Commodities Corner

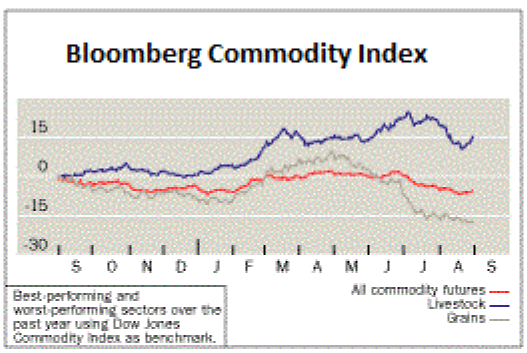
How to Simplify Commodities

Using just oil, soybeans, copper, and cotton, an economist says, he's created an index that is a proxy for the entire market.

By Simon Constable Aug. 30, 2014 1:17 a.m. ET

Investors have long known that adding a dash of commodities to their portfolios can be beneficial to their wealth. The only problem has been implementing this strategy.

It's difficult to know which commodities are a good bet, and broad commodities-focused indexes are inadequate. Investors also worry that futures prices don't always track the spot market. But veteran economist David Ranson, at Cambria, Calif.-based HC Wainwright & Co. Economics, might have a solution to all these potential problems: investing in just four commodities.



"A small handful of individual commodities can [act as a] proxy for the commodities universe as a whole," writes Ranson in a July report. He uses equal weights of crude oil, soybeans, copper, and cotton to represent energy, foodstuffs, industrial metals, and textiles/fibers. The index is rebalanced annually to maintain equal weight of each commodity. To make Ranson's list, each commodity had to meet three criteria: a long price history, economic importance, and a liquid market.

Crude was the only choice in energy, he says, and likewise cotton for fibers. Among the metals, copper has a wide acceptance as a barometer of economic activity and has a price history that goes at least as far as the 19th century. Picking the food item was trickier. Corn was excluded because it is partially used in a fuel, ethanol; wheat was possible but there are too many varieties. In the end, Ranson settled on soybeans, which are processed into edible oils and livestock feed and used to make tofu.

RANSON'S INDEX TAKES A MIDDLE ROAD between two benchmarks, the Commodities Research Bureau index and the S&P GSCI (formerly the Goldman Sachs Commodity Index). The CRB lacks an energy component and tracks spot prices, not futures, so it can't be traded. The S&P GSCI has a high energy exposure -- 72%, about two-thirds of which is crude oil, according to S&P Dow Jones Indices. That's a problem, given how volatile oil prices are compared with those of other commodities, Ranson says. A major move in crude could swamp changes in other components of the index.

The average price of the four commodities fell 1% in the year through July, compared with a 0.4% decrease in the CRB average in the same period and a 1% drop for the S&P GSCI average, according to a *Barron's* analysis of data from SIX Financial Information and FactSet Research Systems.

Ranson's approach has a 65% correlation to both the CRB and the GSCI when using monthly data back to 1970. The economist dismisses concerns that futures prices don't always track the spot market. He says that, using average annual data, he found correlations of at least 99% between near-dated futures contracts and spot prices. Still, there are potential risks. What if the selected commodity fails to truly represent the whole subclass? In 1998, average prices for copper dipped below $1 a pound, even though the economy took off. But the uncoupling didn't last forever.

Another concern: Not all investors can constantly monitor futures positions and renew credit agreements, a big factor in successful commodity trading. Ranson says the way around this is to use commodity exchange-traded funds or notes, such as the iPath Dow Jones UBS Copper Subindex Total Return ETN (ticker: JJC) which tracks copper prices.

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