



Index commodity funds

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The dominant asset classes which most private investors use in their portfolios are likely to be cash, fixed interest and equities. These provide a good combination of liquidity and long term inflation protection and afford investors with the greatest reasonable prospect of achieving their goals in most market conditions at a level of risk that is acceptable to them. One scenario, however, in which equities and bonds are not particularly effective at providing inflation protection, is that of sudden inflationary shocks, such as that which followed the October 1973 Arab-Israeli war. Such spikes are often accompanied by (or indeed caused by) commodity price increases, so there are diversification benefits to be gained by the inclusion of some exposure to this asset class. Indeed, during the stagflation (slow economic growth combined with rising prices) of the 1970s, commodities were the only asset class to post positive returns for UK investors.

Since commodity prices are driven solely by the imbalances between supply and demand as the asset class has no inherent mechanism for generating returns and therefore no income stream which can be valued by conventional methods, the returns tend to be highly volatile (almost as volatile as equities). However, commodity returns do not move in tandem with either equities or bonds, which can make them a useful diversifier within a portfolio. Obtaining diversified pure commodity exposure (i.e. to the actual commodity prices and not to the share prices of businesses which are involved with them, which tend to correlate better with equity prices generally) at sufficiently low cost has also been difficult for the retail investor.



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In the past year or so several funds have been launched which allow access to passive exposure via a diversified commodity futures index at relatively low cost. The latest of these is the Lyxor ETF Commodities CRB (GBP), which is based on the Reuters CRB Index. This is the oldest commodity index, which was introduced in 1957 and began trading on the New York Futures Exchange, now part of the New York Board of Trade, in 1986. On 10th May of this year, Reuters, which owns the rights to the index, announced a major revision of its structure in partnership with Jefferies Financial Group. Instead of giving all the commodities an equal weight, the index now assigns each commodity to one of four tiers, with weightings ranging from 23% for crude oil to 1% for orange juice, nickel and wheat. In addition, the index will be rebalanced monthly and prices will be drawn from the nearby futures contract month, rather than the six-month average previously used as reference period.

In our opinion, this fund offers the most diversified pure exposure to global commodities for retail investors compared to the other five alternative indices. It is also very low cost with a TER of just 0.35% p.a. and as it is an ETF it suffers no stamp duty on purchase.

Inclusion of a globally diversified commodities fund in a diversified investment portfolio makes sense, providing that the index used avoids over concentration, the costs are low and the amount allocated to this asset class is appropriate. Having the discipline to review one's portfolio regularly and re-balance whenever it deviates from the overall target composition is essential for all investors. Once commodities are included such re-balancing is likely to be required more frequently, given their higher volatility. If you can apply this discipline to your portfolio yourself, then self-manage. If you can't then find a professional who can.

Contacts	Telephone	Email
Jason Butler	07973 951107	jasonbutler@bloomsburyfp.co.uk
Carolyn Gowen	07775 712969	carolyng@bloomsburyfp.co.uk
Robert Lockie	07951 725880	robertl@bloomsburyfp.co.uk

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Bloomsbury Financial Planning, New Broad Street House, 35 New Broad Street, London, EC2M 1NH United Kingdom
 Telephone: 00 44 (0)20 7194 7830 | Fax: 00 44 (0)20 7194 7831 | Email: info@bloomsburyfp.co.uk

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