises and consequently trading and investment opportunities increase. This is generally positive for hedge funds,” he says.

While many funds continue to offer investors access to the upswing in the commodity complex with traditional long-only exposure to markets such as oil and metals, some hedge fund managers say they have detected the beginnings of a shift in investor demand. These managers believe investors will turn away from the highly concentrated trading strategies that were popular during previous commodity upswings but collapsed in the ensuing years. As a result, new strategies are emerging to target what these managers see as a growing investor interest in a less concentrated approach to investing and managing risk in the commodities space.

A. Top hedge fund strategy performance (annual percentage return), 2008–16									
	2008	2009	2010	2011	2012	2013	2014	2015	2016
Long volatility	45.81	2.98	12.36	12.83	0.27	-4.44	1.58	-1.07	-2.96
Trend following	29.74	5.18	11.36	0.71	-1.86	1.02	13.44	-2.18	-1.55
Relative value volatility	20.56	10.97	6.98	5.46	8.81	6.04	-0.36	4.47	7.09
Equity short-bias	20.38	-10.13	-0.44	14.72	-10.28	-22.55	1.73	5.09	-7.79
CTA/Managed Futures	19.44	6.64	13.49	2.33	2.66	0.55	9.66	-0.31	0.38
Tail risk	12.58	-6.33	0.10	16.39	-21.21	-10.98	-3.22	-9.51	-13.37
FX	6.09	5.44	6.18	8.89	3.85	3.52	6.08	6.14	-0.99
Macro	3.33	14.87	7.72	0.36	4.55	4.50	4.80	1.81	2.04
Equity market neutral	0.04	7.05	5.06	2.57	3.30	7.82	3.32	7.39	-0.95
Commodity	-7.42	17.86	16.87	-1.53	0.58	-5.98	3.65	-4.77	7.14
Relative value	-7.55	22.77	11.91	0.61	10.40	7.12	4.17	1.46	6.16
Arbitrage	-9.09	23.75	8.96	1.10	7.36	7.68	2.86	5.04	4.81
Short volatility	-9.41	19.10	11.35	-1.20	9.07	9.53	4.47	1.09	4.56
Multi-strategy	-9.85	21.28	9.63	-1.30	7.92	7.50	4.91	2.26	4.14
Fixed income	-10.82	24.49	12.82	4.14	11.45	8.41	3.93	0.95	5.50
Long/short equities	-19.24	25.92	10.87	-5.92	8.55	16.10	3.65	3.15	2.86
Event driven	-21.06	39.94	15.38	-4.64	10.76	13.63	2.67	-0.94	7.97
Distressed debt	-25.57	36.20	22.70	1.36	14.32	14.90	1.59	-4.06	11.54
Equity long-bias	-35.24	43.80	14.29	-10.90	12.92	19.74	3.41	-0.34	4.25

Source: Eurekahedge

Battling the cowboy mentality

Adam Hoffman, who currently runs Houston-based risk management consultancy Wooded Park Strategies, believes there is growing interest in more measured commodity investment strategies in the current market environment. “There is no doubt commodity prices are currently more stable than they have been over the past few years, but what I think is really driving the renewed interest in commodities is the fact that the old paradigm of ‘the cowboy mentality’ – where a fund bets it all on black – is effectively over,” Hoffman says. He believes commodities investors are becoming less interested in funds that track on one particular market segment or strategy, leaving themselves open to huge losses when the markets do not go their way. “A lot of hedge funds have made this mistake and a lot of them have blown up as a result. Commodity funds have had a horrible run in performance [over the past nine years] because many were too concentrated and too levered, and so when they were wrong, they would see a massive drop in the space of a month. In 2017, investors are not willing to stomach those kind of drawdowns.”

Hoffman has previously managed two separate commodity funds focusing on oil, metals and agricultural commodities. He now wants to target what he sees as changing investor demand with a fund he plans to launch by the end of 2017 with assets under management (AUM) of at least $150 million. In his new venture, he will work with a number of principles with commodity market experience in the hedge funds space (including at Millennium Partners), as well as major asset management firms and investment banks. It will trade futures and options primarily in the energy and metals markets and will mix discretionary and systematic trading strategies, according to Hoffman, who has not yet named the hedge fund.

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Multi-strategy approach

In 2015, as many investors were leaving the commodities space, Marcos Bueno and Aurelia Lamorre-Cargill launched Argon Capital Management to provide diversified exposure to these markets. Bueno – who is Argon's New York-based chief investment officer – says the fund aims to "provide an investable solution" that is designed to attract the capital that left the commodity space before 2015. The fund takes a multi-strategy approach, using a team of managers that each specialise in a particular type of commodity. Bueno acts as the senior portfolio manager of the team and says the strategy allows managers to share insight across the fund, but also provides the diversification investors now seek in these markets.

This approach has also affected how the fund manages risk, according to Bueno. Each investment strategy is subject to a systematic, rules-based risk management framework that reduces capital allocation for those that go through pre-determined drawdown limits. The fund's returns are blended, with Argon netting the risk among the strategies on behalf of investors. And rather than taking the traditional approach, in which a hedge fund manager hires a risk manager but ultimately has the last word on risk issues, at Argon the portfolio

managers all report to a central risk manager. “The institutional investors we talk to are very interested in this format,” Bueno says. “Risk management [has increasingly become] a part of their assessment so they are very keen to see we have an independent risk manager that the portfolio managers report to.”

Sampling new strategies

While some market participants would disagree, managers of commodity trade finance funds believe this type of strategy could also provide investors with exposure to the increasingly idiosyncratic nature of the commodities complex. These funds lend money to companies that purchase, transport and sell commodities. They use those commodities as the primary collateral for these loans, which are typically short-term. As such, they are not traditionally seen as a commodities play, but managers in the space argue that they should be considered by commodity investors that want high yields, low volatility and low correlation.

“For commodity investors, we would argue that having a portion of your allocation attributed to trade and commodity finance makes tremendous sense,” says C Mead Welles, New York-based portfolio manager at Octagon Asset Management, which specialises in funds that provide alternative structured finance in global trade, commodity finance and transportation. Welles emphasises the ability of this type of strategy to perform in a variety of market situations and dilute volatility within a portfolio, providing diversification benefits for investors. “The strategy performs well in both boom and bust cycles,” he says.

“A rising tide lifts all ships: as the commodity markets experience a boom, there is a greater need for capital for the same volume of business. If the supply of capital does not expand at the same rate as the demand, the price or cost of the capital goes up, leading to higher absolute returns for risk, which is in most cases fully collateralised, self-liquidating and short term. In ‘bust’ cycles, traditional sources of liquidity tend to dry up, leading to the same shortage of capital to meet the ongoing demand, resulting in higher yields for providers of trade and commodity finance.”

Welles argues that the low volatility, low correlation and high absolute returns that trade finance funds can provide could dilute the volatility of an overall allocation to commodities without sacrificing return. As such: “We’ve seen a

material pick-up in demand for trade finance and commodity finance, which are derivatives of the commodity space," he says.

"We have seen a really strong investor appetite over the last 12–18 months. I would hate to speculate going forward, but I don't see that waning anytime soon," agrees Gerry Afentakis, the London-based head of strategic development at EFA Group, which manages a number of commodity and natural resources trade finance solutions. It took over management of the Galena Commodity Trade Finance Fund from Trafigura's Galena Asset Management in November 2016. "In investors' minds, this asset class has become less esoteric and is now recognised as being something that they can and maybe should consider. Whether investors will continue to want the kinds of uncorrelated returns we're generating, that's a different question, but as an asset class overall, trade finance has established itself as being very much more mainstream than it was considered in the past," Afentakis says.

The commodity trade finance market has traditionally been dominated by banks, but stricter capital requirements put in place after the global financial crisis have lead to a retrenchment by many of the major players in recent years. Commodity trade finance funds have filled the resulting liquidity gap to some degree. At the same time, those active in this space, such as Afentakis, believe these funds will continue to become more mainstream as investors, faced with less attractive fixed income products, are forced to search for non-traditional sources of yield.

Armilla Partners' Houlihan adds that the interest in commodity trade finance funds he has seen in recent years has largely arisen from greater interest in "peripheral investment strategies" that deliver "something a bit more esoteric and interesting" than the products currently found in the equities and fixed income space.

While analysts believe investor interest in commodity hedge funds is likely to continue this year, it remains to be seen whether the current upswing is part of a cyclical trend, or will lead to a new era for commodities investors looking for more abstract strategies that offer diversification and reduce correlation. Regardless, some hedge funds are already taking steps to provide a different approach, whether that's through brand new strategies or by opening up new routes to commodity exposure through non-traditional vehicles. If investors maintain or increase allocations to the market in 2017, as expected, these funds could enhance the options that are already available in this space, providing another useful tool for portfolio diversification.