Investment Commentary **June 2017**

Commodities: Focus on Metals

Broad commodity indices and strategies usually contain exposures to three main sectors: energy (crude oil, natural gas, and refined products), agriculture (grains, livestock, and softs), and metals (industrial and precious). Of these, the energy sector typically receives an inordinate amount of attention. When most investors think about commodities, much of the time it's really crude oil they're thinking about. This is perfectly natural since the price of crude tends to dominate the financial news headlines due to its volatility, with spot prices for WTI ranging from approximately $11/bbl to $145/bbl over the last 20 years. The price of crude oil can also act as a litmus test for the stability of the world, and tends to respond dramatically to geopolitical events. We are constantly reminded of current prices when we fill our cars with gasoline. Pundits frequently express market calls on the direction of future prices, even if none can rightfully claim any special insight. Although the energy sector can represent a significant proportion of many broad commodity indices, there is much more to the commodities asset class than just energy. We thought it would be interesting to focus on an area that does not get a lot of attention, despite the fact that it has historically been the *most important return driver*, the metals sector.

A breakout of the relative contribution to total return of each of the three commodity sectors is very revealing. Using the Rogers International Commodity Index® as our example, along with a comparison to the benchmark Bloomberg Commodity Index, the following table shows the returns* from the energy, agricultural, and metals sectors, from the mutual inception dates of both indices in 1998 through May 31, 2017:

INDEX	TOTAL RETURN	AVERAGE ANNUAL RETURN
RICI® Total Index	117.88%	4.22%
RICI® Energy Index	123.88%	4.37%
RICI® Agricultural Index	-30.90%	-1.94%
RICI® Metals Index	**298.19%**	**7.61%**
BCOM Total Index	30.72%	1.43%
BCOM Energy Index	-39.46%	-2.63%
BCOM Agricultural Index	-32.35%	-2.05%
BCOM Metals Index	208.64%	6.16%
S&P 500 Index	207.03%	6.13%
Barclays U.S. Aggregate Bond	151.17%	5.01%

The RICI® Metals sector index outperformed not only the equivalent BCOM metals sector, but also the broad RICI® Total and BCOM indices, and the energy and agricultural sector indices as well. It also beat both the S&P 500 and Barclays U.S. Aggregate Bond indices. This was not just the result of a recovery in precious metals. The RICI® Metals index is diversified across 6 industrial and 4 precious metals, 10 constituents in total.** Industrial metals in isolation also performed well, with a 6.79% average annual return over the same period. The data also highlights an important point about the methodology of commodity indices, which is that weightings and diversification matter. Likely due to its historically higher natural gas allocation relative to crude oil, the BCOM energy sector is actually negative since inception, and the benchmark BCOM total index is only positive due to the returns of its metals sector. The BCOM metals sector is also less diversified, with copper and gold typically dominating the weighting across its 6 constituents.

In 2016, the RICI® metals sector was up 17.19%, beating the S&P 500 by over 500 basis points, and YTD through 5/31/2017 it's already up 6.36%. Beyond the significant outperformance that metals have demonstrated both recently and over a longer period, the dynamics of the global metals markets should be compelling for investors for a number of reasons. Unlike energy, where recent technological enhancements have enabled a quicker production response to price increases, mining is a long term business. Increased production in reaction to higher prices is a necessarily slower process. Mines that were shuttered following a protracted period of low prices are not easily brought on line again, and mines operating at capacity cannot increase their output. In recent years we have also seen dramatic reductions in capital expenditures at the major mining companies, and a number of mine closures, outages, and strikes. In the past, these conditions have been precursors to future price increases.

With infrastructure spending at the forefront of anticipated policy actions in most areas of the world, investors can expect the demand for industrial metals to be robust in the coming years. Although gauging the long term demand picture for individual metals can be difficult, the scenario for metals in the aggregate is still bullish. As an example, we hear about the expected decline in use of palladium in catalytic converters as a shift to electric automobiles takes place over the next decade or more. Electric vehicles consume four times the amount of copper as conventional cars, however.

Moreover, technical factors also indicate that now is a favorable entry point in the metals markets. Despite the high returns in the current period, the average discount from previous high prices across the 10 RICI® industrial and precious metal components is over 50%. This implies a continuing high potential for recovery, especially when compared to equities and fixed income, which are both close to record highs.

The overall observation should be that stocks, bonds, and commodities have each delivered average annual returns of around 4-6% for the past 20 years or so. Within each of those asset classes, there are likely sub-sectors that have delivered returns better than the broad asset class. For commodities, that sector is metals.

Of course, there can be no guarantee that past trends will necessarily continue, so investors should weigh the considerable portfolio benefits of broad diversification, which will capture trends in all markets, against a more focused approach. But metals have clearly demonstrated a history of excellent performance, and one that is not well known, the sector is still relatively underowned. Given the current combination of good performance, supportive fundamentals, and opportunistic entry point, investors should seriously consider commodity strategies with a well diversified metals allocation.

John Reese
Chief Executive Officer

**Referencing the period 8/1/1998 to 5/31/2017, returns data source: Bloomberg L.P.*
***RICI Metals Index components: aluminum, copper, gold, lead, silver, zinc, platinum, nickel, tin, and palladium*

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