

Know your Commodity basket

- We look at Commodity basket weighting schemes
- Comparing Traditional vs “Smart” weighting schemes
- Contrasting equal weighted approaches

Commodity indices, and the ETPs that track them provide a convenient way of accessing a broad commodity basket exposure with a single trade.

What’s inside the basket?

Commodity indices represent baskets of commodities constructed using futures prices. The Bloomberg Commodity Index which was launched in 1998 as the Dow Jones-AIG Commodity Index has a weighting scheme is based on target weights for each commodity exposure.

These weights are subject to the index methodology rules that incorporate both liquidity (relative amount of trading activity of a particular commodity) and production data (actual production data in USD terms of a particular commodity) to reflect economic significance¹.

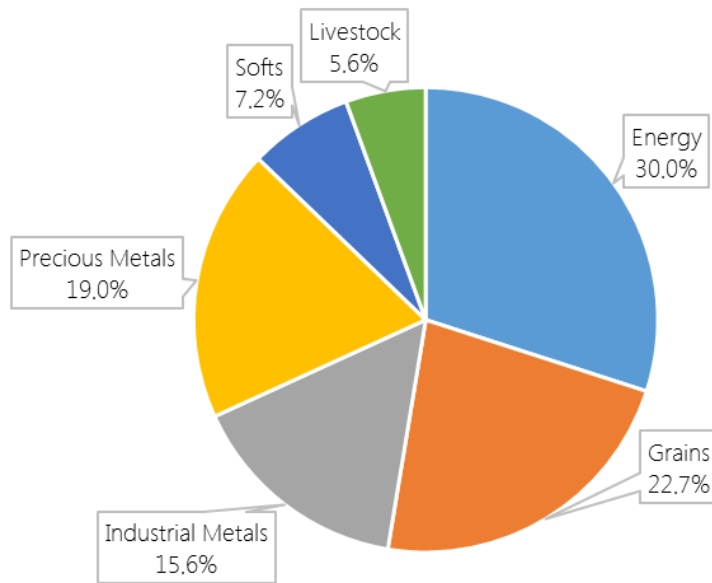
The index subdivides commodities into “Groups”, such as: Energy (WTI Crude Oil, Natural Gas etc), Grains (Corn, Soybeans etc), Industrial Metals (Copper, Aluminium etc), Precious Metals (Gold, Silver), Softs (Sugar, Coffee, Cotton) and Livestock (Live Cattle, Lean Hogs).

The index rules include diversification requirements such that no commodity group constitutes more than 33% weight in the index; no single commodity (together with its derivatives) may constitute over 25% weight; and no single commodity may constitute over 15% weight.

The make up for 2021 at Group and Commodity level is presented below:

¹ For index methodology, see <https://data.bloomberglp.com/professional/sites/10/BCOM-Methodology.pdf>

BCOM Commodity Group 2021 Target Weights



Source: Elston research, Bloomberg data

Source: Elston research, Bloomberg data²

Owing to changes in production and or liquidity, annual target weights can vary. For example the material change in weight in the 2021 target weights vs the 2020 target weights was a +1.6ppt increase in Precious Metals (to 19.0%) and a -1.9pp decrease in Industrial Metals to 15.6%.

Traditional vs “Smart” weighting schemes

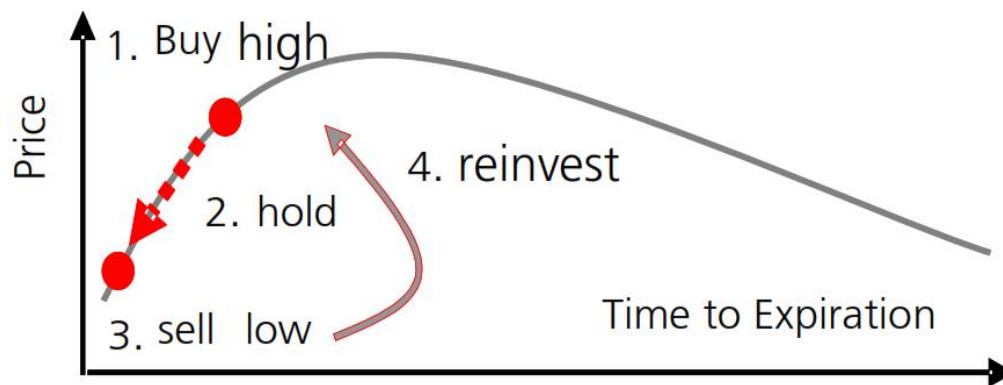
One of the drawbacks of the traditional production- and liquidity-based weighting scheme is that they are constructed with short-dated futures contracts. This creates a risk when futures contracts are rolled because for commodities where the forward curve is upward sloping (“contango”), the futures price of a commodity is higher than the spot price. Each time a futures contract is rolled, investors are forced to “buy high and sell low”. This is known as “negative roll yield”.

A “smart” weighting scheme looks at the commodity basket from a constant maturity perspective, rather than focusing solely on short-dated futures contracts. This approach aims to mitigate the impact of negative roll yield as well as potential for reduced volatility, relative to traditional indices.

This Constant Maturity Commodity Index methodology was pioneered by UBS in 2007 and underpins the UBS Bloomberg BCOM Constant Maturity Commodity Index and products that track it.

² <https://www.bloomberg.com/company/press/bloomberg-commodity-index-2021-target-weights-announced/>

Illustration of futures rolling for markets in contango



Source: UBS Bloomberg CMCI Index factsheet

An Equal Weighted approach

Whilst the traditional index construction considers economic significance in terms of production and liquidity, investors may seek alternative forms of diversified commodities exposure, such as Equal Weighted approach.

There are two ways of achieving this, equal weighting each commodity, or equal weighting each commodity group.

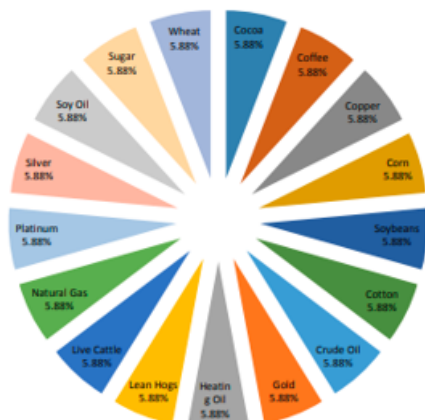
The Refinitiv Equal Weight Commodity Index³ equally weights each of 17 individual commodity components, such that each commodity has a 5.88% (1/17th) weight in the index. This results in an 18% allocation to the Energy Group, 47% allocation to the Agriculture group, 12% allocation to the Livestock group and 23% allocation to Precious & Industrial Metals.

An alternative approach is to equally weight each commodity group. This is the approach we take in the Elston Equal Weight Commodity Portfolio, which has a 25% allocation to Energy, a 25% allocation to Precious Metals, a 25% Allocation to Industrial Metals and a 25% Allocation to Agricultural commodities. This is on the basis that commodities components within each group will behave more similarly than commodity components across groups.

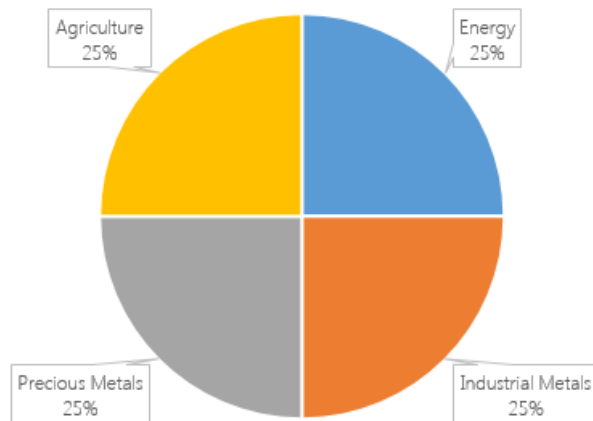
These two contrasting approaches are summarised below:

³ https://www.refinitiv.com/content/dam/marketing/en_us/documents/fact-sheets/equal-weight-commodity-index-fact-sheet.pdf

Refinitiv Equal Weight Commodity Index
% weight, by commodity component



Elston Equal Weight Commodity Portfolio
% weight, by commodity group

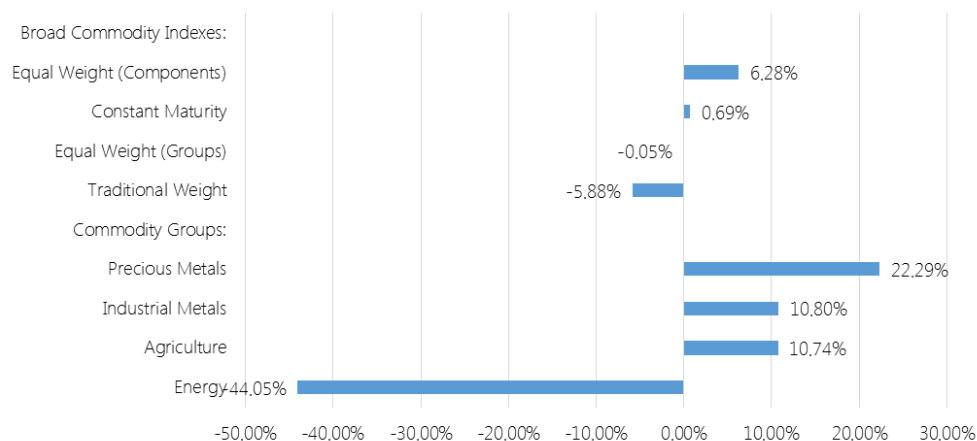


Source: Refinitiv, Elston

Performance

In 2020, the Equal Weight component strategy performed best +6.28%. The Constant Maturity strategy delivered +0.69%. The Equal Weight Group strategy was flat at -0.05% and the traditional index was -5.88%, all expressed in GBP terms.

Commodity Group and Commodity Index Performance
(2020, GBP)



Source: Elston research, Bloomberg data

Informed product selection

This summarises 4 different ways of accessing a diversified commodity exposure: traditional weight, constant maturity weighting, equal component weighting and equal group weighting. Understanding the respective strengths and weaknesses of each approach is an important factor for product selection.



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