Pensions ploughing money into agriculture

As fears over global warming become ever-present, institutions have been more willing to look for greener sources to invest in. Soft commodities, such as forestry and alternative energy sources, have proven popular, writes **KRISTEN PAECH**

Investing in trees might sound like a strange idea but it is exactly what a growing number of European pension funds are doing. Having bought into the commodities story in the early-2000s, Dutch funds in particular are branching out and seeking exposure to commodities which are not available through the major benchmark indices.

In July the €86bn healthcare pension fund PGGM allocated $200m (€150m) to the GMO Long Horizons Forestry Fund for a term of 15 years. The fund invests in forestry plantations in North and South America and the Asia Pacific region.

Just days later, the €215bn civil service pension fund ABP announced a $60m investment in the Global Solidarity Forest Fund, a fund focused on sub-Saharan Africa which currently consists of five established investments in Mozambique and Angola, carrying out reforestation on degraded lands and responsibly managing natural forests.

The growing stable of funds investing in timber also includes PME, the London Pension Fund Authority, Sweden's Kapan Pensioner and Denmark's BankPension.

Those schemes that have embraced lumber cite stable long-term returns and non-correlation with economic cycles as its major attractions.

According to PGGM, timber is one of the few commodities that have appreciated faster than inflation over the long term.

But it is not just timber grabbing the attention of the more astute commodity investors.

Interest is mounting in renewable energy sources, mainly provided by bio-diesel or bio-ethanol. Both are produced by processing plants – bio-ethanol in the US is made from grain while in Brazil they use cane sugar.

James Paget, co-head of Europe Middle East and Africa structured commodities sales at UBS Investment Bank, says: "We are doing some interesting deals on the agricultural side with institutional investors. Metals and energy have performed strongly in the last few years whilst agricultural commodities have lagged well behind. The bio-fuels story and dietary change stemming from increasing wealth in China and India have boosted demand for agricultural commodities whilst water shortages and other issues are constraining supply. We're seeing a great deal of demand from investors wanting to play this theme."

Ebele Okeke, sales representative in the commodities structured solutions group at Lehman Brothers, adds: "Even with the slowdown in the US housing market, there's still increasing global demand from China for lumber. We are seeing funds buying directly into forestry investment funds and increasing interest in lumber index strategies where they get direct exposure to the exchange contract prices."

Investments in sustainable forestry aim to avoid devastating scenes of deforestation as pictured above

Wheels in motion

The success of the commodity markets in recent years has been characterised by strong performance in the energy sector, yet certain economic indicators suggest we are about to move into a new phase of the commodity cycle.

A five-year bull run in the asset class was dealt a blow last year as energy prices were hit by supply side issues as well as geopolitical tensions.

A balmy winter in the US led to sluggish demand for oil at a time when supply was at an all time high. Organization of the Petroleum Exporting Countries oil production stood at almost 35,000 barrels a day compared to 17,000 in 1985, according to industry statistics.

The S&P Goldman Sachs Commodity Index (S&P GSCI), one of the main benchmark indices for the commodity markets, took the greatest hit – a direct consequence of its heavy weighting in energy, which currently stands at 70.49 per cent.

The S&P GSCI returned 8.56 per cent in 2003, 9.34 per cent in 2004 and 40.43 per cent in 2005 before falling to -25.53 per cent in 2006, according to Morningstar.

Nudgem Richyal, investment manager, Baring Latin America Fund, says history shows soft commodities such as sugar, soybeans, wheat and oats tend to follow energy in terms of capital inflows in each commodity cycle.

Against a backdrop of concern about global warming, demand for soft commodities such as bio-fuels has grown exponentially, creating a source of demand which simply was not present to the same extent in previous cycles, he says.

Mr Richyal believes the interest in timber from Dutch pension funds was kicked off by the search for alternative investments rather than specific demand for soft commodities.

"Timber proved to be an area where you get the yield

over the long term and you are also playing any capital appreciation in the land," he explains.

"That whole move started independently of the move into soft commodities. It was more a move into real assets and now they have both come together again."

Historically, soft commodity prices have demonstrated high volatility due to short-term weather conditions. However, recently, prices have picked up in tandem across the board.

Over the last 12 months, the Reuters CRB Grains Index, a proxy for soft commodities, has returned 43 per cent versus 10 per cent for the Reuters CRB Industrial Index, which covers metals and minerals, according to Datastream.

Despite rising interest in commodities in general, actual take-up has been subdued relative to other alternative asset classes.

A recent survey by Watson Wyatt found global alternative assets managed by the largest 99 alternatives managers stand at just under $600bn, yet commodities account for only $12bn.

In comparison, the top 30 managers within real estate, fund of hedge funds and private equity fund of funds managed $38bn, $105bn and $80bn respectively at the end of 2006.

A substantial portion of the allocations to date have come from the Netherlands, Denmark and Sweden, with the UK lagging a long way behind.

Stephan Wrobel, partner at Lausanne-based Diapason Commodities Management, says as those funds that have already been investing in commodities become more comfortable with the asset class, the appetite for soft commodities is a natural progression.

What is more, agricultural commodities have a low correlation with hard commodities such as energy and industrial and precious metals.

"Pension funds are becoming more familiar with the asset class," Mr Wrobel says.

"First they understood energy, then metals and now they are starting to understand agriculture. It's loosely correlated to energy or metals as it is less linked to economic activity and it tends to do well during times of economic set back. The prices are coming from a very low historical base, fundamentals in terms of supply/demand/inventory are strong and as a result pension funds have started to understand there is value in this sector."

Tactical vs strategic

Although energy continues to dominate the commodities space, managers operating across the complex landscape have responded to the change in supply and demand fundamentals in agricultural commodities by adapting their offerings to capitalise on any major market shifts.

Goldman Sachs Asset Management defends recent volatility within the energy sector, noting that while energy has historically been the most volatile of the four main sectors – energy, industrial metals, precious metals and agriculture/livestock – it is the only one to offer negative correlation with equities.

However Olivier Cassin, director, head of product development & research, at bfinance says: "Some active managers have discovered a counter cyclicality of some soft commodities with oil for instance, so in this game of cross correlation and different behaviour in different markets, investment in soft commodities has become very interesting."

He adds: "We have seen a trend for pension funds to use indices that are more diversified than the S&P GSCI, which has about 12 per cent in agriculture, whereas the Dow Jones AIG has over 30 per cent."

Grain is being used to make biofuels in the US

And it is not only active managers. On top of the standard S&P GSCI index funds Barclays Global Investors offers investors, BGI also provides index funds which purely track the energy and non-energy sectors.

Marko van Bergen, head of Benelux and a commodities product specialist at BGI, says: "If pension funds have concerns about energy and non-energy, they can combine energy and non-energy index funds to customise their desired target allocation between the two sectors."

However, Mr van Bergen says that for most pension funds, the driver behind an investment in commodities is predominantly the diversification benefits that come with a strategic allocation.

"Most pension funds are more interested in the strategic allocation to commodities so they do not have a very highly active tactical approach," he explains.

"Only a few of our clients who are interested in more tactical views have allocated between energy and non-energy, but for the majority of our clients it's more about having a broad diversified basket of all commodity sectors."

To a certain extent, it is also a question of materiality. Given that the average pension fund investing in commodities allocates less than 5 per cent of their total portfolio to the asset class, taking tactical bets potentially increases the risk within the overall portfolio for little reward.

So is an allocation to soft commodities really something pension funds should be worrying about?

Gareth Derbyshire, managing director in the pensions advisory group at Lehman Brothers, says: "For the medium-sized funds with a small allocation to commodities the main goal is to get the first level of diversification. But if the fund is large enough and the allocation is sufficiently material then it does make sense. Thinking strategically, there is a positive trend towards pension funds looking for good ideas and sources of added value across the board, whether it's commodities or other alternative assets."

John Prestbo, editor and executive director at Dow Jones Indexes, says: "At some point I would think that the soft commodities would have had their time in the sun but when that will happen is another question and it could happen even when oil or energy is still in a rallying phase. That's the nature of commodities; these are not related markets except that they deal with physical things.

"But as a general rule, if something has been quiet for a while; look out, it may wake up," he adds. ■

Getting active with commodity allocations

Pension funds have traditionally invested in commodities through indices, but a recent contango has exposed the limitations of riding the curve and perhaps the time is right to get active. **KRISTEN PAECH** investigates how pensions are diversifying their allocations

The vast majority of pension fund money going into the commodities sector is being invested via index providers. However, a recent economic phenomenon has dealt a blow to passive commodities investment prompting heightened interest in actively managed strategies as a means of overcoming the cyclical nature of the asset class.

In the UK Hermes, the £38bn (€56bn) pension fund manager for BT Pension Scheme got the passive ball rolling last year with a 3 per cent (€1.6bn) allocation to the asset class through the Hermes Commodity Index Fund, while on the continent, the €32bn French reserve fund, Fonds de Reserve pour Les Retraites (FRR), is expected to tender a mandate for the passive replication of commodities indices later this year.

In the Netherlands, PGGM was savvy enough to join the asset class at the start of a five-year bull run in 2000, and now has 5 per cent of its total portfolio invested in commodities.

PGGM achieves its exposure through a passive long-only allocation through a GSCI total return swap, whereby the fund receives the total return of the index in exchange for fees and an interest rate payment, usually the three month T-bill. Its return from commodities in the first half of 2007 was 6.9 per cent, while the fund returned 4.9 per cent overall.

Passive investing was a natural route for first time allocations to the asset class, not least because of its simplicity.

For many years, the structure of the oil curve exhibited a pattern of 'backwardation' – essentially a downward sloping price curve.

As futures approach their expiration, they must be rolled to a future contract further out, and with markets in backwardation, nearby futures were trading at a higher level than futures with a later expiration, meaning funds were receiving a roll premium every time they sold one contract and bought the next.

By buying low and selling high each month, they were riding the commodities wave and raking in the cash.

However, over the last year, certain sectors of the commodities market have moved into contango – an upward sloping price curve – highlighting the limitations of making a simple index allocation to the complex.

Justin Simpson, senior portfolio manager, commodities at Morgan Stanley, says: "If you hold a passive position and you roll it you're buying a more expensive contract each time you roll your futures contract so passive investment has this tremendous financial drag on it.

"Not only do you have the fact that the curve is upward sloping and costs money each time you roll, but the exact

dates on which the exact proportions of contract will be rolled are also know by the entire range of market participants and not surprisingly around the time that happens it becomes expensive."

Passive managers claim that despite the negative roll yield, commodities still offer pension funds the diversification and long term returns they desire.

Yet the current market environment has caused some funds to delay their entrance into the sector and hunt for more efficient ways of implementing their decisions.

The £928m Clwyd Pension Fund is one such fund to have gone against the grain. In April, the fund allocated 2 per cent to Wellington through an actively managed commodities mandate with a tactical range of +/- 1 per cent.

"The target is +1.5–2 per cent above an equally weighted S&P GSCI," a spokesperson said.

"We preferred a more diversified approach within commodities than the S&P GSCI index, which has a high allocation to energy."

A grey area

The S&P GSCI, Dow Jones-AIG Commodity Index and the Reuters/Jefferies-CRB Index are the main benchmark indices and account for the lion's share of assets in the passive commodities space.

But unlike other asset classes, where the choice of benchmark tends to be based on convenience rather than any material belief, in the commodities space, performance between index providers is becoming ever more divergent.

As a result, Olivier Cassin, director and head of product development & research at bfinance, believes even if a pension fund chooses to invest passively, the

choice of benchmark is a fairly active decision over the medium term.

"Even if over a very long term period these indices tend to converge in terms of performance, over the short or medium term, some are more volatile than others," he says.

"Pension funds are confronted with a choice of benchmark. They have to decide how heavily they want to be exposed to the oil market but in terms of selection, it makes their life easier."

Alasdair Macdonald, senior investment consultant at Watson Wyatt, adds: "Passive versus active is a bit emotive because in reality every commodities product is active, simply because you have to roll the futures; it's not buy and hold like traditional passive. All clients are open to an element of enhanced indexation; it's just about how much you turn up the dial on the risk level."

Indeed, the weighting in energy varies widely between index providers with offerings in this space.

According to the latest available data, the S&P GSCI, at 70.49 per cent, has the highest weighting to energy, followed by the Lehman Brothers Commodity Index (58.27 per cent) and the DJ AIG and Reuters/Jefferies CRB, both with 33 per cent.

Gareth Derbyshire, managing director in the pensions advisory group at Lehman Brothers, says: "The single biggest issue is probably concentration in some of the energy stocks. The choice of index is going to be fundamental – the difference between the main commodity indices is greater than the difference between the main equity indices."

Active strategies

A number of strategies are emerging that attempt to address the concerns of more cautious investors spanning from enhanced indexation to outright active absolute return strategies.

Index providers have launched indices which play on modified rolls, meaning they roll on different days of the month, as well as indices that roll on different parts of the curve.

In July last year, Dow Jones AIG created three new versions of the DJ AIG Commodity Index known as the Dow Jones AIG Commodity Forward Indexes.

The indexes allow investors to measure exposure to longer-dated commodity futures contracts and include one-, two- and three-month versions.

More recently, Diapason Commodities Management rolled out the DCI BNP Paribas Enhanced Index, which uses quant-based methodology to determine the best maturity futures to roll forward in order to optimise the roll return.

The more tactically inclined investors can take asset allocation positions either underweight or overweight particular sectors of the commodity world, while a handful of active managers offer funds which blend a variety of alpha generating strategies to outperform a given benchmark index.

At the extreme end of the spectrum, commodity hedge funds offer absolute returns, but charge a much higher fee for the privilege.

"Using active managers, it's possible to maintain the core exposure to the commodities market but use active strategies both with respect to rolling of positions as well as with respect to the substitution of commodities where appropriate that maintain a high correlation to, for example, expensive commodities, but don't cost as much

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> **Justin Simpson, Morgan Stanley**

to roll," says Mr Simpson.

Rob Treich, principal at Mercer Investment Consulting, believes active management is the only way that a pension fund can hope to overcome the cyclicality of commodities.

"The challenge in allocating to active managers is identifying managers that are strong across the commodities complex in very specialised areas," he says.

"Some firms may be strong in agriculturals, energy or metals, but not in all the different segments of the market. This is one area where it might be a good idea to look at fund of funds. Fund of funds managers know the commodities markets well, know who the key players are in the individual segments of the market and can identify those people and build a diversified fund from that, whereas for a single corporate pension investor it may be difficult to find the right managers."

However, Ebele Okeke, member of the commodities investor desk at Lehman Brothers, says pension funds and asset managers need to review why they initially invested in commodities.

"A lot of them went into commodities for diversification reasons and we feel that in order to gain the maximum benefit from commodities in your portfolio, a benchmark index should still be relevant," he says.

Marko van Bergen, head of Benelux and a commodities product specialist at Barclays Global Investors, agrees.

"The cyclicality exists but pension funds are more driven by the total plan motives and trustee board resolutions allowing them to go into commodities than they are driven by the actual market in a particular period," he says.

A core-satellite approach makes sense, where pension funds want to extract both alpha and beta from the market, according to Stephan Wrobel, partner at Lausanne-based Diapason Commodities Management.

"If investors want to structure their approach using the alpha approach only, it is possible, but we don't recommend it. Ignoring the beta is very dangerous because you should add commodities to your portfolio because of their characteristics of diversification, potential return and inflation protection. You are not sure to get that if you rely on a portfolio manager who could be long or short," he says.

John Prestbo, editor and executive director of Dow Jones Indexes, says there is no absolutely foolproof safe place to invest in commodities.

"You pick your position and you ride with it, that's the nature of the markets," he says.

"If you're investing for diversified exposure to the commodity asset class then you take your lumps with your successes and over time, the successes will outweigh the lumps." ■