GLOBAL X
by Mirae Asset

GLOBAL X ETFs RESEARCH

Introducing BCOM: The All-in-One Commodities Basket

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Commodities cover a broad range of raw materials that form the basis of the global economy, including everything from oil to grains and industrial metals. While essential, they are often poorly understood as investments. There is a plethora of commodities around the world, most of which are produced and traded in their own way. This can make choosing between them and identifying how best to invest in them complicated. Adding to the complexity is that commodities often have different risk-return trades offs to equities and bonds.

This Investment Case outlines the advantages of investing in a broad commodities basket, the long-term diversification and inflation hedging benefits, and explains how investors can access ETFs such as the Global X Bloomberg Commodity ETF (ASX: BCOM).

Key Takeaways

- As a separate asset class, commodities offer genuine diversification, potentially enhancing risk-adjusted returns for Australian dollar investors.
- Commodities function as a natural inflation hedge, given their weighting in consumer price index (CPI) baskets, hedging both expected and unexpected inflation.
- By buying a broad basket of commodities, individuals can be spared the risks and volatility of trying to pick winners in this crowded field.

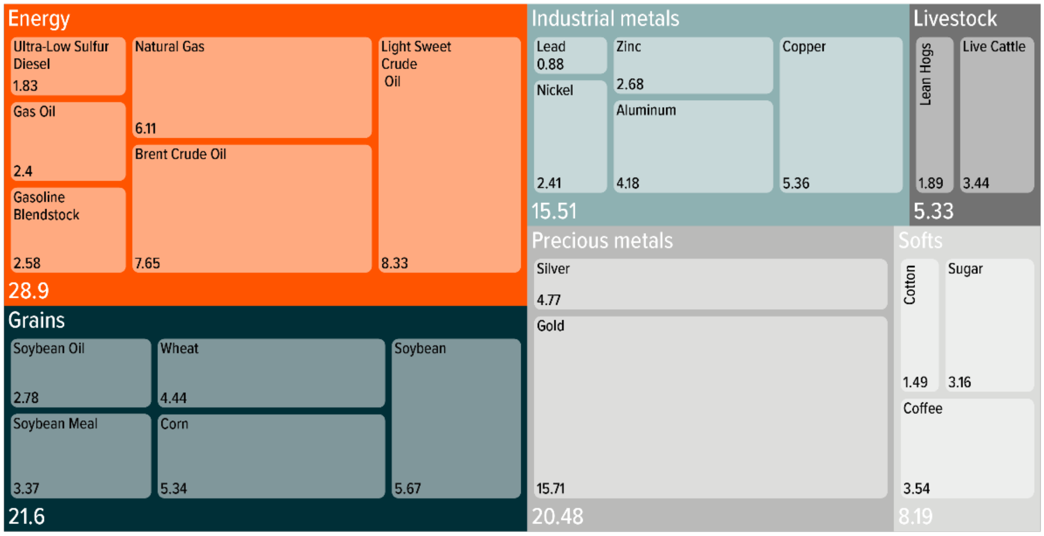
What Are Commodities?

Commodities are the primary materials and inputs that drive the global economy. They are the livestock and agriculture grown and raised on farms. They are the metals and oils dug out of the earth's crust. Commodities are used to build houses, make cars and consumer goods, and feed the world.

There are numerous commodities, spanning everything from sugar and coffee to oil and gas. However, investors tend to focus on the most heavily produced commodities, which fall into energy, grains and metals categories. This is because these commodities are the most significant to the global economy and tend to have the largest and most liquid futures markets, making them easiest to access. A full breakdown is available in the following chart.

BLOOMBERG COMMODITY INDEX

Source: Bloomberg. Data as of April 2023.



Why Invest in Commodities?

Genuine Diversification

When it comes to diversification, commodities have historically exhibited low correlations with most assets that Australians consider, such as property, shares and bonds. Historically, they have also exhibited low correlations to the Australian dollar, despite the Australian dollar sometimes incorrectly being called a “commodity currency”, given the significant role the mining sector plays in the local economy. These numbers are reflected in the correlation matrix below, where the closer a score is to 1, the more correlated the asset is to broad commodities.

10-YEAR CORRELATIONS TO BROAD COMMODITIES

Source: Bloomberg. Returns in AUD monthly. Data as of 20 April 2023.

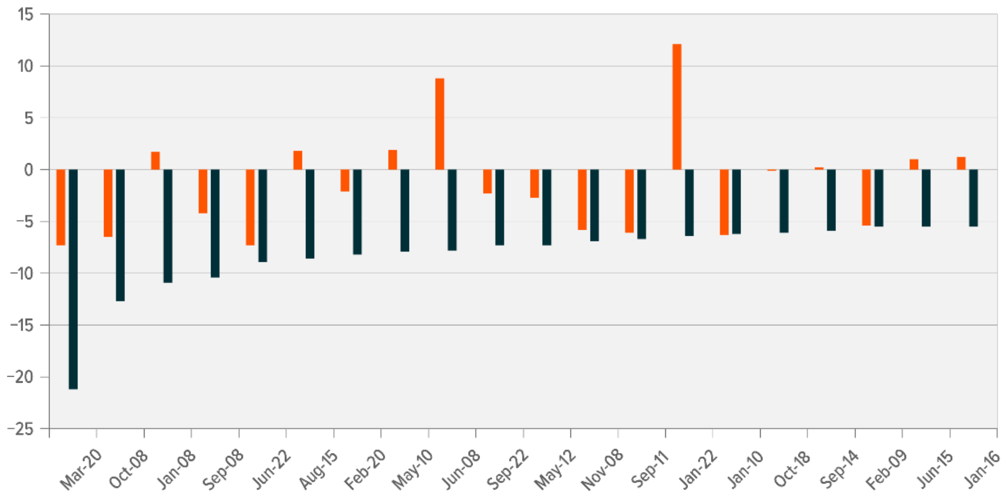
Asset Class	Correlation	
Broad Commodities	1.00	
ASX 200	0.10	Low
Australian Bonds	-0.16	Negative
Global Shares	0.22	Low
Australian Residential Property	0.14	Low
Global Bonds	-0.24	Negative
Gold	-0.02	Negative

What these low correlations mean in more practical terms can be seen in the following graph. It demonstrates how commodities have tended to outperform in the worst months for the S&P/ASX

200 Index over the past 20 years. This outperformance provides powerful diversification for investors.

COMMODITY RETURNS DURING WORST 20 MONTHS FOR THE ASX SINCE 2003

Source: Bloomberg. Data as of 20 April 2023. All returns in Aussie dollars.



As most companies are not commodity producers, they are short on commodities and therefore uncorrelated to their prices — creating a natural hedge between equities and commodities. Conversely, commodity producers, like oil majors, are structurally long on commodities and benefit from price rises. But most businesses are commodity consumers, benefitting when commodity prices fall.

A prominent example of this is the electric vehicle (EV) industry. Since 2019, lithium and copper prices have soared while the price of EVs has fallen. Competition between EV makers has prompted these businesses to absorb higher input prices, and the industry globally is barely profitable, despite increased sales growth. This illustrates the natural push and pull between commodity prices and corporate profits in competitive industries.

A Powerful Inflation Hedge

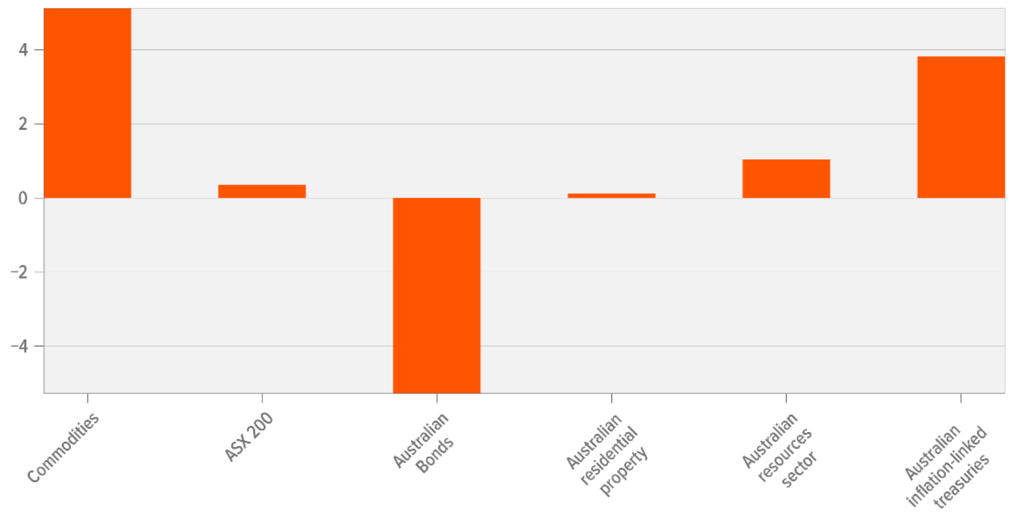
Historically, when inflation rises, shares and bonds fall as investors worry that inflation will erode the future value of the cash flows – such as dividends, earnings, and coupons – they produce. Many investors seek to hedge against inflation because a large portion of Australian portfolios has hefty allocations to these assets.

This is where commodities can be used as a natural inflation hedge. CPI, which measures inflation in the economy, is heavily composed of commodities – meaning rising commodity prices can be a key driver of inflation. In this way, commodity and inflation indexes are ultimately measuring the same thing. We can see the specifics of this by cracking open the CPI basket used by the Australian Bureau of Statistics (ABS).

In Australia's CPI basket, housing is the most heavily weighted item, which primarily reflects the cost of buying or renting property. Housing is not a component of investible commodity indexes—as residential property is not "financialised", meaning it doesn't trade on exchanges like shares, ETFs or oil futures. However, many Australians already own residential property — with our national home ownership rate at 67%. So, it could be argued that they are already naturally hedged here anyway. The ability of commodities prices to rise when inflation also rises is reflected in the graph below, which measures the sensitivity of asset classes (called "beta" in finance jargon) to rising inflation.

ASSET CLASSES BETA TO INFLATION

Source: Bloomberg, Australian Bureau of Statistics. Data as of 25 April 2023.



However, other items in the CPI basket are very well represented in investible commodity indexes. For example, food, drink, alcohol, and tobacco – collectively make up 25% of the CPI basket – appear as softs, grains and agriculture in the Bloomberg Commodities Index and take 33% of its weight.

Energy is also well represented in both indexes. It shows up four times in different capacities in the CPI basket, including automotive fuel under transport (3.6% weight), electricity and gas under housing (3.1%), holiday travel due to airline fares set by kerosene prices (~4% weight) as well as toys and durable goods thanks to hydrocarbons' use in plastics. By Global X's estimates, energy costs comprise 7 – 10% of the CPI basket.

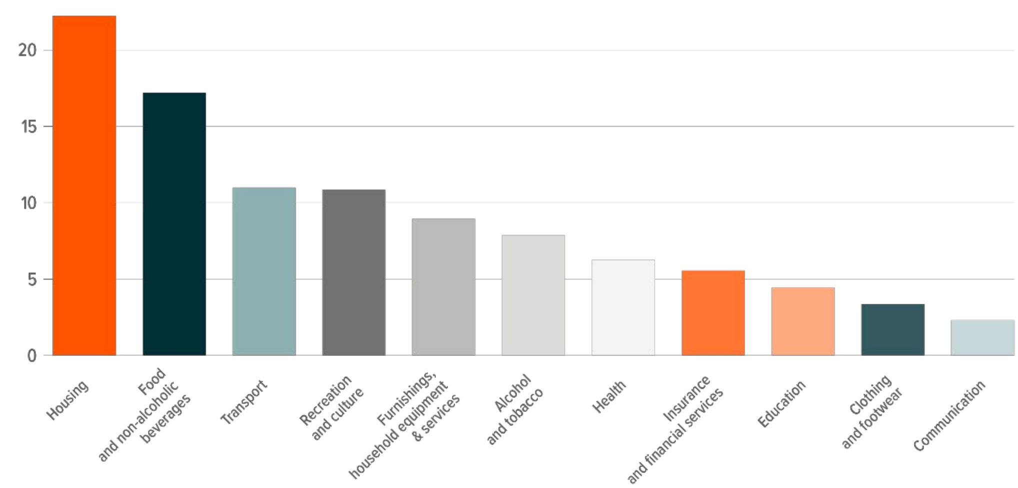
How to Invest in Commodities?

Investors looking to access commodities naturally wonder what the best approach is to suit their individual needs, risk, and investment goals. In Global X's view, there are two main ways investors can approach commodities, depending on which commodities they are interested in.

The most common access route for investors wishing to invest in broad commodities discussed in this article is the futures market. Barrels of oil, boxcars of soybeans, bushels of wheat – these things cannot be directly added to a portfolio. However, it is comparatively simple to add commodity futures contracts. Commodity futures – which mainly trade on specialist exchanges in the US – are highly liquid and have existed in various forms for hundreds of years.

THE WEIGHTING OF COMMODITIES IN AUSTRALIA'S CPI BASKET

Source: Australian Bureau of Statistics, Bloomberg. Annual weight update of the CPI and Living Cost Indexes December 2022



COPPER FUTURES PRECISELY TRACK THE COPPER PRICE

Source: Bloomberg. Data as of April 2023.

In Global X's view, investors wishing to invest in precious metals can also consider physically backed ETFs. Precious metals like gold lend themselves better to physical investment as they can be stored in bank vaults and are imperishable. Precious metals ETFs, like futures, are widely used by investors and house over US$200 billion in assets.

Considerations for Investing in Commodities

All investing comes with risks, and commodities and futures are no exception. A key risk to investing in commodities is that they come with higher volatility. This is because commodities, as an asset class, are more volatile than shares and bonds.

High volatility can unsettle investors as it is often taken as a way to measure risk and, ultimately, the probability of losing money. High volatility may cause some investors to class commodities as risk assets.

ANNUAL VOLATILITY

Source: Bloomberg. Data as of April 2023.

	Bloomberg Commodities Index	S&P/ASX 200
Annual Volatility	20.8	14.9
Annualised 10-Year Total Return	2.7	8.7
Skewness	0.12	-0.49

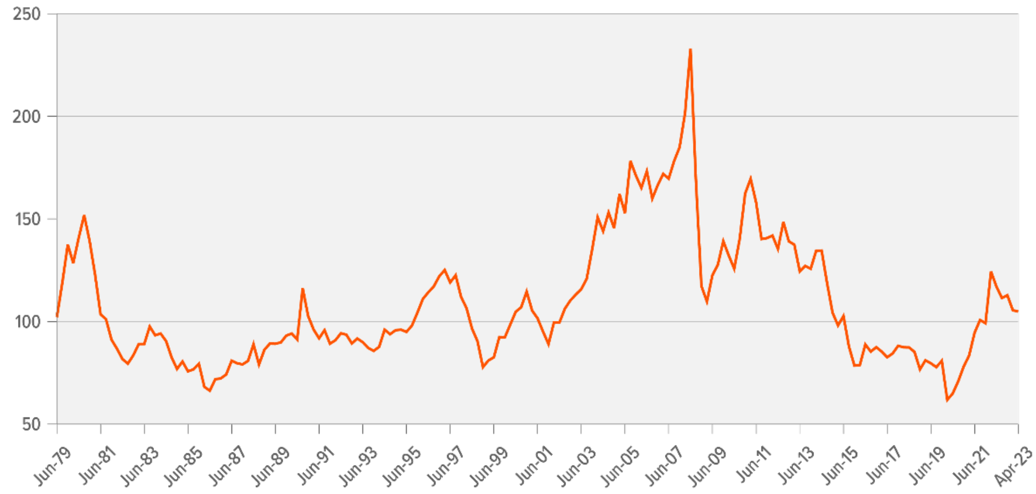
However, some comfort can be taken from the fact that commodity volatility has been positively skewed. This means commodity prices have been more likely to rise than fall sharply. As can be seen again, the opposite is the case for equities, which are more likely to fall than rise sharply.

Comfort may also be taken from the fact that broad commodity returns over the past 40 years have been rangebound—meaning commodity prices have historically only fallen so far.

Risks are not limited to these.

BLOOMBERG COMMODITY INDEX PRICES RETURN OVER 40 YEARS

Source: Bloomberg. Data as of April 2023.



Related Fund

BCOM: For those wishing to invest in broad commodities, the Global X Bloomberg Commodity ETF (Synthetic) (ASX: BCOM) provides one way of doing so. BCOM tracks the Bloomberg Commodity Index, which tracks a basket of global commodities based on production and liquidity. It invests in its index via a swap agreement with J.P. Morgan.

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