

Staying tuned

Martin Steward found a different take on recent investor mood music around the asset class and a robust case for allocation when he spoke to one of the largest commodities managers

Interview Diapason Commodities Management

Swiss asset manager Diapason is a good place to go to get a sense of the mood music from investors around commodities.

The firm oversees \$7bn (€5.2bn) in commodity-related assets, half of which comes from pension funds.

Read the financial press and you would be left in little doubt that the mood music is in a minor key: China, engine of the commodities 'super-cycle', is re-balancing to become less materials-intensive; big institutions like CalPERS are trimming allocations; regulators and NGOs fret about speculators making prices more and more volatile.

"When the CalPERS announcement came out I had three RFPs on my desk relating to institutions that were making significant rotations into commodities," notes Diapason's head of institutional sales, managing director Mark McDonnell.

Nonetheless, he acknowledges that the firm started hearing about terminated mandates during the course of 2012, particularly among US institutions, and a number of trips across the Atlantic to expand the Diapason franchise last year turned into something of a fact-finding mission, as well.

"The message we got was not as dark as some of the press had painted it," McDonnell says. "For the traditional reasons associated with commodity allocation – diversification, inflation protection – there was still ongoing demand. But

investors had moved on from the approach they were taking 10 years ago."

The common theme was that investors want to move away from the standard benchmarks to more tailored ones, with decent track records as opposed to a theoretical return-enhancing algorithm. In addition, they want to see managers capable of generating consistent alpha around those benchmarks.

Diapason can certainly do active commodities management. As well as a long/short commodity futures programme, in February it rolled-out the first of a new range of relative-value strategies, the Relative Value Petroleum Industry fund, which will pursue a series of crack spread-arbitrage trades between a short list of crude oil and distillate futures.

But thanks to its proprietary commodity indices, developed in its early days to address the weaknesses of the standard benchmarks, Diapason remains best-known as a manager that designs access points to commodities as an investable asset class.

But, as McDonnell has intimated, the beta benchmark – itself often the result of close collaboration – is just the starting point for a good allocation to commodities. Right now investors are interested in 'smart-beta' strategies around those benchmarks. This is what inspired the firm's 'Virtuoso' platform, developed in partnership with Banque Cantonale Vaudoise, which

seeks to enhance returns through futures-curve optimisation and a quantitative tactical allocation process based on a variety of fundamental and market-sentiment indicators.

"Our job as a leading commodities manager is to anticipate where the institutional investor is going and to guide them as to the format for their commodity allocation," says McDonnell.

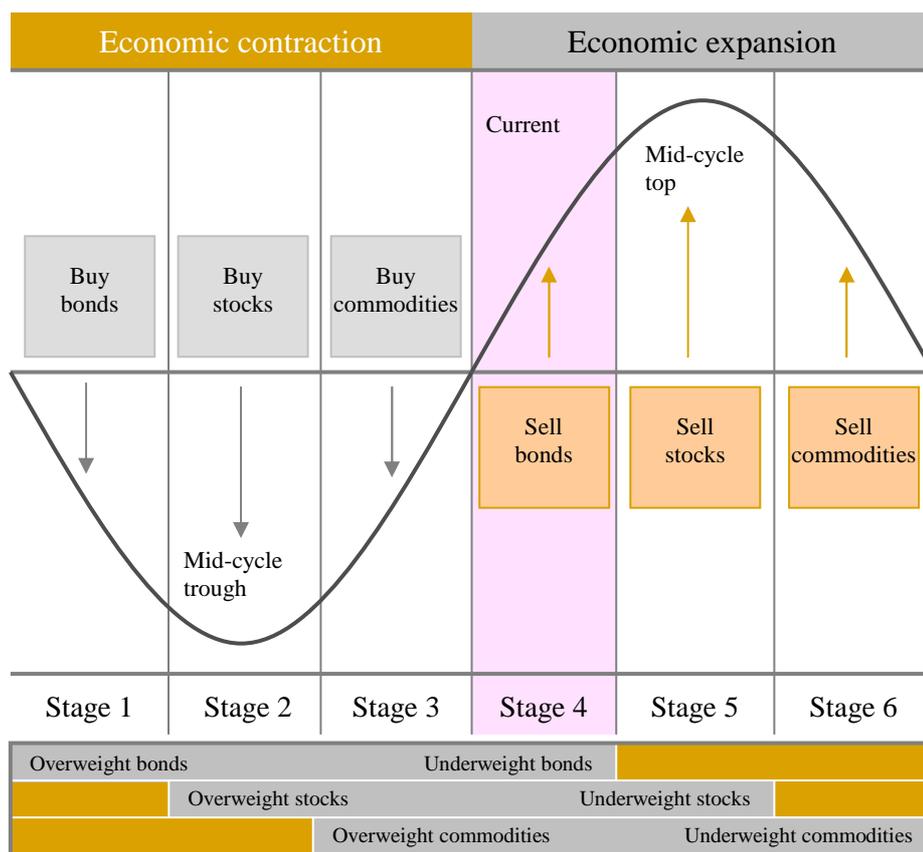
Part of that remit is to make the overall case for the asset class if the firm feels that the argument is being missed – which it does.

"Some investors say that the story of a secular trend is over – but the demand curves today are higher than they were in 2007," insists founding partner Stephan Wrobel. "Where these emerging countries are coming from is not a story for three or five years."

There is no doubt that some institutions have been having a re-think, he concedes, but this is precisely the sign that the liquidation cycle is maturing. The momentum is turning around, he insists.

"This summer has, if anything, confirmed the thesis," he explains. "We've been through the panic selling, we've seen institutions liquidating. But more recently we have started to see the turnaround: of oil in April; then of industrial metals, now precious metals; agriculture will be next."

Asset class leadership rotation during the various stages of the business



Sources: Pring Turner, Diapason

Correlations with financial assets have been dropping, he adds, which is important for sentiment because diversification is one of the main reasons investors want exposure.

“Asset-class behaviour through the business cycle is returning to a more ‘normal’ pattern,” he says. “So where are we in the business cycle? Equities are finishing their move and are now fully-valued, with some markets beginning to look expensive, and commodities are just starting their run. In terms of valuation, where would you like to be – stocks, bonds or commodities?”

The financial crisis, and the beginnings of China’s policy of re-balancing its economy from 2011, resulted in five years of volatility and uncertainty that contrasted with the previous five years in which “all the stars were aligned” – China was

growing, the dollar was relatively weak, the geopolitical situation was supportive.

“Now, investors see growth coming through in the US and we see some stabilisation in the numbers out of China, so a lot of the negative sentiment is being taken out,” Wrobel reasons. “But there could also be some surprises on Fed ‘tapering’: we see the possibility of US unemployment remaining stuck or even picking-up again, which could result in a weaker dollar into the end of this year.”

Wrobel also makes the point that “reality is catching up with producers”. Changes in senior management denotes the pressure being applied by shareholders, which is translating into unprofitable projects being closed-down. Coming on top of five years

in which investment has in any case been less aggressive, this is good news for those looking for tighter supply in general – but also for investors hoping for more fundamental dispersion between individual commodity markets.

“Correlation between commodity sectors has diminished,” Wrobel confirms. “Energy has been the clear leader because of ongoing demand, relatively tight supply, geopolitical risk and very good, defensive management from OPEC. Look at the backwardation at the moment and you can see that supply is tight.

“On the other hand, grains had a good year for supply in 2013 – there is great value in the sector, now. In industrial metals the cycle hasn’t been positive since 2011, but dispersion has been pretty significant: copper was very resilient because supply and demand was in good balance; but metals like aluminium, zinc, nickel and lead have seen falls of 30% - 50%.”

Producers bringing their horns in, China stabilising, the US growing steadily but US dollar strength possibly having run its course: Wrobel is bullish. “Since the bottom in June, I think we have a nine-month window in which commodities should enjoy a good period,” he says.

His one big exception – gold – is the one that definitely proves the rule.

“Gold is not the place to be because it is a risk-off asset – and all we are seeing at the moment is economic improvement and rising real rates,” he says. “In 1974-76 gold fell 50% while still in a bull trend – there’s no reason why we couldn’t see that again.”

Commodities are the place to be, he argues, and institutional investors, far from turning their backs on the asset class, are just getting smarter about how they allocate.